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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board meeting:	**20 June 2006, London**
Project:	**Earnings per share**
Subject:	**Treasury stock method (Agenda Paper 10)**

Introduction

1. In preparing the Exposure Draft of amendments to IAS 33 *Earnings Per Share*, the staff have noted significant differences between the proposed IAS 33 and the proposed FASB Statement No. 128 *Earnings Per Share.*

2. The purpose of this paper is to inform the Board of the differences between the two proposed standards and to reaffirm the decision of the Board to amend IAS 33 in the manner agreed at the November 2005 and January 2006 Board meetings.

Outline of the paper

3. The format of this paper is as follows:

- Background to the treasury stock method and Board decisions to date (paragraphs 5-13);
- Differences in the proposed standards (paragraphs 14-27);
- Possible directions (paragraphs (28-34); and
- Conclusion (paragraphs 35-39).

Staff Recommendation

4. The staff recommend that the Board should not proceed with the proposed amendments. Given the importance of convergence to the IASB, the staff believe that the amendments to IAS 33 should be limited to those that would achieve convergence with the proposed FASB Statement No. 128

Background

What is the treasury stock method?

5. The treasury stock method is a term used in connection with diluted Earnings Per Share (EPS) calculations. The current version of IAS 33 uses a form of the treasury stock method to compute the dilutive effects of options, warrants and their equivalents.

6. Currently, an entity applies the treasury stock method in accordance with paragraph 45 of IAS 33 in the following way:

- An entity assumes the exercise of dilutive options and warrants of the entity;
- The assumed proceeds from the instruments are regarded as having been received from the issue of ordinary shares at the average market price of ordinary shares during the period;
- The difference between the number of ordinary shares issued and the number of ordinary shares that would have been issued at the average market price of ordinary shares during the period is treated as an issue of ordinary shares for no consideration;

- The shares issued for no consideration are dilutive and are added to the number of ordinary shares outstanding in the calculation of diluted EPS. Example 5 of the Illustrative Examples accompanying IAS 33 shows the effects of share options on diluted EPS.

7. IAS 33 does not define what assumed proceeds are but it does imply that the assumed proceeds are:[1]

- the issue or exercise price of the options or warrants, including

- the fair value of any goods or services to be supplied to the entity in the future under the share option or other share-based payment arrangements, for share options and other share-based payment arrangements to which IFRS 2 Share-based Payment applies.[2]

Summary of previous decisions

8. At the November 2005 meeting, the Board decided to amend IAS 33 *Earnings Per Share.* This amendment was proposed as a result of the FASB's decision to change the definition of 'assumed proceeds' when using the treasury stock method to calculate the dilutive effect of options, warrants and their equivalents.

9. The amendments proposed by the IASB would include the carrying value of any option, warrant or their equivalent classified as a liability assumed to be converted in the assumed proceeds. This amendment was consistent with the proposed amendment to FASB Statement No. 128 *Earnings Per Share*.

10. At the January 2006 meeting, the Board decided that the (amended) treasury stock method should also be used to calculate the dilutive effect of convertible instruments on EPS calculations. This would replace the 'if converted' method that is used for these instruments at present.[3]

1 Paragraphs 46-47A of IAS 33

2 Paragraph 47A of IAS 33 and Illustrative Examples 5 and 5A accompanying IAS 33

3 The 'if converted' method refers to the method of assuming conversion of a dilutive instrument at the beginning of the period (or if later, the date of issue of the instrument). The numerator is adjusted for any interest or dividends related to the convertible instrument recognised during the period. No adjustment is made for the extinguishment of the carrying amount of the debt or equity component that would occur if the instrument were converted to shares. The shares that would have been issued on conversion are included in the denominator when earnings per share is calculated.

11. The reason for this amendment was to eliminate the inconsistent treatment of options, warrants and their equivalents and convertible instruments in diluted EPS calculations.

12. Further, the Board decided to include instruments (or components of instruments) classified as equity in the assumed proceeds for the purposes of the treasury stock calculation.

13. The staff were directed to prepare an Exposure Draft to amend IAS 33 to reflect the decisions of the November 2005 and January 2006 Board meetings. In preparing this Exposure Draft, the staff noted that the amendment to IAS 33 will create significant divergence from proposed FASB Statement No. 128.

Differences in proposed standards

14. The main differences noted between the two proposed standards are in the following areas, each of which are explained below:

- Instruments (or components of instruments) classified as equity;
- Using the treasury stock method for convertible instruments; and
- Changes to the numerator when using the treasury stock method.

Instruments (or components of instruments) classified as equity

15. In November 2005, the Board decided to include the carrying amount of an option, warrant or their equivalent classified as a liability in the assumed proceeds for the purposes of the treasury stock calculation. This amendment was proposed in order to be consistent with the proposed amendment to FASB Statement No. 128.

16. In January 2006, the Board decided to include the carrying amount of instruments (or components of instruments) classified as liabilities <u>and equity</u> in the assumed proceeds for calculations using the treasury stock method. The rationale for including equity amounts is that by extinguishing an instrument

classified as equity, an entity has removed a class of equity that has a prior claim on the ordinary shares of the entity.

17. [Sentence omitted from observer notes]. As such, there will be significant divergence between the manner in which the treasury stock method is applied between IAS 33 and FASB Statement No. 128 if the amendments are adopted as proposed.

Using the treasury stock method for convertible instruments

18. Currently, IAS 33 uses the treasury stock method to calculate the dilutive effect of options, warrants and their equivalents. In January 2006, the Board decided to extend the use of the treasury stock method to calculate the dilutive effect of convertible instruments.

19. The FASB decided not to extend the use of the treasury stock method to calculate the dilutive effect of convertible instruments until completion of their 'liabilities / equity' project. This project may change the classification of convertible instruments for US GAAP financial reporting purposes.

20. As a result, the current and proposed FASB Statement No. 128 uses the treasury stock method to calculate only the dilutive effect of options, warrants and their equivalents. The dilutive effects of convertible instruments are calculated using the 'if converted' method.

21. Use of the treasury stock method allows any dilution to be shown as a marginal increase in the ordinary shareholdings as a result of potentially convertible instruments. Conversely, the dilutive effect of the same instrument calculated in accordance with the 'if converted' method, would include the entire number of shares that would have to be issued on conversion of the instrument into the denominator. The effect of using the 'if converted' method as compared to the treasury stock method would be to substantially alter the effect on assumed conversion of a convertible instrument.

22. The difference in treatment of convertible instruments between IFRSs (treasury stock method) and US GAAP (if converted method) will have significant effects

on the calculation of diluted EPS. Using the treasury stock method proposed in the amendments to IAS 33, most convertible instruments would not be dilutive. Using the 'if converted' method, an instrument is dilutive when the dividend or interest on the instrument is lower than basic EPS.

Changes to the numerator when using the treasury stock method.

23. The treasury stock method used in IAS 33 (current and proposed) adjusts the numerator for any income or expense that would not have occurred were the option, warrant or their equivalents converted.

24. Using the treasury stock method in accordance with the <u>proposed</u> IAS 33 to calculate the dilutive effect of a convertible bond would result in the interest being added back to the numerator. This would reduce the likelihood of the convertible bond being dilutive (as to be dilutive the adjustment for interest would need to be offset by an even greater movement in the share price).

25. [Paragraph omitted from observer notes].

26. Assuming the FASB Statement No. 128 was to use the treasury stock method to calculate the dilutive effect of convertible bonds, there would be no adjustment to the numerator and hence, the instances of dilution would be increased compared to the proposed IAS 33.

Example

27. The following example illustrates the differences between the proposed IAS 33 and FASB Statement No. 128. for convertible bonds:

	Using the 'if converted' method in accordance with the current IAS 33 and current and proposed FASB Statement No. 128	**Treasury stock method**	
		Using the treasury stock method in the proposed IAS 33.	**Using the treasury stock method as proposed in FASB Statement No. 128***
Adjustment to the numerator (earnings)	Add back the interest on the bonds recognised in the period.	Add back the interest on the bonds recognised in the period.	No adjustment to the numerator.[4]
Adjustment to the denominator (number of ordinary shares)	Add the shares that would be issued on conversion of the convertible bonds to the denominator.	Add the shares that would be issued on conversion of the convertible bonds to the denominator. Subtract the amount of shares that could have been purchased from the assumed proceeds at the average market price.	Add the shares that would be issued on conversion of the convertible bonds to the denominator. Subtract the amount of shares that could have been purchased from the assumed proceeds at the average market price.

* Note, this is for illustrative purposes as the FASB do not propose to use the treasury stock method to calculate the dilutive effect of convertible bonds.

4 [Footnote omitted from observer notes].

Possible direction

28. Accepting that the amendments to FASB Statement No. 128 will be adopted as proposed, the staff has identified two courses of action that it would like the Board to consider:

    1. Modify the proposed standard to converge with the proposed FASB Statement No. 128.

    2. Proceed with the proposed standard in its current form.

Modify the proposed standard to converge with the proposed FASB Statement No. 128

29. The proposed amendments to IAS 33 could be limited to those areas that would create convergence with the proposed FASB Statement No. 128.

30. If this approach was to be adopted, only one change would be required to the current IAS 33. The application of the treasury stock method would need to be amended to include the carrying amount of options, warrants and their equivalents classified as liabilities in assumed proceeds.

31. Overall, the main difference in approach would be to remove the effect of the January 2006 decision to extend the treasury stock method to convertible instruments. The proposed requirement to include equity instruments (or components of equity instruments) in the assumed proceeds would also be removed.

Proceed with the proposed standard in its current form

32. The decisions of the Board to date have resulted in proposed amendments to EPS that improve the standard.

33. The January 2006 decision to extend the treasury stock method to convertible instruments creates a consistency within the standard for the treatment of options, warrants and their equivalents and convertible instruments. The staff have not noted any reason why the treasury stock method should not be extended to convertible instruments.

34. By proceeding with the proposed standard in its current form, the staff believe that the standard would be improved. However, this would create a divergence from FASB Statement No. 128.

Conclusion

35. If the two standards are adopted as proposed, it will lead to an increase in divergence in the calculation of Earnings Per Share between IFRSs and US GAAP. The Board noted at its November 2005 Board meeting that divergence from US GAAP should not preclude it from making amendments to IAS 33 that were considered to be improvements to the standard.

36. Convergence with the FASB on Earnings Per Share is not part of the Memorandum of Understanding (MOU) regarding the roadmap for convergence between IFRSs and US GAAP. However, the principal reason for the change to the treasury stock method in November 2005 was to maintain convergence with US GAAP.

37. Currently, the FASB is yet to complete its liability / equity project, the result of which may change the classifications and treatment of liability and equity instruments.

38. **The staff believe that at this stage, making minor amendments to IAS 33 would be a more practical solution.** At a later date, a project could be undertaken to develop an EPS standard convergent in principles and application and that improves upon the current standard.

39. The above conclusion is based on FASB adopting their proposed standard in its current form. If the changes to FASB Statement No. 128 were not made, the staff recommend that no changes be made to IAS 33.