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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **19 September 2007, London**

Project: **Short-term convergence – Earnings per Share**

Subject: **Impact of forward purchase contracts on eps calculation**

(Agenda Paper 9)

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1 The Board discussed and tentatively concluded at the March 2007 meeting to make certain changes to the methods used to calculate earnings per share (eps) as part of its short-term convergence project with the FASB. Additionally, the Board considered at the July 2007 meeting the impact of these decisions on certain instruments.

2 One of the issues that the Board discussed in July was the calculation of eps when the entity has entered into a forward purchase contract for its own shares. The Board asked the staff to consider how IFRS and U.S. GAAP eps calculations might be converged when the counterparty to the forward purchase contract is obliged to remit back to the entity any dividends paid in respect of the shares during the term of the forward purchase contract.

3 The Board tentatively concluded that convergence is achieved if either the same eps result or the same eps denominator is given, when calculated in accordance with IFRS and U.S. GAAP.

4 The staff have discussed the views and conclusions set out in this paper with the FASB staff during the preparation of this paper.

Accounting for gross physically settled forward purchase contracts

5 It is helpful to consider the accounting for the forward purchase contracts before determining their effect on eps. The first part of this paper considers gross physically settled forward purchase contracts under which dividends paid on the shares subject to repurchase *are not* remitted back to the entity and gross physically settled forward purchase contracts under which dividends paid during the life of the contract *are* remitted back to the entity. The second part of the paper considers forward purchase contracts where there is a choice of gross or net settlement, written put options where there is gross physical settlement and written put options where there is a choice of gross or net settlement.

6 Gross physically settled forward purchase contracts for own shares are accounted for in accordance with paragraph 23 of IAS 32 as if the shares have already been purchased. A financial liability is recognised for the present value of the redemption amount with a reclassification from equity.

7 The staff's view is that the effect of the forward purchase contract is to cause the ordinary shares to be accounted for as a participating debt instrument rather than an equity instrument.

EPS calculation for gross physically settled forward purchase contracts

8 The staff believes that a consequence of viewing the shares subject to repurchase as a participating debt instrument is that the two class method should be applied to calculate eps. The shares subject to repurchase are one class and the remaining ordinary shares are another class. This approach gives the same eps result, using the same eps method and the same eps denominator for both IFRS and U.S. GAAP. This is illustrated in examples 1(a) and 1(b) in the appendix [appendix omitted from observer note].

9 **Does the Board agree with the staff's view that the shares subject to repurchase should be viewed as accounted for as a participating debt instrument and that as**

such, dealt with as a separate class of participating instruments in accordance with the two class method for the calculation of eps?

Consequential considerations for the accounting for shares subject to gross physically settled forward purchase contracts

10 A consequential question that arises from viewing the forward purchase contract for own shares as a participating debt instrument is how the dividends paid on such shares should be presented. Paragraph 36 of IAS 32 states that the classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss.

11 The liabilities and equity team staff have advised that there are differing views and practices about whether the dividends paid on shares to be repurchased are presented as interest expense in profit or loss in accordance with paragraph 36 or whether they continue to be presented as a distribution from equity. A principal argument for continuing to present dividends on such shares as equity distributions is that the shares have not yet been repurchased and cancelled and they continue to have the rights associated with equity shares. The eps team staff however believe that the dividends should be presented as a finance expense in profit or loss because the shares subject to repurchase are accounted for as a debt instrument as described above. The examples included in the appendix [appendix omitted from observer note] illustrate both views and conclude that the presentation of dividends as interest expense in profit or loss or as an equity distribution does not affect the calculation of eps in these particular circumstances.

12 Concluding how dividends paid on shares to be repurchased should be presented (ie as interest expense or an equity distribution) is not critical for the eps project because the staff believes it does not affect the eps calculation. However, it would be helpful for the purposes of including examples in the eps exposure draft to clarify this point. The staff is therefore requesting the Board's view on how dividends paid on shares subject to a gross physically settled forward purchase contract should be presented. The staff understands that such dividends are presented as an interest expense in profit or loss for U.S. GAAP purposes.

13 **Does the Board agree with the eps team staff's view that dividends paid in respect of shares subject to repurchase in accordance with a gross physically settled forward purchase contract should be presented as an expense in profit or loss?**

14 The staff also requests the Board's view regarding the timing of the recognition of a liability for the payment of discretionary dividends in respect of shares that are subject to repurchase in accordance with a forward purchase contract. The staff believes that there is no change in the timing of recognition of a liability for payment of discretionary dividends irrespective of whether those dividends are presented as a finance expense in profit or loss or as a distribution from equity. This view is reflected in the examples in the appendix [appendix omitted from observer note].

15 **Does the Board agree with the staff's view that a liability for discretionary dividends payable in respect of shares subject to repurchase in accordance with a gross physically settled forward purchase contract should be recognised when the dividends are declared, irrespective of whether those dividends are presented as a finance expense in profit or loss or as an equity distribution?**

Accounting for gross physically settled forward purchase contracts with remittance of dividends

16 Forward purchase contracts for own shares will sometimes include an additional condition that requires the holder of the forward purchase contract to remit back to the entity any dividends paid on the shares to be repurchased. Such a condition will be reflected in the purchase price of the shares under the contract. The net cash flows associated with the shares subject to a forward purchase contract with remittance of dividends are therefore fixed.

17 The requirement to remit dividends back to the entity does not affect the basic accounting for the forward purchase contract. A financial liability is recognised for the present value of the redemption amount by a reclassification from equity. The staff's view therefore is that the effect of a forward purchase contract with the requirement to remit dividends is to cause the ordinary shares to be accounted for as a non-participating debt instrument.

EPS calculation for gross physically settled forward purchase contracts with remittance of dividends

18 The staff believes that a consequence of viewing the shares subject to repurchase with remittance of dividends as a non-participating debt instrument is that the two class method should be applied for calculating eps. This approach gives the same eps result, using the same eps method and the same eps denominator for both IFRS and U.S. GAAP. This is illustrated in examples 2(a) and 2(b) in the appendix [appendix omitted from observer note].

19 **Does the Board agree with the staff's view that the shares subject to repurchase in accordance with a gross physically settled forward purchase contract with remittance of dividends should be viewed as accounted for as a non-participating debt instrument and that as such, dealt with as a separate class of non-participating instruments in accordance with the two class method for the calculation of eps?**

Consequential considerations for the accounting for shares subject to gross physically settled forward purchase contracts with remittance of dividends

20 The staff notes however that the counterparty to the forward purchase contract does not need to hold the shares to be repurchased until the forward purchase contract matures. The shareholder to whom the dividends are paid and the counterparty from whom the entity receives the remittance of the dividends might be different parties. The staff therefore believes that at the date that the dividends are declared, the liability for the dividends payable and the receivable for the dividends to be remitted back do not qualify for an offset presentation and should be presented gross in the statement of financial position. Similarly, dividends remitted back will be presented as finance income in profit or loss.

21 **Does the Board agree?**

Forward purchase contracts with a choice of gross physical or net settlement, gross physically settled written put options and written put options with a choice of gross physical or net settlement

22 These three types of contract are accounted for in accordance with IFRS in the same way as a forward purchase contract with gross physical settlement. That is, a financial liability for the present value of the redemption amount is recognised by a reclassification from equity.

23 The staff believes that the eps calculation for these instruments should be consistent with that described above for gross physical settled forward purchase contracts because the accounting is the same. The staff's view is that this applies whether or not the contracts require the remittance of dividends.

24 The staff notes however that these contracts are accounted for as derivatives in accordance with U.S. GAAP. Accordingly these contracts are accounted for at fair value with changes in fair value recognised in profit or loss. The proposed U.S. GAAP eps calculation for these instruments is therefore the application of the proposed 'fair value method'. Accordingly the eps result, method and denominator for these instruments will be different for U.S. GAAP purposes compared with IFRS.

25 The staff recommends that the difference in eps calculations for these instruments be accepted as a symptom of the difference in the underlying accounting. The staff recommends that the difference be identified as a known difference between IFRS and U.S. GAAP in the Basis for Conclusions on IAS 33.

26 **Does the Board agree?**