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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 May 2008, London**

Project: **Earnings per Share**

Subject: **Issues identified in reviewing the pre-ballot draft (Agenda paper 2)**

Introduction

1. The Board has reviewed a pre-ballot draft of proposed amendments to IAS 33 *Earnings per Share*. In addition, the staff has asked a limited number of constituents to review the pre-ballot draft regarding its technical application (fatal flaw review).

2. The staff intends to address most of the comments received in drafting. However, we would like to ask for the Board's input on the following issues that were identified in the review process:

    a. Scope of IAS 33

    b. EPS calculation for options, warrants and their equivalents

    c. EPS calculation for gross physically settled forward contracts to buy an entity's own shares

    d. EPS calculation for contracts that may be settled in ordinary shares or cash

    e. Effective date and transition guidance

f. Introduction of a comprehensive earnings per share measure

Scope of IAS 33

Puttable financial instruments

3. Some external reviewers believe that the scope of the pre-ballot draft is inconsistent with the amendments that the Board has made to IAS 32 *Financial Instruments: Presentation*. In February 2008, the Board amended IAS 32 to require that an instrument that meets the definition of a financial liability should be classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of that standard. When amending IAS 32, the Board discussed to which standards the exception should apply. The Board decided that the amendment should be a limited scope exception to the definition of a financial liability in IAS 32. Paragraph 96C of IAS 32 restricts therefore this exception to the definition of a financial liability to the accounting for such an instrument under IAS 1, IAS 32, IAS 39 and IFRS 7. As a consequence, the exception does not apply to IAS 33 and those instruments would not be treated as ordinary shares for the purpose of the pre-ballot draft.

4. IAS 33 provides a performance measure for ordinary shares. The pre-ballot draft defines an ordinary share as an equity instrument that is subordinate to all other classes of equity instruments. The instruments subject to the exception in IAS 32 are not equity instruments for purposes of the pre-ballot draft. Therefore, the pre-ballot draft does not apply to mandatory or voluntary per-instrument-measures of those instruments.

5. The staff recommends to amend paragraph 96C of IAS 32 to include IAS 33 in the exception for instruments that meet the definition of a financial liability, but are classified as equity instruments if they have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32. This amendment would align the EPS calculation with the accounting treatment for those instruments. ***Does the Board agree?***

Reclassification of puttable financial instruments

6. In addition, some external reviewers asked, how IAS 33 would apply to a financial liability that some time after its issue, but not at the time of issue, has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32. In other words, how would IAS 33 apply to an instrument that meets the definition of a financial liability but is required to be classified as equity at some point after initial recognition?

7. If the Board should decide not to amend paragraph 96C of IAS 32 so to extend the scope of the exception in IAS 32 to IAS 33, this question would not arise. The instrument would be treated as a liability for EPS purposes both before and after it meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32.

8. On the other hand, if the Board decides to amend paragraph 96C of IAS 32 to extend the scope of IAS 32 to IAS 33, the standard would provide principles for instruments that:

    a. meet the definition of a participating instrument and to which the application guidance in paragraphs A25-A30 of the pre-ballot draft (paragraphs A13 and A14 of IAS 33) applies. Paragraph 6 of the pre-ballot draft defines a participating instrument as an instrument that gives its holder the right to participate in dividends with ordinary shares according to a predetermined formula.[1]

    b. are measured at fair value through profit or loss and for which no adjustment to the denominator of the EPS calculation is required.

9. The staff cannot think of an instrument that is required to be reclassified from a liability to equity, but meets neither of the criteria mentioned above. We believe therefore that no further amendment to the pre-ballot draft is necessary.

    Does the Board agree?

[1] This wording will change in response to further editorial comments.

EPS calculation for options, warrants and their equivalents

Forward contracts to sell an entity's own shares

10. Some external reviewers asked for clarification of the EPS treatment of forward contracts to sell an entity's own shares. For basic EPS, an entity would not treat ordinary shares subject to a forward contract to sell an entity's own shares as outstanding because the forward contract does not meet the definition of an ordinary share in the pre-ballot draft. However, the diluted EPS calculation for those instruments is less clear.

11. In particular, external reviewers asked the staff to clarify whether the requirements for options, warrants and their equivalents in paragraphs 44 – 48 of the pre-ballot draft (paragraphs 45 – 47 of IAS 33) should apply to those instruments. Paragraph 6 of the pre-ballot draft defines options, warrants and their equivalents as financial instruments that give the holder the right to purchase ordinary shares. Some external reviewers were concerned that a forward to sell an entity's own shares would not meet this definition and that therefore the EPS treatment of those instruments would be unclear.

12. The staff notes that neither IAS 33 nor SFAS No. 128 provides explicit requirements for the EPS calculation of a forward contract to sell an entity's own shares. This issue is therefore not a convergence question. The staff believes that the EPS treatment of forward contracts to sell an entity's own share is outside the scope of the short-term convergence project.

    Does the Board agree? If not, how should such contracts be treated for EPS purposes, and why?

Proceeds – Carrying amount of liability

13. Paragraph 46 of the pre-ballot draft states that proceeds from the assumed exercise of options, warrants and their equivalents include (a) the amount, if any, the holder must

pay upon exercise and (b) the end-of-period carrying amount of any liability for the options or warrants that would be extinguished upon exercise.

14. Some external reviewers argued that options, warrants and their equivalents that are classified as liabilities would always be measured at fair value through profit or loss and no denominator adjustment of the diluted EPS calculation is necessary. Therefore, reviewers questioned whether the proposal to define the proceeds from the assumed exercise of options, warrant and their equivalents is necessary.

15. The staff agrees with those review comments and recommends to delete the examples of items to be included in proceeds from the exercise of options, warrants and their equivalents in paragraph 46 of the pre-ballot draft as unnecessary. The staff notes that this would also mitigate the concerns of some Board members and external reviewers who disagree, that the end-of-period carrying amount of any liability for an option or warrant that would be extinguished upon the assumed exercise of the instrument should be included in proceeds.

    Does the Board agree?

Proceeds – Deferred taxes

16. In some tax jurisdictions, the grant of share-base remuneration gives rise to a deferred tax asset or liability. Paragraphs 68A – 68C of IAS 12 *Income Taxes* state:

> In some tax jurisdictions, an entity receives a tax deduction (ie an amount that is deductible in determining taxable profit) that relates to remuneration paid in shares, share options or other equity instruments of the entity. The amount of that tax deduction may differ from the related cumulative remuneration expense, and may arise in a later accounting period. For example, in some jurisdictions, an entity may recognise an expense for the consumption of employee services received as consideration for share options granted, in accordance with IFRS 2 Share-based Payment, and not receive a tax deduction until the share options are exercised, with the measurement of the tax deduction based on the entity's share price at the date of exercise.
>
> [..] the difference between the tax base of the employee services received to date (being the amount the taxation authorities will permit as a deduction in future periods), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset.
>
> [The amount of the tax deduction] may differ from the related cumulative remuneration expense. Paragraph 58 of [IAS 12] requires that current and deferred tax should be recognised as income or an expense and included in profit or loss for the period, except to the

> extent that the tax arises from (a) a transaction or event that is recognised, in the same or a different period, outside profit or loss, or (b) a business combination. If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, the excess of the associated current or deferred tax should be recognised directly in equity.

17. Paragraphs 58-63 of SFAS No. 123(R) *Share-Based Payment* contain similar requirements. Some external reviewers noted that paragraph 21 of SFAS No. 128 includes in the proceeds from the assumed exercise of employee options the tax benefits that would be credited to equity upon exercise of the option. Those reviewers stated that some constituents interpret the wording in paragraph 49 of the pre-ballot draft (paragraph 47A of IAS 33) to prohibit including those tax benefits in the assumed proceeds and asked whether the Board could clarify the requirements in IAS 33.

18. The staff believes that the wording in IAS 33 was never intended to prohibit an entity from including those tax benefits in the proceeds from the assumed exercise of employee options. We recommend therefore to amend paragraph 49 of the pre-ballot draft to state that the proceeds from the assumed exercise of employee options include tax benefits that are credited to equity upon exercise of the option.

    Does the Board agree?

EPS calculation for gross physically settled forward contracts to buy an entity's own shares

Forward purchase contracts without remittance of dividends

19. Paragraph 23 of IAS 32 deals with contracts that contain an obligation for an entity to purchase its own equity instruments for cash or another financial asset. It states that such a contract gives rise to a financial liability for the present value of the redemption amount. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognised initially under IAS 39 *Financial Instruments: Recognition and Measurement*, its fair value (the present value of the redemption amount) is reclassified from equity.

20. In September 2007, the Board decided that the effect of a gross physically settled forward purchase contract on an entity's own shares for EPS purposes is to cause the ordinary shares to be accounted for as a participating debt instrument rather than an equity instrument. IAS 33 defines a participating instrument as an instrument that gives its holder the right to participate in dividends with ordinary shares according to a predetermined formula. An entity calculates EPS for participating instruments in accordance with the application guidance in paragraphs A25 – A30 of the pre-ballot draft.

21. Paragraph A33 of the pre-ballot draft states:

> If ordinary shares are the subject of a forward purchase contract on an issuer's equity instruments that requires physical settlement in exchange for cash, those shares are classified as a liability under IAS 32 *Financial Instruments: Presentation*. However, those shares meet the definition of a participating instrument because they participate in dividends to the same extent as ordinary shares.

22. Some external reviewers questioned whether the proposed amendment would achieve convergence with paragraph 25 of SFAS No. 150 *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* because:

    a. the wording in paragraph A33 is not clear on whether the Board believes that the gross physically settled forward purchase contract or the ordinary shares subject to the contract meet the definition of a participating instrument.

    b. not all gross physically settled forward contracts to buy an entity's own shares are participating instruments. For example, an entity might enter into a forward contract to purchase its own shares with a party that, at inception of the contract, does not hold ordinary shares of the entity. In this scenario, the holder of the forward contract does not hold ordinary shares of the entity and therefore does not participate in dividends with ordinary shareholders.

23. The staff agrees with those review comments and intends to improve the wording on how an entity calculates diluted EPS for gross physically settled forward contracts to buy an entity's own shares. For this purpose, the staff would like to affirm the following principles underpinning the EPS treatment of those contracts. These are:

    a. The EPS treatment follows the accounting requirements in IAS 32.

b. An entity deems that ordinary shares subject to a forward purchase contract on an entity's own shares have already been repurchased and deducts them from the denominator of the EPS calculation.

c. Even though ordinary shares subject to a forward purchase contract to buy an entity's own shares are accounted for as if they had been repurchased, those shares are legally outstanding and continue to participate in dividends. For EPS purposes, the entity attributes dividends paid on those ordinary shares to the liability that it has reclassified from equity.

d. The liability that it has reclassified from equity is a participating instrument because it participates in dividends with ordinary shares according to a predetermined formula.

e. An entity applies the application guidance in paragraphs A25 - A30 of the pre-ballot draft to calculate EPS for a participating instrument.

24. The staff notes that this interpretation achieves convergence with US GAAP. Paragraph 25 of SFAS No. 150 requires the denominator of the basic and diluted EPS calculation to exclude ordinary shares that are to be repurchased. According to SFAS No. 150, any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to shares that are to be repurchased that have not been recognised as interest cost are deducted in computing income available to common stockholders (the numerator of the EPS calculation) and the 'two-class' method is applied. The 'two-class method' under US GAAP is similar to the method prescribed for participating instruments and two-class ordinary shares in paragraphs A25 – A30 of the pre-ballot draft.
Does the Board agree? If not, how should such contracts be treated for EPS purposes, and why?

Forward purchase contracts with remittance of dividends

25. Gross physically settled forward contracts to purchase an entity's own shares sometimes require the holder to remit back to the entity any dividends paid on the shares to be repurchased. Paragraph A34 of the pre-ballot draft stated:

> The shares subject to such a contract do not participate in dividends with ordinary shares and are therefore not participating instruments. However, the shares subject to the contract represent a class of ordinary shares with a different dividend rate from that of other ordinary shares without having prior or senior rights. As a consequence, the application guidance in paragraphs A25-A30 applies to all forward contracts on an issuer's equity instruments that require physical settlement in exchange for cash, regardless of whether dividends are remitted back.

26. The staff believes that this requirement is inconsistent with the principles identified in paragraph 24 of the agenda paper. When dividends are remitted back, the liability that has been reclassified from equity no longer meets the definition of a participating instrument. On the other hand, the ordinary shares subject to the forward purchase contract are still deemed repurchased and do not represent a second class of ordinary shares. Therefore, the staff believes that the denominator of the EPS calculation should be reduced for the number of ordinary shares subject to a forward purchase contract with remittance of dividends, but the application guidance in paragraphs A25-A30 should not apply.

    Does the Board agree?

27. The staff will investigate possible ways to include an illustrative example in the pre-ballot draft to better explain the EPS treatment of gross physically settled forward contracts to buy an entity's own shares.

Mandatorily redeemable shares

28. Paragraph 18 a) of IAS 32 states that a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability. The staff believes that this requirement is similar to the accounting treatment of gross physically settled forward contracts to buy an entity's own shares and that therefore the same EPS treatment should apply. The staff recommends to amend the wording

in paragraphs A33 and A34 of the pre-ballot draft accordingly because this would align the EPS treatment for instruments that are accounted for similarly. This would also achieve convergence with US GAAP where the same EPS requirement applies to a gross physically settled forward purchase contract on an entity's own shares and mandatorily redeemable shares.

Does the Board agree?

Contracts that may be settled in ordinary shares or cash

29. Paragraphs 55 – 58 of the pre-ballot draft (paragraphs 58 – 61 of IAS 33) contain requirements for the diluted EPS calculation of contracts that may be settled in ordinary shares or cash. The external reviewers could not think of an instrument to which those requirements would apply. In their view, an entity would measure a financial instrument with settlement options either at fair value through profit or loss and therefore no denominator adjustment would be required or the instrument would meet the definition of a participating instrument and the application guidance in paragraphs A25 - A30 of the pre-ballot draft would apply. The staff agrees with those review comments and recommends to delete paragraphs 55 – 58 from the pre-ballot draft.

    Does the Board agree?

Effective date and transition guidance

30. The pre-ballot draft did not specify whether the standard should permit earlier application. The staff notes that former amendments to IAS 33 permitted earlier application. However, one objective of IAS 33 is to improve performance comparisons between entities in the same reporting period. The staff is concerned that earlier adoption of the proposed amendments by some entities might impair those performance comparisons. The staff recommends therefore that earlier adoption of

the proposed amendments is not permitted. This would be consistent with the FASB's decision to prohibit earlier application of the proposed amendments.

31. The staff is not aware of circumstances that would require additional transition guidance for the proposed amendments.
    Does the Board agree?

Introduction of a comprehensive earnings per share measure

32. The 2007 amendments to IAS 1 *Presentation of Financial Statements* introduced the notion of comprehensive income. Some external reviewers questioned whether IAS 33 should therefore encourage the disclosure of a 'Comprehensive Earnings per Share' measure in addition to EPS. The staff sees merit in such a disclosure and believes that the impact of the comprehensive income notion on IAS 33 should be investigated further. However, we believe that this question is beyond the scope of the short-term convergence project and should be dealt with as part of a more comprehensive review of the EPS calculation under IAS 33.
    Does the Board agree?