

## STAFF PAPER

April 2016

## IASB Meeting

<b>Project</b>	<b>Financial Instruments with Characteristics of Equity research project</b>
<b>Paper topic</b>	Attribution of profit or loss and other comprehensive income to classes of equity claims other than ordinary shares
<b>CONTACT(S)</b>	Manuel Kapsis <a href="mailto:mkapsis@ifrs.org">mkapsis@ifrs.org</a> +44 (0) 2072466459

*This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board<sup>®</sup> ("the Board") and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS<sup>®</sup> Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB Update.*

## Introduction

1. In this meeting we consider ways to attribute profit or loss and other comprehensive income to classes of equity claims other than ordinary shares. We explore different attribution approaches for derivatives which we illustrate using a simple physically settled fixed-for-fixed warrant. Such a warrant would be classified as equity under all three approaches we are considering.
2. This paper is structured as follows:
  - (a) Background and scope (paragraphs 3–16)
  - (b) Staff analysis (paragraphs 17–35)

## Background and scope

3. In February 2016 we considered the attribution of profit or loss and other comprehensive income to classes of equity claims other than ordinary shares. The purpose of that discussion was to explore how subclasses within equity might help in providing additional information about features we identified as being relevant. We have previously stated that financial statements need to provide information about relevant features one way or another. At present, more information is provided for items classified as liabilities than those classified as equity. Providing more information about items classified as equity will help a user to

make an informed assessment for all items regardless of their classification. That gap in information may also be the reason why some users of financial statements support a narrow definition of equity, limited to ordinary shares.

4. In this paper we focus on the attribution requirements for claims that would be classified as equity under the Gamma approach. We note that these claims will also be classified as equity under approaches Alpha and Beta. Under those approaches, there will be additional claims classified as equity. We will consider attribution requirements for the additional claims classified as equity under Alpha and Beta approaches in a future meeting.
5. Although the claims within equity under the Gamma approach will require neither an outflow of resources, nor a fixed return, differences between equity claims will remain. The Board observed that existing IFRS Standards require the attribution of profit or loss and other comprehensive income between non-controlling interests and parent equity interests. The Board indicated that, under all of the approaches being considered, it would be useful to:
  - (a) require entities to attribute profit or loss and other comprehensive income to some or all subclasses of equity other than the ordinary shares of the parent entity; and
  - (b) update the carrying amount of each subclass of equity to reflect any such attribution.
6. In February 2016 we identified the following broad subclasses of equity:
  - (a) Ordinary shares—the class of equity that is the most residual and requires the entity to transfer economic resources only at liquidation for an amount equal to a pro-rata share of the entity’s net assets on liquidation.<sup>1</sup>
  - (b) Classes of equity claims other than ordinary shares—other classes of equity claims that reduce the net assets available to ordinary shares at liquidation. Examples under the Gamma approach might include equity

---

<sup>1</sup> The entity’s net assets for the purposes of this description are those assets that remain after deducting all other claims against the entity. The class of ordinary shares may include two or more ‘alphabet’ legal share classes which share the same priority and rights at liquidation, but which could have different right to say, voting.

components of compound instruments, derivatives on own equity and non-cumulative preference shares.

7. In that meeting, we also stated that we will need to develop additional requirements for the recognition and attribution of amounts to classes of equity claims other than ordinary shares. As a starting point, we intend to consider the existing principles for attribution in IAS 33 *Earnings per Share* that are required for the purpose of calculating basic earnings for ordinary shares. For example, IAS 33 requires adjustments for:
  - (a) the after-tax amounts for preference dividends on non-cumulative preference shares and any difference between the carrying amount and the fair value of the consideration paid to repurchase such shares.
  - (b) amounts allocated to participation features for equity instruments that participate in dividends with ordinary shares in accordance with a predetermined formula.
  
8. As some Board members pointed out in February 2016, while IAS 33 has attribution requirements for some types of preference shares, it displays the effect of dilutive instruments (including derivatives) by:
  - (a) excluding the effect of those instruments in the calculation of basic earnings per share; and
  - (b) including the effect of those instruments in the calculation of the number of shares (the denominator) for diluted earnings per share.
  
9. In this paper, we explore potential ways of providing information about other classes of equity through the attribution of total profit or loss and other comprehensive income. We will discuss additional disclosure requirements at a future meeting.
  
10. The objective of this project is not to reconsider the requirements of IAS 33. However reviewing the information provided through those requirements will give us a better idea of what additional information is already required (or not) and the extent that we can leverage the existing requirements to provide a basis for the attribution that is less costly than introducing new requirements.

**Earnings per Share summary**

11. IAS 33 applies to entities with ordinary shares or potential ordinary shares that are traded in a public market, or entities that are issuing ordinary shares in a public market.
12. IAS 33 requires an entity to disclose basic and diluted earnings per share for profit or loss attributable to the ordinary equity holders of the parent entity. These amounts are required to be calculated for each class of ordinary share that has a different right to share in profit for the period.
13. Basic earnings per share is calculated by:
  - (a) adjusting profit or loss attributable to the parent entity for the after-tax amounts of preference dividends, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity; and
  - (b) dividing (a) by the weighted average number of ordinary shares outstanding during the period.
14. Dilutive earnings per share is calculated by adjusting basic earnings per share for the effects of all dilutive *potential ordinary shares*<sup>2</sup>. This is done by the following adjustments in addition to those for basic earnings per share:
  - (a) profit or loss is also adjusted for other changes in income or expense that would result from the conversion of the dilutive ordinary shares; and
  - (b) the weighted average number of ordinary shares are adjusted for any dilutive potential ordinary shares that might be issued as a consequence of options and warrants classified as equity. The amount of this adjustment is calculated by determining the number of ordinary shares that would have been issued for no consideration.<sup>3</sup>

---

<sup>2</sup> IAS 33 defines *potential ordinary shares* as a financial instrument or other contract that may entitle its holder to ordinary shares.

<sup>3</sup> For example, if a warrant exercise price is CU100 for 10 shares, and the average market price is CU12, then the entity calculates how many shares it could have issued for the same amount of the exercise price

15. IAS 33 defines dilution as a reduction in earnings per share when there is a profit in total, or an increase in loss per share when there is a loss in total. This assessment is made on the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions:
- (a) Potential ordinary shares are dilutive when, and only when, their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations.
  - (b) Potential ordinary shares are *antidilutive* when their conversion to ordinary shares would increase earnings per share or decrease loss per share from continuing operations. Potential ordinary shares that are antidilutive are not considered in the calculation of diluted earnings per share. All purchased call and put options are antidilutive under IAS 33, therefore for these options no effect is taken into account in either basic earnings per share, or dilutive earnings per share.
16. Applying IAS 33:
- (a) no amount is attributed to options or warrants when calculating the numerator (ie the earnings figure) for basic earnings per-share; and
  - (b) there is no disclosure of the effect for basic earnings per-share or on diluted earnings per-share for options or warrants that are antidilutive.

### Staff analysis

17. In the staff's view, there are two possible sets of equity claims other than ordinary shares under the Gamma approach:
- (a) Non-derivative equity claims—These include non-cumulative preference shares, other participating equity claims and non-derivative equity components of compound instruments<sup>4</sup> (paragraphs 18–20).

---

given the average market price (CU100/CU12 = 8.33 shares), then deducts this amount from the number of shares issued (ie 10 shares), to determine that 1.66 shares would be issued for no consideration.

<sup>4</sup> Compound instruments are financial instruments that contain both liability and equity components.

- (b) Derivative equity claims—These include forwards, and written and purchased options to issue equity instruments in exchange for economic resources, or purchased options to purchase equity instruments, or derivative equity components of compound instruments (paragraphs 21–34).

***Attribution to non-derivative equity claims***

- 18. As we mentioned in February 2016, in our preliminary view the attribution of total profit or loss and other comprehensive income to non-cumulative preference shares and participating equity instruments should follow the existing requirements in IAS 33.<sup>5</sup>
- 19. In addition to the general requirements for preference dividends noted in paragraph 13, IAS 33 has requirements for ‘participating equity instruments’ (paragraphs A13-A14 of IAS 33). These instruments participate in dividends with ordinary shares according to a predetermined formula with, at times, an upper limit in the extent of participation. For participating equity instruments, profit or loss is first adjusted for any dividends declared for each class of shares, and the remaining profit or loss is attributed to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed. The total profit or loss attributed to each class of equity instrument is determined by adding together the amount attributed for the dividends declared and the amount attributed for the participation feature.
- 20. Example 11 accompanying IAS 33 illustrates the requirement for participating equity instruments as follows:

Assume the following:	
Profit attributable to equity holders	CU100,000
Ordinary shares outstanding	10,000
(Contd...)	

---

<sup>5</sup> If non-derivative equity claims are convertible to ordinary shares, then the general requirements for calculating the effect for diluted earnings per share apply (see paragraph 14).

Non-convertible preference shares	6,000
-----------------------------------	-------

Non-cumulative annual dividend on preference shares (before any dividend is paid on ordinary shares)	CU5.50 per share
--	------------------

After ordinary shares have been paid a dividend of CU2.10 per share, the preference shares participate in any additional dividends on a 20:80 ratio with ordinary shares (ie after preference and ordinary shares have been paid dividends of CU5.50 and CU2.10 per share, respectively, preference shares participate in any additional dividends at a rate of one-fourth of the amount paid on ordinary shares on a per-share basis).

Dividends on preference shares paid	CU33,000 (CU5.50 per share)
Dividends on ordinary shares paid	CU21,000 (CU2.10 per share)

**Basic earnings per share is calculated as follows:**

Profit attributable to equity holders	100,000
---------------------------------------	---------

Less dividends paid:

Preference	33,000
------------	--------

Ordinary	<u>21,000</u>
----------	---------------

Undistributed earnings	46,000
------------------------	--------

Allocation of undistributed earnings:

Ordinary shares = A; Preference share = B;  $B = \frac{1}{4} A$  (20:80 ratio)

$(A \times 10,000 \text{ shares}) + (\frac{1}{4} \times A \times 6,000 \text{ shares}) = \text{CU}46,000$

$A = \text{CU}46,000 \div (10,000 + 1,500)$

$A = \text{CU}4.00$

$B = \frac{1}{4} A$

$\therefore B = \text{CU}1.00$

Basic per share amounts:

	Preference shares	Ordinary shares
Distributed earnings	CU5.50	CU2.10
Undistributed earnings	<u>CU1.00</u>	<u>CU4.00</u>
Totals	CU6.50	CU6.10

(contd...)

**Based on the above, the attribution of profit or loss and other comprehensive income that we would propose would be as follows:**

	Preference shares	Ordinary shares
Distributed earnings	CU33,000	CU21,000
Undistributed earnings	<u>CU6,000 (CU1 x 6000)</u>	<u>CU40,000</u>
Totals	CU39,000	CU61,000

This attribution could be presented as:

Total profit or loss	100,000
----------------------	---------

Attributed to:

Preference shares	39,000
-------------------	--------

Ordinary shares	61,000
-----------------	--------

***Attribution to derivative equity claims***

21. In the staff’s view, there are three potential ways of attributing total profit or loss and other comprehensive income to derivative equity claims:

(a) **Approach A:** Do not attribute any changes—Continue the existing treatment of disclosing the effect only through diluted earnings per share. We include this for the purposes of comparison.

(b) **Approach B:** Attribute based on change in fair value

(c) **Approach C:** Attribute on a *relative* fair value basis—Attribution under this approach would be based on changes in the attribution of total recognised equity on a relative fair value basis between derivatives and other classes of equity.

22. In the following sections, we consider the advantages and disadvantages of each of the approaches.



23. We illustrate the three different attribution approaches using the following example:

At 1 January 20x0 an entity has recognised assets of CU180,000. The entity is funded by:

- Zero coupon bonds, with a carrying amount of CU100,000 with an effective interest rate of 5%, payable 20x5
- 1000 ordinary shares. The ordinary shares were issued for a total of CU10,000 and there is CU70,000 of retained earnings.

On 2 January 20x0, the entity issues warrants with the following terms:

- Exercise date 1 January 20x5 (European terms)
- Exercisable by the holder
- Exercise price of CU102 per share
- 1,000 shares to be delivered if exercised
- The entity receives CU5,000 in exchange for issuing the warrants on 2 January 20x0

During the year ending 31 December 20x0, the following other events occurred:

- income of CU20,000 was recognised on the entity's assets
- interest of CU5,000 accrued on the bonds

Other relevant information:

Market price of shares on 1 January 20x0	CU100
Market price of shares on 31 December 20x0	CU120
Fair value of warrant on 2 January 20x0	CU5,000
Fair value of warrant on 31 December 20x0	CU10,000

*A note on diluted earnings per share*

24. Under all of the approaches we have identified, diluted earnings per share calculated under IAS 33 will be the same. This is because when an entity calculates diluted earnings per share, it needs to adjust the numerator of the calculation (the earnings), and the denominator (the share count) assuming that the potential ordinary shares were converted to ordinary shares. In the approaches below, we consider attributing some amount to derivatives on own equity. This

amount will affect the numerator for the basic earnings per shares, but any amount attributed will be reversed for the purposes of calculating diluted earnings per share as if the derivative was exercised. Therefore we have not illustrated diluted earnings per share in the examples below.

***Approach A—No attribution***

25. Under this approach, no amounts of total profit or loss and other comprehensive income would be attributed to derivatives classified as equity. This would be consistent with the current treatment for the calculation of the numerator of basic earnings per share. The dilutive effect of these instruments will only be disclosed through the diluted earnings per share calculation

<b><u>Approach A—No attribution</u></b>	
<b><i>Income and expense for year ended <u>31 December 20x0</u></i></b>	
Income from assets	CU20,000
Less: Interest on ordinary bond	CU 5,000
<b>Total income (expense)</b>	<b>CU15,000</b>
Total income attributed to:	
Warrants	-
Ordinary shares	15,000
Basic earnings per share	CU15 per share
	(15,000/1,000)

26. The main advantage of Approach A is that it would require no change from current requirements and will therefore be the least costly of the three approaches.
27. The disadvantages of Approach A include:
- (a) Consistent with the current requirements, it will not show the effect of derivatives classified as equity on ordinary shares. However, this information might be provided through the diluted earnings per-share disclosure, or we can consider other additional disclosures that would help a user calculate the effect.

- (b) It would not be responsive to calls from users for more information regarding the effect on ordinary shares of other classes of equity.
- (c) The amount after attribution of non-derivative equity claims could not be referred to as profit or loss and other comprehensive income attributed to ordinary shareholders. However, it might be referred to as profit or loss and other comprehensive income attributed to *current and other potential* ordinary shareholders.

***Approach B—Attribution based on fair value***

28. Under this approach, the derivative would be measured at fair value at each period and the changes in fair value would be the basis of the attribution of total profit or loss and other comprehensive income to the derivative.

<b><u>Approach B—Attribution based on fair value</u></b>	
<b><i>Income and expense for year ended 31 December 20x0</i></b>	
Income from assets	CU20,000
Less: Interest on ordinary bond	CU 5,000
<b>Total income (expense)</b>	<b>CU15,000</b>
Attributed to:	
Warrants	5,000
Ordinary shares	10,000
Basic earnings per share	CU10 per share
	(10,000/1,000)
The amounts attributed have been calculated as follows:	
Warrants: Based on the change in the fair value of the warrant (CU10,000 – CU5,000)	
Ordinary shares: Total income (expense) less the amount attributed to warrants (CU15,000 – CU5,000).	

29. The advantages of Approach B include:

- (a) The effect on ordinary shareholders will be measured on the same basis as an equivalent cash-settled derivative with the same terms. This is because the movement in fair value of the instrument would be the same as the equivalent cash-settled derivative, reflecting the same effect on the distribution of returns. The only difference would be that for derivatives classified as equity this will be presented as an attribution of total profit or loss and other comprehensive income, as opposed to the presentation of changes in the cash settled derivative as an item of income and expense. Thus the approach would deliver equivalent information to a narrow equity approach (or basic ownership instrument approach).
- (b) Fair value will, for option and warrant contracts, reflect the *potential* for the ordinary shares to be issued or not. This is because the fair value of an option will include the effect of the time value of the option. In contrast, the existing calculation of diluted earnings per share focuses on the intrinsic value of the option through the assumption of immediate exercise or conversion.
- (c) Fair value measurement would be an understandable standalone measurement objective for the derivative. That is, it would be meaningful on its own, not just for the purposes of comparison with the amount attributed to ordinary shares.
- (d) Fair value would also automatically take into account other features of warrants and similar derivatives which might affect its value, for example some warrants reduce the exercise price of the contract for the same amount as dividends paid on ordinary shares. It would also reduce the need to develop additional requirements for particular transactions such as settlement, conversion, expiration and modification.

30. The disadvantages of Approach B include:
- (a) It will require the measurement of fair value for these derivatives, therefore, there will be additional costs if those fair values are not easily observable.
  - (b) The fair value change in any given period of an instrument that could have a dilutive impact is unlikely to have significant predictive value without also providing the inputs to that valuation (for example, the strike price). However, we are not proposing to change the diluted earnings per share disclosure which will provide additional details about the dilutive effect of such instruments. We also plan to consider disclosure requirements for equity claims in a future meeting.
  - (c) It may amplify the consequences of incomplete recognition and mixed measurement on the amount ultimately attributed to ordinary shares (and consequently earnings per share calculations). This is because, under the Gamma approach, claims classified as equity will be for an amount that depends on the residual amount. As we discussed in February 2016, recognising changes in claims that depend on the residual without recognising the changes that drive them might result in counterintuitive amounts. For example, if the change in the fair value of a warrant is greater than the recognised residual return, then Approach B would result in the attribution of a deficit amount for ordinary shares. The greater the percentage of the claims that depend on the residual and are measured at a current value, the greater the mismatch. On the other hand, the user can still use the amounts recognised to estimate the prospects for future cash flows. The objective of financial statements is not to value the entire entity, but to provide information to help a user estimate those values.

### ***Approach C—Attribution based on relative fair value***

31. Under this approach, the entity would first attribute total recognised equity on a relative fair value basis between derivatives and other classes of equity. The amount of profit or loss and other comprehensive income to be attributed to

derivatives for the period would be based on the changes in the carrying amounts. This would require the entity to calculate the fair values of both ordinary shares and the derivatives classified as equity, and calculate the relative change in fair values. This approach can be considered similar to the attribution requirements for participating equity instruments (see paragraph 19).

**Approach C—Attribution based on relative fair value**

***Income and expense for year ended 31 December 20x0***

Income from assets	CU20,000
Less: Interest on ordinary bond	CU 5,000
<b>Total income (expense)</b>	<b>CU15,000</b>
Attributed to:	
Warrants	CU2,700
Ordinary shares	CU12,300
Basic earnings per share	CU12.3 per share
	(12,300/1,000)

The amounts attributed have been calculated as follows:

*Fair value of warrants and ordinary shares at the end of the period*

Ordinary shares (1,000 x CU120)	CU120,000
Warrants (1,000 x CU10)	<u>CU 10,000</u>
Total fair value	CU130,000

*Relative fair value of warrants*

= CU10,000 / (CU130,000) = 0.77

Net assets attributable at end of period	CU100,000
Net assets attributable to warrants based on relative fair value (CU100,000 * 0.77)	CU7,700
Beginning carrying amount of warrants	<u>CU5,000</u>
Change in carrying amount	CU2,700

32. The advantages of Approach C include:

- (a) By calculating the relative change in fair values, it does not amplify the consequences of incomplete recognition and mixed measurement as Approach B would (see paragraph 30(c)). This is because the total recognised equity, including the residual return, will be allocated on a pro-rata basis, including the value of ordinary shares.
- (b) It arguably makes the amount allocated to ordinary shares more useful, as the amount attributed to ordinary shares would be comparable, in relative terms, to the amount attributed to other equity claims. However, the amounts attributed would not be meaningful in isolation.
- (c) Unlike the equivalent cash-settled derivatives, derivatives classified as equity will have different consequences for the liquidity of the entity, therefore there is less of a reason to measure them directly. Attribution based on relative fair values would still provide some information regarding the distribution of return relative to other equity claims.

33. The disadvantages of Approach C include:

- (a) The amount attributed will only be understandable relative to the amount attributed to ordinary shares. That is, it will not be an understandable measurement of the derivative in isolation. However, because the fair value will need to be determined in order to perform the calculation, it can be disclosed with little additional cost.
- (b) The additional steps required to calculate the attribution include determining the fair value of all the entity's equity claims (including ordinary shares), and calculating the relative amounts and the changes in the carrying amounts, adds additional costs and complexity. Thus it would be more costly than Approach B.
- (c) Additional requirements will be needed to account for changes in the carrying value that arise from other transactions related to the instrument. As mentioned previously, we intend to consider the accounting for the issuance, settlement, conversion, expiration and modification of classes of equity at a future meeting.

- (d) Valuing the entire entity, goes beyond the stated objective of general purpose financial reports.

### **Summary of analysis for derivative equity claims**

34. In summary:
- (a) Approach A is unlikely to improve the information provided by the existing requirements.
  - (b) Approach B would provide more information, and the method of attribution does not depend on other calculations. However, this approach may amplify the consequences of partial recognition and mixed measurement. Approach B would also provide equivalent information to a narrow equity approach.
  - (c) Approach C would limit the consequences of partial recognition and mixed measurement, however the amount attributed would only be relevant in comparison to the amount for ordinary shares. It would also be the most costly.
35. Based on the analysis in this paper, in the staff's preliminary view, the information provided by Approach B might provide a greater benefit given the costs than that provided by Approach C. However, we think that both Approach B and C should be included in the Discussion Paper.

#### **Questions for the Board**

Does the Board agree that the attribution for *non-derivatives* equity claims should use the same requirements as in IAS 33? (paragraph 18)

Does the Board agree that *some* attribution should be performed for *derivatives* classified as equity?

Does the Board have a preference between Approach B and Approach C?  
Does the Board agree that both Approaches B and C should be included in the Discussion Paper?