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STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**New item for initial consideration**
Paper topic	IAS 33 *Earnings per Share*—Basic earnings per share and participating equity instruments

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Introduction

1. The IFRS Interpretations Committee (the Committee) received a request to clarify how an entity determines profit attributable to ordinary equity holders when calculating basic earnings per share (EPS). In the fact pattern in the submission, the entity has two classes of equity instruments—ordinary shares and participating equity instruments.

2. The objective of the paper is to:

   (a) provide the Committee with a summary of the issue and the staff's analysis; and

   (b) ask the Committee whether it agrees with the staff recommendation not to add the issue to its agenda.

Structure of the paper

3. This paper includes the following:

   (a) background information;

   (b) staff analysis; and

   (c) staff recommendation.

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4. There are two appendices to this paper:

   (a) Appendix A—proposed wording for the tentative agenda decision; and

   (b) Appendix B—submission.

Background information

5. An entity has two classes of equity instruments—ordinary shares and participating equity instruments. Participating equity holders participate in dividends together with ordinary shareholders according to a predetermined formula.

6. We understand from the submission that:

   (a) the entity classifies the participating equity instruments as equity applying IAS 32 *Financial Instruments: Presentation*. The entity therefore recognises dividends on the participating equity instruments in equity.

   (b) under national tax rules, the participating equity instruments are classified as liabilities. Accordingly, the entity includes dividends on the participating equity instruments as a deductible expense in its income tax filing. The expense reduces taxable income and, thus, reduces income taxes paid to the tax authorities ('tax benefit').

   (c) dividend payments are discretionary. If the entity pays no dividend on ordinary shares, participating equity holders do not receive dividends.

   (d) the participating equity holders do not participate in any proceeds on liquidation (ie it is only the ordinary shareholders that benefit from liquidation proceeds).

   (e) the entity recognises the tax benefit in equity applying paragraph 61A of IAS 12 *Income Taxes*. Paragraph 61A requires an entity to recognise current and deferred tax directly in equity if the tax relates to items recognised directly in equity.

   (f) ordinary shareholders (and not participating equity holders) benefit from the tax benefit.

7. Paragraph A14 of IAS 33 requires an entity to allocate profit or loss (after adjusting for cumulative dividends and/or dividends declared in the period) 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.

8. The submitter asks whether, in making this allocation, the entity includes the tax benefit that would arise from the hypothetical distribution of profit to the participating equity holders. In other word, the submitter asks whether the entity adjusts profit attributable to ordinary shareholders (ie the numerator in the basic EPS calculation) to reflect the tax benefit.

9. The following example illustrates the question submitted:

   (a) participating equity instruments participate ten to one in dividend payments (ie the participating equity holders receive CU10 for every CU1 paid to the ordinary shareholders);

   (b) profit for the period applying IFRS Standards is CU330, and no dividends are declared or paid during the period;

   (c) the tax rate is 30 per cent;

   (d) if all of the profit or loss for the period had been distributed, participating equity holders would have received CU300 and ordinary shareholders CU30; and

   (e) the hypothetical distribution of profit (ie dividend payment) to participating equity holders would give rise to a tax benefit of CU90 (CU300 dividend payment × 30 per cent tax rate). The ordinary shareholders receive this tax benefit.

10. The submitter has observed the following two views in practice:

(a) View 1—an entity adjusts profit or loss attributable to ordinary shareholders to reflect the tax benefit arising from the hypothetical distribution of profit on participating equity instruments.

Applying this view, in the example described in paragraph 9 of this paper, profit attributable to ordinary shareholders when calculating basic EPS is CU120[1] (ie CU30 (profit distribution) plus the tax benefit of CU90).

(b) View 2—an entity does not adjust profit or loss attributable to ordinary shareholders to reflect the tax benefit arising from the hypothetical distribution of profit on participating equity instruments.

Applying this view, in the example described in paragraph 9 of this paper, profit attributable to ordinary shareholders when calculating basic EPS is CU 30 (ie there is no adjustment for the tax benefit of CU90).

View 1—adjust profit or loss attributable to ordinary shareholders to reflect the tax benefit arising from the hypothetical distribution of profit on participating equity instruments

11. The submitter notes that proponents of View 1 say the following:

(a) IAS 33 has specific requirements about participating equity instruments (ie paragraphs A13–A14). Those paragraphs do not explicitly address whether an entity considers a tax benefit recognised directly in equity. Accordingly, an entity considers other requirements in IAS 33 dealing with similar transactions. Paragraph 12 of IAS 33 contains requirements for preference shares classified as equity, and requires an entity to adjust profit or loss for the after-tax amount of preference dividends.

(b) paragraphs 12-13 of IAS 33 contain requirements for both preference shares classified as equity and preference shares classified as liabilities. Both paragraphs require an entity to deduct the after-tax amount of dividends—

[1] Also calculated as CU 330- CU210. CU330 is the profit for the period and CU210 is the after-tax amount of dividend payment to participating equity instruments (CU300 less tax benefit of CU90).

they do not differentiate between dividends and any resulting tax benefits recognised in equity and those recognised in profit or loss.

(c) the objective of basic EPS (ie to provide a measure of the interest of each ordinary share in the performance of the entity) will not be met if the tax benefit is ignored. Ignoring the tax benefit would result in understating the interest of each ordinary share in the performance of the entity.

View 2—do not adjust profit or loss attributable to ordinary shareholders to reflect the tax benefit arising from the hypothetical distribution of profit on participating equity instruments

12. The submitter notes that proponents of View 2 say the following:

(a) paragraph A14 of IAS 33 does not specifically require an entity to adjust profit or loss for tax benefits recognised in equity. Accordingly, it is not appropriate to include the tax benefit in the calculation of basic EPS.

(b) an entity cannot apply paragraph 12 of IAS 33 by analogy to participating equity instruments because of the differing characteristics of these instruments. Preference shareholders have rights to dividends before ordinary shareholders, whereas participating equity holders participate in dividends together with ordinary shareholders according to a predetermined formula.

Staff analysis

Existing requirements in IFRS Standards

13. Paragraph 10 of IAS 33 states:

> Basic earnings per share shall be calculated by dividing profit or loss attributable to ordinary equity holders of the parent entity (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the period.

14. Paragraph A14 of IAS 33 contains specific requirements about participating equity instruments. Paragraph A14 of IAS 33 states (emphasis added):

> A14 ...For those instruments that are not convertible into a class of ordinary shares, profit or loss for the period is allocated to the different classes of shares and participating equity instruments in accordance with their dividend rights or *other rights to participate in undistributed earnings*. To calculate basic and diluted earnings per share:
>
> (a) profit or loss attributable to ordinary equity holders of the parent entity is adjusted (a profit reduced and a loss increased) by the amount of dividends declared in the period for each class of shares and by the contractual amount of dividends (or interest on participating bonds) that must be paid for the period (for example, unpaid cumulative dividends).
>
> (b) the remaining profit or loss is allocated 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 allocated to each class of equity instrument is determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

Staff view—View 1 in the submission

15. We think that, in applying IAS 33, the entity adjusts profit or loss attributable to ordinary shareholders to reflect the tax benefit when calculating basic EPS (ie View 1 in the submission). This is because:

(a) paragraph A14(b) of IAS 33 requires an entity to assume that all of the profit or loss for the period had been distributed—this hypothetical distribution of profits to the participating equity holders would generate a tax benefit that would effectively result in additional amounts available for distribution to the ordinary shareholders[2]; and

(b) paragraph A14 requires an entity to consider 'other rights to participate in undistributed earnings' when allocating profit or loss. In the fact pattern in the submission, the ordinary shareholders would benefit from, or have rights to receive, the tax benefit. In our view, this represents a right to participate in undistributed earnings that the entity considers when allocating profit or loss.

16. In effect, in the example described in paragraph 9 of this paper, if the entity assumes that it had distributed all of the profit for the period (as required by paragraph A14 of IAS 33), then it would have distributed CU300 to participating equity holders and CU30 to ordinary shareholders. The entity would then receive CU90 back in the form of the tax benefit. Accordingly, the cost to ordinary shareholders of making a distribution to participating equity holders would not be CU300, but instead CU210. Ordinary shareholders would receive CU30 as part of the initial distribution, and would also receive the additional CU90 that the entity receives back in the form of a tax benefit.

17. We also considered the objective of basic EPS, outlined in paragraph 11 of IAS 33:

> The objective of basic earnings per share information is to provide a measure of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period.

[2] In the fact pattern in the submission, ordinary shareholders (and not participating equity holders) benefit from the tax benefit. However, if that were not the case and ordinary shareholders and participating equity holders were to share the tax benefit in the same proportion as other dividend payments (for example, ten to one), an entity would allocate the tax benefit using the relevant ratio to calculate the amount of the tax benefit attributable to ordinary shareholders.

18. In our view, the tax benefit is an interest of the ordinary shares that arises from the hypothetical distribution of profit to the participating equity holders. Accordingly, adjusting the profit attributable to ordinary shareholders to include the tax benefit is consistent with this objective.

Why we do not agree with View 2 in the submission

19. Proponents of View 2 say that because the entity recognises the tax benefit in equity, it should ignore the tax benefit when calculating basic EPS. We disagree with this view. Notwithstanding that paragraph 10 of IAS 33 requires an entity to calculate basic EPS by dividing 'profit or loss' by the weighted average number of shares, other paragraphs of IAS 33 explicitly require an entity to adjust profit or loss for particular amounts, including tax benefits, recognised in equity. For example, paragraph 12 of IAS 33 states (emphasis added):

> 12 For the purpose of calculating basic earnings per share, the amounts attributable to ordinary equity holders of the parent entity in respect of:
>
> (a) profit or loss from continuing operations attributable to the
>
> parent entity; and
>
> (b) profit or loss attributable to the parent entity
>
> shall be the amounts in (a) and (b) adjusted 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*.

20. In addition, although the entity described in the submission recognises the tax benefit in equity, we understand that not all entities would do so. Some entities might recognise such a tax benefit in profit or loss applying paragraph 52B of IAS 12.[3] The Board has proposed to amend IAS 12 to clarify where an entity recognises the tax

[3] Paragraph 52B of IAS 12 states: "In the circumstances described in paragraph 52A, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequences of dividends are recognised in profit or loss for the period as required by paragraph 58 except to the extent that the income tax consequences of dividends arise from the circumstances described in paragraph 58(a) and (b)."

consequences of dividends (see paragraphs 21-23 of this paper for further information on the effect of these proposed amendments). We think that view 2 (ie to ignore any tax benefit recognised in equity when calculating basic EPS) would create an arbitrary distinction in the calculation of basic EPS on the basis of where an entity recognises the tax benefit. We do not see a basis for this distinction having considered the objective of basic EPS in paragraph 11 of IAS 33 (reproduced in paragraph 17 of this paper).

The effect of the proposed amendments to IAS 12 Income Taxes

21. The Board recently published proposed amendments to IAS 12 as part of the Exposure Draft on *Annual Improvements to IFRS Standards 2015-2017 Cycle*. These amendments would clarify that an entity recognises the income tax consequences of payments of dividends (ie distributions of profit) in profit or loss, except to the extent that the entity recognises the transactions that give rise to the profit distributed outside profit or loss.

22. The submission notes that the entity currently recognises the tax benefit in equity applying paragraph 61A of IAS 12. Finalisation of the proposed amendments to IAS 12 might result in the entity recognising the tax benefit associated with distributions to participating equity holders in profit or loss.

23. In our view, applying IAS 33, an entity adjusts the profit attributable to ordinary shareholders for the tax benefit. Accordingly, we think that the application of the proposed amendments to IAS 12 would not change how an entity calculates basic EPS in the fact pattern described in the submission.

Conclusion having considering the Committee's agenda criteria

24. We think that, in the fact pattern in the submission, the entity adjusts profit or loss attributable to ordinary shareholders to reflect the tax benefit that would result from the hypothetical distribution of profit to participating equity instruments (ie View 1).

25. In our view, this conclusion reflects the application of paragraph A14 of IAS 33, which requires an entity to allocate profit or loss to ordinary shares and participating equity instruments:

    (a) in accordance with their dividend rights or other rights to participate in undistributed earnings; and

    (b) as if all of the profit or loss for the period had been distributed.

26. This conclusion also results in calculating basic EPS in a manner that is consistent with the objective of basic EPS in paragraph 11 of IAS 33.

27. For these reasons, we think that the principles and requirements in IAS 33 provide an adequate basis to enable an entity to calculate basic EPS in the fact pattern described in the submission. Accordingly, we have concluded that it is not necessary to add to or change IFRS Standards to improve financial reporting.

Staff recommendation

28. On the basis of our assessment of the Committee's agenda criteria (and, in particular, our assessment of whether it is necessary to add to or change IFRS Standards to improve financial reporting), we recommend that the Committee does not add this issue to its agenda. Instead, we recommend publishing an agenda decision that includes educative guidance outlining how an entity applies the relevant principles and requirements in IAS 33 to the fact pattern in the submission.

29. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions for the Committee
1. Does the Committee agree with the staff recommendation not to add this issue to its agenda? 2. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

Appendix A
Proposed wording of the tentative agenda decision

IAS 33 *Earnings per Share*—Tax benefit arising from dividend payments on participating equity instruments

The IFRS Interpretations Committee (the Committee) received a request to clarify how an entity determines profit attributable to ordinary equity holders when calculating basic earnings per share (EPS). In the fact pattern described in the submission:

a. the entity has two classes of equity instruments—ordinary shares and participating equity instruments. Participating equity holders participate in dividends together with ordinary shareholders according to a predetermined formula.

b. applying IAS 32 *Financial Instruments: Presentation*, the entity classifies the participating equity instruments as equity. Accordingly, the entity recognises dividends on participating equity instruments in equity.

c. under national tax rules, the participating equity instruments are classified as liabilities. Accordingly, the entity recognises dividends on participating equity instruments as a deductible expense in its income tax filing. The expense reduces taxable income and, thus, reduces income taxes paid to the taxation authorities ('tax benefit').

d. the tax benefit is attributable only to the ordinary shareholders, and not to the participating equity holders.

e. no dividends are declared or paid in the reporting period.

The submitter asked whether, in determining profit attributable to the ordinary shareholders (ie the numerator) in the basic EPS calculation, the entity reflects the tax benefit that would arise from the hypothetical distribution of profit to participating equity holders.

The following example illustrates the fact pattern described in the submission and the question submitted:

a. participating equity instruments participate ten to one in dividend payments (ie the participating equity instruments receive CU10 for every CU1 paid to the ordinary shareholders);

b. profit for the reporting period applying IFRS Standards is CU330; and

c. the tax rate is 30 per cent.

In this example, if all of the profit or loss for the period had been distributed, participating equity holders would have received CU300 and ordinary shareholders CU30 (ie in the ratio of ten to one). This hypothetical distribution of profit to participating equity holders would give rise to a tax benefit of CU90 (CU300 profit distribution × 30 per cent tax rate). This tax benefit is attributable to the ordinary shareholders. In this example, the submitter asks whether the profit attributable to the ordinary shareholders is CU120 (ie CU30 (profit distribution) adjusted for the tax benefit of CU90) or CU30 (ie no adjustment is made for the tax benefit of CU90).

Paragraph A14 of IAS 33 requires an entity to allocate profit or loss to the different classes of shares and participating equity instruments in accordance with their dividend rights and other rights to participate in undistributed earnings. Paragraph A14 of IAS 33 also requires an entity to allocate profit or loss (after adjusting for cumulative dividends and dividends declared in the period) 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 Committee concluded that, when calculating basic EPS, the entity adjusts profit or loss attributable to ordinary shareholders for the tax benefit attributable to those ordinary shareholders (ie in the example described above, profit or loss attributable to the ordinary shareholders is CU120).

This is because the hypothetical distribution of profit to the participating equity holders required by paragraph A14 of IAS 33 would give rise to the tax benefit. This tax benefit would result in additional amounts being attributable to the ordinary shareholders. The Committee observed that this treatment is also consistent with the objective of basic EPS outlined in paragraph 11 of IAS 33—that paragraph says that the objective of basic EPS is to provide a measure of the interests of each ordinary share in the performance of the entity over the reporting period.

The Committee concluded that the principles and requirements in IAS 33 provide an adequate basis to enable an entity to calculate basic EPS in the fact pattern described in the submission. In the light of the existing requirements in IFRS Standards, the Committee [determined] that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Committee [decided] not to add this issue to its agenda.

Appendix B
Submission

B1. We received the following request. We have deleted details that would identify the submitter of this request.

Potential Agenda Item Request on the application of IAS 33

I. The issue

1. Our issue deals with participating equity instruments in terms of IAS 33.A13 et seq. The instrument considered by us grants the holder (dividend) payments according to a specified formula, e.g. ten times the dividend paid to the holders of ordinary shares. If no dividend is paid to the holders of ordinary shares, the participating instrument does not pay any dividends either.
2. When liquidating the entity, the holders of the participating equity instruments do not participate in any proceeds. It is only the holders of the ordinary shares that benefit from the liquidation proceeds.
3. According to IAS 32, these instruments are classified as equity under IFRS. (This is based on the facts that the instrument has no defined life, thus, is infinite, and there is no unconditional obligation on behalf of the issuer to deliver cash.) Therefore, dividends from the instruments are paid out of equity.
4. Under (national) tax rules, however, the participating instruments are classified as liabilities. (This results from tax rules focusing on other criteria.) Consequently, dividends paid to the holders of these instruments are recognised as an expense in profit or loss in the tax accounts. The expense reduces taxable income and, in the end, reduces income taxes to be paid to the local tax authorities. We refer to this reduction of income taxes as 'tax benefit'.
5. In the corresponding IFRS financial statements, the tax benefit is recognized in equity since the basis for this benefit—the participating equity instrument and the dividends thereon—is also recognised in equity per IAS 12.61A (for current developments please refer to para. 19 below).
6. It seems unclear how this tax benefit resulting from the participating instrument should be considered when calculating basic earnings per (ordinary) share (EPS) according to IAS 33.

II. Current practice

7. When presenting the alternatives, the following fact pattern is being used:
   - The participating equity instruments participate 10 to 1 in dividends. The tax rate is 30%.
   - The IFRS profit for the year is CU 330.
   - Allocation to participating equity instruments: CU 300; residual amount allocated to ordinary shares: CU 30.
   - Tax benefit: CU 300 x 30% = CU 90.
   - The task is to calculate EPS of the ordinary shares whereby, pursuant to IAS 33.A14, total profit of the year is assumed to be distributed.

We are aware of at least two alternatives that are being applied in practice that are reproduced below.

Alternative 1: Adjust profit or loss by the <u>after-tax amount</u> of the instrument's dividend

8. When calculating EPS, IAS 33.A14 must be considered with regard to participating equity instruments. IAS 33.A14 does not provide any guidance as to how income taxes resulting from these instruments are to be handled. Therefore, it seems appropriate to take the requirements in IAS 33.12 et seqq. into consideration. According to these paragraphs, and for the purpose of calculating basic earnings per share, an entity shall deduct the after-tax amount of preference dividends from profit or loss. IAS 33.12 contains the term "preference shares classified as equity" and IAS 33.13 the term "preference shares classified as liabilities", however, there does not seem to be any difference in calculation that would depend on the classification of the preference shares. Further, IAS 33.14 does not differentiate between whether (the dividends or) resulting tax benefits are recognised in equity or profit or loss. Therefore, when calculating the after-tax amount that should be deducted from profit or loss, tax benefits that are recognised directly in equity must be included and reduce the amount that is deducted. Consequently, the tax benefit increases EPS for ordinary shares compared to a calculation that does not include the tax benefit.
9. According to this alternative, the basis for the EPS calculation, i.e. the allocation of profit to ordinary shares, is CU 120 in the example above [30 + 90 = 120 or 330 - (300 - 90), respectively]. This results from the principle that, under IAS 33, calculation of EPS is not an allocation of dividends *declared* but rather an *attribution* of the IFRS profit or loss to (different classes of) shareholders.
10. Even though the tax benefit is recognised in equity, it is the ordinary equity holders and not the holders of the participating instruments who benefit from the tax benefit (at the latest in the moment of liquidation of the entity). If the tax benefit were to be ignored, it would never be included in the EPS calculation.

Alternative 2: Adjust profit or loss by the <u>pre-tax amount</u> of the instrument's dividend

11. The tax benefit resulting from the participating instrument's dividends is ignored when calculating EPS. IAS 33.A14 does not explicitly require inclusion of any tax benefits from participating equity instruments; therefore, the tax benefit must not reduce the dividends paid to the holders of the instruments.
12. IAS 33.12 et seqq. cannot be applied by analogy to participating equity instruments since, contrary to preference shares, they participate contemporaneously with ordinary shares in profit or loss according to a predetermined formula.
13. Hence, the basis for EPS calculation for the ordinary shares in the example above is CU 30.

Question

14. Which alternative is the correct reading of the requirements of IAS 33?

III. Reasons for the IFRS IC to address the issue

a) Is the issue widespread and has, or is expected to have, a material effect on those affected?

15. Yes. Participating equity instruments are a common way of financing in many jurisdictions. Some of them are classified as equity under IFRS and as a liability following tax law. Therefore, it appears that the issue is widespread. Treatment of the tax effects resulting from these instruments — as in the case described — might materially influence EPS. As EPS is an important performance indicator within IFRSs, the issue has a material effect on those affected.

b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

16. Yes. EPS is regularly in the focus of users of the financial statements. Divergent accounting treatments would lead to different EPS calculations even though the underlying numbers are exactly the same.

c) Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?

17. Yes. There is a possible gap in IAS 33 regarding the treatment of tax effects resulting from participating equity instruments, which could be resolved by the IFRS IC.

d) Is the issue sufficiently narrow in scope?

18. Yes. As the issue deals with a specific question regarding the calculation of EPS when considering specific instruments, it is sufficiently narrow in scope. However, as these instruments are used frequently, the issue is not so narrow that it would not be cost-effective to address this issue.

e) Will the solution developed by the IFRS IC be effective for a reasonable time period?

19. Yes. Currently, there are discussions regarding IAS 12.52A and 12.52B possibly resulting in an amendment of IAS 12 as part of the AIP cycle 2015-2017 (cf. IASB Update June 2016, last issue, and the respective staff paper (June 2016, Agenda Paper 12A)). Such an amendment would clarify that the presentation requirements in IAS 12.52 apply to all payments on financial instruments classified as equity that are distributions of profits, and are not limited to the circumstances described in IAS 12.52A (Agenda Paper, par. 2). That being said, an entity will still need to apply judgement to determine whether such payments are distributions of profit. If the payments are distributions of profits, then IAS 12.52B applies to any income tax consequences of such payments (recognition in profit or loss). If the payments are not distributions of profits, then the entity applies IAS 12.57 and .61A and presents any income tax consequences of such payments directly in equity (Agenda Paper, paras. 29 and 30). We are of the view that even with this clarification for the application of IAS 12.52B, it will still not be clear whether it also applies to the EPS calculation as IAS 12.52B prescribes the accounting for the income tax implications (via equity or profit and loss) only when a liability to pay the dividend is recognized, whereas IAS 33.A14 assumes that all profit or loss is distributed.