STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity (FICE)**		
Paper topic	Disclosures—potential dilution		
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Introduction

1. At its February 2021 meeting, the Board discussed potential refinements to disclosure proposals explored in its 2018 Discussion Paper *Financial Instruments with Characteristics of Equity* (the 2018 DP). In this paper, the staff continue to discuss further refinements to the proposals for disclosures on potential dilution of ordinary shares.

2. This paper is structured in the following way:

   (a) objective of the potential dilution disclosures (paragraph 3);

   (b) maximum dilution (paragraphs 4–54):

      (i) dilution resulting from instruments and transactions accounted for under IFRS 2 *Share-based Payment* (paragraphs 7–32);

      (ii) calculating the maximum number of shares (paragraphs 33–39);

      (iii) illustrative examples (paragraphs 40–48);

      (iv) illustrative disclosure (paragraph 49);

(v) derivatives on own shares used in economic hedging transactions (paragraphs 50-54)

(c) staff's recommendations (paragraphs 55–56); and

(d) question for the Board (paragraph 57).

Objective of the potential dilution disclosures

3. Consistent with the Board's preliminary view set out in the 2018 DP, the objective of these disclosures is to enable users of financial statements to assess the potential dilution of ordinary shares arising from financial instruments that could be settled by delivering ordinary shares, for example convertible bonds and derivatives on own equity. Such information would help in understanding how the entity distributes its returns to ordinary shareholders, how the entity has financed its operations in the past, and how the entity's capital structure might change in the future based on the instruments issued at the reporting date. Information about such potential dilution is useful for existing and potential investors in the entity's ordinary shares.

Maximum dilution

4. As discussed in the February 2021 meeting, the proposed disclosure would show maximum dilution, which is different from diluted earnings per share (DEPS) applying IAS 33 *Earnings per Share*—it represents the maximum number of additional ordinary shares that could be delivered from settling each type of potential ordinary share[1] outstanding at the reporting date. Maximum dilution, unlike the DEPS calculation in provides information about dilution that could arise from any potential increase in the number of issued ordinary shares from settling financial instruments the entity has issued regardless of the current conditions at the reporting date.

5. The proposed maximum dilution disclosures would not replace the DEPS calculation but would be separate disclosures. The staff believe that providing the

[1] A potential ordinary share is defined by IAS 33 as 'a financial instrument or other contract that may entitle its holder to ordinary shares'.

maximum dilution disclosures would not be too costly for preparers because the maximum dilution calculation would require a simpler set of assumptions (see paragraph 38 of this paper) compared to those required for the DEPS calculation. Entities that prepare the DEPS disclosures would be able to leverage off the information that is already being used for the existing DEPS calculation. For unlisted entities that may not currently prepare DEPS disclosures, the maximum dilution calculation would not be too onerous because it does not require determining the market price of ordinary shares at the reporting date or the average market price over a reporting period. Providing maximum dilution disclosures would benefit users of financial statements because they would meet the objectives set out in paragraph 3 of this paper.

6. At the February 2021 Board meeting, feedback from Board members on the potential dilution disclosures was largely supportive. However, based on some stakeholders specifically requesting the inclusion of potential dilution from share-based payment transactions under IFRS 2 (hereafter referred to as 'IFRS 2 instruments and transactions') to determine a true 'maximum dilution' number, and additional explanations about the maximum dilution calculation, the Board directed the staff to:

   (a) consider whether and if so, how IFRS 2 instruments and transactions that may result in dilution could be included in the calculation of maximum dilution (see paragraphs 7-32); and

   (b) provide information on calculating the maximum number of additional ordinary shares (see paragraphs 33-54).

Dilution resulting from IFRS 2 instruments and transactions

7. In this section, the staff consider whether it would be useful for the maximum dilution disclosures to incorporate the potential dilution from IFRS 2 instruments and transactions. Some stakeholders told us that 'maximum dilution' should include dilution from all types of instruments, especially those in the scope of IFRS 2 because they are often the most common cause of dilution. We understand that some investors also make their own adjustments to the DEPS calculations for

example, when determining the future IFRS 2 charges which are added to the assumed proceeds.

8. In considering if and how to incorporate the IFRS 2 instruments and transactions, the staff relooked at some of the requirements in IFRS 2 and IAS 33 and the assumptions proposed in the maximum dilution calculation for non-IFRS 2 instruments which were discussed by the Board at the February 2021 meeting. In particular, the staff set out to understand the following:

   (a) for share-based payment transactions that have settlement options—IFRS 2 classification and DEPS requirements and how such transactions would be incorporated in the maximum dilution calculation (see paragraphs 9-10);

   (b) for other IFRS 2 instruments and transactions—DEPS requirements and how such instruments and transactions would be incorporated in the maximum dilution calculation (see paragraphs 11-12); and

   (c) current IFRS 2 disclosure requirements (see paragraphs 13-19).

   Although the maximum dilution calculation would be different from the DEPS calculation and would not replace it, the staff considered the DEPS requirements for completeness and to get an overall understanding of how much additional work for example, for listed entities, would be involved by incorporating IFRS 2 instruments and transactions in the maximum dilution disclosures. Even though the maximum dilution calculation has a simpler set of assumptions, additional complexity may arise if there are too many sets of assumptions used for different purposes ie for IFRS 2, DEPS and maximum dilution purposes.

Interaction with IFRS 2 classification requirements for share-based payment transactions that have settlement options

9. IFRS 2 requires classification of share-based payment transactions as equity-settled or cash-settled. A cash-settled share-based payment does not entitle the holder to equity instruments of the entity. The focus in this paper is therefore on equity-settled share-based payments and share-based payment transactions that may be settled in either ordinary shares of the entity or cash.

10. Where share-based payment transactions have settlement options, there are differences between the IFRS 2 classification requirements, the assumptions made for DEPS purposes and the assumptions that would be used in the proposed maximum dilution calculation if an entity were to include these share-based payment transactions. The table below summarises these differences

Transaction type	*IFRS 2 classification*	*IAS 33 DEPS*	*Maximum dilution*[2]
Either the entity or the counterparty can choose whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments	**Cash-settled share-based payment transaction** if, and to the extent that, the entity has incurred a liability to settle in cash or other assets, or **equity-settled share-based payment transaction** if, and to the extent that, no such liability has been incurred.	No specific requirements in IAS 33.	Assume settled in shares
Counterparty can choose whether settled in cash or by issuing equity instruments	Entity has granted a **compound financial instrument.**	The **more dilutive** of cash settlement and share settlement shall be used in calculating diluted earnings per share.	Assume settled in shares

[2] Maximum dilution using the assumptions applied to non-IFRS 2 instruments.

Entity can choose whether to settle in cash or by issuing equity instruments	Account for the transaction under the requirements for **cash-settled share-based payment** transactions if the entity has a **present obligation to settle in cash**. If **no such obligation exists**, account for the transaction in accordance with the requirements applying to **equity-settled share-based payment** transactions.	**Presume** that the contract will be **settled in ordinary shares.** When such a contract is presented for accounting purposes as an asset or a liability, or has an equity component and a liability component, the entity shall adjust the numerator for any changes in profit or loss that would have resulted during the period if the contract had been classified wholly as an equity instrument.	Assume settled in shares

Interaction with DEPS calculations for other IFRS 2 instruments and transactions

11. Applying IAS 33, employee share options with fixed or determinable terms and non-vested ordinary shares are treated as outstanding options on the grant date in the calculation of DEPS, even though they may be contingent on vesting. Performance-based employee share options are treated as contingently issuable shares because their issue is contingent upon satisfying specified conditions in addition to the passage of time.

12. If an entity were to include these IFRS 2 instruments and transactions in the maximum dilution calculation, it could use the same simplified set of assumptions applied to non-IFRS 2 instruments if they are also treated as options, similarly to IAS 33. The following table summarises some differences between the IAS 33 DEPS requirements and the proposed maximum dilution requirements for employee share options and non-vested ordinary shares.

IAS 33 DEPS	*Maximum dilution*
An entity shall assume the exercise of dilutive options and warrants of the entity. Options and warrants have a dilutive effect only when they are 'in the money'. An option may be 'out of the money' at the end of the period, so is not included in DEPS even though it has the potential to be dilutive depending on the value of ordinary shares in the future.	Assume exercise of all options and warrants regardless of in-the-moneyness at the reporting date.
For written call options and warrants, the number of ordinary shares assumed to be issued for no consideration is included. The proceeds from exercise are divided by the average market price per share during the period and the difference between the total number of shares issued and the number of shares assumed to be issued at the average market price is the bonus element. For share options and other share-based payment arrangements to which IFRS 2 applies, the issue price and the exercise price shall include the fair value (measured in accordance with IFRS 2) of any goods or services to be supplied to the entity in the future under the share option or other share-based payment arrangement.	For written call options and warrants, use the total number of shares that would be delivered upon exercise, not only the bonus element.
The number of contingently issuable shares included in the DEPS calculation is	For financial instruments where settlement in shares, or the number of

based on the number of shares that would be issuable if the end of the reporting period were the end of the contingency period. If the condition is not satisfied based on this assumption, the instrument is considered as not dilutive and the potential dilutive effect is not disclosed.	shares to be delivered, depends on a contingent event, assume the contingency is met at the reporting date.

Interaction with IFRS 2 disclosures

13. At the February 2021 meeting, the Board discussed the possible exclusion of IFRS 2 instruments and transactions from the maximum dilution calculation and the potential simplification to cross-refer to IFRS 2 disclosures instead. The staff therefore re-examined the existing IFRS 2 disclosure requirements to establish what information is currently provided to users of financial statements.

14. Paragraph 44 of IFRS 2 contains the principle that an entity shall disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period.

15. IFRS 2 further specifies the minimum set of information an entity should disclose to give effect to this principle. Among others, it includes the following:

    (a) a description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement, such as vesting requirements, the maximum term of options granted, and the method of settlement (eg whether in cash or equity).

    (b) the number and weighted average exercise prices of share options for each of the following groups of options:

        (i) outstanding at the beginning of the period;

        (ii) granted during the period;

        (iii) forfeited during the period;

        (iv) exercised during the period;

        (v) expired during the period;

(vi) outstanding at the end of the period; and

(vii) exercisable at the end of the period. […]

(c) for share options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life. If the range of exercise prices is wide, the outstanding options shall be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

16. Based on the staff's understanding of the disclosure requirements in IFRS 2, the number of share options outstanding at the end of the period could be seen as a type of maximum number ie assuming all vesting conditions are met, and all options are exercised, the share options outstanding represent the maximum number of additional ordinary shares to be delivered.

17. For other types of share-based payments not involving options for example, deferred share awards, we would assume that information such as the number of vested and unvested shares would be provided to meet the IFRS 2 disclosure requirement reproduced in paragraph 15(a) of this paper ie in describing the share-based payment arrangement. However, the staff note that there is no explicit requirement to disclose the number of unvested shares or potential ordinary shares under these types of share-based payment arrangements. Paragraph 52 of IFRS 2 does state that if the information required to be disclosed by this Standard does not satisfy the principle, the entity shall disclose such additional information as is necessary to satisfy it. However, it is not clear whether maximum dilution information would be covered by the principle in paragraph 44 of IFRS 2 (see paragraph 14 of this paper) for both shares and share options.

18. In addition, in many cases the number of unvested shares or shares to be purchased by counterparties may not yet be known at the reporting date. For example, consider the following employee share purchase plan: On 1 January 2021, Company X offers 100 of its employees the opportunity to participate in an employee share purchase plan. The employees can choose to contribute up to 2% of their gross monthly salary, for a period of 24 consecutive months. The contributions may be used (within 3 months following the end of the 24-month period) to purchase shares of Company X at a price of 20% below the average

share price of Company X over the 10 days immediately preceding 1 January 2021. Only employees that remain in employment and contribute the required amounts for the 24 consecutive months will be entitled to purchase the shares. Employees who do not meet these requirements or who do not exercise their options to purchase shares will be refunded their contributions. In this example the number of shares to be purchased depends on a number of factors including the employees' salaries over the 24-month period.

19. In some share-based payment transactions where the employee can choose settlement in shares or cash at a future date, the amount of cash or number of shares may not be known at the reporting date. For example, if the terms of the arrangement allow employees to choose between:

(a) a cash payment based on the increase in the entity's share price between 1 January 2021 and 1 January 2023 for 500 shares; or

(b) shares with a value equal to 108% of the cash payment amount.

In this example the number of shares that could be delivered depends on a number of factors, including the share price over a specified period.

Alternative approaches

20. Taking into consideration the findings in paragraphs 9-19 of this paper, the staff set out alternative approaches for incorporating the maximum dilutive impact from IFRS 2 instruments and transactions in the proposed disclosures.

Alternative A

21. Under this alternative IFRS 2 instruments would be kept **separate** from the calculation of the maximum dilution number and entities would need to cross-refer to the existing IFRS 2 disclosures as a narrative. In this way, any complexity from applying the assumptions used in the maximum dilution calculation to IFRS 2 instruments would be eliminated and users of financial statements would still get some information about the potential dilution from this source. The information they obtain will however, be subject to the information entities provide to meet the disclosure principle in IFRS 2, which may not necessarily represent maximum dilution in all cases, especially if the number of shares to be delivered is not known at the reporting date.

Alternative B(i)

22. Under this alternative, only the **number of options disclosed as outstanding at the reporting date** will be added to the maximum dilution number and entities would need to cross-refer to IFRS 2 disclosures for details of other share purchase plans and share awards. This is because IFRS 2 only explicitly requires disclosure of the number of share options. The staff believe the number of options outstanding at the reporting date would likely represent the maximum additional number of shares to be delivered from this source, on the assumption that all options vest and all options are exercised. Similar to Alternative A, the information entities provide to meet the disclosure principle in IFRS 2 for other share purchase plans and share awards, may not represent maximum dilution, especially if the number of unvested shares or shares to be purchased by counterparties is not known at the reporting date.

Alternative B(ii)

23. This alternative is similar to Alternative B(i) but in addition to the number of options outstanding at the reporting date, the **number of known unvested shares** would be added to the maximum dilution number and entities would need to cross refer to IFRS 2 disclosures for details of other share purchase plans and share awards. If the number of unvested shares under share award schemes such as deferred share awards at the reporting date is known, the staff believe this number would likely represent the maximum additional number of shares to be delivered from this source, on the assumption that all shares vest. In contrast, the information disclosed for some share purchase plans and share awards, may not represent maximum dilution if the number of unvested shares or shares to be purchased by counterparties under the plan is not known at the reporting date.

Alternative C

24. Under this alternative, the IFRS 2 numbers would be added to the maximum dilution number but **IFRS 2 would need to be amended** to ensure IFRS 2 explicitly requires entities to disclose the number of unvested shares or the number of shares to be purchased under share award schemes and share purchase plans in addition to the number of share options outstanding at the reporting date. Where the number of unvested shares or the number of shares to be purchased by

counterparties is not known at the reporting date, entities would be required to estimate and disclose such a number. More work would be required to develop guidance on determining such a number, for example whether the number would be a maximum number or could be determined based on weighted probabilities or the most likely outcome.

Alternative D

25. This alternative is similar to Alternative C but it does not require any amendment to IFRS 2. The IFRS 2 disclosed numbers would be added to the maximum dilution number but where **the number of unvested shares or the number of shares to be purchased** by counterparties is not disclosed for example, because it is not known at the reporting date, entities would need to **estimate this number**. Such determination may not result in the maximum dilution for example, it could be based on the most likely outcome.

Alternative E

26. Under this alternative, IFRS 2 instruments and transactions which may result in dilution of ordinary shareholders' interests will be included in the scope of the maximum dilution calculations by **applying the proposed maximum dilution assumptions** (see paragraphs 34–38 of this paper).

27. The main difference between Alternative E and the IFRS 2 requirements (and the IAS 33 DEPS calculation) would likely arise when there are settlement options (see paragraphs 9-10 of this paper) because settlement in shares would always be assumed for the maximum dilution calculation regardless of which party has the choice. For other IFRS 2 instruments and transactions, if an entity were to include these IFRS 2 instruments and transactions in the maximum dilution calculation, it could use the same simplified set of assumptions applied to non-IFRS 2 instruments if they are also treated as options, similarly to IAS 33 (see paragraphs 11-12 of this paper). This would result in similar numbers to the number of options disclosed as outstanding at the end of the reporting date and the number of known unvested shares that could be disclosed under IFRS 2. For share purchase plans and share award schemes where the number of shares to be purchased by counterparties or the number of unvested shares is not known at the reporting date, additional assumptions would need to be developed for the maximum

dilution calculation for example, relating to employee salary levels or increase in the entity's share price. The staff think it would be difficult to develop assumptions that could be applied to all such transactions because there could be many different variations in vesting conditions.

28. To summarise, each alternative would include the following in the maximum dilution disclosures:

	Alternative A	Alternative B(i)	Alternative B(ii)	Alternatives C-E
Share options	Excluded	Included	Included	Included
Unvested shares (max number known)	Excluded	Excluded	Included	Included
Unvested shares and share options (max number not known)	Excluded	Excluded	Excluded	Included

Although the scope of Alternatives C-E is the same, the alternatives require different levels of complexity and effort and the degree to which the calculation represents a maximum dilution number would also differ.

Staff preference - Alternative B(ii)

29. Alternative A does not provide additional information about potential dilution resulting from IFRS 2 instruments and transactions beyond what is currently disclosed applying IFRS 2. What is currently disclosed may not necessarily represent maximum dilution in all cases, especially if the entity only discloses the number of share options outstanding and not the number of unvested shares for other types of IFRS 2 transactions.

30. Alternatives C-E would require additional assumptions to calculate the number of unvested shares and shares to be purchased by counterparties and cannot cater for all instances as the vesting and non-vesting conditions of share awards and other share purchase plans differ. Alternative C is also beyond the scope of this project

and additional work would be needed to avoid any unintentional consequences or inconsistencies with the rest of IFRS 2.

31. The staff believe both Alternative B(i) and Alternative B(ii) involve a compromise because some IFRS 2 instruments and transactions would be included in the maximum dilution calculation where the maximum number of additional shares are known at the reporting date. The staff prefer Alternative B(ii) because it would incorporate additional information about IFRS 2 transactions which may result in dilution ie known number of unvested shares. There is a risk that investors may think that potential dilution from all IFRS 2 transactions are included in the maximum dilution disclosure when this may not be the case (ie due to an unknown number of unvested shares or shares to be purchased by counterparties). This risk could be mitigated by cross-referring to IFRS 2 disclosures that provide a narrative description of other IFRS 2 transactions.

32. In addition, the staff believe entities need to disclose information about share buybacks related to IFRS 2 transactions (for example, shares to be bought back and held in an employee share trust for issuing to employees under employee share purchase plans). However, we do not think it is necessary to provide separate disclosure of share buyback transactions related to IFRS 2 transactions from other share buybacks. What is important to users of financial statements is to understand the maximum dilution number before (gross) and after (net) taking into account required repurchases of own shares (see paragraphs 34-37 of this paper).

Calculating the maximum dilution number

33. In this section, the staff discuss how the maximum number of additional ordinary shares will be calculated for disclosure purposes and the key terms and conditions that should be disclosed together with the maximum dilution number.

34. In order to determine the maximum dilution, the underlying principle is that an entity must assume:

    (a) the maximum possible increase in the number of shares for instruments that could be settled by delivering own shares (eg convertible bonds, written call options such as warrants); and

(b) the minimum reduction in the number of shares for instruments to repurchase own shares (eg purchased call options, committed share buy-back programme).

35. In determining the maximum dilution number before taking into account required repurchases of own shares, an entity should disclose the maximum number of shares that could be delivered **for each type** of potential ordinary shares outstanding at the reporting date. By types of potential ordinary shares, the staff mean potential ordinary shares with similar terms and conditions. For example, depending on the terms of the instruments that an entity has, an entity may categorise all convertible bonds into one type of potential ordinary share if they have broadly similar terms and conditions. In other cases, an entity may categorise them into several types, such as convertible bonds with holder options, convertible bonds with issuer settlement options, and contingent convertible bonds. For an illustration of these disclosures, see paragraph 49 of this paper.

36. As discussed in the February 2021 meeting, the staff think information about share buybacks which the entity has committed to at the reporting date is relevant to understanding the maximum dilution of ordinary shares. In addition, treasury shares are not treated as outstanding ordinary shares because they are held by the entity itself or its subsidiaries and are deducted from the number of shares outstanding in the IAS 33 calculations. For example, shares held by an entity, to satisfy its obligations under employee share award schemes are excluded from both basic and diluted EPS because they are not shares outstanding in the market. It therefore follows that committed share buy-backs should be deducted in calculating the maximum dilution because they will not be outstanding when they are repurchased. The maximum dilution disclosures will therefore provide an overview of the net maximum number of additional ordinary shares after deducting the number of shares the entity is required to repurchase under committed share buy-back programmes (which set out the buy-back terms eg number of shares, exercise price, etc).

37. If the entity has not contractually committed to specific terms of repurchase but only has the intention to repurchase shares, or if the entity committed to spending a specific amount of cash but does not know the minimum number of shares to be repurchased, narrative disclosure should be provided of the details of such plans

without reducing the net maximum number of additional ordinary shares. Similarly, if an entity has purchased a call option or issued a written put option on its own shares, the minimum number of ordinary shares required to be repurchased under that option is zero. This is because the holder of the option can decide not to exercise the option. Therefore, purchased call options[3] and written put options should not be included in the quantitative disclosure and should only be disclosed as a narrative explanation.

38. The following are examples of how the principle described in paragraph 34 would apply. In determining the maximum number of additional ordinary shares, an entity would:

(a) include **anti-dilutive instruments** that could become dilutive in future even if they are not dilutive at the reporting date.

(b) for financial instruments where settlement in shares, or the number of shares to be delivered, depends on a **contingent event**, assume the contingency is met at the reporting date.[4]

(c) for **convertible bonds, written call options and warrants**, assume the holder will exercise their option to buy or convert to shares and use the total number of shares that would be delivered upon exercise, not the bonus element.

(d) Where either party has the **option to choose settlement in cash or shares**, assume shares will be delivered for instruments that may be settled by delivering shares and assume no shares will be bought back (ie assume cash settlement) for instruments that require repurchasing own shares.

(e) for **forward contracts to buy back shares**, use the minimum number of shares that is required to be bought back (not the bonus element) to reduce the maximum number.

[3] Exception for purchased call options used in economic hedge transactions which is discussed later in the paper.

[4] If the number of shares to be delivered depends on more than one contingent event, the entity should assume the contingent event that results in the maximum number of shares to be delivered is met.

(f) for **purchased call options and written put options** to buy back own shares, assume zero reduction ie assume the option is not exercised.

(g) Some instruments may require the entity to deliver a **variable number of shares equal to a fixed or variable value** (eg a value that is linked to gold price). In such cases, the entity should calculate the maximum dilution by applying the share price (and/or other relevant underlying variable's price) at the reporting date. The entity should provide a narrative explanation that a higher number of shares might need to be delivered depending on the share price or other underlying variable's price on the settlement date. As a simplification for unlisted entities whose ordinary shares are not publicly traded and is not quoted, the entity may disclose that the maximum dilution is unknown. This simplification is offered so that unlisted entities would not have to value their own shares purely for the purpose of preparing this disclosure. If the entity is able to reliably measure its share price at the reporting date, the entity could use that share price for calculating the maximum number in these cases.

39. In determining the key terms and conditions to be disclosed together with the maximum dilution numbers, an entity should consider the information that is relevant to assessing the likelihood of potential dilution of ordinary shares. For example, information about whether a conversion into ordinary shares is contingent on a specified event, would be relevant to users of financial statements. Depending on the volume of potential ordinary shares, disclosing terms such as strike prices and exercise dates may not always be feasible at an individual instrument level. The maximum dilution disclosures are furthermore required for each type of potential ordinary shares outstanding at the reporting date rather than at an individual instrument level. In providing additional information about key terms and conditions, an entity should put more weight on those potential ordinary shares that represent the most significant sources of dilution.

Illustrative examples

40. Company X has a number of instruments that will or may be settled in ordinary shares of Company X. Paragraphs 41-48 of this paper illustrate how the maximum

number of additional ordinary shares is determined for each of them, and paragraph 49 of this paper illustrates what the overall disclosure may look like.

41. Convertible bond A includes an option for the holder to convert the bond into a fixed number of shares.

> Convertible bond A has a par amount of CU5,250. The holder has an option to convert the bond into ordinary shares at its maturity date based on a ratio of CU15 per share.
>
> In calculating the maximum number of shares Company X may be required to issue to settle Convertible bond A, Company X would assume the holder exercises the conversion option and chooses to receive shares. Company X would disclose 350 shares [CU5,250/CU15] as the maximum number of additional ordinary shares relating to Convertible bond A.

42. Convertible bond B includes a clause that adjusts the number of shares to be delivered on the occurrence of a change of control of Company X.

> Convertible bond B has a par amount of CU2,000. The holder has an option to convert the bond into ordinary shares at its maturity date based on a ratio of CU9 per share. In the event of a change of control of Company X prior to the maturity date, the conversion ratio would be adjusted to CU8 per share.
>
> In calculating the maximum number of shares Company X may be required to issue to settle Convertible bond B, Company X would assume a change of control occurs at the reporting date and the holder exercises the conversion option. Company X would disclose 250 shares [CU2,000/CU8] as the maximum number of additional ordinary shares relating to Convertible bond B.

43. Convertible bond C is anti-dilutive and not included in the DEPS calculation ie the conversion option in Convertible bond C is out-of-the-money at the reporting date.

> Convertible bond C has a par amount of CU3,000. The holder has an option to convert the bond into ordinary shares at its maturity date based on a ratio of CU12 per share. The share price at the reporting date is CU10. The bond is not included in the DEPS calculation because it is anti-dilutive.
>
> In calculating the maximum number of shares Company X may be required to issue to settle Convertible bond C, Company X would include the conversion option (ie assuming the holder exercises the conversion option) regardless of the fact that it is anti-dilutive and is out-of-the-money as at the reporting date. Company X would

> disclose 250 shares [CU3,000/CU12] as the maximum number of additional ordinary shares relating to Convertible bond C.

44. Convertible bond D includes an option for Company X to settle the bond in cash (equal to the value of the shares) or shares, if the holder exercises the conversion option.

> Convertible bond D has a par amount of CU5,250. If the holder exercises the conversion option, Company X has an option to settle the bond, in cash (equal to the value of the shares) or in shares based on a conversion ratio of CU15 per share.
>
> In calculating the maximum number of shares Company X may be required to issue to settle Convertible bond D, Company X would assume the holder exercises the conversion option and Company X will settle the bond in shares. Company X would disclose 350 shares [CU5250/CU15] as the maximum number of additional ordinary shares relating to Convertible bond D.

45. Contingently convertible bond E includes a clause that converts the bond into a fixed number of shares based on the occurrence of non-viability event.

> Contingently convertible bond E has a par amount of CU1,000. The bond is convertible upon the occurrence of a non-viability event (ie if Company X's Common Equity Tier 1 ratio falls below 5.125%) based on a ratio of CU20 per share. The bond does not have a maturity date but Company X has an option to call it in November 2030, at the earliest.
>
> In calculating the maximum number of shares Company X may be required to issue to settle Contingently convertible bond E, Company X would assume a non-viability event occurs. Company X would disclose 50 shares [CU1,000/CU20] as the maximum number of additional ordinary shares relating to Contingently convertible bond E.

46. Share-settled bond F is not settled in cash but is settled by Company X delivering a variable number of shares based on the par value of the bond and the share price at the date of settlement.

> Share-settled bond F has a par amount of CU500. Company X would need to deliver as many shares as are worth CU500 at the settlement date. The share price at the reporting date is CU10.
>
> In calculating the maximum number of shares Company X may be required to issue to settle Share-settled bond F, Company X would use the share price at the reporting date. Company X would disclose 50 shares [CU500/CU10] as the maximum number of additional ordinary shares relating to Share-settled bond F. Company X would however

also disclose as a narrative explanation that depending on the share price at settlement date, a higher number of shares might need to be delivered.

For entities whose ordinary shares are not traded in a public market, they may disclose that the maximum dilution relating to the share-settled bond is unknown.

47. Mandatorily convertible note G is convertible into a variable number of shares based on the par value of the note and the share price at the date of conversion. The note includes a floor for the minimum number of shares to be delivered and a cap for the maximum number of shares to be delivered.

Mandatorily convertible note G has a par amount of CU1,000. Company X would need to deliver as many shares as are worth CU1,000 at the conversion date. The note is subject to a cap of 100 shares and a floor of 10 shares.

In calculating the maximum number of shares Company X may be required to deliver to settle Mandatorily convertible note G, Company X would use the cap as the maximum number of shares. Company X would disclose 100 shares as the maximum number of additional ordinary shares relating to Mandatorily convertible note G.

48. Under the share buy-back programme, Company X commits to purchase own shares from the market.

The share buy-back programme includes a commitment to purchase own shares on the open market. Company X plans to spend up to CU5,000 and purchase a minimum of 100 shares and a maximum of 500 shares over a period of 2 years.

Company X would use the *minimum* number of shares it has committed to purchase because the buy-back transaction would result in a *reduction* in the number of ordinary shares outstanding. Company X would disclose 100 shares as the minimum reduction resulting from the share buy-back program. Using the minimum reduction from the share buy-back programme will more accurately depict the maximum dilution from all transactions that involve the delivery of shares.

Illustrative disclosure

49. Taking into account the illustrative examples in paragraphs 41-48 of this paper, the staff provide an example of the maximum dilution disclosure that would be provided for Company X. This disclosure includes the effect of IFRS 2 instruments and transactions under Alternative B(ii) which is the staff's preferred alternative (see paragraph 31 of this paper) We have assumed Company X has

disclosed 100 options outstanding and 100 unvested shares from share awards at reporting date per its IFRS 2 disclosures.

Instruments	*Maximum number of additional ordinary shares to be disclosed*	*Key terms and conditions relating to the instrument/transaction*
Convertible bonds B	250	In the event of a change of control of Company X prior to the conversion date, the conversion ratio is adjusted downwards to a pre-determined strike price.
Convertible bonds D	350	Issuer holds an option to settle in shares or cash (equal to the value of the shares).
Convertible bonds (A and C)	600	Holder holds an option to convert the bond at a specified conversion date using a specified conversion ratio.
Contingently convertible bond E	50	Conversion contingent on the occurrence of non-viability event X. Redeemable at the option of the issuer for cash.
Share-settled bond F	50 Or unknown dilution (if unlisted shares)	Depending on the share price at settlement date a higher number of shares might need to be delivered.
Mandatorily convertible note G	100	Subject to a cap of 100 shares and a floor of 10 shares.
Number of share options in the scope of IFRS 2 outstanding at reporting date	100	Refer to note x (IFRS 2 disclosures on share options).
Number of known unvested shares from share awards in the scope of IFRS 2 at reporting date	100	Refer to note y (IFRS 2 disclosures on share awards).
Maximum number of additional ordinary shares	**1,600**	

Less: minimum reduction in the number of ordinary shares		
Share buy-back	(100)	Commitment to buy 100 –500 shares.
Net maximum number of additional ordinary shares	**1,500**	

Derivatives on own shares used in economic hedging transactions

50. In some cases, an entity may economically hedge the potential dilution from a particular instrument by entering into derivatives on own shares to mitigate the potential dilutive effect (hereafter referred to as a 'mitigating derivative'). For example, an entity may purchase a call option on its own shares to mitigate the potential dilution from convertible bonds.

51. The staff considered how the underlying principle in paragraph 34 of this paper should be applied to such transactions ie whether the maximum dilution number should be reduced by the potential reduction in ordinary shares in those cases to avoid overstating the maximum dilution number. In the staff's view, when an entity has entered into a derivative(s) on own shares for the specific purpose of mitigating the potential dilution from a specific instrument, the entity would be required to determine the maximum dilution by considering the transactions as a whole. In doing so, the entity should consider the interdependencies of exercising any options. In some cases, the construct of the overall transaction is such that one instrument would always be exercised if another instrument is exercised (eg by having the same exercise prices). If so, the entity should consider such interdependencies in determining the maximum dilution.

52. Although these transactions are generally described as hedging transactions, hedge accounting is not applied. Therefore, the staff do not think there is a need for any strict documentation requirements to allow entities to reflect the effects of the mitigating derivatives in presenting the maximum dilution number. Reducing the maximum dilution number would merely be reflecting the economic substance of the mitigating derivatives. The entity would still present the maximum dilution information on a gross basis so investors would get the maximum dilution before the effects of the mitigating derivative. We also expect that it would be clear from

the terms of the instruments when a derivative is a mitigating derivative compared to other derivatives on own equity, ie the relevant terms such as exercise date of the instruments should match.

53. Consider the following example. Company A issues convertible bonds with an aggregate principal amount of CU100 million. Each bond has a principal amount of CU1,000 convertible into 5 shares of Company A at the holder's option (ie conversion price per share is CU200). To hedge potential dilution from the bonds, Company A buys 300,000 call options with a strike price of CU200 each. The call options are gross physically settled.

54. Applying the principle in paragraph 34 to determine the maximum dilution from the whole transaction, for the purpose of the calculation it is assumed the holder will exercise the conversion option and Company A will choose to settle in shares. Company A assumes it will deliver 500,000 shares [100 million/1000*5] to settle the convertible bonds. Because the exercise prices of the convertible bonds and the purchased call options are the same, if the convertible bonds are exercised, so will the purchased call options ie they are interdependent. By considering the transactions as a whole, the maximum number of additional shares of this transaction is 200,000 shares [500,000 – 300,000]. Company A reports 500,000 as the gross maximum dilution and reports 300,000 as the minimum reduction from these transactions as a whole.

Staff's recommendation

55. Based on the analysis set out in this paper, the staff recommend the following disclosures to be incorporated into IFRS 7 to meet the objectives set out in paragraph 3 of this paper:

(a) information about the maximum dilution of ordinary shares:

(i) disclose the maximum number of additional ordinary shares that an entity could be required to deliver **for each type** of potential ordinary shares outstanding at the reporting date. Included in this number is the total number of share options outstanding (as required by IFRS 2) and the number of unvested shares to the extent it is known, at the reporting date;

(ii) disclose the minimum number of ordinary shares required to be repurchased; and

(iii) a narrative explanation of any significant changes in (i) and (ii) from the prior reporting period;

(b) disclose key terms and conditions relevant to understanding the likelihood of maximum dilution and the possibility for unknown dilution.

(c) as a simplification, cross-refer to IFRS 2 disclosures for description of share-based payment arrangements, instead of estimating the maximum dilution, where the number of unvested shares or shares to be purchased is not yet known at the reporting date.

56. Consistent with the Board's discussion in February 2021 (Agenda Paper 5C), the staff recommend the above disclosure be required for all entities, both listed and unlisted.

Question for the Board

57. The staff would like to ask the Board the following question.

Question for the Board
Does the Board agree with the staff's recommendations set out in paragraphs 55–56 of this paper?