STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity (FICE)**		
Paper topic	Disclosures: Potential refinements—Potential dilution		

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Purpose of this paper

1. In this paper the staff recap some of the key concerns raised and suggestions made by stakeholders on the proposals related to potential dilution set out in 2018 Discussion Paper *Financial Instruments with Characteristics of Equity* (2018 DP) and then present potential refinements to address some of these concerns and suggestions. The staff also provide feedback from additional outreach conducted with stakeholders to discuss these potential refinements. Based on the additional feedback and the staff's analysis, the staff then present their views on the way forward.

2. This paper is structured as follows:

   (a) 2018 DP proposal and feedback (paragraphs 3–5);

   (b) potential disclosure refinements, which include a summary of feedback from further outreach with stakeholders (paragraphs 6–33); and

   (c) next steps (paragraph 34);

(d) question for the Board (paragraph 35); and

(e) Appendix A—summary of the requirements in IAS 33 *Earnings per Share* for the calculation of diluted earnings per share.

2018 DP Proposal and feedback

3. The Board's preliminary view was that information in the notes to the financial statements about the potential dilution of ordinary shares would be useful to users of financial instruments. The objective of these disclosures was to help users of financial statements assess the potential dilution of ordinary shares arising from financial instruments that could be settled by issuing ordinary shares, for example convertible bonds and derivatives on own equity. Such information would help users of financial statements understand the distribution of returns to ordinary shares, how the entity has financed its operations in the past, and how the entity's capital structure might change in the future. Information about such potential dilution is useful for existing and potential investors in the entity's ordinary shares.

4. The 2018 DP provided examples of information that an entity could disclose to meet the objective. They are as follows:

   (a) a list at the end of each reporting period of all financial instruments that could dilute the ordinary shares ie instruments that may be settled in own shares

   (b) the maximum number of ordinary shares an entity may need to deliver to settle such financial instruments outstanding at the reporting date, eg assuming all convertible bonds will be converted into shares;

   (c) a reconciliation of the movement in the number of ordinary shares outstanding, and the maximum number of additional ordinary shares during the period;

(d) for each group of potentially dilutive financial instruments, disclose the terms and conditions, eg dates of potential settlement, and number of shares to be delivered at settlement;

5. The following challenges were raised in the 2018 DP feedback:

(a) concerns over complexity of a reconciliation of the movement in the maximum number of additional ordinary shares during the period.

(b) concerns that addressing the issue may be beyond the scope of the FICE project. Determining what constitutes appropriate information reflecting the returns for shareholders is a complex issue that warrants a separate research project.

(c) some of the proposed disclosures might easily be confused with the information provided about the calculation of diluted earnings per share (DEPS) in IAS 33 because there is some overlap with information already partly covered by IAS 33. Furthermore, the disclosures are potentially onerous to non-listed companies that currently do not need to apply IAS 33.

(d) contracts with potential share redemptions or repurchases could also be considered in the reconciliations as it may also be useful to users of financial statements to understand the maximum potential ordinary share reductions as they analyse the performance of an issuer.

(e) to provide complete information about potential dilution, instruments in the scope of IFRS 2 *Share-based Payment* ie financial instruments such as share options and restricted stock units issued for performance-linked compensation should be included and minimum potential dilution should also be disclosed.

Potential disclosure refinements

6. Based on the feedback on the 2018 DP the staff developed the following disclosure refinements for the additional outreach conducted in 2020:

(a) for both listed and unlisted entities:

(i) disclose the maximum number of additional ordinary shares that could be issued for each type of potential ordinary shares outstanding at the reporting date and a narrative explanation of any significant changes from the prior reporting period; and

(ii) disclose key terms and conditions relevant to understanding potential dilution such as strike price, exercise date and any conditions for exercise.

(b) as a simplification, disclose a narrative description of share-settled IFRS 2 instruments eg employee share options with cross reference to IFRS 2 disclosures.

Disclosure of movements in maximum number of additional ordinary shares

7. In light of the feedback that a reconciliation of the movement during the reporting period is too onerous to implement especially in a large, complex entity and may result in information that is difficult for users of the financial statements to understand, the staff sought views on an alternative. In particular, the staff asked investors whether it would still be useful if an entity discloses the maximum number of additional ordinary shares at the reporting date with a narrative explanation of any significant changes from the prior reporting period.

8. Investors were generally supportive of this alternative noting that reporting date number would be sufficient. One investor stressed the importance for an entity to explain significant changes in the number during the reporting period. A standard-setter questioned whether the incremental usefulness of an entity disclosing significant changes in the maximum number of additional ordinary shares as a narrative would outweigh the concern for disclosure overload given that the entity would also be required to disclose the key terms for understanding the potential dilution.

9. The staff are of the view that providing this disclosure at the reporting date with narrative explanation for significant changes would be a solution that balances the costs of preparation and the benefits to the users of financial statements. Any significant change in the maximum number of additional ordinary shares would be

material enough to warrant disclosure in the financial statements or in management commentary thereon and so requiring it would not impose any significant additional costs on preparers.

How this disclosure is different from the requirements in IAS 33

10. In line with the overall objective described in paragraph 3 of this paper, the objective of these potential dilution disclosures is to enable users of financial statements to assess the potential dilution of ordinary shares so that they can understand how the entity's capital structure may change and how their returns might be affected. The intention is not to repeat or duplicate disclosures already required by IAS 33 or to amend IAS 33 to correct its perceived shortcomings. Before developing the potential disclosure refinements, the staff therefore explored the existing requirements in IAS 33 for the calculation of diluted earnings per share (DEPS) (see summary in Appendix A).

11. The DEPS calculations aim to maximise the dilution of basic earnings per share and contain various requirements and assumptions for the calculations depending on the type of potential ordinary share. On the other hand, the proposed potential dilution disclosures would provide information about dilution that could arise from any potential increase in the number of issued ordinary shares regardless of the current conditions at the reporting date.

12. Under the proposed disclosures, disclosing a maximum number of additional ordinary shares that could be issued would enable users to understand the circumstances that will result in the maximum dilution of the ordinary shares and what that impact is. The maximum number differs from the number used in the DEPS calculations because it is not weighted for the period outstanding and uses different assumptions to determine the number of shares. The following are examples of some of the assumptions that could be considered in determining the maximum number of additional ordinary shares:

    (a) include anti-dilutive instruments that could become dilutive in future in the maximum number of additional shares 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.

(c) for written call options and warrants, use only the number of shares that would be delivered upon exercise, not the bonus element.

(d) 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.

(e) assume share settlement for any instrument that gives either party an option to settle in cash or shares.

13. Most users of financial statements said it was important to understand the maximum number of shares and assumptions as information in practice is currently limited. They said that in practice, analysts do not dilute the EPS in the same way it is done in IFRS Standards because they make their own judgments on dilution such as including stock options that are currently out-of-the-money because they have a long outlook period (for example 5-6 years).

14. Analysts who cover the banking sector said dilution is not a particularly contentious or complex issue and noted that there are often no significant differences between basic EPS and DEPS for banks. One of them also said that EPS is mainly a governance issue for equity investors therefore other information such as the source of the dilution risk and the period over which the risk exists would be more relevant.

15. The staff are of the view that disclosures of the maximum number of additional ordinary shares are still useful and can provide the information DEPS does not provide. Although dilution may not be a significant problem in the financial sector, the feedback provided by investors covering other sectors suggests that it is an important area requiring improvements. Having said that, it would be important to make it clear what the maximum number represents, how it differs from DEPS figures and how to calculate it. In order to achieve that clarity, entities should disclose any assumptions made in calculating the maximum number.

Unlisted entities

16. The staff considered the concern raised that the disclosures are potentially onerous for unlisted entities that currently do not need to apply IAS 33. The staff acknowledge that this disclosure would likely require additional effort for unlisted entities. However, based on the proposed assumptions on which the calculation of the maximum number of additional ordinary shares would be based, we do not think these disclosures would be too onerous. This is because the disclosure would not require determining the market price of ordinary shares at the reporting date or the average market price over a reporting period, which would be required to provide IAS 33 disclosure. For example, the calculation of the maximum number does not require the reporting entity to determine whether an instrument is anti-dilutive or not at the reporting date. Further, where an instrument could be settled in a variable number of shares, a potential simplification might be to require qualitative disclosure that the maximum number of additional shares in such a case would be unlimited.

17. Most investors said that disclosure is relevant or useful for both listed and unlisted entities. An investor said disclosure is more important for unlisted entities than for listed entities because some unlisted entities have very complicated capital structures with many participating instruments which, depending on specified events, change their characteristics.

18. Most standard-setters and preparers agreed with requiring disclosure of the maximum number of additional ordinary shares for both listed and unlisted entities because users of financial statements need information about share dilution for both types of entities. Some standard-setters said that unlisted entities in their jurisdictions tend to have more complex capital structures and therefore more dilutive instruments than listed entities. While acknowledging these points, there was a standard-setter who still thinks it would be too onerous for unlisted entities. Some preparers acknowledged that the main information that is hard to calculate for unlisted entities is the fair value of shares, therefore if the fair value is not a required input, it would be possible for unlisted entities to provide this disclosure.

19. Considering the additional feedback received, the staff did not find any compelling reason for scoping out unlisted entities from this disclosure requirement. Based on the rationale explained in paragraph 16 of this paper, the staff are of the view that this disclosure should be required by all entities.

Information about dilution from share-based payment instruments

20. The staff also considered the suggestion from some stakeholders to provide a similar list for instruments in the scope of IFRS 2 *Share-based Payment* for example, financial instruments such as share options and restricted stock units issued for performance-linked compensation. We note that IFRS 2 already requires detailed disclosures for example:

    (a) a description of each type of share-based payment arrangement including vesting requirements and method of settlement; and

    (b) the number and weighted average exercise prices of share options including those granted during the period, exercised during the period and outstanding at the end of the period.

21. We also noted that the DEPS calculation has specific requirements for contingently issuable shares, contingently issuable potential ordinary shares and contracts that may be settled in ordinary shares or cash. Therefore, including instruments that are in the scope of IFRS 2 in calculating the maximum number of additional shares would require additional assumptions which may differ from those used in the DEPS calculation. In addition, IFRS 2 has specific classification and disclosure requirements, thus including those instruments in the proposed disclosure would add complexity. The staff therefore suggest a simplification so that the disclosure of potential dilution from IFRS 2 instruments can be made using the information already provided in the IFRS 2 disclosures for example, by cross-reference to the relevant IFRS 2 disclosures.

22. Most preparers and standard setters supported the potential refinements including the simplification to cross-refer to IFRS 2 disclosures.

23. An investor commented that it would be ideal if an entity disclosed potential dilution from IFRS 2 share-based payment transactions using the same bases it

uses for other financial instruments—which would indicate the total potential dilution of the entity's ordinary shares. However, other investors said they agreed with the potential refinement suggesting that the Board only require an entity to provide a narrative describing potential dilution from such transactions.

24. On balance, the staff are of the view that IFRS 2 instruments should be excluded from the calculation of the maximum number of additional ordinary shares. Instead, information about dilution from IFRS 2 instruments should be provided using the existing disclosures required by IFRS 2. Entities should state in the narrative that they have equity-settled IFRS 2 instruments outstanding at the reporting date that could require issuance of additional shares and cross-refer to the IFRS 2 disclosure.

Minimum number of additional ordinary shares

25. Some stakeholder feedback included a request for the disclosure of the minimum number of additional ordinary shares in addition to the maximum number ie disclosure of a range of additional ordinary shares that could be issued. The staff think that the calculation of both the maximum and minimum number of additional ordinary shares that could be issued would need to factor in a number of assumptions in order for the calculations to be applied consistently in practice.

26. Having different assumptions for determining the maximum and minimum numbers respectively (and which may also be different from the assumptions used in the DEPS calculation) would add more complexity for both preparers and users of financial statements. We also question the merit and usefulness of calculating and disclosing the minimum number of additional ordinary shares that could be issued when the possibility always exists that options will not be exercised regardless of the assumptions being used. Nevertheless, given the feedback, the staff asked users of financial statements whether they would find the disclosure of the minimum number as well as maximum number of additional ordinary shares useful.

27. Most investors said that the minimum number of additional ordinary shares would be less informative and would therefore not really provide useful information. An

investor said that requiring both minimum and maximum number of additional ordinary shares might encourage a company to imply in its financial statements that it will likely only issue the minimum number of additional ordinary shares, which could, in turn, reduce the transparency of the disclosures.

28. Based on the feedback received, the staff are of the view that disclosure of the minimum number of additional ordinary shares would not provide useful information and should therefore not be required.

Information about potential reductions in the number of shares in issue

29. Some stakeholders said potential share redemptions or repurchases could also be considered in the reconciliations as it may also be useful to users of financial statements to understand the maximum potential ordinary share reductions as they analyse the performance of an issuer.

30. The staff think it would be relevant to reduce the maximum number of additional ordinary shares with the total number of shares that will be redeemed or repurchased. This would still be in line with the objective of these disclosures which is to show the maximum dilutive effect. The staff note however, that this would also be different from the treatment of written put options in the DEPS calculation. Under IAS 33, contracts that require the entity to repurchase its own shares are reflected in the calculation of DEPS only if the effect is dilutive. The bonus element is calculated and *added* to the denominator in calculating DEPS (see paragraph A1(l) of this paper.)

31. An investor acknowledged that disclosing the number of shares subject to potential redemption would be useful but said it would be more useful to disclose the existence of any buyback programme and any restrictions placed on buying back shares.

32. The staff think that information about future share buybacks is relevant to understanding potential dilution of ordinary shares. As the objective of this disclosure is to show the *maximum* dilutive effect (ie entities are required to disclose the *maximum* number of ordinary shares they *could be required* to issue), with regards to share buybacks, entities should disclose the *minimum* number of

ordinary shares they are *required* to repurchase. This will provide an overview of the maximum number of additional ordinary shares net of what 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).

33. If the entity has not contractually committed to specific terms of repurchase but only has the intention to repurchase shares, narrative disclosure should be provided of the details of such plans. Similarly, if an entity has 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 can decide not to exercise the option. Therefore, written put options should not be included in the quantitative disclosure and should only be disclosed as a narrative explanation.

Next steps

34. Subject to the Board's feedback provided in this meeting, the staff plan to further analyse some aspects of the disclosure set out in the previous section for the Board's discussion at its future meeting. In particular, the staff plan to illustrate how to calculate the maximum number of additional ordinary shares that an entity could be required to issue.

Question for the Board

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

Questions for the Board
Do Board members have any comments or questions on the staff's analysis and views on potential disclosure refinements and next steps set out in this paper?

Appendix A – Summary of IAS 33 requirements for calculation of DEPS

A1. The following is a summary of the requirements in IAS 33 for calculating DEPS which the staff considered, amongst other considerations, when developing the potential disclosure refinements for the potential dilution disclosures. It is provided for information purposes only.

(a) IAS 33 only applies to the separate or individual financial statements of listed entities and the consolidated financial statements of a group with a listed parent entity.

(b) The objective of DEPS is to provide a measure of the interest of each ordinary share in the performance of an entity while giving effect to all dilutive potential ordinary shares outstanding during the period. These potential ordinary shares are weighted for the period they are outstanding.

(c) Potential ordinary shares are treated as dilutive when, and only when, their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations. To maximise the dilution of basic earnings per share, each issue or series of potential ordinary shares is considered in sequence from the most dilutive to the least dilutive.

(d) The number of ordinary shares that would be issued on conversion of dilutive potential ordinary shares is determined from the terms of the potential ordinary shares. When more than one basis of conversion exists, the calculation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential ordinary shares.

(e) For the purpose of calculating DEPS, 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.

(f) 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.

(g) Convertible preference shares are antidilutive whenever the amount of the dividend on such shares declared in or accumulated for the current period per ordinary share obtainable on conversion exceeds basic earnings per share. Similarly, convertible debt is antidilutive whenever its interest (net of tax and other changes in income or expense) per ordinary share obtainable on conversion exceeds basic earnings per share.

(h) IAS 33 has specific requirements for contingently issuable shares and contingently issuable potential ordinary shares. The number of contingently issuable shares included in the DEPS calculation is 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. If the number of ordinary shares contingently issuable depends on the future market price of the ordinary shares, the calculation of DEPS is based on the number of ordinary shares that would be issued if the market price at the end of the reporting period were the market price at the end of the contingency period.

(i) Employee share options with service conditions are treated as options 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.

(j) When an entity has the option to settle a contract in shares or cash, the entity shall presume that the contract will be settled in ordinary shares, and the resulting potential ordinary shares shall be included in DEPS if the effect is dilutive. Where the choice of settlement is at the holder's option, the more dilutive of cash settlement and share settlement shall be used in calculating DEPS.

(k) Contracts such as purchased put options and purchased call options are not included in the calculation of DEPS because including them would be antidilutive.

(l) Contracts that require the entity to repurchase its own shares, such as written put options and forward purchase contracts, are reflected in the calculation of DEPS if the effect is dilutive. The bonus element is included in the calculation. It shall be assumed that sufficient ordinary shares will be issued (at the average market price during the period) to raise proceeds to buy back the ordinary shares. The difference between the number of ordinary shares assumed issued and the total number of ordinary shares bought back is the bonus element.