The Corporate Reporting Users' Forum

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Dear Michael

***"Simplifying"* Earnings per Share**

The Corporate Reporting Users' Forum (CRUF) welcomes the opportunity to comment on the Exposure Draft, *Simplifying Earnings per Share*. We would also like to thank you for taking the time to present the issues to us at one of our recent meetings.

MAJOR POINTS

While we are happy to comment on the Exposure Draft for the proposed amendments to IAS 33, we don't believe that the existing standard is currently leading to material issues affecting user understanding of corporate reporting. We note that an alternative view on the proposed amendments has been provided by Steve Cooper in the Exposure Draft and we agree with this alternative view. In addition, the IASB is currently involved in a significant project with the FASB on the classification of debt and equity, where we commented separately. The outcome of this project may have a very material impact on EPS calculation and so we suggest it would be worth delaying deliberations until then. In particular, our proposal to define "Equity Participating Instruments" as those which participate without upward limit to increases in the value of the business would create a definition, which would be more consistent with deriving fully diluted earnings per share numbers. In our view it would deliver an economically meaningful underlying "earnings per common stock equivalent". Whilst we understand that the Boards have recommended that staff only pursue the "Basic Ownership" and "Perpetual" instrument models, we would again encourage the boards to review their position.

We were disappointed that there was no real attempt to discuss how analysts use EPS in this exposure draft. We believe that a clear understanding of this is critical to the issue at hand. Any attempt to define EPS which does not deliver a useful "denominator" is doomed to fail. We summarise our understanding below.

- Analysts use EPS as an important input into valuation metrics; in particular the PE ratio. However, it plays little or no role in other metrics e.g. EV / EBIT.
- The objective for analysts is to obtain a 'clean' or 'underlying' EPS calculation where comparability is key. This comparability is important both in terms of a time series for a particular company and as an input to valuation metrics which are compared between companies in the same sector and across the market.
- There is little universal agreement about exactly how to calculate an underlying EPS measure so analysts tend to derive their own. Even within an investment house adjustments can vary widely from sector to sector. *Good disclosure* is therefore required to enable analysts to construct an underlying EPS measure that suits their needs.
- Few analysts will make complex adjustments to EPS unless the impact is highly material and where information is clear and available.
- Diluted EPS is usually more important than basic EPS for analysts as they attempt to assess the upside for other participants in equity on a forward looking basis.

Our responses to the questions below therefore focus on how the changes will affect analysts' ability to use and interpret EPS in their analysis.

SPECIFIC QUESTIONS

Question 1—Mandatorily convertible instruments and instruments issuable for little or no cash or other consideration

Paragraphs 18 and 19 of the exposure draft propose that the weighted average number of ordinary shares should include only instruments that give (or are deemed to give) their holder the right to share currently in profit or loss of the period. If ordinary shares issuable for little or no cash or other consideration or mandatorily convertible instruments do not meet this condition, they will no longer affect basic EPS.

(a) Do you agree that the weighted average number of ordinary shares for basic EPS should include only instruments that give (or are deemed to give) their holder the right to share currently in profit or loss of the period? Why or why not?

(b) Does the exposure draft apply this principle correctly to mandatorily convertible instruments and ordinary shares issuable for little or no cash or other consideration? Why or why not?

1.1 This question would become irrelevant were our definition of equity to be used as the denominator would become common stock equivalents. Basic EPS is often regarded as less useful than diluted EPS by analysts, in our opinion. We expand on this in the answer to Question 6.

1.2 Ignoring the equity definition debate, we agree that the denominator for basic EPS should include only instruments that give their holder the right to share *currently* in profit for the period. This is consistent with the objective that basic EPS provides a measure of the interests of each ordinary share in the performance of the entity for that period. In addition this change will enhance comparability between companies reporting under IFRS and US GAAP.

1.3 We agree that the application of the principle to mandatorily convertible instruments and shares issuable for little or no cash or other consideration is consistent with the objective that basic EPS includes instruments giving the right to share currently in profit for the period.

Question 2—Gross physically settled contracts to repurchase an entity's own shares and mandatorily redeemable ordinary shares

Paragraphs A31 and A32 of this exposure draft propose clarifying that an entity treats ordinary shares that are subject to a gross physically settled contract to repurchase its own shares as if the entity had already repurchased the shares. Therefore, the entity excludes those shares from the denominator of the EPS calculation. To calculate EPS, an entity allocates dividends to the financial liability relating to the present value of the redemption amount of the contract. Therefore, the liability is a participating instrument and the guidance in paragraphs A23–A28 applies to this instrument. However, such contracts sometimes require the holder to remit back to the entity any dividends paid on the shares to be repurchased. If that is the case, the liability is not a participating instrument.

The Board proposes that the principles for contracts to repurchase an entity's own shares for cash or other financial assets should also apply to mandatorily redeemable ordinary shares.

Do you agree with the proposed treatment of gross physically settled contracts to repurchase an entity's own shares and mandatorily redeemable shares? Why or why not?

2.1 We agree with the proposed treatment for gross physically settled contracts to repurchase an entity's own shares and mandatorily redeemable shares as this is consistent with the principle of ensuring a link between the financing of the resources to generate earnings and the number of participating shares.

Question 3—Instruments that are measured at fair value through profit or loss

For an instrument (or the derivative component of a compound instrument) that is measured at fair value through profit or loss, paragraphs 26 and A28 propose that an entity should not:

(a) adjust the diluted EPS calculation for the assumed exercise or conversion of that instrument; or

(b) apply the guidance for participating instruments and two-class ordinary shares in paragraphs A23–A28.

Do you agree that the fair value changes sufficiently reflect the effect on ordinary equity holders of instruments measured at fair value through profit or loss and that recognising those changes in profit or loss eliminates the need for further adjustments to the calculation of EPS? Why or why not?

3.1 This seems to pre-judge the equity definition as not including those instruments which give holders "equity participation", which is how we defined it in our response on the DP on Financial Instruments with the Characteristics of Equity.

3.2 Putting this to one side, we agree that fair value changes reflect the effect on ordinary equity holders of instruments measured at fair value through profit or loss. However, we note that this method would reduce available information about the number of shares that would be issued upon conversion of these instruments and therefore believe it may be a retrograde step for use in an EPS calculation. At the very least additional disclosures should be required to reflect this. In addition, we are concerned that some users may be inclined to remove the volatile fair value changes in calculating underlying EPS without a commensurate change to reflect the potential dilution from these instruments.

3.3 This is reflected in our response to Q6 where we recommend that listed companies provide the disclosure of the equity participating instruments that we suggested. In this letter we illustrate disclosure that would help users to define an economically meaningful earnings per share number where we would require analysis of all fair value movements on the participating instruments.

Question 4—Options, warrants and their equivalents

For the calculation of diluted EPS, an entity assumes the exercise of dilutive options, warrants and their equivalents that are not measured at fair value through profit or loss. Similarly, paragraph 6 of this exposure draft proposes clarifying that to calculate diluted EPS an entity assumes the settlement of forward contracts to sell its own shares, unless the contract is measured at fair value through profit or loss. In addition, the boards propose that the ordinary shares arising from the assumed exercise or settlement of those potential ordinary shares should be regarded as issued at the end-of-period market price, rather than at their average market price during the period.

(a) Do you agree that to calculate diluted EPS an entity should assume the settlement of forward sale contracts on its own shares in the same way as options, warrants and their equivalents? Why or why not?

(b) Do you agree that ordinary shares arising from the assumed exercise or settlement of options, warrants and their equivalents should be regarded as issued at the end-of-period market price? Why or why not?

4.1 We agree that diluted EPS should assume the settlement of forward sales contracts on own shares as this is consistent with the treatment for similar instruments. We would point out that if our definition of equity were used there would only be one definition of EPS required, removing the necessity to calculate separate basic and diluted EPS.

4.2 Whilst we would prefer the use of an average share price, we do agree that assumed exercise or settlement of options, warrants and their equivalents at end-of-period market price is also appropriate as you can only buy or sell a share at a point in time. However, we note that this amendment will result in diluted EPS being more sensitive to share price volatility. We would therefore prefer both measures to be disclosed for listed entities as this will ensure users understand these variances better.

Question 5—Participating instruments and two-class ordinary shares

Paragraph A23 proposes to extend the scope of the application guidance for participating instruments to include participating instruments that are classified as liabilities. In addition, the Board proposes to amend the application guidance for participating instruments and two-class ordinary shares. The proposed application guidance would introduce a test to determine whether a convertible financial instrument would have a more dilutive effect if the application guidance in paragraph A26 and A27 for participating instruments and two-class ordinary shares is applied or if conversion is assumed. The entity would assume the more dilutive treatment for diluted EPS. Also, the amended application guidance would require that, if the test causes an entity to assume conversion of dilutive convertible instruments, diluted EPS should reflect actual dividends for the period. In contrast, diluted EPS would not include dividends that might have been payable had conversion occurred at the beginning of the period. Do you agree with the proposed amendments to the application guidance for participating instruments and two-class ordinary shares? Why or why not?

5.1 We note that this prejudges the outcome of the DP on Financial Instruments with the Characteristics of Equity.

5.2 We agree with the extended scope of the application guidance to include participating instruments that are classified as liabilities for the purpose of basic EPS as this will ensure consistency of treatment by preparers.

5.3 We agree with the proposed application guidance for participating instruments and two-class ordinary shares as this is consistent with the objective to include the effect of dilutive potential ordinary shares by reflecting the more dilutive treatment.

Question 6—Disclosure requirements

The Board does not propose additional disclosures beyond those disclosures already required in IAS 33.

Are additional disclosures needed? If so, what additional disclosures should be provided and why?

6.1 As noted in our introductory comments, good disclosure is key to enabling analysts to construct an underlying EPS measure that suits their needs, particularly in relation to the potential effects of different classes of instrument on the weighted average number of shares.

We therefore believe that disclosure of the period end number of shares that would be issued on conversion or exercise of each class of instrument is essential, regardless of their effect on the diluted EPS calculation. This is particularly applicable where instruments are measured at FVTPL or the dilutive potential of convertible instruments is calculated under paragraphs A26 and A27, since, in both of these situations, conversion is not assumed.

6.2 Current disclosure requirements for the fully diluted number of shares only make reference to the weighted average number of shares outstanding. We believe that it would also help users in forecasting to know the period end full diluted share count.

6.3 Below is an extract from our Equity letter and the disclosure desired to calculate a meaningful EPS. We highlight that this disclosure (bold) would still be relevant to users whatever definition of Equity is finally determined as it would allow us to make adjustments that describe the interaction between the equity participations when performing our valuations.

Definition
Equity participations are those financial instruments issued by the entity which participate without upward limit in the proceeds of a disposal of the reporting entity or a business within the entity.

All other financial instruments shall be within the scope of IAS 39.

Recognition
Equity participations shall be recognised when issued.

Where a financial instrument or other contract contains an equity participation component, that component shall be separated at inception.

Initial and subsequent measurement
Equity participations shall be carried at the fair value of the instrument on issue and shall not be re-measured.

Derecognition
Equity participations shall be derecognised when they are extinguished or they expire.

Disclosure
Disclosure in the notes should be in tabular form and be adequate to distinguish material variations in rights and returns of all equity participations including but not limited to: votes, liquidation preference, dividends, optional and mandatory cash flow commitments,

proportionate share in gains and losses, and any other terms of derivative instruments (including expected lapse rates for employee stock options).

The notes shall also contain an analysis of equity participations issued and redeemed during the year.

The disclosure regarding mandatory cash flow commitments, where an equity participation is payable at a date that is not wholly within the discretion of the board to defer until liquidation of the entity, must include the current fair value and expected payment date of each class of instrument. Fund raising plans should be explained if settlement is expected to require the entity to arrange additional sources of finance.

Additional disclosure for quoted companies should include the fair value of each derivative either directly or derived from quoted market prices, with a sensitivity analysis indicating how the fair value will move with price changes in the underlying equity instrument. Quoted companies should also disclose EPS where the number of shares in issue is a derived "common stock equivalent" total reflecting the average or median fair values of all equity instruments during the period.

6.4 Below is a suggested format for the disclosure to enable users to calculate a Common Stock Equivalent which is economically meaningful. We would suggest that this disclosure is given whether or not Equity is ultimately defined in line with our proposal.

Statement of equity participating interests

		Listed companies only							Cash flow maturity		
Instrument	**Note**	**Period average fair value**	**Common stock equivalents (based on avg price)**	**Balance sheet date fair value**	**Delta at BS date fair value**	**Contractual cash flows**	**Cash flows at holders discretion**	**Cash flows at company's discretion**	**1 year**	**2-5 years**	**5-10 years**
		CU'm	'm	CU'm		CU'm	CU'm	CU'm	CU'm	CU'm	CU'm
Common stock	A	2,340	1,100	2,550	1	-	-	-	-	-	-
Other perpetual security	B	330	145	390	1.05	-	-	-	-	-	-
Forward purchase of common stock	C	-65	-31	-75	1	-245	-	-	-245	-	-
Written put option on common stock	D	43	20	36	0.75		-350			-350	
Employee stock options group 1	E	95	45	150	0.65		160			160	
Employee stock options group 2	F	84	39	145	0.5			-230		-230	
Conversion option for 4% 2012 converible bond	G	22	10	29	0.6						
Puttable shares											
Forward sale of common stock											
Total equity		**2,849**	**1,329**	**3,225**							

Use for EPS calculation*

Notes: Give description of each security that enables investors in the common shares to understand the impact of the security on their investment and the effect on future cash flows, including details about rights, cash flows, optionality, settlement features, maturity, distributions, fair value calculation (if co. is listed), delta at different common stock prices, etc

*** Single EPS calculation based on total of common shares plus common share equivalents. Scrap existing diluted eps calculation altogether.**

About the Corporate Reporting Users' Forum

The CRUF was formed in 2005 as a discussion forum with the aim of helping its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of the International Accounting Standards Board.

The CRUF is a discussion forum. Its participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. It does not seek to achieve consensus views, though at times its participants will agree to make joint representations to standard setters or to the media.

CRUF participants include individuals from both buy and sell-side institutions, and from both equity and fixed income markets. The forum includes individuals with global or regional responsibilities and from around the world. The CRUF meets on a regular basis in London, Frankfurt and Sydney with facilities for remote participation.

Yours sincerely

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