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Exposure Draft Proposed Amendments to Simplifying Earnings Per Share Proposed Amendments to IAS 33

Grant Thornton International is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft Simplifying Earnings Per Share Proposed Amendments to IAS 33 (the ED). We have considered the ED, as well as the accompanying draft Basis for Conclusions.

We support the Board's efforts to make appropriate simplifications to the determination of earnings per share (EPS) and to reduce the differences between IFRS and US generally accepted accounting practice in this area. We believe that the ED includes a number of welcome simplification proposals. However, we also have technical concerns over some of the proposals and believe that the clarity and structure of the ED as a whole should be enhanced.

Our responses to the questions in the ED's Invitation to Comment are set out below.

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?

Before turning to the specific questions, we comment that we believe that paragraphs 15-20 (addressing the denominator in the basic EPS calculation) should be expressed more clearly. In particular, we believe these paragraphs do not distinguish adequately between (i) the circumstances in which basic EPS is determined for more than one class of share (or participating interests); and (ii) how to calculate the number of shares (or participating interests) to include in the denominator for the EPS calculation.

We have the following specific comments with regard to clarity:

- Paragraph 17 addresses the timing of inclusion of ordinary shares and states that such shares are included from the date the holder has the right to share currently in profit or loss for the period. This would normally be the date from which the holder of a share (or right to a share) is entitled to receive dividends. However, the specific application guidance in A8-9 is largely unchanged from current IAS 33. That guidance generally requires that shares are included from the date the consideration is receivable. It is not therefore evident that the guidance in A8-9 is consistent with the new principle as described.
- Paragraph 18 is unclear and confusing for a number of reasons. We recommend that this paragraph is redrafted (and possibly) repositioned to explain that its purpose is to set out types of instrument that trigger a requirement for more than one basic EPS calculation (in accordance with the two-class method). In addition:
  - this paragraph refers to 'instruments that give the holder the right to share in profit or loss for the period'. The word 'currently' does not appear. Consequently, it is not clear that this aspect of the principle described in the above question is faithfully reflected in the text of paragraph 18;
  - paragraph 18 purports to address the weighted number of ordinary shares outstanding (or at least the instruments that an entity must 'consider' in determining that amount). In fact this paragraph, when read in conjunction with the draft Application Guidance at A23 to A28, sets out some types of instrument for which discrete basic EPS calculations are required (in accordance with the two-class method).
- Paragraph 23 of existing IAS 33, which refers to mandatorily convertible instruments, has been deleted without replacement. The ED itself therefore makes no reference to such instruments. However BC11 of the ED explains the Board's view of the consequences its proposals would have for such instruments. We suggest that the Board should consider whether the guidance in BC 11 should be promoted into the Standard itself (perhaps the Application Guidance).

Turning to the substance of the proposals, we are concerned that the Board has not made a robust case for treating 'mandatorily convertible instruments' (excluded from the denominator) differently to 'ordinary shares issuable for little or no cash or other consideration' (included). The exclusion of the former is on the grounds that these instruments do not give the holder the right to share currently in profit or loss with ordinary shareholders (BC11-12). However, it seems to us that ordinary shares issuable for little or no cash or other consideration do not confer such a right either - they are merely deemed to do so for the purpose of the ED. We find this approach unsatisfactory - to 'deem' that a principle is met when it is not surely undermines the purpose of the principle? The most straightforward way to achieve this would be to delete paragraph 19 and therefore determine basic EPS using the number of shares actually in issue.

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?

We find the Board's proposals for gross physically settled contracts to repurchase an entity's own shares and mandatorily redeemable shares somewhat tortuous.

With regards to gross physically settled contracts, it would be simpler and more consistent with the proposed principle to <u>include</u> the related shares in the denominator for the basic EPS calculation. Any interest expense recognised in respect of the recorded liability (ie the unwinding of the discount on the liability recognised for the redemption amount in accordance with paragraph 23 of IAS 32 Financial Instruments: Presentation) would need to be added back to earnings under such an approach. No adjustment would be required in relation to dividends.

However, we also understand that IAS 32 treats these instruments as if they have already been exercised. We therefore acknowledge that there is a case for taking the same approach for EPS purposes. Even under such an approach, we have the following concerns with the requirements as expressed in A31-32:

- The reference in A32 to allocation of dividends to the liability is confusing. If the intention is that such dividends should be deducted from earnings, the final Standard should express this more clearly. However, if the shares had been repurchased, those dividends would not have been paid. It is not therefore evident that such an adjustment contributes to a more meaningful EPS figure.

- We disagree that the allocation of dividends to the liability makes the liability a participating instrument. The instrument is a contract to acquire own shares which is unlikely to meet the definition of that term at paragraph 6. Moreover, the application of A24 (concerning the calculation of basic EPS for participating instruments) to these instruments is unclear. Specifically, are both the interest on the recognised liability and the dividends on the (as yet unpurchased) shares allocated to the participating instrument? We recommend that an example is added to the Illustrative Examples to clarify the intended treatment.

Regarding mandatorily redeemable shares, we note that such instruments are generally treated as liabilities in accordance with IAS 32. Payments of dividends and the redemption amount will be taken into account in determining the effective interest expense in accordance with IAS 39. Such instruments may or may not meet the proposed definition of participating instruments. Either way, it is not clear to us that it is necessary or appropriate to treat instruments that are reported as liabilities as an additional class of ordinary share for basic EPS purposes.

The ED does not appear to differentiate between mandatorily redeemable shares presented as liabilities and those presented as equity instruments (ie that meet the conditions in IAS 32 paragraphs 16A-16B). In the latter case, we believe the redeemable shares in question will usually be the only class of instrument classified as equity. If so, we are not convinced that there is any need for a two-class approach.

We also note that paragraphs A31-32 do not refer to mandatorily redeemable 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?

We agree.

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?

We agree. We see no reason to treat forward sale contracts on own shares differently from options, warrants and their equivalents.

(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?

We agree. Using the end-of-period market price will simplify the calculation of diluted EPS and would appear to be equally valid in the context of a rule governing a hypothetical calculation.

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?

We agree with the proposed approach for two-class ordinary shares and participating instruments classified as equity.

For participating instruments classified as liabilities, we are not convinced that the two-class approach is necessary or appropriate. In these cases, basic 'earnings' will be reported after deduction of the financing expense relating to the instrument. The ED and its Basis for Conclusions do not explain why any further allocation or adjustment is necessary or contributes to a more meaningful EPS amount.

In addition, we note that paragraph 58 requires the presentation of EPS for each class of ordinary shares that has a different right to share in profit for the period. Accordingly, it appears that the purpose of an EPS calculation for participating instruments is to attribute earnings to ordinary shares (rather than for separate display). If this is indeed the Board's intention, we recommend that the point is clarified.

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?

Do you agree with the proposals? If not, why?

We agree.

Other comments

We have some other minor comments and suggestions as follows.

Definitions - we suggest that a definition of 'preference shares' should be added. These should be defined in a manner that distinguishes them from 'participating instruments'. Also, we believe the definition of ordinary share would be better expressed as: 'an equity instrument to which no other class of equity instruments is subordinate'.

Illustrative Example D.1 - this purports to illustrate the treatment of ordinary shares issuable for little or no cash or other consideration but actually addresses contingently issuable shares.

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If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gtuk.com or telephone + 44 207 391 9510).

Yours sincerely,

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