FAR SRS

The institute for the accountancy profession in Sweden

International Accounting Standards Board
30 Cannon Street
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2nd December 2008

**Exposure Draft on Simplifying Earnings per Share, Proposed amendments to IAS 33**

FAR SRS, the Institute for the Accountancy Profession in Sweden, is responding to your invitation to comment on the *Exposure Draft on Simplifying Earnings per Share (EPS), Proposed amendments to IAS 33.*

FAR SRS sees a need for further improvements of IAS 33, beyond the improvements of the current exposure draft, and understands that effects from the outcome of projects such as that on liabilities and equity may have an impact on possible conclusions regarding EPS-issues. Having reached this point in the EPS project it is desirable that it is completed. FAR SRS would be pleased to see a future more fundamental review of IAS 33.

FAR SRS' main concern regarding the exposure draft concerns the fair value method, which in our view introduces a logical inconsistency and reduces both the usefulness and comparability of diluted earnings per share. FAR SRS' conclusion on this method is that the benefit of the simplifying aspect does not outweigh the costs incurred in the form of reduced usefulness.

For gross physically settled contracts to repurchase an entity's own shares and mandatorily redeemable ordinary shares, FAR SRS is concerned about the calculation of dilution, since the logic of the reverse treasury share method seems to have been eliminated. More comprehensive disclosures of characteristics of potential ordinary shares are also an issue that is given some space.

Apart from these issues a number of comments of a more detailed nature related to the six questions are discussed in the attached appendix. At the end of the appendix some further concerns are raised, among other things on whether the paragraph on inclusion of future services in assumed proceeds has received an unintended change in meaning.

FAR SRS

Göran Arnell

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*Chairman Accounting Practices Committee*

## Appendix 1

### *Question 1 – Mandatorily convertible instruments and instruments issuable for little or no cash or other consideration*

FAR SRS agrees with the approach described in the first sentence of BC10, which appears to indicate that the line between BEPS and DEPS should be drawn between instruments that have a right to share in profit or loss of the current period and those instruments that do not yet have such a right. It seems plausible also to include instruments that are deemed to give the holder a right to share in profit or loss on the BEPS-side of such a line, since it is highly probable that those instruments will actually share in profit or loss on the day that the right to receive dividends is separated from the ordinary share.

It is, however, not clear how the use of "currently" should be interpreted in paragraphs 17 and 19 of the ED. One question concerns whether "currently" means at the end of the reporting period or when the report is authorised for issue. A related question concerns whether "currently" is an important part of paragraph 17 or if it is tautological, given the reference to "...from the date the holder of the shares has the right..." in the beginning of the sentence.

Apart from the above questions, FAR SRS agrees with the basic principle for calculating the basic weighted average number of shares and with the treatment of mandatorily convertible instruments and instruments issued for little or no cash or other consideration.

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

Taking gross physically settled contracts to repurchase an entity's own shares and mandatorily redeemable ordinary shares into account in calculating BEPS appears consistent with the introduced basic principle for determination of the basic number of outstanding shares; shares and other instruments that have (or are deemed to have) a right to share in profit or loss should be included. It seems reasonable that these shares are taken into account with the two-class method. Based on these impressions FAR SRS agrees with the proposed calculation of BEPS.

FAR SRS also agrees with the exclusion from BEPS-calculations of contracted shares that do not have a right to keep any dividends paid. This is also consistent with the basic principle mentioned in the previous paragraph.

FAR SRS, however, is concerned that with the proposed amended IAS 33, gross physically settled contracts to repurchase an entity's own shares and mandatorily redeemable ordinary shares do not seem to affect DEPS, even if the contracted repurchase/redemption price is higher than the prevailing share price. There does not seem to be any requirement in A23-A28 referring to dilution of these types of contracts. Although these contracts cannot be converted into ordinary shares they involve transactions with ordinary shares and the level of profit or loss per ordinary share should be expected to be reduced after the entity has repurchased the shares at a higher price than the prevailing share price. This reasoning is consistent with the logic of the still included treasury share method and with the reverse treasury share method that has been eliminated in the ED.

Therefore FAR SRS suggests that additions or clarifications are made to the proposed amended IAS 33 so that the dilutive effects – from a higher repurchase price than prevailing share price – of the mentioned contracts are not foreseen. The idea incorporated in IAS 33.63 (the reverse treasury share method) should not be lost in the amended IAS 33.

### *Question 3 – The Fair Value Method*

FAR SRS is of the opinion that the fair value method for instruments that are measured at fair value through profit or loss reflects dilution in a way that significantly reduces the usefulness of the DEPS-measure. The underlying problem in FAR SRS' view is that the purpose of calculating and presenting diluted earnings per share is not sufficiently developed.

The comments below are divided into three different areas, with the opinions of FAR SRS expressed as a conclusion in connection with each area.

- The first area relates to the different treatment of equity- and cash-settled instruments. A short discussion on whether instruments with a settlement choice should be treated consistently with one of those two types of instruments is presented.

- The second area may be considered as the core of the answer to the question regarding the fair value method. In this section the opinion is put forward that the inner logic of the fair value method is less useful than that of the treasury share method.

- In the third section the question of whether the fair value method is consistent with the standard's definition of dilution or not is addressed.

*Settlement in equity instruments, cash or a choice of equity instruments and cash*

There appears to be a number of choices that are involved in the problem. In order to find a structure it may be useful to relate to three types of outstanding call options: equity-settled options, cash-settled options, and options with a possibility to choose settlement in cash or equity instruments. The dilutive effect of equity-settled options is taken into consideration with the treasury share method. Cash-settled options are not potential ordinary shares and are consequently excluded from calculations of DEPS.

A question is then if options with a choice of settlement should be dealt with consistently with equity-settled or cash-settled options. However, the answer in the ED is surprisingly a mix. Options with a choice of settlement are similar to equity-settled options to be taken into account in connection to the DEPS-concept, but the method suggested results in an effect that is the same as that for cash-settled options (i.e. DEPS = BEPS).



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*Opinions/conclusions on "Settlement in equity instruments, cash or a choice of equity instruments and cash":*

- FAR SRS finds that options with a choice of settlement and other potential ordinary shares measured at fair value through profit or loss should either be excluded from the definition of instruments that may be dilutive (which may require changes to the concept of 'potential ordinary shares') or be required to be treated in a way that is consistent with the treasury share method. The latter part of this opinion is further developed below.

- Alternatively, a fundamental review of the idea of potential ordinary shares could be considered. It might e.g. be the case that all instruments whose value are based on the price of the entity's shares should be considered potentially dilutive and be dealt with in a consistent way, since the wealth of current holders of ordinary shares is equally diluted regardless of whether the options are settled in equity instruments or cash.

*The inner logics of the fair value and treasury share methods are inconsistent*

The treasury share and if-converted methods produce a DEPS-measure that can be used as an indicator of the *value* of the shares. This DEPS-measure can be used as an indicator of value creation that can be extrapolated into the future in order to estimate a share value; e.g. with a p/e-ratio approach. Ideally, the methods should be based on the fair value of the potential ordinary shares; but the current methods still produce a DEPS-measure that gives an indication of the *value* of the share. Relating to academic association studies, it might be possible to say that these methods create a DEPS-measure that is focused on EPS as an explanatory variable for the *value* of the share.

The problems connected to the fair value method relate to the fact that it introduces a method that reflects dilution with reference to the *change in share value* during the period. The method creates a DEPS-measure that incorporates the period's change in wealth of existing owners of ordinary shares. If the value of dilutive options has increased (decreased) during the period, an expense (income) has been recognised in profit or loss for this change in value and both BEPS and DEPS has been reduced (increased) with this change in value. Relating to academic association studies, it might be possible to say that this method creates a DEPS-measure that is focused on EPS as an explanatory variable for the *change in value* of the share (i.e. the share return).

Several negative effects from the introduction of the fair value method's focus on the current period's change in value can be identified:

- If users of financial reports tend to use EPS as an indicator of possible future value creation (e.g. in a p/e-ratio approach), the fair value method introduces an error that users will need to adjust DEPS for. Our impression is that users tend to view EPS as such an indicator of future value creation. In this respect the fair value method would *reduce the usefulness of DEPS.*



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- DEPS will be a product of mixed approaches to EPS as an indicator of value or change in value. Users will be confused as to how to understand the purpose of DEPS and the DEPS-measure will not be good for any of the two approaches. FAR SRS would prefer the use of methods for calculation of DEPS that is consistently focused on one of the purposes; preferably the existing (implicit) value creation purpose.

- Entities with options that are equity-settled cannot be compared with entities with options that can be settled in either cash or equity instruments, although both types of options meet the definition of potential ordinary shares. Option programmes with potential ordinary shares that are otherwise identical will produce totally different DEPS-numbers. In this respect the fair value method would *reduce the comparability of DEPS.*

*Conclusion/opinion on "The inner logics of the fair value and treasury share methods are inconsistent":*

FAR SRS finds that the benefit in the simplifying characteristic of the fair value method does not outweigh the above presented costs. FAR SRS suggests that the fair value method is not added to IAS 33 and that the existing paragraphs on contracts that may be settled in ordinary shares or cash continue to be used in some form.

*The definition of dilution*

FAR SRS believes that the underlying idea of DEPS should be more thoroughly elaborated on. Only then can useful and consistent approaches to dilution be developed. Inspiration might be found in the basis for conclusions in the existing SFAS 128 (SFAS 128.93-94), although that discussion could probably also be carried further.

The existing and amended versions of IAS 33 do not elaborate much on the purpose of DEPS. In the proposed amendment's paragraph 25 is stated "...while giving effect to the dilutive potential ordinary shares...". This statement gives no indication on what kind of effect is aimed at. However, in the definition paragraph (p. 6 in the ED) the following can be found:

> "*Dilution* is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, options or warrants are exercised, and forward contracts are settled or ordinary shares are issued upon the satisfaction of specified conditions."

*Conclusion/opinion on "The definition of dilution":*

Although the underlying reasons for using this definition are not clear, it appears to FAR SRS that the fair value method is not consistent with this definition. FAR SRS would prefer that the fair value method is withdrawn and that the above definition is not changed to something vaguer that could incorporate the inner logic of the fair value method.



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### *Question 4 – Options, warrants and their equivalents*

FAR SRS agrees with using the treasury share method also for forward contracts to sell its own share and with using the end-of-period market price in the treasury share method. Regarding the end-of-period market price FAR SRS believes that simplification is not the only advantage. This change will also improve the quality of DEPS in its possible use in prediction of future value creation (as e.g. in a p/e-ratio). Average market price during the period is usually a poorer proxy than end-of-period market price of dilution at the share valuation date. It is not obvious that average market price should be theoretically justified just because profit or loss was generated over the whole reporting period. Consequently, FAR SRS also agrees with the proposal to use the end-of-period market price.

### *Question 5 – Participating instruments and two-class ordinary shares*

FAR SRS agrees with the requirements for participating instruments and two-class ordinary shares. Some concerns regarding pedagogical aspects of paragraphs A23-A28 can, however, be expressed.

Paragraphs A23-A28 in the application guidance probably belongs to the percentile of paragraphs within IFRSs that are most difficult to comprehend. Fortunately, Illustrative Example D.3 casts some light on some issues. The paragraphs should, however, be able to stand more for themselves and IE.D.3 does not clarify all questions. Therefore, FAR SRS believes that it would be worth developing a more clear structure for the requirements in A23-A28.

It is possible that the following examples of possible areas for clarification are more or less implicitly understood in the current formulation of the text, but it is probably still worth considering a new structure that makes them easier to understand.

- Should DEPS always be calculated for a second class of ordinary shares and participating instruments; also e.g. when such instruments are convertible into the first class of ordinary shares and DEPS for the first-class shares are calculated under the assumption that convertible second-class ordinary shares or participating instruments are converted?

- How should DEPS be calculated for a second class of ordinary shares or participating instruments when such instruments are convertible? The requirements in paragraph A26 do not explicitly refer to the first class of ordinary shares, but the illustrative example indicates that this paragraph concerns DEPS for the first class of ordinary shares. The impression of the illustrative example is that DEPS for the second class of ordinary shares should always be calculated based on paragraph A25. If this is true, it may be worth expressing more clearly.

- The requirements in paragraph A24 are to be applied to instruments described in paragraph A23. It seems that paragraph A23 describes participating instruments and ordinary shares with a different dividend rate. The first class of ordinary shares does not seem to be included in paragraph A23, but it appears that paragraph A24 should still also be applied to the first class of ordinary shares.



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- Where can the general requirements for calculating DEPS for the first class of ordinary shares be found? Paragraph A25 seems to refer only to participating instruments and ordinary shares with a different dividend rate. Paragraph A26 seems to relate to the first class of ordinary shares, although not explicitly so. But paragraph A26 seems like a special case paragraph that does not need to be taken into consideration when no convertible participating instruments or second class of ordinary shares exist.

- The essence of paragraph A25 is difficult to nail down. It might help somewhat if the first sentence makes explicit reference to paragraphs 25-55. It might also help somewhat if the first sentence is somehow given more prominence. Currently the two bullets (a) and (b) may catch too much attention.

***Question 6 – Disclosure requirements***

There is both an element of inconsistency and incompleteness in IAS 33.70 (c) and 72. The inconsistency lies in the fact that exercise prices, numbers of options and other possible conditions provide useful information regardless of whether options are currently dilutive or not. Paragraph 70 (c) requires such disclosure to some extent, whereas paragraph 72 only encourages similar information.

The incompleteness lies in non-existing requirements to provide the reader with a concise numerical summary of central elements of the fair value of all potential ordinary shares; such as number of instruments outstanding, exercise/conversion prices, time to exercise /conversion and other conditions that restrict the use and value of the instruments. To the extent that such information is already disclosed in other parts of the annual report, explicit reference to that part would be useful. This kind of disclosure would be very useful for advanced users of annual reports that e.g. prefer to prepare personal estimates of the dilutive effects of these instruments. These disclosure requirements should also be extended to include instruments that are cash-settled.

***Other comments***

*Potential unintended change in meaning of paragraph 49 (a)*

IAS 33.47A requires the value of *future* IFRS 2-services to be added to assumed proceeds when applying the treasury share method. I.e. in addition to the exercise price, employees are assumed to pay for the exercise of options by supplying services from the reporting date to the vesting date.

The changed wording in the ED (in paragraph 49 (a)) states that the amount to be added to assumed proceeds is "the fair value at the grant date of any goods or services to be supplied to the entity under the share option or other share-based payment arrangement". The reference to future services has been eliminated and the new text appears to imply that the total value at grant date, including services already supplied/received, should be added to the assumed proceeds.

FAR SRS is of the impression that this change in meaning is unintended. Example B.2 (of the ED) still refers to the amount "to be recognised over the remainder of the vesting period" and the corresponding amended paragraph in FASB's ED (p. 21 in sections A3 of



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Appendix A) states that assumed proceeds includes "the end-of-period amount of compensation cost attributed to future services and not yet recognized".

FAR SRS suggests two changes to paragraph 49 (a) in the ED:

- Addition of a reference to *future* services, so that it becomes clear that it is not the total fair value at grant date that is to be included in assumed proceeds.

- A change in the text so that it becomes clear that with future services is meant services to be received/supplied after the reporting date. The current version of IAS 33.47A opens up for the usage of either future services after the reporting date or future services as an average during the reporting period. With the new requirement to use share price at the reporting date in the treasury share method it would be natural to restrict the value of future services to those that will be received/supplied after the reporting date. Therefore FAR SRS suggests using a formulation similar to the one in paragraph 21 in Appendix A in FASB's ED to amendment of SFAS 128.

*Convertible debt and the if-converted method*

FAR SRS finds *the if-converted method* for convertible debt unsatisfactory and would like to see a stronger commitment from the boards to take on an amendment of this area. The reason for not being satisfied with the if-converted method is that it does not take into consideration the relation between the conversion price and the prevailing share price.

*The concept of dilution, an area for future consideration*

Paragraph BC9 of the ED states that the boards may conduct a more fundamental review of IAS 33 and SFAS 128 after having completed the projects on liabilities and equity, and financial statement presentation. As follows from the opinions on question 3 above, FAR SRS supports a fundamental review of IAS 33. Especially, the concept of dilution deserves being thoroughly analysed. A question that may be analysed is e.g. if dilution should refer to the effect on wealth of current holders of ordinary share. Another possible question is how the DEPS-measure should relate to being an approximation of an amount that can be used as a starting point for future value creation or that shows the change in wealth of holders of ordinary shares during the current period. This latter issue has been elaborated on above under question 3.

*Contingencies in IAS 33.52-57, another area for future consideration*

FAR SRS finds that the current method for dealing with *contingencies in IAS 33.52-57 needs to be reconsidered.* More useful information would be provided if the same approach was taken as in IFRS 2 – i.e. to use estimates of what the probable outcome will be. In an attempt to avoid the verifiability problem with such an approach, the current requirements e.g. imply that "expected" future profit or loss is set equal to zero. FAR SRS finds that the verifiability advantage of the current approach is outweighed by the usefulness advantage of the IFRS 2-approach. Furthermore, for entities that report in accordance with IFRS 2 it would be both natural and connected with no or small extra efforts to use estimates of probable outcomes.



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*Clarification of IAS 33.64*

It seems as if the wording has been changed in some paragraphs in order to enhance the way matters are expressed i.e. not always as a consequence of the changes made to accomplish convergence and simplification. FAR SRS finds that it would be useful to clarify IAS 33.64 (paragraph 56 of the ED) in two aspects in a similar way.

First, the first sentence refers to capitalisation, bonus issue, share split and reverse share split. In IAS 33.27 a bonus element in any other issue is included separately from a pure bonus issue. It would be useful to clarify that rights issues with a bonus element are also included in the requirements of IAS 33.64. Furthermore, the general paragraph IAS 33.26 could be effective for other transactions than those exemplified in IAS 33.27 e.g. a programme to repurchase own shares at a price that was higher than the prevailing share price. Therefore, FAR SRS finds that the first sentence of IAS 33.64 should refer to all transactions covered by IAS 33.26.

Second, it would be useful to clarify if the third sentence refers only to the second sentence or to both the first and the second sentence.

*Missing exclusion of instruments measured at fair value through profit or loss in proposed paragraph 30 (a)?*

Should not paragraph 30 (a) of the ED contain the same exclusion of instruments measured at fair value through profit or loss at e.g. paragraphs 29 and 30 (b)?

*Paragraphs 12 and 31 of the ED necessary?*

The necessity of paragraphs 12 and 31 of the ED may be considered. The presentation of BEPS and DEPS for profit or loss and for profit or loss from continuing operations is required by paragraph 58 (of the ED). It may be sufficient with paragraph 58, just as it already seems to be sufficient with paragraph 60 (of the ED) regarding BEPS and DEPS for discontinued operations.

*Incompleteness in paragraph 45 of the ED?*

Within parenthesis is referred to time of actual exercise or settlement. How should *forfeiture* e.g. due to failure to meet a service condition be treated? If employees end employment during a reporting period and thereby lose the right to exercise options, should those options not be included in the DEPS-calculations until employment is ended (if they were in the money)?

*Editorial mistakes in Illustrative Example D.3*

On page 96 "CU" is used in some places where it should not, and in one case "CU" is missing where it should be used.



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