THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

1 December 2008

Our ref: ICAEW Rep 133/08

Your ref:

Sir David Tweedie
The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

By email: commentletters@iasb.org

Dear David

**EARNINGS PER SHARE**

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on the exposure draft *Simplifying Earnings per Share - Proposed Amendments to IAS 33*, published in August 2008.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours sincerely

Desmond Wright
Senior Manager, Corporate Reporting
T +44 (0)20 7920 8527
F +44 (0)20 7638 6009
E desmond.wright@icaew.com

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

# ICAEW REPRESENTATION

**ICAEW REP 133/08**

**EARNINGS PER SHARE**

**Memorandum of comment submitted in December 2008 by The Institute of Chartered Accountants in England and Wales, in response to the exposure draft *Simplifying Earnings per Share - Proposed Amendments to IAS 33*, published by the International Accounting Standards Board in August 2008.**

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Chartered Accountants' Hall
PO Box 433 Moorgate Place London EC2P 2BJ
www.icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX DX 877 London/City

## INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the International Accounting Standards Board exposure draft *Simplifying Earnings per Share - Proposed Amendments to IAS 33*, published in August 2008.

## WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms.

## MAJOR POINTS

5. While we are happy to comment on the Exposure Draft for the proposed amendments to IAS 33, we do not believe that it is an appropriate time to make detailed changes to the existing standard. We note that an alternative view on the proposed amendments has been provided by Steve Cooper in the Exposure Draft and we have significant sympathy with this alternative view. In particular, we feel there is no empirical evidence that existing EPS numbers are causing difficulties for users of financial statements. In the absence of such evidence we believe that any changes to the standard should be part of a root and branch overhaul of EPS calculation. In addition, the IASB is currently involved in a significant project with the FASB on the classification of debt and equity. The outcome of this project may have a very material impact on EPS calculation and so we suggest it would be worth delaying deliberations at least until then.

6. Notwithstanding our comments above, in order to be helpful for future developments to IAS 33, we have taken the opportunity to provide comments on the Exposure Draft. We also wish to point out that it was very difficult to follow the rather poor drafting of the proposed changes. We urge the IASB to impose greater quality control over their output, particularly at the Exposure Draft stage.

7. Given that an appreciation of how analysts use EPS is of key importance to the issue at hand we summarise our understanding below. This has been provided with direct input from equity analysts, the primary users of EPS as a base metric, and should inform further development of the standard.

(a) 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 eg, EV / EBIT.

(b) 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.

(c) 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.

(d) Few analysts will make complex adjustments to EPS unless the impact is highly material and where information is clear and available.

(e) Diluted EPS is often as important as basic EPS for analysts.

8. 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?**

9. We agree that the denominator for basic EPS should include only instruments that give their holder the right (or are deemed to give 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.

10. 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?**

11. 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 resources to generate earnings and the number of participating shares. We would expect that this treatment is already common practice for preparers of financial statements.

***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?**

12. Whilst we agree with the technical premise that fair value changes reflect the effect on ordinary equity holders of instruments measured at fair value through profit or loss we note that this method would reduce available information about the number of shares that would be issued upon conversion of these instruments. Therefore we are not convinced that this would provide analysts with more useful information than they currently have without additional disclosures. This is reflected in our response to Question 6.

*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?**

13. 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.

14. We agree that assumed exercise or settlement of options, warrants and their equivalents at end-of-period market price is appropriate, as an average share price is not a meaningful concept since 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.

15. We also recommend that the IASB provide guidance on the term 'end-of-period' market price (ie, bid, asking or mid-market price) to ensure clarity and consistency for financial statement preparers.

*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?**

16. 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.

17. 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?**

18. 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 the number of shares that would be issued on conversion or exercise of each class of instrument should be disclosed, 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 are calculated under paragraphs A26 and A27, since in both of these situations, conversion is not assumed.

19. In addition, in respect of the rule that applies when a special dividend together with a share consolidation has the overall effect of a share repurchase at fair value (paragraph 24) it would be useful for a user of financial statements to know when this special rule has been applied and perhaps there should be a disclosure requirement in that case.

**DRAFTING COMMENTS**

20. In addition to the above comments, we provide the following comments on the wording of the exposure draft:

    (a) We suggest the following amendments to the definitions within the exposure draft:

        (i) In the definitions of both anti-dilution and dilution within paragraph 6 ‘based on continuing operations’ should be included after the words ‘loss per share’ to reflect the requirement of the standard as expressed in paragraph 40.

        (ii) In the definition of options, warrants and their equivalents within paragraph 6 ‘or subscribe for’ should be included after the words ‘the right to purchase’ to reflect the different way in which an option holder can obtain the shares on exercise of an option.

        (iii) In the definition of a participating instrument replace ‘ordinary shares’ with ‘ordinary shareholders’.

    (b) In paragraph 19 insert ‘or from the date they become currently issuable if part way through the period’ at the end of the second sentence to reflect the case when they are not ‘currently issuable’ for the whole of the financial year (which is how the IAS is applied as shown in Example D1 of the illustrative examples).

(c) In paragraph 20 'from the date they become subject to a right of recall' should be inserted after the words 'as not outstanding' to cover the circumstance of when the right to recall did not exist throughout the financial year.

(d) In paragraph 45 'dilutive' should be inserted before 'options, warrants and their equivalents'.

(e) In paragraph 46, the first sentence refers to the 'end of period market price'. However in the situation where a potential ordinary share becomes an outstanding share during the year, paragraph 37 correctly tells a user to bring it into the dilutive earnings per share calculation only from the start of the year to the date of conversion into ordinary shares. However as drafted a user is told to use the end of period market price to calculate the dilutive effect; if read as meaning the end of the financial period, the natural reading, this is clearly not sensible and instead the relevant market price that should be used in the dilution calculation is the market price at the date of conversion. In fact, in example C of the illustrative examples, the IASB appears to show the latter approach Therefore we would recommend that the IASB changes the wording of paragraph 46 to specify clearly how this rule should be applied in these cases.

(f) In paragraph 49 various changes have been made from the current equivalent paragraph 47A of the current IAS 33. In (a) 'the fair value of any goods and services to be supplied to the entity in the future' has been changed by adding 'at the grant date' after the term 'the fair value' and the deletion of the terms 'in the future'. This change, appears to mean that the IFRS 2 amount included in the proceeds in calculating dilution will be the same for all periods on the same option, unlike the current treatment when the future IFRS 2 charges decreases through time with the consequence that an option becomes more dilutive nearer to vesting date. We therefore query whether it was the intention of the board to amend the treatment for IFRS 2 charges by amending the wording. If so we believe that there should be further clarification of this within the standard.

(g) In paragraph 49 another amendment has been made to require the tax benefit, if any, that would be credited direct to equity on the exercise of the share option to be taken into account in calculating the amount of the dilution. From (a) of that paragraph, the proceeds brought in would be a grant date fixed amount. However it is not clear whether for (b) this is also a grant date estimate for which the amount calculated is repeatedly used for various financial year ends' earnings per share calculations or whether at each financial year end a re-estimate is made of the total tax benefit that would be credited (including amounts already so treated) with these varying amounts are used.

(h) Paragraph 49 states that paragraph 47 refers to 'proceeds'; however, in paragraph 47 itself the phrase 'issue price' is used.

Email: desmond.wright@icaew.com