22 December 2008

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Madam/Sir

Re: Exposure Draft *Simplifying Earnings per Share*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft *Simplifying Earnings per Share*. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

The exposure draft contains proposals for amendments designed to simplify IAS 33 *Earnings per Share* (EPS) and to converge the computation of EPS with FAS 128 *Earnings per Share.*

Our detailed comments are set out in the appendix to this letter. To summarise our main views are as follows:

- As the IASB and the FASB are currently involved in a joint project on distinguishing equity from liabilities, and the outcome of this project is likely to change the current split between equity and liabilities, we question the wisdom of spending scarce Board resources on this project at the current time. Our recommendation would be to defer further work on this project until later;

- Although EFRAG agrees that the introduction of the fair value method is an improvement from a measurement perspective, we think that it needs to be accompanied by additional disclosures if some important information is not to be lost.

We hope that you find our comments helpful. If you wish to discuss them further, please do not hesitate to contact Frederiek Vermeulen or myself.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1
EFRAG's detailed comments on the ED *Simplifying Earnings per Share*

General comments

1 The IASB is currently involved in a joint project with the FASB on financial instruments with characteristics of equity. A number of alternatives have been considered in this project as to how to draw the line between equity and liability in a more meaningful manner and it seems likely that a change in the split between equity and liabilities will be made. EFRAG questions the wisdom of spending scarce Board resources at the present time on trying to converge and simplify the calculation of Earnings per Share (EPS) when such an important element in the calculation—what is equity—has not been converged and is expected to change. We think it would be better to delay the EPS project until the equity and liabilities project has been completed. That would also enable the Boards' limited resources to be re-allocated to more urgent projects.

2 In this respect we would like to refer to our earlier comments on the Board's agenda priorities. (See EFRAG's letter to the IASB on its agenda setting dd. 22 July 2008.)

3 Although we believe that the IASB should not be carrying out a project on Simplifying earnings per Share at this time, to be constructive, we have nevertheless responded to the questions in the Invitation to comment.

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?*

4 EFRAG agrees that the denominator in the computation of EPS should be based on the shares participating in profit or loss with ordinary shareholders. EFRAG welcomes therefore the introduction of the principle that the weighted average number of ordinary shares for basic EPS should include only those instruments that give (or are deemed to give) their holder the right to share currently in profit or loss of the period. In EFRAG´s view this principles-based approach reflects better the economics of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period.

(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?

5 EFRAG agrees that the principle referred to above has been applied correctly to mandatorily convertible instruments and ordinary shares issuable for little or no cash or other consideration. However, we think that the requirements as described in the

proposed amendments could be made clearer. We have made some drafting suggestions in Appendix 2.

6 We think that a result of the proposed amendments will be that the EPS disclosures required by paragraph 58 (for each class of ordinary shares that has a different right to share in profit of the period) will need to be provided more than hitherto. As we understand that a number of users question the usefulness of this disclosure, we suggest the IASB considers whether the benefits of this disclosure requirement continue to exceed the costs involved.

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 principle for contacts to repurchase an entity's own shares for cash or other financial assets should also apply to mandatorily redeemable shares? Do you agree with the proposed treatment of gross physical settled contracts to repurchase an entity´s own shares and mandatorily redeemable shares? Why or why not?

7 It is EFRAG's opinion that the denominator for EPS should not be affected by shares that will have to be repurchased. We think this amendment is in line with the objective of EPS and the principle the IASB proposes to include in paragraphs 18 and 19 of the ED.

8 EFRAG agrees with the proposed amendment on gross physically settled contracts to repurchase an entity's own shares and mandatorily redeemable ordinary shares. Indeed, judging from the various consultations we have had to date with the user community on the proposed amendments it seems clear that this proposed treatment is already common practice.

9 However, EFRAG notes that some divergence will remain between US GAAP and IFRS for contracts with a choice of gross physical or net settlement.

10 In addition we think that the wording of paragraphs A31 and A32 could be made clearer and that the IASB should consider including some additional examples to illustrate the application of the principle. We refer you to Appendix 2 where we have made some suggestions along these lines.

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 recognizing those changes in profit or loss eliminates the need for further adjustments to the calculation of EPS? Why or why not?

11 The ED proposes the use of the so-called fair value method for all financial instruments that can be settled in cash or shares, are classified as liabilities and are measured at fair value in their entirety with changes in fair value recognised in earnings. Under this method, such instruments would be excluded from the computation of diluted EPS. The ED further proposes that the denominator shall not include incremental shares resulting from their assumed exercise or conversion. The Board does not propose any additional disclosures beyond those already required in IAS 33.

12 EFRAG notes that an alternative view has been developed by an IASB member. His dissenting view includes the following comment "(...) Although the proposal not to calculate a separate diluted EPS for instruments measured at fair value through profit and loss can be theoretically justified, he does not believe that the proposals (…) would be beneficial for users. (...) users would in practice need to make estimates of the expected value change (the cost of capital for the instrument) for (the) period or estimate a forecast value change for the following period to produce useful measures of performance" [IAS 33.AV5].

13 EFRAG believes that the fair value method represents a more realistic picture of dilution in the way that, in contrast to the treasury stock method, it assumes neither the hypothetical exercise of all in-the-money options nor the subsequent repurchase of shares from proceeds of the exercise. The fair value adjustments will reflect the economic effect of the instruments on the current owners for the instruments currently subject to the treasury stock method and the two-class method. EFRAG therefore supports the introduction of the proposed treatment. However,

(a) we mentioned at the beginning of this appendix that we think this EPS project should be delayed until the equity and liabilities project has been completed. We think that comment is particularly relevant in the context of the proposals in this part of the ED;

(b) it would appear to us, from the comments we have received and the conversations we have had that there are a range of views on how to move forward this issue and not much support for what the ED is proposing, particularly amongst users. We therefore suggest that the IASB discuss the proposals in this part of the ED with a wide range of users to ensure that this amendment would actually be welcomed;

(c) EFRAG also believes that under this approach additional disclosures would be necessary because the currently if-converted method might be more useful for some instruments (e.g. convertible instruments) from an investor's standpoint. In particular, EFRAG thinks that disclosure of the number of options which could be converted and the number of shares that would result from their conversion should be provided regardless of their effect on the diluted EPS calculation.

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?

14 We agree that for the computation of diluted EPS an entity should assume the settlement of forward contracts (not measured at fair value through profit or loss) to sell its own shares.

(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?

15 We agree that 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 rather than at the average market price. We believe that this will result in a better reflection of the performance of an entity and in a more consistent application of the treasury stock method. We also agree with the IASB that the difference between the number of ordinary shares issued and the number that would have been issued at the end-of-market price should be treated as an issue of ordinary shares for no consideration.

Question 5 – Participating instruments and two-class ordinary shares

Paragraph A23 proposes to extend the scope of the application guidance for participating instrument 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 the dilutive convertible instruments, 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 EFRAG notes that paragraph A14 of current IAS 33 explains how participating equity instruments and two-class ordinary shares affect diluted EPS. If those instruments are convertible into ordinary shares, conversion is assumed if the effect is dilutive. If those instruments are not convertible into a class of ordinary shares, profit or loss for the period is allocated to the different classes of instruments in accordance with their dividend rights or other rights to participate in undistributed earnings. Although paragraph A14 of current IAS 33 is clear on how to calculate diluted EPS under the two-class method for participating instruments we agree with the IASB's view that it might in certain cases not maximise the dilution of EPS and thus not meet the objective of IAS 33 in providing a measure of the interest of each ordinary share in the performance of an entity, while giving effect to the dilutive potential ordinary shares outstanding during the period.

17 However, EFRAG does not agree with the proposed test as it is too complex and time-consuming, without providing sufficient additional benefit. We would prefer a more principles-based approach.

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 Apart from the issue discussed in paragraph 11 above, EFRAG thinks that the disclosures requirements in the current version of IAS 33 are sufficient and that no other disclosures should be considered at this moment.

Appendix 2
Drafting Comments

1 In addition to the comments in the preceding appendix, we found the drafting of the proposed amendments difficult in places and, as a result, did not think it is always easy to understand what the IASB is proposing. We would therefore encourage the IASB to consider the following clarifications, drafting improvements etc:

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

(i) In the definitions in paragraph 6 of anti-dilution and dilution, we suggest adding the words “based on continuing operations” 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 in paragraph 6, we suggest adding the words “or subscribe for” 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 we suggest replacing the words “ordinary shares” with “ordinary shareholders”.

(b) We think the wording in paragraph 18 would be clearer if it referred to “examples of instruments with terms and conditions that might give their holder the right to share in profit or loss of the period.”

(c) In paragraph 19, we suggest inserting “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).

(d) In paragraph 20 we suggest inserting the words “from the date they become subject to a right of recall” after the words “as not outstanding” to cover the circumstance of when the right to recall did not exist throughout the financial year.

(e) We think the word ‘dilutive’ should be inserted in paragraph 45 before “options, warrants and their equivalents”.

(f) 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 says that it should be brought into the dilutive earnings per share calculation only from the start of the year to the date of conversion into ordinary shares. However, the end of period market price is supposed to be used to calculate the dilutive effect. Assuming this is a reference to the end of the financial period, we think the effect will be a bit odd. We suggest that the relevant market price that should be used in the dilution calculation is the market price at the date of conversion; and it seems to us that example C of the illustrative examples appears to be adopting that 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.

(g) In paragraph 49 various changes have been made to the equivalent paragraph in the existing standard (paragraph 47A). The change to subparagraph (a) seems 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; the existing treatment is that future IFRS 2 charges decrease through time with the consequence that an option becomes more dilutive nearer to vesting date. We wonder whether this was the intention. And, if it was, we think this should be made clearer in the standard.

(h) In paragraph 49 another amendment has been made to require any tax benefit credited directly to equity on the exercise of the share option to be taken into account in calculating the amount of the dilution. According to subparagraph (a). the amount used in the calculation would be the grant date fair value. However it is not clear what the implications of this are for sub-paragraph (b). For example, is it the intention that for (b) the grant date estimate should be repeatedly used for the various financial year ends' earnings per share calculations? Or is it the intention that 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.

(i) Paragraph 49 states that paragraph 47 refers to 'proceeds'; however, paragraph 47 refers to 'issue price' not 'proceeds'.