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Mr David Boymal
The Chairman
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31 October 2008
Our Ref: AC:DT

Dear David

ED 166 ***Simplifying Earnings per Share: Proposed Amendments to AASB 133***

Thank you for the opportunity to comment on the Australian Accounting Standards Board (AASB) Exposure Draft 166 *Simplifying Earnings per Share: Proposed Amendments to AASB* ('ED 166').

This letter sets out our principal comments on ED 166. Our responses to the specific matters for comment raised by the AASB are contained in Appendix A. Our response to the questions raised by the IASB in the Exposure Draft are contained in Appendix B.

Overall, we support the proposals in ED 166 to amend and simplify the requirements in AASB 133 Earnings per Share. However, we have some concerns such as in the areas of gross physically settled contracts to repurchase an entity's own shares, instruments that are measured at fair value through profit or loss and contracts that may be settled in ordinary shares or cash.

Due to the later IASB submission deadline for the Exposure Draft, the global firm of Deloitte Touche Tohmatsu has not finalised its views in relation to the matters raised in the IASB's Exposure Draft. Therefore, the views presented in this document in relation to ED 166 should be read in this context and may not necessarily represent the view of the global firm of Deloitte.

If you have any questions concerning our comments, please contact Anna Crawford on (02) 9322 7177.

Yours sincerely

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APPENDIX A

Response to specific matters for comment raised by the AASB

(a) whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
(i) not-for-profit entities;
(ii) public sector entities

Since not-for-profit entities and public sector entities do not normally presenttearnings per share disclosures in their financial statements, theseproposals will not impact such entities.

(b) whether, overall, the proposals would result in financial statements that would be useful to users

We believe that the proposals will result in financial statements that are useful to users. We also support continued movement towards convergence (even though in this case only the denominator in the EPS calculation will be converged) with US GAAP.

(c) whether the proposals are in the best interests of the Australian economy

We believe that the proposals are in the best interests of the Australian economy through issuance of an equivalent Australian Accounting Standard to ensure full convergence with IFRSs.

APPENDIX B
Response to specific questions raised by the IASB

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?

- We agree with the principle that only those instruments that share in profit or loss in the period should be included in basic EPS. Those not sharing in profit or loss in the period but that may do so in the future are potential ordinary shares and, therefore, rightly will only be included in diluted EPS if they are deemed to dilute earnings per share.

- The principle is applied correctly to ordinary shares issuable for little or no cash or other consideration. This will capture options that have a very low strike price (deemed to be little consideration) compared to the ordinary share that is delivered under the option where the holder has the ability to become an ordinary shareholder without little effort. Equally, prepaid forward sales of shares where the holder can demand delivery of shares with immediate effect will also be deemed outstanding ordinary shares.

- We presume mandatorily convertible instruments will only be included in basic EPS if the holder has the right at the end of the reporting period to become an ordinary shareholder. Most mandatorily convertible instruments convert at a specified date in the future, i.e. are not immediately convertible, and therefore would not be considered as ordinary shares until the specified date is reached. In the case where the holder of a mandatorily convertible instrument does have a right to demand immediate delivery of ordinary shares then the ordinary shares delivered under the instrument will be deemed as outstanding. We question what the treatment would be if the number of shares under the mandatorily convertible instrument is not fixed, but varies. In such case the instrument may be classified as a financial liability.

- We do not understand the inclusion of the term "non-participating" in paragraph A8(c) and (d) and believe it should be removed. Whether a debt or other financial instrument is non-participating or not is not relevant in determining when ordinary shares have been issued. Ordinary shares are included in the weighted average number of shares from the point when the holder has the right to share in profit or loss of the period. By including the term "non-participating", it implies that ordinary shares issued as a result of conversion of a participating instrument are *not* included in the weighted average of ordinary shares which is not the case.

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?

- Firstly, forward purchase contracts. The ED would require a forward purchase contract over own equity to be treated as if the shares have already been acquired, a reduction in the number of shares, and the liability that is presented under IAS 32 as a participating instrument – the participation is in effect the dividends on the shares that remain outstanding because they have not yet been acquired. An alternative view is whether the shares instead should still be treated as outstanding, as they have yet to be repurchased, and therefore any dividends paid to the shareholders are not dividends on a participating instrument, rather it is merely the dividends on the actual shares. Para A31 acknowledges that the shares are not actually repurchased, and are treated "as if it has already repurchased" the shares. Para A32 states dividends are "allocated" to the financial liability, indicating that dividends that are payable under shares that will be acquired in the future under a forward purchase contract are recognised in equity as dividends, but are then allocated to a financial liability for EPS purposes only. This also supports that the liability recognised is the obligation to buy the shares back in the future, and is not itself a participating instrument. Para A32 also states some forward contracts require dividends paid under shares that are subject to a forward to be remitted back to the entity and then in that case the instrument is not a participating instrument. In reality, the dividends are paid to whoever is the shareholder, and the 'dividend' remitted back is a synthetic dividend by whoever is the counterparty to the forward contract. These two parties are often different parties as the counterparty to the forward is not obligated to hold the shares. This also questions whether the liability recognised under a forward contract is really a participating instrument as dividends payable under the shares are actually paid to the shareholder, and not the counterparty to the forward contract, and, therefore, the holder of the forward is not in fact 'participating'.

- Secondly, written put options. The ED proposes to treat written puts the same as forward contracts. This justification is based on the fact that IAS 32 has the same presentation, being a financial liability to buy back the shares in the future. The logic for treating these as a participating instrument seems weaker than for forward contracts as the entity does not know whether it will buy back the shares. Therefore, we propose that for written put options which are not FVTPL the shares should still be treated as outstanding for basic EPS purposes.

- The ED is not clear on the diluted EPS treatment for these gross physically settled forward purchase contracts and written puts. We propose that if they are not at FVTPL, then the diluted EPS treatment should be the same as under the current IAS 33 i.e they would be potentially dilutive under the reverse treasury stock method for diluted EPS.

- We believe that, should the Board decide to make any amendments to its proposals, it is important to maintain the consistency in the EPS treatment of forward purchase contracts and written put options over own equity.

- It is not clear how the guidance on forward purchase contracts and written puts over own equity can be equally applied to mandatorily redeemable ordinary shares. The latter would be presented wholly as a financial liability at issue (because they are puttable for cash or other financial asset) – there is no debit in equity at inception as in the case of forward purchase or written put. If the instrument is presented wholly as a financial liability then it cannot be considered an ordinary share as the definition of ordinary share requires the instrument to be an equity instrument[1].

[1] Perhaps it could be argued this is referring to puttable instruments that are presented as equity following the IAS 32 amendment

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?

- We agree that standalone or embedded derivatives that are FVTPL that may result in the delivery or receipt of ordinary shares should be excluded from diluted EPS. Current earnings will include the fair value of the instrument and, therefore, already include the degree to which a written option is in-the-money, or a forward sale results in shares being issued at less than fair value, or a forward purchase results in shares being acquired at more than fair value[2].

- The downside of an approach that does not adjust for dilution is that users will not know the degree to which earnings will be diluted in future periods by the entity effectively issuing shares for nil consideration – this lack of information is important to equity analysts and other users and therefore consideration should be given to subsequent disclosure. This problem is exacerbated when, for example, the instrument has not changed in fair value during the period, yet the option is deeply in-the-money, and therefore the entity will issue ordinary shares cheaply. The fact that current ordinary shareholders will have future earnings diluted by issuing shares cheap will no longer be visible in the financial statements and therefore supplementary disclosure should be considered of the fair value of these instrument to the extent not already identifiable in the financial assets and liabilities notes (see question 6). Such disclosure could be achieved by requiring separate disclosure within the financial assets and liabilities notes of instruments that are share settled.

- The ED does not make clear whether ordinary shares that are issued as 'currency' for settlement of a financial liability, for example, a variable number of shares equal to a fixed amount, are potentially dilutive. We believe IAS 33 as currently drafted would imply they potentially are because the entity would be forced to apply the if-converted' method, i.e. add back any interest to the numerator, and add the *total* number of shares to be issued based on the period end share price to the denominator. This treatment makes no sense when the entity is merely issuing shares at fair value (alternatively the entity

[2] Under IFRS this would only be the case where the forward contract did not allow for gross physical settlement, i.e. the instrument could be net cash settled or net share settled.

could have issued a variable shares for cash, and used the cash to repay a financial liability and EPS would not have been dilutive). We believe there should be a statement upfront in the standard that contracts that require the issue of shares at future fair value should not be considered dilutive (e.g. a variable number of shares to be issued as settlement of a financial liability). Equally, there should be a statement that contracts that require the receipt of shares at future fair value should not be considered a reduction in the number of shares outstanding for basic EPS and should not be considered potentially dilutive for diluted EPS (e.g. a variable number of shares to be received as a settlement of a financial asset). We believe the basis for this proposal is partly evident in the ED (and in the existing standard) in para A10 where it states that potential ordinary shares that are issued for full fair value and, therefore, result in a proportionate change in the resources of the entity does not give rise to a bonus element. The potential ordinary shares that are issued or acquired at future market value must be made clear that they are excluded from diluted EPS calculations.

- We disagree that cash settled share based payments should be entirely excluded from diluted EPS. Firstly, the arrangement is not FVTPL, it is rather remeasured only for movements in the entity's share price only in proportion to the time lapsed before vesting. It is only when the instrument has vested that the impact of movements in share price fully impact existing shareholders. Secondly, by ignoring these share based payment transactions you would get the anomalous treatment that a SBP transaction that is equity settled can be dilutive at inception if it is equity settled, and not dilutive if it is deemed cash settled (but still may result in the issue of ordinary shares e.g. in the case of share-based payments with settlement alternatives) even when the impact of the entity's share price has yet to impact profit or loss because the SBP transaction has just been entered into. Our preference, is to instead apply the treasury stock method for cash-settled SBP that are potential ordinary shares as follows: for the numerator add-back the impact on earnings that has been recognised in the period that would not have been recognised had the arrangement been equity settled; for the denominator determine the number of shares issued for nil consideration but looking to the strike price of the option plus the fair value of the services to be rendered (as for determining EPS for equity settled SBP).

- Paragraph 51 states: "If convertible instruments (or conversion options that are accounted for separately") are not measured at fair value through profit or loss the entity shall reflect..." The term used in brackets is confusing as 'separation' is a term often used for embedded derivatives in hybrid contracts which under the ED would be treated as measured at fair value through profit or loss anyway. The sentence should instead state: "If the conversion feature in a convertible instrument meets the definition of equity, and therefore is not fair valued through profit or loss, the entity shall reflect...."

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?

- We agree that forward sale contracts over own equity that are not FVTPL are potentially dilutive by applying the treasury stock method, i.e. the entity determines the number of shares that are effectively issued for nil consideration, which will be the case when the period end share price is higher than the forward price under the contract. This is generally the approach that is applied currently in practice and it is helpful that IAS 33 clarifies this.

- We note that the question above appears to suggest that the entity should always assume that forward sale contracts (unless at FVTPL) are settled in the calculation of diluted EPS. This follows from the wording in para IN7 which says "The boards propose to clarify that for the calculation of diluted EPS an entity assumes that ordinary shares relating to such a contract are sold and <u>the effect is dilutive</u>, unless they are measured at fair value through profit or loss." In fact, dilution should not be assumed, but should be determined based on the actual fact pattern and the application of the treasury stock method.

- We agree to the use of the period end, not average, share price, for determining the number of shares deemed to be issued for nil consideration.

We question the relevance of including "joint ventures or associates" in para A33. A conversion feature that converts into ordinary shares of a joint venture or associate would not meet the definition of equity in the consolidated or separate financial statements as the instrument is not an equity instrument. Only a conversion feature that converts into ordinary shares of a subsidiary would be equity in the consolidated financial statements if it meets the 'fixed-for-fixed' criterion in IAS 32. All other instruments would be scoped into IAS 39 and will be measured at FVTPL. We believe a statement should be included as paragraph A35 that instruments that may result in the delivery of ordinary shares in a joint venture or associate are normally FVTPL in IAS 39 and therefore the requirements of A33 and A34 will not normally apply in these instances.

- We believe paragraph 26 should be amended as follows:

  "An entity shall not increase the denominator for the number of additional ordinary shares that would arise from the exercise, settlement or conversion of ~~instruments~~ potential ordinary shares (or the derivative components of ~~compound~~hybrid instruments) that are measured at fair value through profit or loss."

  The inclusion of the term 'settlement' reflects the inclusion of forward sale contracts; 'potential ordinary share' is more specific than 'instrument' as the instrument must result in the potential delivery of ordinary shares; such arrangements are 'hybrid' instruments, not 'compound' instruments as the instruments fails the definition of equity.

- Paragraph 27 should also be amended: "it is not necessary to increase the denominator for the number of additional shares that would arise from the exercise, ~~or~~ conversion or settlement of those instruments in shares."

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 propose 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?

- Our general concern regarding the impact on EPS of participating instruments is that it could be made clearer. For example, it could be made clearer that determining the amount of earnings and number of ordinary shares allocated to two-class ordinary shares or participating instruments is required only in order to determine the amount of earnings and number of ordinary shares available for ordinary shareholders. As per paragraph 58 of the ED (and paragraph 66 of the existing IAS 33), basic and diluted EPS should be presented for each class of ordinary shares that has a different right to share in profit for the period. It is not a requirement to disclose EPS for participating instruments. This point could be made clearer in paragraph 18 and paragraphs A24 and A25.

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?

- As set out above in our comments to Question 3, we propose that, in respect of instruments that may result in the issue or acquisition of ordinary shares in the future and that are FVTPL, some supplementary disclosure would be necessary.

Other comments

1. Contracts that may be settled in ordinary shares or cash

Paragraph IN8 of the ED states the following:

"Under the proposed amendments, contracts to repurchase an entity's own shares and contracts that may be settled in ordinary shares or cash would either be measured at fair value through profit or loss or the liability for the present value of the redemption amount would meet the definition of a participating instrument. For those instruments, no adjustments would be required in calculating diluted EPS or the application guidance on participating instruments and two-class ordinary shares would apply. Therefore, the Board proposes to delete the calculation requirements for contracts that may be settled in ordinary shares or cash in paragraphs 58–61 and for contracts to repurchase an entity's own shares in paragraph 63 of IAS 33."

The reasoning behind this statement is not set out (also not explained in paragraph BC25 in the Basis for Conclusions). It is not clear how the above statement reconciles to the United States FASB Exposure Draft which requires that, for such contracts that may be settled in ordinary shares or cash (at the election of either the entity or the holder), it shall be assumed that the contract will be settled in shares, if dilutive.

2. Contingently issuable shares

We believe that Paragraph A16 which deals with the application of paragraph 54 of the ED is incorrect. The contingently issuable shares should be included in the calculation of diluted EPS from the beginning of the period (or from the date of the contingent share agreement, if later).