Potential Agenda Item Request on the application of IAS 33

I. The issue

1. Our issue deals with participating equity instruments in terms of IAS 33.A13 et seq. The instrument considered by us grants the holder (dividend) payments according to a specified formula, e.g. ten times the dividend paid to the holders of ordinary shares. If no dividend is paid to the holders of ordinary shares, the participating instrument does not pay any dividends either.
2. When liquidating the entity, the holders of the participating equity instruments do not participate in any proceeds. It is only the holders of the ordinary shares that benefit from the liquidation proceeds.
3. According to IAS 32, these instruments are classified as equity under IFRS. (This is based on the facts that the instrument has no defined life, thus, is infinite, and there is no unconditional obligation on behalf of the issuer to deliver cash.) Therefore, dividends from the instruments are paid out of equity.
4. Under (national) tax rules, however, the participating instruments are classified as liabilities. (This results from tax rules focusing on other criteria.) Consequently, dividends paid to the holders of these instruments are recognised as an expense in profit or loss in the tax accounts. The expense reduces taxable income and, in the end, reduces income taxes to be paid to the local tax authorities. We refer to this reduction of income taxes as 'tax benefit'.
5. In the corresponding IFRS financial statements, the tax benefit is recognized in equity since the basis for this benefit—the participating equity instrument and the dividends thereon—is also recognised in equity per IAS 12.61A (for current developments please refer to para. 19 below).
6. It seems unclear how this tax benefit resulting from the participating instrument should be considered when calculating basic earnings per (ordinary) share (EPS) according to IAS 33.

II. Current practice

7. When presenting the alternatives, the following fact pattern is being used:
   - The participating equity instruments participate 10 to 1 in dividends. The tax rate is 30%.
   - The IFRS profit for the year is CU 330.
   - Allocation to participating equity instruments: CU 300; residual amount allocated to ordinary shares: CU 30.
   - Tax benefit: CU 300 x 30% = CU 90.
   - The task is to calculate EPS of the ordinary shares whereby, pursuant to IAS 33.A14, total profit of the year is assumed to be distributed.

   We are aware of at least two alternatives that are being applied in practice that are reproduced below.

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Alternative 1: Adjust profit or loss by the <u>after-tax amount</u> of the instrument's dividend

8. When calculating EPS, IAS 33.A14 must be considered with regard to participating equity instruments. IAS 33.A14 does not provide any guidance as to how income taxes resulting from these instruments are to be handled. Therefore, it seems appropriate to take the requirements in IAS 33.12 et seqq. into consideration. According to these paragraphs, and for the purpose of calculating basic earnings per share, an entity shall deduct the after-tax amount of preference dividends from profit or loss. IAS 33.12 contains the term "preference shares classified as equity" and IAS 33.13 the term "preference shares classified as liabilities", however, there does not seem to be any difference in calculation that would depend on the classification of the preference shares. Further, IAS 33.14 does not differentiate between whether (the dividends or) resulting tax benefits are recognised in equity or profit or loss. Therefore, when calculating the after-tax amount that should be deducted from profit or loss, tax benefits that are recognised directly in equity must be included and reduce the amount that is deducted. Consequently, the tax benefit increases EPS for ordinary shares compared to a calculation that does not include the tax benefit.
9. According to this alternative, the basis for the EPS calculation, i.e. the allocation of profit to ordinary shares, is CU 120 in the example above [30 + 90 = 120 or 330 - (300 - 90), respectively]. This results from the principle that, under IAS 33, calculation of EPS is not an allocation of dividends *declared* but rather an *attribution* of the IFRS profit or loss to (different classes of) shareholders.
10. Even though the tax benefit is recognised in equity, it is the ordinary equity holders and not the holders of the participating instruments who benefit from the tax benefit (at the latest in the moment of liquidation of the entity). If the tax benefit were to be ignored, it would never be included in the EPS calculation.

Alternative 2: Adjust profit or loss by the <u>pre-tax amount</u> of the instrument's dividend

11. The tax benefit resulting from the participating instrument's dividends is ignored when calculating EPS. IAS 33.A14 does not explicitly require inclusion of any tax benefits from participating equity instruments; therefore, the tax benefit must not reduce the dividends paid to the holders of the instruments.
12. IAS 33.12 et seqq. cannot be applied by analogy to participating equity instruments since, contrary to preference shares, they participate contemporaneously with ordinary shares in profit or loss according to a predetermined formula.
13. Hence, the basis for EPS calculation for the ordinary shares in the example above is CU 30.

Question

14. Which alternative is the correct reading of the requirements of IAS 33?

III. Reasons for the IFRS IC to address the issue

a) Is the issue widespread and has, or is expected to have, a material effect on those affected?

15. Yes. Participating equity instruments are a common way of financing in many jurisdictions. Some of them are classified as equity under IFRS and as a liability following tax law. Therefore, it appears that the issue is widespread. Treatment of the tax effects resulting from these instruments — as in the case described — might materially influence EPS. As EPS is an important performance indicator within IFRSs, the issue has a material effect on those affected.

b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

16. Yes. EPS is regularly in the focus of users of the financial statements. Divergent accounting treatments would lead to different EPS calculations even though the underlying numbers are exactly the same.

c) Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?

17. Yes. There is a possible gap in IAS 33 regarding the treatment of tax effects resulting from participating equity instruments, which could be resolved by the IFRS IC.

d) Is the issue sufficiently narrow in scope?

18. Yes. As the issue deals with a specific question regarding the calculation of EPS when considering specific instruments, it is sufficiently narrow in scope. However, as these instruments are used frequently, the issue is not so narrow that it would not be cost-effective to address this issue.

e) Will the solution developed by the IFRS IC be effective for a reasonable time period?

19. Yes. Currently, there are discussions regarding IAS 12.52A and 12.52B possibly resulting in an amendment of IAS 12 as part of the AIP cycle 2015-2017 (cf. IASB Update June 2016, last issue, and the respective staff paper (June 2016, Agenda Paper 12A)). Such an amendment would clarify that the presentation requirements in IAS 12.52 apply to all payments on financial instruments classified as equity that are distributions of profits, and are not limited to the circumstances described in IAS 12.52A (Agenda Paper, par. 2). That being said, an entity will still need to apply judgement to determine whether such payments are distributions of profit. If the payments are distributions of profits, then IAS 12.52B applies to any income tax consequences of such payments (recognition in profit or loss). If the payments are not distributions of profits, then the entity applies IAS 12.57 and .61A and presents any income tax consequences of such payments directly in equity (Agenda Paper, paras. 29 and 30). We are of the view that even with this clarification for the application of IAS 12.52B, it will still not be clear whether it also applies to the EPS calculation as IAS 12.52B prescribes the accounting for the income tax implications (via equity or profit and loss) only when a liability to pay the dividend is recognized, whereas IAS 33.A14 assumes that all profit or loss is distributed.

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