New Headline Earnings definition introduced

UKSIP's pioneering work on headline earnings per share reached a new milestone on August 31 when the Johannesburg Stock Exchange implemented an updated version that takes account of the switch to international financial reporting standards (IFRS).

JSE listing requirements demand that companies use this formula for the consistent calculation of P/E ratios. It is also used by the Financial Times for the P/Es in its London Share Service.

The headline earnings formula was developed by the IIMR, a forerunner of the UK Society of Investment Professionals (UKSIP), in 1992 at the request of the FT, which wanted a consistent P/E number in the wake of the new FRS 3 standard. The issue then, as with developments of IFRS, was that the earnings standard contained several items of a 'capital' nature.

David Damant, a Fellow of the society and former chairman of UKSIP's Accounting Advocacy committee, has led both the creation and the updating of the formula. UKSIP has worked with the South African Institute of Chartered Accountants on the latest version. The changes taking effect on August 31 are the most significant since the original publication, which has proved robust.

The original formula made a distinction between changes in value of items in the 'platform' (essentially capital items) on which a company operated and the trading which took place on that platform. To take the example of retail, changes in the value of such items as the long-term debt or the value of the premises were excluded from the headline earnings figure, whereas sales, salaries and so on were included.

The new approach is to exclude from headline earnings all changes in fair value except those changes in fair value of items in the current position of the company – for example changes in the value of inventories. This approach is identical in principle to the original distinction between the platform and trading - and very close in practice. Historic and future data can be seen as a continuum.

This approach produces a figure for headline earnings close to historic cost earnings. Those who are concerned about the use of fair values will, therefore, find headline earnings particularly useful as changes in the fair value of balance sheet items - except for those in current assets or current liabilities –will be excluded from the headline earnings figure.

A ratio of the share price to headline earnings is rational, but the P/E ratio will not be rational if changes in fair value are included in the earnings number, since those changes in fair value will move with the various markets and not reflect the annual earning power of the company. Fair value changes are a relevant performance outcome, but cannot be handled as part of the stream of positive and negative cash flows generated by the company and correctly reflected in a P/E ratio. Changes in capital values ought to be assessed separately.

The official circular concerning the rules for the calculation of Headline Earnings Per Share, HEPS, as part of the Listing Requirements for the Johannesburg Stock Exchange is on the UKSIP website, together with a covering note concerning the application of this formula in the UK. This covering note points out that there are no differences between the application of the formula as between the UK and South Africa, except for certain specialized industry practices which exist in South Africa but not in the UK (for example, the transfers of assets in line with the Black Empowerment requirements). The circular also sets out the limited cases where the new approach may produce outcomes different from the old approach.

For further information, please contact Jane Fuller, chair of the CFA UK Accounting Advocacy committee on 0207 280 9620.

HEADLINE EARNINGS

CONTENTS

PREFACE

This circular has been issued by the South African Institute of Chartered Accountants (SAICA) at the request of the JSE Limited (JSE). The JSE Listings Requirements require the calculation of headline earnings and disclosure of a detailed reconciliation of headline earnings to the earnings numbers used in the calculation of basic earnings per share in accordance with the requirements of IAS 33 – *Earnings per Share*. Disclosure of headline earnings is not a requirement of International Financial Reporting Standards (IFRS).

SAICA acknowledges that headline earnings is only one possible measure of an entity's performance, and the disclosure of headline earnings may be made in addition to the presentation of revenue, expenses, gains and losses in accordance with IFRS. Furthermore, headline earnings is not a mechanism to use in order to adjust an entity's financial results for disagreements an entity might have with the application of IFRS, or to circumvent the correct accounting treatment.

INTRODUCTION

.01 The requirement to disclose headline earnings has been a reporting requirement for companies listed on the JSE Limited (JSE) since 2000.

.02 Circular 7/2002 – *Headline Earnings* was issued in 2002 following the amendment of AC306 – *Headline Earnings – The Effect of the Issue of AC103 (revised) on the Calculation and Disclosure of Earnings Per Share*, issued in November 1995. Circular 7/2002 became outdated as a result of the increased use of the fair value model in accounting standards. Circular 7/2002 was therefore superseded by Circular 8/2007. This circular, Circular 3/2009, will supersede Circular 8/2007, as it updates Circular 8/2007 with the amendments and revisions to International Financial Reporting Standards (IFRS) issued between June 2007 and April 2009. The only changes made to Circular 8/2007 by this new circular are to some of the detailed rules in Section C for amendments and revisions to specific IFRSs, the new terminology brought in by IAS 1 – *Presentation of Financial Statements,* and specific matters considered when drafting this proposed circular in the "Basis for Conclusions" section.

.03 This circular intends to:

(i) provide a background to the use of headline earnings in South Africa;

(ii) illustrate the link to IFRS and accounting policy choices;

(iii) provide definitions of the terms used in calculating headline earnings;

(iv) provide rules for calculating headline earnings for every relevant IFRS[1];

(v) provide guidance on the calculation of the "per share" number, presentation of comparative headline earnings numbers and the format of the reconciliation of headline earnings;

(vi) provide sector-specific rules where necessary; and

(vii) provide the basis for conclusions for decisions made in this circular.

SECTION A: BACKGROUND

Background to the use of headline earnings in South Africa

.04 The focus of most IFRSs is on the recognition of assets and liabilities. Some may argue that this approach results in performance being assessed largely as the difference between two statements of financial positions and not as a stand-alone profit or loss figure. In addition, some standards require gains and losses to be recognised directly in other comprehensive income and then, in some instances, reclassified to profit or loss at a later stage. This means that not all gains and losses are necessarily recognised in the reported net profit figure, or that some gains and losses are not recognised in the period in which they arise.

.05 The International Accounting Standards Board (IASB) is of the view that there is no single number that encapsulates the performance of an entity. Investors and analysts worldwide have expressed this view for some time. The market takes note of a wider information set. Nevertheless, there is still the call from users for a single earnings number that can be used as an unambiguous reference point.

.06 The headline earnings survey carried out by SAICA in 2006 and subsequent interviews with various user groups, including fund managers, analysts and financial institutions, showed a large demand from

[1] The detailed rules per relevant IFRS address all IFRSs issued as at 30 April 2009. This list will be updated as and when necessary.

users in general for a clearly defined reference number (other than the earnings per share number in terms of IAS 33 – *Earnings per Share*), which can be used for reporting and comparative purposes.

.07 One of the main uses of a single earnings number in South Africa is in the calculation of a consistent price earnings (P/E) ratio. A P/E ratio is a useful analysis tool for comparing the market ratings of companies and for trend analysis of the valuations of companies and sectors over time, even though the earnings of the various companies are not necessarily calculated using the same accounting policies. The P/E ratio can also be considered as the number of years' earnings, calculated on a consistent basis, that are represented by the current share price. The linking of the share price to earnings can be difficult to apply to the re-measurement[2] of assets and liabilities, as markets that drive these re-measurements fluctuate, thus removing the element of consistency. There are inherent difficulties in determining a standard basis for calculating maintainable earnings, and headline earnings is not intended to be representative of maintainable earnings. The use of P/E ratios is not limited to the less sophisticated private investor; these ratios are also used by sophisticated institutional investors worldwide.

.08 Some believe that a meaningful P/E ratio should use the earnings items that relate to the operating/trading of an entity and not those items (such as the revaluation of certain assets) that relate to the capital platform of the business. The operating/trading items are essentially those that reflect performance in the current period (sales, salaries, etc.) and that can be extrapolated (modified or not) into the future.

.09 Not all re-measurements should, however, be ignored. Those relating to working capital are of an operating/trading nature; for example, any impairment of the carrying value of inventories or fair value adjustments relating to a portfolio of securities held-for-trading. These re-measurements are part of an entity's operating/trading activities and should legitimately be included in an earnings number used for the calculation of a P/E ratio.

.10 These considerations point to the need for continuing to require disclosure of an additional, adjusted earnings per share number to supplement the IAS 33 earnings per share number.

Headline earnings and IFRS, including accounting policy choices

.11 SAICA and the JSE are fully supportive of IFRS as issued by the IASB. Full compliance with IFRS is of paramount importance for the integrity of South African financial markets within the context of a global equities market.

.12 Headline earnings should not be seen as a divergence or departure from the recognition criteria for revenue, expenses, gains and losses in IFRS. Instead, it is a way of dividing the IFRS reported profit between re-measurements that are more closely aligned to the operating/trading activities of the entity, and the platform used to create those results. Headline earnings, based on these principles, has been used in South Africa since 1995.

.13 Headline earnings is not a means for an entity to adjust its financial results for disagreements it might have with the application of IFRS or to circumvent the correct accounting treatment. The starting point for headline earnings is the earnings number used to calculate basic earnings per share, in accordance with IAS 33. Accordingly, if items were excluded from basic earnings, they would also be excluded from headline earnings. For this reason, accounting policy choices that affect basic earnings would also impact headline earnings.

[2] Refer to the definitions in paragraph .14.

SECTION B: DEFINITIONS

.14 The following definitions are used within the context of this circular.

Headline earnings is an additional earnings number that is permitted by IAS 33. The starting point is earnings as determined in IAS 33, excluding *"separately identifiable re-measurements"* (as defined), net of related tax (both current and deferred) and related non-controlling interest, other than re-measurements specifically included in headline earnings *("included re-measurements"*, as defined).

A **re-measurement** is an amount recognised in profit or loss relating to any change (whether realised or unrealised) in the carrying amount of an asset or liability that arose after the initial recognition of such asset or liability. A re-measurement may be recognised in profit or loss either when the re-measurement occurs or subsequently. This latter situation occurs when re-measurements are initially recorded in other comprehensive income (in accordance with the relevant IFRS) and subsequently included in or reclassified to profit or loss. This includes gains or losses on available-for-sale financial assets under IAS 39 – *Financial Instruments: Recognition and Measurement,* and foreign exchange translation gains or losses under IAS 21 – *The Effects of Changes in Foreign Exchange Rates*.

A re-measurement can, by definition, never be:

i) the initial recognition of an asset or liability at fair value; or

ii) the expensing of a cost that fails to meet the definition of an asset; or

iii) a gain recognised in other comprehensive income, such as a revaluation gain on property, plant and equipment, which is not reclassified to profit or loss.

Included re-measurements are the re-measurements identified in the table in paragraph .21 (Section C) of this circular and are to be included in headline earnings because:

(i) they have been determined as normally relating to the operating/trading activities of the entity;

(ii) they relate to the usage (as reflected by depreciation) of a non-current asset, which is an operating/trading activity of the entity;

(iii) they relate to current assets or current liabilities, and thus relate to the operating/trading activities of the entity (other than current assets or liabilities as part of a disposal group within the measurement scope[3] of IFRS 5 – *Non-current Assets Held for Sale and Discontinued Operations*);

(iv) they are foreign exchange movements on monetary assets and liabilities and thus relate to the operating/trading activities of the entity, except for those relating to foreign operations that were previously recognised in other comprehensive income and subsequently reclassified to profit or loss. This exception also applies to the translation differences of loans or receivables that form part of such net investment in a foreign operation;

(v) they are financial instrument adjustments arising from the application of IAS 39 (whether as the result of revaluation, impairment or amortisation), except for all reclassified gains and losses other than those detailed in (vi) below. For example, gains or losses on available-for-sale financial assets that are reclassified to profit or loss on disposal or impairment of the financial

[3] Refer to IFRS 5, paragraph 5, for those assets not within the measurement scope of IFRS 5. It must be noted that financial assets within the scope of IAS 39 are not within the measurement scope of IFRS 5. Section C of this circular indicates that impairment losses recognised in respect of disposal groups in terms of IFRS 5, paragraphs 20 – 24, are excluded re-measurements.

asset are excluded from headline earnings because the reclassified fair value gains and losses do not only reflect performance in the current period; or

(vi) they are reclassified items relating to IAS 39 cash-flow hedges because these amounts are matched with those relating to the hedged item.

Reclassification (or reclassification adjustments) occurs when re-measurements are initially recorded in other comprehensive income (in accordance with the relevant IFRS) and are subsequently recycled or reclassified to profit or loss. This is referred to as a "**reclassified** gain or loss item".

Separately identifiable re-measurements are those where the applicable IFRS explicitly requires separate disclosure of the operating/trading and/or the platform re-measurement in the separate or individual financial statements of the entity/company/subsidiary/associate/joint venture or in the consolidated financial statements. No adjustments would be permitted on the basis of voluntary disclosure of gains or losses (or components of these). For example, in the case of biological assets, even if the operating/trading portion and the platform portion of the fair value gain on an apple orchard were voluntarily disclosed, no adjustments to headline earnings would be permitted because this disclosure is not required by IFRS.

The interested parties group includes members of SAICA, the Investment Analysts Society of Southern Africa (IASSA), the Investment Managers Association of South Africa (IMASA) and the headline earnings sub-committee of the United Kingdom Society of Investment Professionals.

Operating[4]/trading activities are those activities that are carried out using the "platform", including the cost associated with financing those activities.

The **platform** is the capital[4] base of the entity. Capital transactions reflect and affect the resources committed in producing operating/trading performance and are not the performance itself.

SECTION C: DETAILED RULES FOR HEADLINE EARNINGS

.15 In terms of Section 8 of the JSE Listings Requirements, headline earnings should be disclosed with a detailed reconciliation to the IAS 33 basic earnings number. In terms of the Listings Requirements, the auditors have an obligation to modify their audit opinion for non-compliance with the headline earnings circular.

.16 IAS 33, paragraph 73, allows disclosure of additional performance numbers in the notes to the annual financial statements. IAS 33, paragraph 73 states that *"basic and diluted amounts per share relating to such a component shall be disclosed with equal prominence and presented in the notes to the financial statements"*.

Calculation of headline earnings

.17 Headline earnings is calculated by starting with the basic earnings number in terms of IAS 33 and then excluding all re-measurements that have been identified in this section (Section C) as relating to the platform of the entity. The focus on re-measurements (whether realised or unrealised) in Circular 8/2007, as opposed to capital items, in Circular 7/2002, provides a clearer and more consistent mechanism for determining headline earnings in the context of IFRS.

[4] The meanings of the words *"operating"* and *"capital"* in this circular are different from their meanings in IFRS.

.18 The main purpose of reconsidering the calculation of headline earnings is to ensure consistency of treatment by all companies listed on the JSE of the same or similar items. The only way to achieve this consistency is to create detailed rules for all items that are separately disclosable in terms of IFRS.

.19 Any deviation from the rules would result in undesirable inconsistencies. Companies are therefore not permitted to override a rule even if they believe that the operating/trading and platform distinction set out in the rules is inappropriate for their specific business. The sector-specific rules section of this circular has been created to allow for an alternative treatment for an entire sector where the general rule is inappropriate to its business. The "Basis for Conclusions" section merely provides background information and guidelines that were used to formulate the calculation of headline earnings and is not to be used to override any of the rules.

.20 The table below identifies items that are separately identified re-measurements (or that might mistakenly be regarded as re-measurements), and indicates whether each of these items is included or excluded from headline earnings. This analysis has been conducted per individual IFRS, is based on all IFRSs and Interpretations issued as at 30 April 2009 and provides the reasoning behind the decision to include or exclude the items. These reasons relate to the definitions set out in Section B of this circular. In many instances the reason for exclusion is that the amount is a re-measurement that has not been specifically included. This is simply referred to as a "re-measurement".

Detailed rules table per IFRS

.21 An entity is to apply the table set out in this paragraph (.21). Rules in this table marked with * are different from rules in Circular 8/2007 (or are new rules) owing to amendments and revisions to IFRSs since Circular 8/2007 was issued. The amendments or revisions brought about by this new Circular, 3/2009, come into effect when that specific revised IFRS is applied by the entity. Therefore, entities not applying these amendments and revisions must use the previous versions of these rules which are set out in the table in paragraph .22. These amendments and revisions reflect changes in IFRS from 30 June 2007 to 30 April 2009.

Standard/ Inter-pretation	**Item**	**In headline earnings**	**Out of headline earnings**	**Reason(s)**
IFRS 2	*Share-based Payment*			
	• The recognition in basic earnings of the receipt of goods or services from share-based payment transactions.	X		• If the receipt of goods or services does not qualify for capitalisation under IFRS, the amount recognised in earnings is not a re-measurement. Thus, black economic empowerment transactions are included in headline earnings. Similarly, consumption of the benefits embodied in the receipt of services under a share-based payment transaction is not a re-measurement.
	• Re-measurements of cash-settled share-based payment transactions.	X		• Included re-measurement (i) as defined. The re-measurements of cash-settled share-based payment transactions relate to the financing of the acquisition of goods or services.

Standard/ Inter-pretation	Item	In headline earnings	Out of headline earnings	Reason(s)
IFRS 3 (as revised in 2008) *	*Business Combinations*			
	• Goodwill impairment.		X	• Re-measurement.
	• The recognised gain from a bargain purchase.		X	• In order to align the treatment with goodwill, it is treated on the same basis.
	• Transaction costs.	X		• Not a re-measurement.
	• Subsequent re-measurement of contingent liabilities.	X		• Included re-measurement (i) as defined.
	• Subsequent amortisation of reacquired rights.	X		• Included re-measurement (ii) as defined.
	• Subsequent re-measurement of contingent consideration (Note: there is no re-measurement if it is equity classified).	X		• Included re-measurement (i) as defined.
	• Gains or losses on deemed disposals in terms of paragraph 42 where the disposal is of an asset previously accounted for as a:			• Re-measurement is dealt with in terms of the normal rules for a gain or loss on disposal.
	- Joint venture		X	
	- Associate		X	
	- IAS 39 financial asset at fair value through profit or loss	X		
	- IAS 39 financial asset classified as an available-for-sale.		X	
IFRS 4	*Insurance Contracts*			
	• Liability adequacy test.	X		• Included re-measurement (i) as defined.
	• Impairment of reinsurance assets.	X		• Included re-measurement (i) as defined.
	• Paragraph 31(b) amortisation and impairment of intangible assets.	X		• Included re-measurement (i) as defined.
	• Paragraph 15 deferred acquisition costs (amortisation and impairment).	X		• Included re-measurement (i) as defined.

Standard/ Inter-pretation	Item	In headline earnings	Out of headline earnings	Reason(s)
IFRS 5	*Non-current Assets Held for Sale and Discontinued Operations*			
	• Discontinued operations: where disposal of an entity meets the definition of a discontinued operation:			
	– the post-tax profit or loss of discontinued operations;	X		• Not a re-measurement.
	– the post-tax gain or loss recognised on the measurement to fair value, less costs to sell, in terms of paragraphs 20 to 24 or on the disposal of the assets or disposal group(s) constituting the discontinued operations.		X	• Re-measurement.
	▪ Gains or losses in terms of paragraphs 20 to 24 on non-current assets or disposal groups held for sale (which include subsidiaries, joint ventures and equity-accounted associates). For current assets and current liabilities that are part of disposal groups, this only refers to the disposal group as a whole and therefore does not apply to those items not within the measurement scope of IFRS 5. For example, it is noted that financial assets are excluded from the measurement scope of IFRS 5 and thus any adjustments on such items would follow the IAS 39 rules for headline earnings. Only the gains or losses on re-measuring the disposal group as a whole would be excluded.		X	• Re-measurement.
IFRS 6	*Exploration for and Evaluation of Mineral Resources*			
	• Impairment/subsequent reversal of impairment.		X	• Re-measurement.
	• For retirement/disposal of the asset see IAS 16/IAS 38.			
IAS 2	*Inventories*			
	• *Re-measurements in terms of this standard.*	X		• Included re-measurement (i) as defined.
	• *Write down or reversal of write down to net realisable value (paragraph 34).*	X		• Included re-measurement (i) and (iii) as defined.

Standard/ Inter-pretation	Item	In headline earnings	Out of headline earnings	Reason(s)
IAS 11	*Construction Contracts*			
	• Changes in provisions for future losses.	X		• Included re-measurement (i) as defined as part of normal trading activities.
	• Percentage completion profit recognition.	X		• Included re-measurement (i) as part of normal trading activities.
IAS 12*	*Income Taxes*			
	• Increases or decreases in the deferred tax balance resulting from a change in tax rate.	X		• Included re-measurement (i) as defined.
	(Note: Changes in the deferred tax balance that do not affect profit or loss are not included in headline earnings as these changes are not included in basic earnings.)			
	• Gain arising from the recognition of deferred tax asset resulting from an assessed loss:			
	– Initial recognition.	X		• Not a re-measurement.
	• Reassessment of recoverability of deferred tax asset.	X		• Included re-measurement (i) as defined, as this is dependent on future profits.
IAS 16 *	*Property, Plant and Equipment*			
	• Depreciation.	X		• Included re-measurement (ii) as defined.
	• Impairment/subsequent reversal of impairment.		X	• Re-measurement of an asset.
	• Disposal gains/losses.		X	• Re-measurement of an asset.
	(Note 1: Gains on revaluation of property, plant and equipment will not be included in headline earnings, as they are not included in profit or loss.)			
	(Note 2: Gains and losses on sale of assets previously held for rental, now transferred to inventory in terms of IAS 16 paragraph 68A, should be dealt with in terms of IAS 2.)			

Standard/ Interpretation	Item	In headline earnings	Out of headline earnings	Reason(s)
IAS 19	*Employee Benefits*			
	• Actuarial gains/losses on recognition in profit or loss (including unexpected returns on plan assets or reimbursement rights).	X		• Included re-measurement (i) as defined, as they are part of employee costs and therefore part of operating/ trading activities.
	• Curtailments and settlements of defined benefit plans (as contemplated by paragraphs 109 – 115).	X		• Included re-measurement (i) as defined, as they are part of employee costs and therefore part of operating/ trading activities.
	• The effect of the limit in paragraph 58(b), unless recognised outside profit and loss in accordance with paragraph 93C.	X		• Included re-measurement (i) as defined.
	(Note: Actuarial gains and losses taken directly to other comprehensive income in terms of IAS 19, paragraph 93A will not be included in headline earnings, as they are not included in basic earnings.)			
IAS 20 *	*Accounting for Government Grants and Disclosure of Government Assistance*			
	• All government grants	X		• Not a re-measurement.
IAS 21	*The Effects of Changes in Foreign Exchange Rates*			
	• Translation of monetary assets/liabilities (whether current or non-current) other than those treated as part of the net investment in a foreign operation.	X		• Included re-measurement (iv) as defined.
	• Translation of the net investment in a foreign operation and monetary assets/ liabilities treated as part of the net investment accounted for initially in other comprehensive income (in the foreign currency translation reserve) and subsequently reclassified to profit or loss.		X	• Re-measurement.
IAS 27	*Consolidated and Separate Financial Statements*			
	• Gains/losses on the loss of control of the subsidiary.		X	• Re-measurement of an asset.

Standard/ Interpretation	Item	In headline earnings	Out of headline earnings	Reason(s)
IAS 28/ IAS 31	*Accounting for Investments in Associates and Joint Ventures* • Gains/losses on the disposal of the associate/joint venture. • The equity-accounted earnings of associates and joint ventures.		 X	 • Re-measurement of an asset. • The rules contained in this table apply equally to the underlying earnings of the associate. For example, the gain on disposal of a non-current asset (or property plant and equipment) by an associate is excluded from headline earnings, i.e. the "look-through" approach is followed.
IAS 29	*Financial Reporting in Hyperinflationary Economies* • Gain or loss on the net monetary position.	 X		 • Included re-measurement (i) as defined.
IAS 36	*Impairment of Assets* • Any impairment/subsequent reversal of an impairment covered in this standard. (Note: The scope of IAS 36 excludes items that are likely to be classified as current assets.)		 X	 • Re-measurement of an asset.
IAS 37	*Provisions, Contingent Liabilities and Contingent Assets* • Any adjustments or re-measurements recognised in profit or loss in terms of this standard.	 X		 • Included re-measurement (i) as defined.
IAS 38	*Intangible Assets* • Amortisation. • Impairment/subsequent reversal of impairment. • Disposal gains/losses. (Note: The revaluation of an intangible asset is not included in basic earnings and is therefore automatically excluded from headline earnings.)	 X	 X X	 • Included re-measurement (ii) as defined. • Re-measurement of an asset. • Re-measurement of an asset.

Standard/ Interpretation	Item	In headline earnings	Out of headline earnings	Reason(s)
IAS 39	*Financial Instruments: Recognition and Measurement* • All re-measurements recognised in profit or loss; • Except: – the reclassification of gains and losses on available-for-sale financial assets upon impairment or disposal and subsequent impairment losses; • But, including: – amounts recognised in profit or loss under cash-flow hedges that were previously recognised directly in other comprehensive income. • The reclassification of all other re-measurements from other comprehensive income to profit or loss, including *inter alia* a hedge of a net investment in a foreign operation.	 X X	 X X	 • Included re-measurement (v) as defined. • Re-measurement falling outside of the definition of an included re-measurement (v). • Included re-measurement (vi) as defined. • Excluded re-measurement (v) as defined.
IAS 40	*Investment Property* • Any adjustments/re-measurements in terms of this standard.		X	• Re-measurement of an asset.
IAS 41	*Agriculture* • All re-measurements in terms of the standard. (Note: As separate disclosure is not required of the fair value measurement changes of the agricultural platform, the full amount is included in headline earnings.)	X		• Included re-measurement (i) as defined.
IFRIC 17*	*Distributions of non-cash assets to owners* The effect of such a distribution is the same as a disposal of the underlying. The headline earnings treatment therefore follows the same treatment as if there were a disposal.			

.22 Those rules that have changed since the issue of Circular 8/2007 are indicated in the rule table above with an *. If an entity is not yet applying these amended or revised IFRSs they must use the previous rule set out in Circular 8/2007. For the sake of completeness, the previous rules that must therefore be applied are set out below.

Standard	Item	In headline earnings	Out of headline earnings	Reason(s)
IFRS 3	*Business Combinations* • Goodwill impairment. • Excess of acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost (previously referred to as "negative goodwill") adjustments. • Goodwill adjustments recognised as result of the subsequent recognition of a deferred tax asset that existed at acquisition (IFRS 3 paragraph 65(b)).		X X X	• Re-measurement. • In order to align the treatment with goodwill, it is treated on the same basis. • Re-measurement (see also IAS 12 where the corresponding gain is also excluded).
IAS 12	*Income Taxes* • Increases or decreases in the deferred tax balance resulting from a change in tax rate. (Note: Changes in the deferred tax balance that do not affect the income statement are not included in headline earnings as these changes are not included in profit.) • Gain arising from the recognition of deferred tax asset resulting from an assessed loss: – Initial recognition; – Recognition of assessed loss of acquiree, which did not qualify for recognition as a deferred tax asset at the date of the business combination to the extent that there is a corresponding good-will adjustment (IFRS 3, paragraph 65 and IAS 12, paragraph 68). • Reassessment of recoverability of deferred tax asset.	X X X	 X	• Included re-measurement (i) as defined. • Not a re-measurement. • Following the goodwill treatment. • Included re-measurement (i) as defined, as this is dependent on future profits.

Standard	Item	In headline earnings	Out of headline earnings	Reason(s)
IAS 16	*Property, Plant and Equipment*			
	• Depreciation.	X		• Included re-measurement (ii) as defined.
	• Impairment/subsequent reversal of impairment.		X	• Re-measurement of an asset.
	• Disposal gains/losses.		X	• Re-measurement of an asset.
	(Note: Gains on revaluation of property, plant and equipment will not be included in headline earnings, as they are not included in profit.)			

SECTION D: THE PRESENTATION OF HEADLINE EARNINGS PER SHARE

Diluted headline earnings

.23 Diluted headline earnings is the headline earnings calculated in terms of the rules, adjusted for exactly the same adjustments as those made to basic earnings when calculating diluted earnings per share. This implies that, if a potential ordinary share is considered to be dilutive in terms of IAS 33, it should be adjusted when calculating diluted headline earnings per share, even if that adjustment does not dilute headline earnings.

Number of shares

.24 The number of shares to be used in calculating the headline earnings per share must be the same as the number used to calculate basic earnings per share in terms of IAS 33. Similarly, the number used to calculate the diluted headline earnings per share must be the same as that used to calculate the diluted earnings per share in terms of IAS 33.

Comparative headline earnings

.25 Headline earnings per share must be presented for each financial period for which basic earnings per share is presented. The comparative number for headline earnings per share may change as a result of retrospective adjustments to the number of shares in issue in terms of the requirements of paragraph 64 of IAS 33. It may also differ where the earnings number used for basic earnings per share has been restated, as that number is the starting point in the calculation for headline earnings.

.26 As a result of issuing Circular 8/2007 to supersede Circular 7/2002, previously reported headline earnings could have been required to be restated in accordance with the requirements of that circular. This would have required restatement of comparative headline earnings. Although it is considered extremely unlikely, if there are changes brought about by Circular 3/2009 there must be a restatement of comparative headline earnings if the calculation of headline earnings was not in accordance with the changed rules.

Comparison of headline earnings per Circular 7/2002 and Circular 8/2007

.27 Whilst we believe that there will be consistency of treatments for most items, it is envisaged that the calculation of headline earnings following Circular 8/2007 may not be identical to the results obtained from applying Circular 7/2002. This is a natural consequence of the focus of Circular 8/2007 on re-measurements and the introduction of detailed rules for each IFRS.

.28 One of the differences that has been identified relates to Issue 4 in Circular 7/2002. Issue 4, which was issued in January 2004, indicated that gains or losses on the closure, sale or termination of a business were excluded from headline earnings. In terms of this circular, such gains or losses, as they relate to current assets or liabilities, will only be excluded if the current assets or liabilities form part of a disposal group under IFRS 5 – *Non-current Assets Held for Sale and Discontinued Operations,* and are within the measurement scope of IFRS 5.

.29 A further departure from the old formula set out in Circular 7/2002 was the initial recognition of a deferred tax asset, after the date of the business combination, in respect of an assessed loss of the acquiree that did not qualify for recognition as a deferred tax asset at the date of the business combination, to the extent that there is a corresponding goodwill adjustment. The rule created in Circular 8/2007 (i.e. exclusion from headline earnings to the extent that it gives rise to a goodwill adjustment) differs from the requirements of Circular 7/2002 (which excluded the goodwill adjustment from headline earnings, but included the deferred tax asset recognised via profit or loss). This change in Circular 8/2007 was necessary in order to ensure consistent treatment of both elements of the transaction. However, as a result of the amendments to IAS 12 (revised in 2008), there will no longer be a corresponding goodwill adjustment; therefore, the amount recognised in profit or loss in respect of the deferred tax asset remains in headline earnings. This change is reflected in this Circular 3/2009.

Format of the headline earnings reconciliation

.30 The headline earnings reconciliation must be separate and must not form part of the statement of comprehensive income (either the single statement or the separate income statement where a two-statement approach is followed under IAS 1.81). The headline earnings reconciliation must be based on the earnings number and not on a "per share" basis. Headline earnings per share, with this reconciliation, must be disclosed in the notes to the financial statements.

.31 A long form of the headline earnings reconciliation is to be included in the annual financial statements. This long form requires disclosure of the gross and net amount of each re-measurement to be excluded from headline earnings. The total of the related tax and the non-controlling interest amounts for each re-measurement can be determined by deduction. Consideration must be given to disclosing the tax and the non-controlling interest of each re-measurement if material and beneficial to users. A short form of the reconciliation may be used in interim, preliminary, provisional and abridged reports. The short-form reconciliation only requires disclosure of the gross amount of each re-measurement adjustment and does not require separate disclosure of the related tax and the non-controlling interest amounts of each adjustment. Instead, the related tax and the non-controlling interest amounts are each shown in aggregate for all of the re-measurement adjustments. When using the short-form reconciliation, consideration must be given to providing additional commentary, for users to be able to understand the related tax and the non-controlling interest amounts.

.32 The starting point for the reconciliation is profit or loss attributable to the ordinary equity holders of the parent. IAS 33, paragraph 73, states that: "*If a component of the statement of comprehensive income is used that is not reported as a line item in the statement of comprehensive income, a reconciliation shall be provided between the component used and a line item that is reported in the statement of comprehensive income."* A detailed line-by-line reconciliation should be provided for each re-measurement to be excluded from headline earnings. The long-form reconciliation should have two columns showing the gross amount and the net amount for each re-measurement. The short-form reconciliation will only have one column. Excluded re-measurements can be aggregated per type of re-measurement per IFRS, unless any such re-measurement is material within the context of the total adjustments. An example is provided below for both the long-form and the short-form reconciliations.

.33 Example of the long-form headline earnings reconciliation

	Gross	Net
Profit attributable to ordinary equity holders of the parent entity		XX
Less undeclared cumulative preference share dividend and related taxation		(XX)
IAS 33 earnings		XX
Less IAS 16 gains on the disposal of land and buildings	(XX)	(XX)
Less IAS 16 gains on the disposal of plant and equipment	(XX)	(XX)
Plus IAS 38 impairment of trademarks	XX	XX
Less the re-measurements included in equity-accounted earnings of associates (1)(2)	(XX)	(XX)
Headline earnings		XX

.34 Example of the short-form headline earnings reconciliation

Profit attributable to ordinary equity holders of the parent entity	XX
Less undeclared cumulative preference share dividends and relative taxation	(XX)
IAS 33 earnings	XX
Less IAS 16 gains on the disposal of land and buildings (3)	(XX)
Less IAS 16 gains on the disposal of plant and equipment (3)	(XX)
Plus IAS 38 impairment of trademarks (3)	XX
Less the re-measurements included in equity-accounted earnings of associates (1)(3)	(XX)
Total tax effects of adjustments	XX
Total non-controlling interest effects of adjustments	XX
Headline earnings	XX

(1) *If material, an analysis must be given of the different types of re-measurements for the equity-accounted earnings.*

(2) *If it is impossible to obtain the actual tax amount from the associate, this fact should be stated and details of any assumption made in determining the tax should be provided.*

(3) *These are the gross amounts, before taking account of the related tax and non-controlling interest.*

SECTION E: HEADLINE EARNINGS PER LINKED UNIT

.35 In certain instances, an entity must disclose headline earnings per linked unit instead of headline earnings per share. Linked units are a common feature of the property sector of the JSE where a share and a debenture trade as a linked unit.

.36 Headline earnings, calculated in terms of this circular, is the starting point for headline earnings attributable to linked unit holders, and the detailed reconciliation between earnings and headline earnings must still be provided. Further adjustments must then be made and disclosed in the reconciliation, for items in profit and loss that are attributable to the other instrument (typically a debenture) that, together with the share, forms part of the linked unit.

.37 When a debenture forms the other component of the linked unit, the additional adjustments are as follows:

(i) add interest paid to debenture holders (as this is the net income attributable to the debentures, which are part of the linked units); and

(ii) add/deduct any IAS 39 adjustments on the debenture (as these relate to the debentures that are part of the linked units) such as:

- amortised cost adjustment where the entity measures the debentures (financial liabilities) at amortised cost after initial recognition; and
- fair value adjustments where the entity has designated the debentures (financial liabilities) at fair value through profit and loss.

.38 The headline earnings attributable to the linked unit holders is divided by the number of linked units to determine the per linked unit number. The number of linked units used must be calculated on the same basis as set out in IAS 33 for earnings per share.

SECTION F: EFFECTIVE DATE

.39 Circular 8/2007 replaced Circular 7/2002 and was applicable for financial periods (interim and/or annual periods) ending on or after 31 August 2007. Early adoption was permitted, but not for results published before 1 September 2007.

.40 This circular replaces Circular 8/2007 and subject to the requirements of paragraph 22, is effective for financial periods (interim and/or annual periods) ending on or after 31 August 2009. Early adoption is permitted.

SECTION G: CREATION OF SECTOR-SPECIFIC RULES FOR HEADLINE EARNINGS

.41 If a specific industry is of the view that a particular rule within the headline earnings formula is inappropriate for that industry, it should make representation to the JSE on the matter. The JSE will, in consultation with the interested parties group (as defined), decide if a rule should be written for that entire industry to exclude or include that specific re-measurement. As the underlying objective is to ensure consistency between companies within a sector, representation should only be made with the full support of the sector. The final decision will be made on the basis of the rationale to treat separately identifiable re-measurements in a particular sector in a different manner from that outlined above, considering any potential implications for other sectors and with the objective of avoiding any potential risk of undermining IFRS. If necessary and when appropriate, Section I of the circular will be updated to address these industry-specific issues. Such rules will be industry specific and may not, by analogy, be applied by industries other than those for which the rules are developed.

SECTION H: BASIS FOR CONCLUSIONS

.42 This section sets out the basis for conclusions in developing the rules for headline earnings. Circular 8/2007 was issued by SAICA as Exposure Draft 220 – *Headline Earnings,* at the request of the JSE, in December 2006, with a comment date of 12 March 2007. Paragraphs .44 to .63 of this section include a discussion of certain issues raised by the commentators to the exposure draft and the response to these issues.

.43 Circular 3/2009 was issued by SAICA at the request of JSE as Exposure Draft 265. Paragraphs .64 to .67 of this section also include a discussion of items considered during the drafting of the revisions to Circular 8/2007 as now incorporated in Circular 3/2009.

Distinction between re-measurements and operating/trading

.44 To be meaningful, the P/E ratio should be based on an earnings number that reflects the underlying operating/trading performance of an entity and should be calculated consistently between entities and over time. Several developments in the financial world (for example, increased use and complexity of derivative instruments) and the consequential accounting treatment, as well as the approach of the IASB to focus on the statement of financial position, have, however, blurred the distinction between capital and income. These developments have also blurred the platform versus operating/trading distinction, developed in the original headline earnings formula of 1995, as contained in the SAICA Circular 7/2002, and make it increasingly difficult to apply the platform versus operating/trading principles consistently.

.45 Recognition of changes in value (re-measurements in IASB terms) in profit or loss has increased as the IASB moves more to a fair value accounting approach. The increase in re-measurements increases the possibility of volatility of an entity's performance numbers. The exclusion of (most) re-measurements (other than those, for example, stemming from operating/trading) parallels in most cases the original headline earnings distinction between platform and operating/trading. This provides ongoing justification for the original principle and validates the continued use of the currently published historic headline earnings data without interruption. This has significant value for time-series analysis, especially over several economic cycles.

.46 In view of the mixed attribute (cost/fair value) model in IFRS, especially in IAS 39 – *Financial Instruments: Recognition and Measurement*, the distinction between the platform and operating/trading mentioned above may sometimes be difficult to make. In some cases this difficulty, and/or the practical considerations involved, may result in headline earnings being based on an accounting treatment that may appear contradictory to the headline earnings principle of distinguishing between the platform and operating/trading. Such imperfections have to be accepted if headline earnings is going to achieve the objective of creating a single earnings number that is consistently calculated.

Specific adjustments considered when issuing Circular 8/2007

.47 Respondents to the SAICA headline earnings research undertaken in 2006 indicated a desire for the following issues to be addressed in a headline earnings revision, because of the problems these issues cause in practice:

(i) fair value adjustments;

(ii) foreign exchange gains and losses;

(iii) amortisation of intangible assets;

(iv) black economic empowerment (BEE) transactions;

(v) effect of straight-lining of operating lease payments; and

(vi) secondary tax on companies (STC) on dividends.

Items (i) to (iii) have been specifically dealt with in the rule table. This should ensure consistency of treatment. The initial recognition of items (iv) to (vi) is not a re-measurement and these items would therefore be included in headline earnings.

.48 As the starting point for the calculation of headline earnings is the IAS 33 earnings number, items not recognised in this earnings number cannot be included in headline earnings. This would include gains on revaluation of property, plant and equipment and fair value gains or losses on available-for-sale financial assets that are recognised in other comprehensive income.

.49 An argument was made during the comment process that in certain BEE transactions the IFRS 2 expense is part of the gain or loss on disposal of a business and should therefore be excluded from headline earnings. BEE credentials are capable of being obtained in a number of ways, including disposing of a business or issuing options or shares at a discount, and in many cases the legal form of the transaction is different from the economic substance. In addition many transactions involve the receipt of services from BEE employees. In order to ensure consistent treatment of BEE transactions from a headline earnings perspective, the decision taken was to include the IFRS 2 charge in headline earnings, as other IFRS 2 charges are included in headline earnings.

The impact of accounting policy choices on headline earnings

.50 The application of IFRS can result in different accounting treatments, depending on the accounting policies adopted and, in the case of financial instruments, the initial designation of such instruments. These choices should be borne in mind from an operating/trading versus platform point of view, as a specific accounting policy choice may imply a certain intention and has the potential to affect headline earnings differently. Accounting policy choices affect earnings, which affect the IAS 33 earnings per share and therefore headline earnings per share (as headline earnings is based on earnings used for earnings per share); these accounting policy choices cannot be "fixed" in the headline earnings calculation.

.51 Examples of accounting policy choices that affect income include the initial designation of financial instruments in terms of IAS 39 – *Financial Instruments: Recognition and Measurement*, which can result in re-measurements going initially to other comprehensive income as opposed to profit and loss. A further example arises under IAS 19 – *Employee Benefits*, where an entity can elect to recognise actuarial gains or losses within profit and loss or outside of profit or loss and in other comprehensive income. The choice to take the actuarial gains or losses to profit or loss includes these gains or losses within headline earnings, while the choice to reflect them in other comprehensive income excludes them from headline earnings. Another example is the application of IFRS 6 – *Exploration for and Evaluation of Mineral Resources.* Some mining companies expense exploration and evaluation costs as incurred, which will include these costs within headline earnings, while others capitalise these costs, which will initially exclude these costs from headline earnings. The amortisation of these costs would be included in headline earnings.

Treatment of IAS 39 re-measurements

.52 When dealing with IAS 39 re-measurements, there are practical difficulties in determining which re-measurements relate to the platform and which relate to operating/trading activities. The four options that were considered were:

(i) include all IAS 39 re-measurements (recognised in earnings[5]) in headline earnings;

(ii) exclude all IAS 39 re-measurements (recognised in earnings[5]) from headline earnings;

(iii) include all IAS 39 re-measurements (recognised in earnings[5]) in headline earnings, but exclude all reclassification items other than cash-flow hedges; or

(iv) exclude some IAS 39 re-measurements in headline earnings, based on management's intentions.

.53 Options (i) to (iii) are essentially arbitrary rules, while option (iv) would allow entities to make their own distinction. While options (i) to (iii) each have their detractors, option (iv) is the most problematic, as it would not result in consistency between companies, which is one of the underlying objectives of headline earnings. This circular follows option (iii), which was considered to be the most

[5] As earnings is the starting point for headline earnings.

objective and robust approach for achieving the purpose of headline earnings, and is also consistent with the approach adopted in Circular 7/2002.[6]

.54 The decision was thus taken that the gains or losses recognised should be dealt with in accordance with the accounting treatment in the financial statements. If the adjustment or gain or loss is initially included in profit or loss, it should be included in headline earnings and vice versa.

.55 The majority of respondents to the exposure draft agreed that option (iii) was the best way to address IAS 39 in headline earnings.

IAS 39 reclassified re-measurements

.56 All IAS 39 reclassified re-measurements, other than those relating to cash-flow hedges, are excluded from headline earnings as they do not only relate to the current period. From the specific way that IAS 39 is drafted, re-measurements that relate to the platform of the entity are initially recognised in other comprehensive income. They are not initially recognised in profit or loss as they do not reflect the entity's underlying trading performance. For example, gains or losses on available-for-sale financial assets that are reclassified to profit or loss on disposal or impairment are excluded from headline earnings because all fair value gains and losses on available-for-sale financial assets are initially recognised directly in other comprehensive income, and therefore the reclassified amounts do not only reflect performance of the current period.

.57 The reclassification of cash-flow hedges, on the other hand, is included in headline earnings, as this re-measurement is only temporarily placed in other comprehensive income so that its recognition through profit or loss can be matched to the underlying related hedged item. Headline earnings adjustments can only be made for separately identifiable items. Therefore, while there may be an argument that some of the cash-flow hedges relate to items that form the platform of the business, since there is no requirement to disclose the reclassification adjustments separately per type of cash-flow hedge and given that most of the cash-flow hedges are likely to relate to items that are included in headline earnings, all reclassifications of cash-flow hedges are included in headline earnings.

Separately identifiable re-measurements

.58 In some cases, the recognised re-measurement adjustments may include elements of both a platform and an operating/trading nature. Only re-measurements where the applicable IFRS explicitly requires separate disclosure of the operating/trading and/or the platform portion of re-measurement in the underlying accounts of the entity/company/subsidiary/associate/joint venture can be adjusted in headline earnings. To allow entities to determine subjectively which portion of a re-measurement relates to the platform would undermine the objective of headline earnings to ensure consistency across entities. The calculation of headline earnings must be robust and objective. Any voluntary disclosure of the components of a gain or loss will not affect the headline earnings treatment as set out

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[6] Paragraph 22A of Circular 7/2002 stated that *"adjustments to the carrying amounts of financial instruments (whether the result of revaluation, impairment or amortisation) and gains or losses on the realisation thereof should be dealt with in accordance with the accounting treatment in the financial statements. If an adjustment or gain or loss is included in"* profit or loss *"it should be included in headline earnings, but otherwise excluded. In those instances where fair value adjustments of available-for-sale financial instruments are recognised in "*other comprehensive income*", but subsequently on disposal or impairment are "* reclassified to profit or loss, the reclassified *" amount is excluded from headline earnings."*
(Note: certain words within this quote from the 2002 circular were amended in order ensure alignment with the new terminology in IAS1. The amended words are excluded from the inverted commas and are not in italics.)

in the rules table. For example, in the case of biological assets, even if the trading/operating portion and the platform portion of the fair value gain on an apple orchard were voluntarily disclosed, no adjustments to headline earnings would be permitted because this disclosure is not required by IFRS.

Format of the headline earnings reconciliation

.59 Exposure Draft 220 raised the question of whether it was necessary to identify the tax and non-controlling interest for each re-measurement separately. Some respondents were concerned that a four-column reconciliation would be too complex and confusing for investors. The suggestion was made that the reconciliation should just include the net amount for each reconciling re-measurement, but still include the detail of the total tax and non-controlling interest amounts attributable to all of the re-measurements. On the other hand it was acknowledged that this detail was useful and in fact necessary to provide a logical flow between earnings and headline earnings. The decision was therefore taken, in trying to balance these two opposing views, to include the detailed, long-form reconciliation in annual financial statements, but to allow a short-form reconciliation to be provided on a net basis in the interim, preliminary, provisional and abridged reports.

The inclusion of a definition of "operating/trading" and "platform"

.60 It was necessary to include a definition of "operating/trading" and "platform" in Circular 8/2007 as the meaning of the words "operating" and "capital" as defined in IFRS did not meet the needs of headline earnings, as set out in the circular. The meanings of the words "operating" and "capital" as defined in IFRS are set out below.

.61 IAS 7 – *Cash Flow Statements* defines *"operating activities"* as being *"the principal revenue-producing activities of an entity and other activities that are not investing or financing activities"*.

.62 The distinction for headline earnings is that some of the financing activities are included within the definition of operating/trading activities. IAS 7 defines *"financing activities"* widely as *"activities that result in changes in the size and composition of the contributed equity and borrowings of the entity"*. Operating/trading activities include the costs associated with financing activities and the return on investments.

.63 Circular 8/2007 uses the word "capital" in the context of non-operating/trading activities or the platform of an entity. This is not necessarily directly aligned with the definition of *"capital"* in terms of paragraph 102 of the *Framework for the Preparation and Presentation of Financial Statements,* being:

- *"under a financial concept of capital, such as invested money or invested purchasing power, the net assets or equity of the entity. The financial concept of capital is adopted by most entities; or*
- *under a physical concept of capital, such as operating capability, the productive capacity of the entity based on, for example, units of output per day."*

Specific matters considered when issuing Circular 3/2009

.64 IFRS 3 (as revised in 2008) introduces a change in the accounting for transaction costs. These are now expensed in profit or loss as opposed to being included in the purchase price. This item is clearly an expense and not a re-measurement and is therefore in headline earnings.

.65 IFRS 3 (as revised in 2008) deals with the subsequent re-measurement of indemnification assets. These re-measurements have not been dealt with in the detailed rules table as they are not separately identifiable. They are therefore included in headline earnings.

.66 With regards to IFRS 3 (as revised in 2008), some argued that any changes to the contingent consideration payable for an acquisition (which by definition are included re-measurements) should be excluded from headline earnings as this contingent consideration relates to amounts that are incurred in acquiring a business, which is not part of the normal operating/trading activities of an entity. Para 58 (b) of IFRS 3 refers one to the relevant standard that should be applied for the subsequent measurement of any contingent consideration. It says that if it is a financial instrument and within the scope of IAS 39, it should be at fair value either through profit or loss or in other comprehensive income. In this case, the headline earnings rules for IAS 39 should be applied and the re-measurement is in headline earnings if the re-measurement is included in profit or loss, and by definition is not in headline earnings if in other comprehensive income. If it is not within the scope of IAS 39, it should be accounted for in accordance with IAS 37 or other IFRSs as appropriate. If such a liability were in the scope of IAS 37, again the headline earnings rule on IAS 37 would apply which rule requires that all re-measurements relating to IAS 37 liabilities are in headline earnings, as on the whole they relate to the trading or operating activities.

.67 As a reminder, if a fair value adjustment relates to the facts and circumstances that exist at the acquisition date and that arise in the measurement period, the initial accounting will be adjusted accordingly. In this case the adjustment forms part of goodwill and will therefore not be in profit or loss unless an excess arises, which is specifically excluded from headline earnings. IFRS 3 does not permit an adjustment to the initial accounting, even during the measurement period (12 months from the date of acquisition), for any changes to the initial accounting that relate to events or conditions that occurred or arose after the acquisition date. In this regard, the Basis for Conclusion of IFRS 3 paragraph BC357 states: "Except for adjustments during the measurement period to provisional estimates of fair values at the acquisition date, the boards concluded that subsequent changes in the fair value of a liability for contingent consideration do not affect the acquisition-date fair value of the consideration transferred. Rather, those subsequent changes in value are generally directly related to post-combination events and changes in circumstances related to the combined entity. Thus, subsequent changes in value for post-combination events and circumstances should not affect the measurement of the consideration transferred or goodwill on the acquisition date. (The boards acknowledge that some changes in fair value might result from events and circumstances related in part to a pre-combination period. But that part of the change is usually indistinguishable from the part related to the post-combination period and the boards concluded that the benefits in those limited circumstances that might result from making such fine distinctions would not justify the costs that such a requirement would impose.)"

.68 A question was raised in the context of IFRIC 16 – *Hedges of a Net Investment in a Foreign Operation* and the treatment of cash-flow hedges in terms of the rule table for IAS 39. Re-measurements resulting from the hedge of a foreign operation reclassified to profit or loss from other comprehensive income is out of headline earnings. If, however, there is a cash-flow hedge of a forecast acquisition or investment, that re-measurement will be in headline earnings. This may result in a situation where the cash-flow hedge treatment in headline earnings is not in fact matched to the headline earnings implication of the hedged item. There is no separate identification of these different types of cash-flow hedges and therefore all cash-flow hedges must follow the same treatment, being included re-measurements.

.69 It is considered unusual that IFRIC 17 appears as a separate item in the rules table. The intention is to include the effects of an IASB interpretation in the section dealing with that specific IFRS. IFRIC 17, however, does not deal with one standard and this makes it necessary to include it separately in the rules table.

.70 The calculation of a consistent P/E ratio is one of the main uses of the headline earnings figure. Given that, other than amendments for terminology changes in IAS 1, the definitions in Section B have not changed in this Circular compared to Circular 8/2007, it was agreed that most appropriate way to ensure the consistent application of those principles to amendments to IFRS issued after 30 June 2007 was to have an effective date as close as possible to the date of issue of the exposure draft. An entity that early adopted a new/revised IFRS should have come to the same answer whether it applied this new circular or applied the definitions in the old circular to that new/revised IFRS.

SECTION I: SECTOR-SPECIFIC RULES FOR HEADLINE EARNINGS

.71 As explained in Section G, Section I may be updated from time to time to include appropriate industry-specific issues.

Issue 1:
Re-measurements relating to private equity activities (associates or joint ventures) regarded as operating/trading activities

Relevant sector: Listed Banks

Rule

.72 All gains or losses on the disposal (or gains or losses recognised in terms of paragraph 42 of IFRS 3 (as revised in 2008)) and distributions to owners in terms of IFRIC 17 of private equity/venture capital associates (equity-accounted) or joint ventures (equity-accounted or proportionately consolidated) for listed banks are included re-measurements and must therefore be included in headline earnings. In addition, the required disclosures, as set out in the definition section below, must be provided in each interim-, preliminary-, provisional- and abridged report and in the annual financial statements.

.73 All investments in associates and joint ventures meeting the definition of those being made by a private equity/venture capital organisation must be dealt with in terms of this rule. There is no flexibility for listed banks (or other entities once they have elected to apply this rule) to “cherry pick” which of their private equity/venture capital investments should be in or out of headline earnings.

.74 Therefore, all private equity/venture capital associates and joint ventures, other than those recognised at fair value through profit and loss in accordance with IAS 39, must be specifically identified and “ring fenced” on initial recognition. Private equity associates and joint ventures in existence at the effective date of this circular must also be specifically identified and “ring fenced”. No subsequent reclassification is allowed in either instance.

.75 Listed entities, other than listed banks, are entitled, but not obliged, to apply this rule. Any entity deciding to apply this rule cannot reverse that decision at a later date.

.76 Any listed entity that has an investment in a listed bank must use the reported headline earnings of that listed bank in its own headline earnings calculation.

Effective date

.77 The effective date for listed banks to apply this rule is for financial periods (interim and/or annual periods) ending on or after 31 August 2007. Any other entity wishing to apply this rule must also do so for any existing private equity/venture capital equity-accounted associates/joint ventures for financial periods (interim and/or annual periods) ending on or after 31 August 2007. Later voluntary adoption of this rule is only possible for other listed entities if they become a private equity/venture capital organisation for the first time after 31 August 2007. Early adoption is permitted, but not for results published before 1 September 2007.

Basis for the rule

.78 The Banking Association of South Africa, with the unanimous support of all of the listed banks, made representation to the interested parties group in terms of Section G of this circular to create a specific rule for the banks' private equity investments. Its motivation for this rule is set out below.

.79 Private equity/venture capital businesses are involved in purchasing investments with the main objective of realising a return on their investment through a combination of dividends, management fees, interest income and profit on the sale of the investments. All investments are made with the view to disposal in the medium term. Consequently, investments are effectively the stock in trade or inventory of the private equity/venture capital business and any profit realised on the disposal of these investments is considered to be part of the trading results of these operations.

.80 In the case of associates and joint ventures, the headline earnings treatment for the gains or losses on disposal of these businesses, as set out in Section C, is based on the classification by management on initial recognition of the investments. If a comparison between two private equity/venture capital entities is made, one having elected to equity account investments and the other to fair value the investments through profit and loss, the headline earnings of the two entities will vastly differ both annually and over the life of the investment, although they operate with the same intention, manage their businesses on the same basis and view the underlying investments on a similar basis, i.e. as inventory.

.81 The Banking Association further believes that it is important to note that IAS 28 – *Investments in Associates* permits a private equity/venture capital business to recognise an investment in an associate at fair value through profit or loss instead of applying equity-accounting. Electing to apply the equity method of accounting does not imply that the investment is part of the capital or platform of the business. The entity has a free choice in making the election. IAS 31 – *Interests in Joint Ventures* contains a similar election for investments in joint ventures held by private equity/venture capital businesses. It is contended therefore that there is no justification for using the accounting policy election option provided in IAS 28 and IAS 31 as a basis for determining whether an investment is part of the operating/trading or platform of the business.

Definitions

.82 The definitions applicable to this rule are set out below.

Private equity/venture capital equity accounted associates/joint ventures are any investments made by private equity/venture capital organisations that could fall within the scope exclusion of IAS 28 paragraph 1 and IAS 31 paragraph 1.

A private equity/venture capital organisation is one that must:

(i) have, as its principal business, the provision of equity finance to unlisted entities and make its returns mainly through medium- to long-term capital gain. These activities may include start-up and other early stage expansion, management buy-out or management buy-in investment, which includes "equity-type" return;

(ii) have experienced executives engaged full-time in venture capital and private equity investment;

(iii) have venture capital and private equity funds under management having made at least one investment in Southern Africa and be actively making investments; and

(iv) take an active role in helping to build and develop the companies in which it invests.

A listed bank is an entity listed on the main board of the JSE in the "Banking" sub-sector of the "Financial" industry classification. To ensure that the objective of headline earnings for consistency is maintained, this rule must be applied to all listed banks.

Interim report, preliminary report, provisional report and abridged report are as defined in the JSE Listings Requirements.

The required disclosure includes separate and additional disclosure of the following information for the private equity/venture capital associates or joint ventures (as defined) that are not recognised at fair value through profit and loss in accordance with IAS 39:

(i) All financial information relating to the associates or joint ventures being:

a. the aggregate cost;

b. the aggregate carrying value of these investments at the reporting date;

c. the equity-accounted income for the period for equity-accounted associates and joint ventures, or the profit attributable to the ordinary shareholders of the private equity/venture capital from the proportionally consolidated joint ventures;

d. the aggregate other income earned for the period (such as management fees); and

e. the aggregate realised gains or losses on disposal for the period;

(ii) The aggregate fair value of the investments in associates or joint ventures.

These required disclosures are necessary to align this sector-specific rule with the separately identifiable objective contained in the headline earnings definition.

Issue 2:
The re-measurement of investment property

Relevant sector: Financial – Listed Life Insurance (other sectors must apply this rule to their long-term insurer and its subsidiaries and associates)

Rule

.83 All gains or losses (unrealised and realised) on the re-measurement (which by definition includes a disposal) of all investment properties are included re-measurements and must therefore be included in headline earnings. This rule applies irrespective of whether the investment property was purchased with policyholders or shareholders' funds and irrespective of whether the entity's accounting policy is to measure its investment properties at cost or fair value. In addition, the required disclosure, as set out in the definition section below, must be provided in each interim-, preliminary-, provisional- and abridged report, and in the annual financial statements.

.84 This rule applies to all investment properties of a listed life insurer, a long-term insurer and all of the listed life insurer's and long-term insurer's subsidiaries and associates. Any listed entity that has a listed life insurer as a subsidiary or associate must use the reported headline earnings of that listed entity in its own headline earnings calculation.

Effective date

.85 The effective date for the listed life insurers and the long-term insurer subsidiaries and associates of entities listed in other sectors of the JSE to apply this rule is for all financial periods (interim and/or annual periods) ending on or after 31 January 2008. Early adoption is permitted but not for results published before 22 February 2008, the date on which this rule was issued.

Basis for the rule

.86 The SAICA long-term insurance industry group, with the unanimous support of all of the long-term insurers that are either listed themselves or are part of a group that is listed, made representation to the interested parties group in terms of Section G of this circular to create a specific rule for their investment properties. Their motivation and the response from the interested parties group are set out below.

.87 There is concern that the treatment of fair value re-measurements and the profits or losses on disposal of investment properties, as currently set out in Section C, is inappropriate for the life insurers.

.88 The nature of the operations of a long-term insurer is to invest in assets that will provide the required return in order to make payments to policyholders as and when they arise. Long-term insurers hold investment properties for the following purposes:

- in order to match policyholder liabilities relating to policy contracts where the return on the contract is matched to the value of the asset (in this case the investment property), or where the policy contract contains a discretionary participation feature, or to match policyholder liabilities relating to insurance contracts; and/or
- in order to invest shareholders' equity (i.e. surplus capital)

.89 In the case of investment properties acquired to match policyholder liabilities, these investments do not form part of the platform of the long-term insurer. These investments meet the definition of an operating/trading activity as they form part of those activities carried out using the platform. Paragraph .14 of Circular 8/2007 defines "included re-measurements" as those that relate to the operating/trading activities of the entity.

.90 The operating performance from investment properties can be realised in two ways by the long-term insurer, either through capital appreciation, or through rental income. The capital appreciation and the rental income are both required to match the increase in the policyholder liability. Rental income is already included in the operating activities of the long-term insurer and thus there is a misalignment in terms of the current Section C rule where the capital appreciation of the investment property is not considered part of the operating activities. The re-measurement of the policyholder liability (under insurance and investment contracts) remains within headline earnings.

.91 The interested parties group considered to the arguments of the SAICA long-term insurance industry group. Concern was raised, however, about the separately identifiable nature of the re-measurement referred to. Paragraph .55 of Circular 8/2007 states that only re-measurements where the applicable IFRS requires disclosure of the operating/trading and/or platform portion of the re-measurement can be adjusted in headline earnings. It goes on to acknowledge that re-measurements may include both a platform and an operating/trading nature. The rule table has been written on the basis of whether the platform or operating/trading portion of the re-measurement makes up the majority portion of that re-measurement. The SAICA long-term insurance industry group acknowledges that by far the majority of its investment properties are held to match policyholder liabilities. It has thus been agreed that all re-measurements relating to investment properties (whether using policyholders or shareholders' funds) will be regarded as included re-measurements.

Definitions

.92 The definitions applicable to this rule are set out below.

Financial risk is the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

An **insurance contract** is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Insurance risk is risk, other than financial risk, transferred from the holder of a contract to the issuer.

Investment contracts are contracts that do not transfer significant insurance risk, but transfer financial risk. An investment contract is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

An **investment property** is an investment property as defined in IAS 40, measured at fair value or at cost.

A listed life insurer is a long-term insurer listed on the main board of the JSE in the "Financial – Life Insurance" sector.

A **long-term insurer** is an entity that has, as its principal business, the issuing of long-term insurance and/or long-term investment contracts, and is registered as a long-term insurer in terms of the Long-term Insurance Act of 1998.

Policyholder means the person entitled to be provided with the policy benefits under an investment or long-term insurance contract.

The required disclosure involves informing the reader that that the headline earnings of insurers includes re-measurements of investment properties, which re-measurements are largely attributable to policyholders.

Johannesburg **M P Matlwa**
August 2009 **Executive President**