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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.

Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: July 2006, London

**Project: Employee Benefit Trusts in the Individual or Separate
Financial Statements of the Sponsor (Agenda paper 8)**

Introduction

1. In its May 2006 meeting, the IFRIC discussed an issue relating to accounting for employee benefit trusts (or other entities) set up by a sponsoring entity specifically to facilitate the transfer of its equity instruments to its employees under a share-based payment arrangement. The IFRIC considered whether the employee benefit trust should be treated as:

- **View 1: an extension of the sponsoring entity.** In that view, the sponsoring entity is in substance in the same position as if it held the shares directly and therefore accounts for them in equity as treasury shares. There would be no difference between the consolidated financial statements and the separate financial statements of the sponsoring entity in respect of the employee benefit trust and the related share-based payment arrangement; or
- **View 2: a separate legal entity** consolidated only at group level. In that view, the sponsoring entity accounts for the investment in the employee benefit trust as an asset in its separate financial statements.

2. IFRIC members cited a number of difficulties arising in practice if the separate entity view is taken.
3. The IFRIC decided to take this issue onto the agenda and asked the staff to analyse further for the next meeting the arguments supporting these two views.

Issues

4. When IFRS 2 became effective, the scope of SIC-12 *Consolidation-Special Purpose Entities* was amended to remove the scope exclusion for equity compensation plans. The amendment resolved the consolidation issue but there remain accounting issues in the separate financial statements that are not dealt with in IFRS 2. By contrast, IAS 19 is clear on how a pension plan should be treated whether in the consolidated or in the separate or individual financial statements.
5. In several countries, employers use employee benefit trusts (EBTs) to issue shares as consideration in share-based payment transactions. While the detailed structures of individual EBTs vary, the main features typically are as follows:
 - The EBT is a “warehouse” for the sponsor's shares. For example the EBT may acquire and hold sponsor's shares that are to be sold or transferred to employees in the future. Acquisition may be with funds provided by the sponsor by way of cash contributions or loans, or by a third-party bank loan guaranteed by the sponsor, or by a combination of the two. Loans from the sponsor often are interest-free. The sponsor may also issue shares directly to the EBT.
 - In most cases, the EBT is not exposed to market price risk, because any increase in value accrues to the employees, or to the sponsor in some circumstances, and any decrease is funded by the sponsor. The EBT may benefit from holding the sponsor’s shares to the extent these are not transferred to beneficiaries but instead are sold in the market at a profit; there may be no requirement to transfer this gain to the sponsor. However, in practice, to anticipate forfeitures, EBTs often will purchase fewer than the expected number of shares required and this possible benefit often will not materialise.

- When the EBT borrows from a third party, the sponsor usually will guarantee the loan, i.e., it will be responsible for any shortfall if the EBT's assets are insufficient to meet its debt repayment obligations. The sponsor also generally will make regular contributions to the EBT to make good any shortfall between the dividend income of the EBT (if any) and the interest payable. As part of this arrangement the trustees usually waive their right to dividends on the shares held by the EBT.
 - The EBT may subscribe directly for shares issued by the sponsor or acquire shares on the market.
 - When the employees exercise their options, the shares may be distributed by the EBT on behalf of the sponsor or by the sponsor after reacquiring the shares from the EBT.
 - In some jurisdictions (such as the UK), the only function of the EBT is to serve the purposes of the sponsor in a narrowly defined field. In other jurisdictions (South Africa for instance), EBTs may undertake various activities.
6. In the agenda paper 10(i) presented at the May IFRIC meeting, the staff considered various difficulties arising in practice in the separate or individual financial statements of the sponsoring entity if the trust is treated as a separate legal entity such as :
- (a) The double counting issue, once when the sponsor accounts for the IFRS 2 charge and once if the funding from the sponsor to the employee benefit trust is also accounted for as an expense. That leads to the question: should the sponsor recognise its funding to the trust as an investment (or a loan) rather than as an expense?
 - (b) The issue of the change in the value of the sponsor's shares during the holding period in the trust.

Staff analysis

7. Following the May IFRIC Meeting, the staff have analysed further the branch approach (view 1), then the accounting issues arising if the trust is treated as a separate legal entity (view 2) and have considered an alternative view (view 3).

a) The branch approach (view 1)

8. Those supporting this view claim that :

- The only purpose of the trust assets is to discharge the sponsor's obligation to the employees, which is already recognised in the sponsor's financial statements as required by IFRS 2.
- The sponsor's control over the assets of the trust is greater than the indirect control by a parent over a subsidiary's assets, which results from the parent's ability to govern the subsidiary's operating and financial policies.
- The sponsoring entity is in the same position as if it held the cash or the shares directly and therefore should account for them as such.

9. At the May IFRIC meeting, the main concern of some IFRIC members was whether clear boundaries could be identified between the sponsoring entity and its employee benefit trust (or other type of trusts or subsidiaries).

10. In paragraph 4, IAS 27 defines a subsidiary as “*an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent)*” [emphasis added].

11. Assuming the sponsoring entity has control over the employee benefit trust, the relevant question seems to be whether or not the employee benefit trust is an entity. However, the staff believe that this issue is in fact a conceptual issue not addressed with sufficient clarity in current IFRSs. Effectively, the entity notion is defined neither in the Framework nor in IAS 27, although the term entity is commonly used. Therefore, view 1 relies only on the substance over form principle enunciated in the Framework.

12. As the notions of entity and reporting entity are not defined in IFRSs, the staff have considered the current projects on the Boards' agenda in connection with this issue:

- Conceptual Framework - Reporting Entity;
- Consolidation;
- Joint Ventures.

13. Concerning the Reporting Entity project, a Discussion Paper or an Exposure Draft is expected to be issued in the first half of 2007. The latest conclusions of the IASB and FASB on this joint project were:

- December 2005: the reporting entity concept should focus on determining the boundaries of the reporting entity, for both an individual reporting entity and a group reporting entity
- March and April 2006: an entity for financial reporting purposes should not be limited to legal entities, such as companies, trusts, and partnerships. Rather, an entity should be defined more broadly to include other types of organizational structures, including a natural person, a sole proprietorship, and, in some circumstances, a branch or segment of a legal entity.

14. Concerning the Consolidation project, an Exposure Draft is expected to be issued in the first half of 2007 and an IFRS in 2008. The goal of this project is to publish a single IFRS on consolidation to replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities* and will cover also separate and individual financial statements. The latest discussion was at the September 2005 Board meeting:

Consolidation (including special purpose entities)

The Board discussed the timing of the recognition of an asset owned directly or through an option in an entity holding that asset. The Board agreed that the relationship between the definition of the reporting boundary and the accounting for an interest in an asset is important. In particular, it is important to identify the circumstances in which the rights conveyed by an option are sufficient to require an entity to prepare consolidated financial statements but are not sufficient to allow the recognition of the asset underlying that option in the individual or separate financial statements of that entity. The discussion also indicated that there may still be some confusion among constituents about the nature of individual and separate financial statements¹.

[IASB Update, September 2005]

¹ The Board also acknowledged that control over a business and control over an asset was different and needed to be rationalised.

15. Finally, concerning the Joint Venture project, the Board decided in its March 2006 meeting that, in view of the potential effects of developments in current Board projects (such as the consolidations and conceptual framework projects and, in particular, the short-term convergence project) on accounting for joint ventures, work on this long-term research project should be suspended, pending the outcome of those developments.
16. At the May 2006 Board meeting, the IFRIC co-ordinator reported to the Board the employee benefit trust issue on the agenda of the IFRIC. No discussion came up but one Board member expressed his concerns saying the traditional view was that the parent statements showed the investment, and the underlying asset was shown in the consolidated statements.
17. Then, the staff asked for the views of the IASB/FASB staff on the Reporting Entity and Consolidation projects regarding the employee benefit trust issue on the agenda of the IFRIC in the light of their most recent researches.
- **Comments from the staff leading the Reporting Entity project:** in the course of the project, the staff proposed to the Boards that for something to be an "entity" it needed to be more than merely a collection of assets and liabilities, and that it needed some sort of "capacity to act". Some Board members reacted negatively to this idea. In particular, they did not want the concept of what constitutes an "entity" for financial reporting purposes to exclude an SPE on autopilot. Based on these discussions, the staff would conclude that, under the reporting entity concept developed to date, the answer to the question of whether the employee benefit trust is an entity is "yes". Then the staff suspect that, in the case of an employee benefit trust, the legal arrangements are such that the shares are in the name of the EBT, and any third party liabilities are also in the name of the EBT. It would be necessary to argue "substance over form" to conclude that they are not assets and liabilities of the EBT. For example, some would argue that the sponsoring entity's role in setting up the EBT, ensuring that the EBT operates to the benefit of the sponsoring entity, and the sponsoring entity's guarantee of the third party loans, are indicators that the sponsoring entity controls the EBT, but that does not mean that the sponsoring entity has direct control over the underlying assets (or direct exposure to the

underlying liabilities). If the EBT controls the assets in its own right, then the sponsoring entity would control those assets indirectly only (through its control of the EBT), rather than directly. In that case, the sponsoring entity would report in its separate financial statements its investment in the EBT, not the underlying assets and liabilities.

- **Comments from the staff leading the Consolidation project:** a parent entity will respect the boundaries of an entity that has its own legal identity. An entity is normally afforded a legal identity through legislation, rather than contract. A simple test might be whether that entity is recognised as being able to have legal title to an asset. For example, a company would normally be able to claim title to an asset in its own right. In contrast, in many jurisdictions a contractual joint venture will not have a legal identity. In such cases the venturers might need to register each of their names on the title. One venturer could do so and then use a contract to define the property rights. Or the venturers might set up an entity that does have legal identity and register that entity as the owner and use contracts to define the property rights. What seems to be clear is that, if there is an entity, it will have a form that allows it to assert its rights and be responsible for obligations in its own name. That is to say, a legal identity. A legal identity should not be confused with statutory form, such as a company. It is almost certain, however, for an entity to be able to justify respecting the boundaries of a form, the rights and obligations of that form will need to be legally enforceable by and against it in its own right. If an entity has a legal identity we respect that form and recognise it as an entity (subsidiary) in the parent rather than as a way of organising activities (such as a branch or division).

18. In order to illustrate these boundaries, the staff suggest considering the following situations:

- i. Entity A is a sponsoring entity which has set up a trust B specifically to facilitate the transfer of its equity instruments to its employees under a share-based payment arrangement. For that purpose, A transferred cash to B, which acquired A's shares on the market. According to the trust deed's provisions, discretion of the trustees of B is minimal, not only in relation to the beneficiaries but also with regard to the use of the trust's assets (shares of A).

- ii. Entity A controls a subsidiary C, which acquired its plant. According to a contract between A and C, C is committed to supply goods solely to A at a predetermined price. Power exercised by A on C is such that in practice discretion of C is minimal in relation to the use of its assets (the plant).
- iii. A subsidiary D grants equity instruments of its parent A to its employees, as in the situation 2A of agenda paper 3 *Group and treasury share transactions*, but assuming that D does not transfer immediately the shares acquired from A to its employees. During this holding period, D has the ownership of the shares.

19. What are the similarities and differentiating factors between those situations?

- Entity A controls the trust or the subsidiaries but has no direct control over the asset. The consolidated financial statements would reflect the economic substance of the transactions -in particular own shares would be treated as treasury shares.
- Entity A has no **legal title** to the asset and therefore is unable to claim title in its own right.
- Entities B, C and D have **legal identity and have the ownership of the assets (or shares)**. That is to say, their rights and obligations are legally enforceable by and against their own right. Therefore, boundaries should be respected.

20. However, it seems to the staff that there is no obvious differentiating factor except maybe the fact that assets of the trust (or the subsidiary) are shares of the sponsor (or the parent).

b) The separate legal entity approach (view 2)

21. When the trust is considered as a separate legal entity, the staff is aware of difficulties in practice to account for the transactions with the trust :

- (a) The double counting issue, once when the sponsor accounts for the IFRS 2 charge and once if the funding from the sponsor to the employee benefit trust is also accounted for as an expense. That leads to the question: should the sponsor consider its funding to the trust as an investment (or a loan) rather than as an expense?
- (b) The issue of the change in the value of the sponsor's shares during the holding period in the trust. Effectively, when the shares are repurchased from the trust, it is acquisition of treasury shares in the books of the sponsor. IAS 32.33 requires treasury shares to be measured based on the consideration paid. This raises the following questions:
 - i. Should the sponsor measure the treasury shares at fair value, or at the book value of the loan or investment in the EBT that will be derecognised?
 - ii. If the fair value of the shares is the measurement basis, then how should any gain or loss on extinguishment of the investment or loan in the sponsor be recognised?

22. The staff believe that it is the role of the consolidated financial statements to reflect the economic substance of the transactions between the sponsoring entity and the trust. By contrast, the purpose of separate financial statements is to report the investment in the trust. In effect, IAS 27.4 defines:

Consolidated financial statements are the financial statements of a group presented as those of a single economic entity.

Separate financial statements are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.

Therefore each transaction with the trust should be treated separately and should not be combined. Mainly, those transactions are as follows:

- The sponsor sets up the trust;
- The trust buys shares from the sponsor or on the market place;
- The sponsor repurchases the shares from the trust when employees exercise their options or, alternatively, the trust distributes the shares to the employees on behalf of the sponsor;
- The trust is wound up.

23. In order to illustrate the accounting issues that may arise in connection with those transactions, the staff suggest considering the example in the appendix (See part b). Even though this example is simplified, it captures the two accounting issues set out in paragraph 23 of this paper. The main conclusions of this example from the sponsor's accounts perspective are:

- The funding of the trust should be accounted for as an investment or a loan receivable, depending on the terms of the arrangement;
- When the sponsor repurchases the shares from the trust, the sponsor accounts for them as treasury shares at the consideration paid (IAS 32.33), i.e. at the fair value of the transaction irrespective of whether or not there is a cash movement;
- As with any other investment, no gain or loss is recognised in the separate or individual financial statements of the sponsor until the trust is wound up (except for impairment of assets).

24. To illustrate more complex situations, the staff have analysed the following circumstances:

- When arrangements are such that gains on the shares value must be transferred to the sponsor, first the classification equity/financial asset of that financial instrument should be considered according to IAS 32 and second, if the instrument is a financial asset then a derivative test should be undertaken.
- When the trust is funded by a third party and the sponsoring entity has guaranteed the loan, a liability should be recognised in the financial statements of the sponsoring entity at the fair value of the guarantee.

- If the value of the shares falls below the exercise price, then the employees would not exercise their options and an impairment of the assets (the shares of the sponsor) booked in the sponsoring entity's separate financial statements might be necessary.

25. In addition, the trust is a related party to the sponsoring entity. Hence, the latter will have to disclose in its separate or individual financial statements the disclosures required by IAS 24 *Related Party Disclosures* which states for instance in paragraph 17 (emphasis added):

If there have been transactions between related parties, an entity shall disclose the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. These disclosure requirements are in addition to the requirements in paragraph 16 to disclose key management personnel compensation. At a minimum, disclosures shall include:

- (a) *the amount of the transactions;*
- (b) *the amount of outstanding balances and:*
 - (i) *their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and*
 - (ii) *details of any guarantees given or received;*
- (c) *provisions for doubtful debts related to the amount of outstanding balances; and*
- (d) *the expense recognised during the period in respect of bad or doubtful debts due from related parties.*

c) Alternative View (view 3)

26. Some staff believe that a problem remains to be dealt with if the EBT is not accounted for as an integral part of the sponsoring entity's financial statements. The problem consists in the nature of the asset that the sponsor has in its investment in the trust. Unlike an investment in a subsidiary, the investment in the EBT may not be supported by assets that could count as assets in the hands of the sponsor. To the extent that the EBT's assets consist of shares in the sponsor, the sponsor's investment in the EBT is effectively impaired. Unless this 'impairment' is debited to equity, the sponsor is overstating its own equity and net assets.
27. Under the Alternative View the 'impairment' write down would be charged directly to equity not to profit or loss. One reason is that profit or loss would be charged at the time that a share-based payment award is granted to employees. A second charge in respect of the shares needed to settle the award would be double counting. More fundamentally, the proposed treatment follows the principle behind IAS 36 Impairment of Assets by adapting the accounting required by that Standard to the nature of the item 'investment in EBT' when that item is supported by the sponsor's own equity. The principle of IAS 36 is that the preparer of financial statements has to enquire whether items shown as assets are capable of generating, directly or indirectly, cash flows above or equal to the carrying amount of the asset. If not, the asset is written down through profit or loss as a form of accelerated depreciation. However, the reduction in value that occurs when an entity buys its own shares, directly or through another entity acting on its behalf, is not deterioration of an asset but a transaction with shareholders whose effect is to shrink the entity. The appropriate accounting is therefore a debit directly to equity.
28. The above argument, together with existing requirements of other IFRSs, should ensure that the substance of the transactions of the sponsor and its EBT will be presented in the individual or separate financial statements of the sponsor without the need to "consolidate" the EBT as proposed in view 1.
- IFRS 2 will ensure that the sponsor recognises a charge at the moment it makes a share-based payment award to its employees;

- If the EBT raises cash from a loan guaranteed by the sponsor, IAS 39 will require the sponsor to recognise a liability for the fair value of the guarantee (ie at an amount that will approximate to the face value of the loan if the EBT has no assets of its own);
- When the EBT acquires shares, whether by purchase or directly from the sponsor, the latter will write down its equity by the fair value of the shares and reduce its investment in the EBT by the same amount;
- When the EBT is wound up, any profit or loss resulting from holding the sponsor's shares is adjusted against the sponsor's equity; any remaining surplus paid to or deficit met by the sponsor is recognised in the sponsor's income statement.

Staff recommendations

29. The staff view is that, if the trust a) has a legal identity and b) has the ownership of the shares, then each transaction should be treated separately in the individual financial statements of the sponsor and the EBT.
30. The staff also believe that without any definition of entity or reporting entity in current IFRSs and in view of the potential effects of developments in current Board's projects (such as the consolidations and conceptual framework projects) on that issue, treating the trust as an extension of the sponsoring entity should not be examined further by the IFRIC.
31. Therefore, a wording for rejection explaining the rationale developed in this paper could be the relevant outcome of this project. In that event, the staff will prepare a wording for rejection for the next IFRIC meeting.

Do you agree with the staff analysis and recommendation?
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Appendix - Illustrative Example

[Paragraph omitted from observer notes]