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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:** May 2006, London

**Project:** IFRS 2 *Share-based Payment*  
Accounting for Employee Benefit Trusts (Agenda Paper 10(i))

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### Introduction

1. During the IASB's deliberations when finalising IFRS 2, it agreed to ask the IFRIC to consider:
  - a) Whether the scope of SIC-12 *Consolidation-Special Purpose Entities* should be amended once IFRS 2 becomes effective, to remove the scope exclusion for equity compensation plans.
  - a) Whether any guidance should be developed on accounting for employee benefit trusts relating to share-based payment arrangements.
2. The IFRIC amended the scope of SIC-12 in November 2004: "*This Interpretation does not apply to post-employment benefit plans or ~~equity compensation plans~~ other long-term employee benefit plans to which IAS 19 applies*".
3. At the July 2004 IFRIC meeting, IFRIC members discussed various issues relating to accounting for employee benefit trusts in the sponsoring entity's consolidated and separate financial statements. No decisions were reached at this meeting.

4. Respondents to *D7 Amendment of SIC-12 Consolidation-Special Purpose Entities*, for the most part, supported the amendment of the scope but pointed out the need for further guidance concerning separate or individual financial statements.
5. This paper addresses employee benefit trusts (or similar entities) that have been set up by a sponsoring entity specifically to facilitate the transfer of equity instruments of the sponsoring entity (or cash or other assets) to the sponsoring entity's employees under a share-based payment arrangement within the scope of IFRS 2.

### **Staff analysis and recommendation**

6. The staff have considered three levels of analysis:
  - a. the consolidated financial statements,
  - b. the separate or individual financial statements of the sponsoring entity,
  - c. the separate or individual financial statements of entities other than the sponsoring entity under a group equity compensation plan.

#### **a) Consolidated financial statements**

7. IAS 27 *Consolidated and Separate Financial Statements* requires a parent entity to consolidate all entities under its control. IAS 27 also provides guidance on determining when control exists, which is supplemented by guidance in SIC-12 on special purpose entities (SPEs). Since its amendment, SIC-12 also applies to employee benefit trusts (or similar entities) relating to share-based payment arrangements.
8. BC 15B and 15C of SIC-12 relate the context of that amendment and give an example of an employee benefit trust (or similar entity): "*removing the scope exclusion in SIC-12 would require an entity that controls such a trust to consolidate the trust and, in so doing, to apply the requirements of IAS 32 to treasury shares held by the trust.*"
9. In determining whether the sponsoring entity controls such an employee benefit trust (or similar entity), the staff believe that, since facts and circumstances vary case-by-case, professional judgement needs to be exercised. In particular, the staff have identified two circumstances which may indicate that control exists :
  - The activities of the employee benefit trust (or similar entity) are predetermined by the sponsoring entity to serve its purpose (the trust operates as an 'autopilot' entity),
  - The sponsoring entity bears most of the benefits and risks of the trust.

10. In determining whether a sponsoring entity controls an ESOP<sup>1</sup> trust, the UK guidance, UITF 38 *Accounting for ESOP trusts*, argues: “*Although the trustees of the ESOP trust must act at all times in accordance with the interests of the beneficiaries under the trust, most ESOP trusts (particularly those established as a means of remunerating employees) are specifically designed so as to serve the purposes of the sponsoring company, and to ensure that there will be minimal risk of any conflict arising between the duties of the trustees and the interest of the company. Where this is so, the sponsoring company has de facto control and there will be nothing to encumber implementation of its wishes in practice.*” [UITF 38.6(d)].
11. In that circumstance, SIC-12 gives the following indicator of a possible relationship in which an entity controls an SPE: “*in substance, the activities of the SPE are being conducted on behalf of the enterprise according to its specific business needs so that the enterprise obtains benefits from the SPE’s operation*”.
12. The second indicator is whether the sponsoring entity bears most of the benefits and risks relating from the activities of the employee benefit trust (or similar entity). The benefits of such trusts mainly lie in facilitating, in some jurisdictions, the transfer of equity instruments to the sponsoring entity’s employees under a share-based payment arrangement. On the other hand, where an employee benefit trust (or similar entity) borrows from a third party, the sponsoring entity will usually guarantee the loan and will be responsible for any shortfall of the trust.
13. [Paragraph 13 omitted for observer note purposes.]
14. For the purpose of consolidated financial statements, the staff do not recommend developing guidance on determining whether an employee benefit trust (or similar entity) is under the sponsoring entity’s control because:
  - the existing guidance in IAS 27 and SIC-12 is likely to be sufficient in most cases;
  - this view is also shared by most respondents to D7 Scope of SIC-12  
*Consolidation-Special Purpose Entities*;
15. For those reasons, the staff recommend that this issue should not be taken on to the agenda.

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<sup>1</sup> Employee Share Ownership Plans

**b) Separate or individual financial statements of the sponsoring entity**

16. Accounting for employee benefit trusts relating to share-based payment arrangements in separate or individual financial statements is not specifically dealt with in current IFRSs. UK GAAP has developed guidance on that issue and US GAAP, though written in the context of consolidated financial statements, has guidance that could also be applied to separate or individual financial statements.
17. The UK interpretation body, in UITF 38, took the view that “*the sponsoring company of an ESOP trust should recognise the assets and liabilities of the trust in its own accounts whenever it has de facto control of those assets and liabilities*” and provides guidance on accounting for:
  - Consideration paid or received for the purchase or sale of the sponsoring entity’s shares held by the SPE as movements in equity. This includes the requirement that the sponsoring entity should not recognise a gain or loss on the purchase, sale, issue or cancellation of its shares;
  - Other assets and liabilities (including borrowings) of the trust;
  - The SPE’s finance and administrative costs;
  - Dividend income of the SPE in respect of the sponsoring entity’s shares;
  - Disclosure.
18. In US GAAP, SOP 93-6 gives guidance, in particular, on reporting of debt for leveraged ESOPs:
  - Direct loan: a loan made by a lender other than the employer to the ESOP which often includes some formal guarantee or commitment by the employer – An employer that sponsors an ESOP should report the obligation of the ESOP to the outside lender as a liability.
  - Indirect loan: a loan made by the employer to the ESOP, with a related outside loan to the employer – An employer that sponsors an ESOP should report the outside loan as a liability but should not report a loan receivable from the ESOP as an asset.
  - Employer loan: a loan made by the employer to the ESOP, with no related outside loan – An employer that sponsors an ESOP should not report the ESOP’s note payable and the employer’s note receivable in the employer’s balance sheet.

19. The staff have considered two alternative views for the purpose of reaching a consensus on the accounting to be applied under IFRSs:
- **View 1** : the employee benefit trust is considered as a branch, i.e. in substance as part of the sponsoring entity;
  - **View 2** : the employee benefit trust is a separate entity only consolidated at group level.
20. “*The IFRS requires an entity to recognise share-based payment transactions in its financial statements, including transactions with employees or other parties to be settled in cash, or other assets, or equity instruments of the entity. There are no exceptions to the IFRS, other than for transactions to which other standards apply*” [IFRS 2 IN3]. Hence, in the sponsor’s financial statements, an expense is recognised in respect of the services from employees, with a corresponding credit to equity (if the transaction is equity-settled) or liabilities (if the transaction is cash settled).
21. Therefore, the remaining elements to consider are:
- i. the shares that are assets of the trust and equity instruments of the sponsor,
  - ii. the sponsor’s investment in the trust,
  - iii. the financial guarantee granted by the sponsoring entity.

**(i) The shares that are assets of the trust and equity instruments of the sponsor**

- **View 1:**

According to the branch approach, the sponsoring entity of an employee benefit trust (or similar entity) should recognise the assets and liabilities of the trust in its own accounts whenever it has *de facto* control of those assets and exposure to the liabilities. In that view, the employee benefit trust may also be considered as an agent acting on behalf of the sponsoring entity.

Those supporting this view claim that 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. Discretion of the trustees is minimal, not only in relation to the beneficiary group but also with regard to the use of the trust’s assets. Those assets are either shares of the sponsor or funds directly or indirectly supplied by the sponsor, which have to be used

either to pay the beneficiaries or to purchase shares of the sponsor to be given to the beneficiaries.

Supporters of View 1 believe that a faithful representation of the sponsor's assets requires that its financial statements should recognise the underlying assets of the trust rather than merely a receivable from such a severely constrained special purpose entity, whose only function is to serve the purposes of the sponsor in a narrowly defined field.

They 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. They reason that 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.

- **View 2:**

Supporters of View 2 regard the arguments for View 1 as relying on the argument of substance over form rather than on specific requirements in IFRSs. They note that the assets of the trust are equity instruments of the sponsoring entity and that IAS 32.33 *Treasury shares* does not specifically address this circumstance.

Accordingly, in separate financial statements, they believe that shares must have been reacquired directly by the entity to be considered as treasury shares under the current IAS 32. *[IAS 32.33] If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity.*

However, the staff is aware that implementing such an approach has proved difficult in practice. For example:

- It could result a double counting of a single employee share-based payment, once under IFRS 2 and once if the funding from the sponsor to the EBT is accounted for as an expense.
- 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:

- a. 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?
- b. 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?

**(ii) The cash investment in the trust**

24. View 1: in the branch approach, when the trust has been funded directly by the sponsoring entity, this investment is eliminated.

25. View 2: if the trust is considered as a separate entity, IAS 27 requires:

- IAS 27 paragraph 7: *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.*
- IAS 27 paragraph 37: *when separate financial statements are prepared, investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 shall be accounted for either at cost, or in accordance with IAS 39. [...]*

**(iii) The financial guarantee granted by the sponsoring entity**

26. 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, which might be equal to the loan itself.

*Staff recommendation*

[Paragraphs 22 through 27 are deleted for observer notes purposes]

**c) Separate or individual financial statements of entities other than the sponsoring entity under a group equity compensation plan**

28. In a group scheme, the sponsoring entity is likely to be the only entity that can claim to exercise any control over the trust (or other SPE), although the exposure to benefits and risks typically lies with each of the companies within the scheme (since companies within the scheme often bear the cost of the scheme in relation to their particular employees).
29. The question arises whether any guidance should be developed on accounting for group equity compensation plans in separate or individual financial statement of entities other than the sponsor under common control. The staff note that this issue is currently under consideration in relation to the project D17 Group and treasury share transactions.
30. Hence, the staff recommend that any guidance on the issue should be consistent with the outcome of that project.

<b>Do you agree with the staff analysis?</b>
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