30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **July 2007, London**

Project: **IFRS 2 *Share-based Payment* - Group cash-settled share-based payment transactions (Agenda Paper 5)**

BACKGROUND

1. The IFRIC has been asked to provide guidance on how to account for the following cash-settled share-based schemes *in the financial statements of a subsidiary* that receives services from its employees:

   - Scheme 1: The employees of the subsidiary will be reimbursed by cash payments that are based on the price of the equity instruments of the *subsidiary*.

   - Scheme 2: The employees of the subsidiary will be reimbursed by cash payments that are based on the price of the equity instruments of the *parent of the subsidiary*.

2. Under both schemes, the parent (*not* the subsidiary) has the obligation to provide the employees of the subsidiary with the cash payments required.

3. The submission says that current IFRSs, for example, IFRS 2 *Share-based Payment*, do not specify how the above schemes should be accounted for in the financial statements of the subsidiary.

4. The submission identifies three alternatives:

- Alternative 1 – Entities should account for the above two schemes in accordance with IFRS 2 because they are cash-settled and share-based.
- Alternative 2 – Entities can choose whether to account for the schemes in accordance with IFRS 2. Proponents of Alternative 2 argue that, in the absence of general guidance in IFRSs on the recognition and measurement of related party transactions, entities can choose not to recognise anything in their financial statements.
- Alternative 3 – Entities should account for the above two schemes in accordance with IFRS 2 only when they clearly receive services from their employees.

SCOPE OF THIS PAPER

5. Whether an entity clearly receives services from its employees is a matter of fact. This paper only addresses situations in which a subsidiary *clearly* receives services from its employees.

6. In addition, this paper does *not* address how the two schemes described in paragraph 1 should be accounted for in the *consolidated financial statements of the parent* for the following reasons:

- IFRS 2 clearly requires Scheme 2 to be accounted for as a cash-settled share-based payment transaction in the *consolidated* financial statements of the parent.

- The submission notes *no* significant diversity in practice in respect of how Scheme 1 is accounted for in the consolidated financial statements of the parent. It observes that Scheme 1 is accounted for as a cash-settled share-based payment transaction in the *consolidated* financial statements of the parent.

7. Instead, this paper focuses on how the two schemes should be accounted for *in the financial statements of the subsidiary* that receives services from its employees.

8. Although the schemes focus on transactions with employees, the discussion in this paper also applies to similar arrangements with suppliers of goods or services other than employees.

ISSUES

9. To address the accounting for the two schemes described in paragraph 1, the staff has identified the following four key issues:

- Issue 1 – Regarding the financial statements of the subsidiary, are the schemes within the scope of IFRS 2? If not, which IFRS is applicable?

- Issue 2 – When should the services received from the employees be recognised in the financial statements of the subsidiary?

- Issue 3 – How should the services received from the employees be measured in the financial statements of the subsidiary?

- Issue 4 – How should the other side of the transaction, that is - the credit side of the transaction, be accounted for?

ISSUE 1 – REGARDING THE FINANCIAL STATEMENTS OF THE SUBSIDIARY, ARE THE SCHEMES WITHIN THE SCOPE OF IFRS 2?

Scheme 1 – Cash payments based on the price of the equity instruments of the *subsidiary*

10. Paragraph 6 of IFRIC 8 *Scope of IFRS 2* states:

> 'IFRS 2 applies to transactions in which an entity or *an entity's shareholders* have granted equity instruments or *incurred a liability* to transfer cash or other assets for amounts that are based on the price (or value) of the entity's shares or other equity instruments of the entity.' *[Emphasis added.]*

11. This appears to suggest that the IFRIC would agree that Scheme 1 is within the scope of IFRS 2 in the financial statements of the subsidiary.

Scheme 2 – Cash payments based on the price of the equity instruments of the *parent*

12. Neither IFRS 2 nor IFRIC 8 specifies whether Scheme 2 is within the scope of IFRS 2 in the financial statements of the subsidiary. Regarding the financial statements of the subsidiary, Scheme 2 theoretically does not meet the definition of either an equity-settled share-based payment arrangement or a cash-settled share-based payment arrangement (see IFRS 2 Appendix A).

13. Paragraph 10 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states: 'In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is … (b) reliable, in that the financial statements: (ii) reflects the *economic substance* of transactions, other events and conditions, are not merely the legal form.'

14. In addition, paragraph 11 of IAS 8 states: 'In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order: (a) the requirements and guidance in Standards and Interpretations dealing with similar and related issues; and …'

15. The staff notes that Schemes 1 and 2 have similar features. Both schemes are cash-settled and share-based.

16. In addition, the staff notes that IFRS 2 applies to equity-settled share-based arrangements in which an entity receives services as consideration for equity instruments of *its parent (or another entity in the same group*) (see paragraph 3 of IFRS 2[1]). That is, equity-settled share-based payment transactions

[1] Paragraph 3 of IFRS 2 states: 'For the purposes of this IFRS, transfers of an entity's equity instruments by its shareholders to parties that have supplied goods or services to the entity (including employees) are share-based payment transactions, unless the transfer is clearly for a purpose other than payment for goods or services supplied to the entity. This also applies to transfers of equity instruments of the entity's parent, or equity instruments of another entity in the same group as the entity, to parties that have supplied goods or services to the entity.'

involving *equity instruments* of the parent (or another entity in the same group) are also within the scope of IFRS 2.

17. By analogy, some believe that IFRS 2 also applies to cash-settled share-based ‘arrangements’ in which an entity receives services from its suppliers and its suppliers in return obtain cash payments that are based on the price of the equity instruments of its parent (or another entity in the same group).

18. Moreover, accounting for Scheme 2 in accordance with IFRS 2 is consistent with the overall objective of IFRS 2. Paragraph 1 of IFRS 2 states: ‘The objective of this IFRS is to specify the financial reporting by an entity when it undertakes a share-based payment transaction. In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions…’ Obviously, Scheme 2 is a share-based payment ‘arrangement’.

19. Furthermore, Scheme 2 is within the scope of IFRS 2 in the consolidated financial statements of the parent.

20. In the light of the above requirements, the staff believes that the subsidiary should account for Scheme 2 in accordance with IFRS 2 (i.e. Scheme 2 should be within the scope of IFRS 2).

Other possible alternatives

21. Some argue that Scheme 2 could be accounted for using one of the following two approaches:

Other possible alternatives	**Staff's comments**
Alternative 1 – Recognise 'nothing' in the financial statements of the subsidiary. IAS 24 *Related Party Disclosures* is applicable to transfers of resources, services or obligations between related parties, regardless of whether a price is charged (see IAS 24 paragraph 9). Consequently, some argue that, provided that relevant disclosures in accordance with IAS 24 are made in the financial statements of the subsidiary, the subsidiary can recognise 'nothing' in respect of the services received from its employees.	Obviously, Alternative 1 is *not* consistent with (i) the overall objective of IFRS 2 (see paragraph 1 of IFRS 2) and (ii) the hierarchy for the selection of appropriate accounting policies set out in paragraphs 10 and 11 of IAS 8. In addition, IAS 24 is merely a disclosure standard. It does *not* address the recognition and measurement of a related party transaction. Furthermore, given that the nature of Schemes 1 and 2 are very similar and that IFRS 2 requires services received from the employees to be recognised when services are received, it is difficult to justify why a subsidiary can recognise 'nothing' in its financial statements in respect of the services received under Scheme 2.

Other possible alternatives	Staff's comments
Alternative' 2 – Scheme 2, in the financial statements of the subsidiary, is within the scope of IAS 19 *Employee Benefits*. Paragraph 1 of IAS 19 states: 'This Standard shall be applied by an employer in accounting for all employee benefits, except those to which IFRS 2 *Share-based Payment* applies.' Therefore, supporters of Alternative 2 argue that one alternative to account for Scheme 2 is to account for it in accordance with IAS 19.	Regardless of whether IFRS 2 or IAS 19 applies, both standards require the subsidiary to recognise the services received from its employees *when the services are received*. However, the measurement bases of the services received (and the disclosures) under IFRS 2 and IAS 19 are different. If Scheme 2 *was* accounted for in accordance with IAS 19, it might be treated as either short-term employee benefits or other long-term employee benefits, depending on whether or not benefits in their entirety fall due within 12 months after the end of the period in which the employees render the related service. Paragraph 9 of IAS 19 requires short-term employee benefits to be accounted for on *an undiscounted basis* whereas IFRS 2 requires the services received to be measured at fair value. Paragraph 128 of IAS 19 requires 'other long-term employee benefits' to be measured based on the net of the present value of the obligation and the fair value of plan assets. Paragraph 78 of IAS 19 requires an entity to determine the discount rate by reference to market yields on high quality corporate bonds. The staff doubts whether the measurement used for 'other long-term employee benefits' in accordance with IAS 19 will be the same as the measurement for the application of IFRS 2. Given the nature of the scheme, the staff believes that Scheme 2 should be accounted for in accordance with IFRS 2 (*not* IAS 19).

Questions for the IFRIC:

22. Regarding the financial statements of the subsidiary, does the IFRIC agree that Scheme 1 is within the scope of IFRS 2?

23. Regarding the financial statements of the subsidiary, does the IFRIC agree that Scheme 2 should be within the scope of IFRS 2?

24. If not, which IFRS(s) does the IFRIC consider applicable?

25. How would the IFRIC justify different accounting treatments for Schemes 1 and 2?

ISSUE 2 – WHEN SHOULD THE SERVICES RECEIVED FROM THE EMPLOYEES BE RECOGNISED IN THE FINANCIAL STATEMENTS OF THE SUBSIDIARY?

26. The discussion below assumes that Scheme 2 is within the scope of IFRS 2. As mentioned above, Scheme 1 is within the scope of IFRS 2 (in accordance with paragraph 6 of IFRIC 8).

27. Paragraph 7 of IFRS 2 states: 'An entity shall recognise the goods or services received or acquired in a share-based payment transaction *when it obtains the goods or as the services are received*.'

28. Therefore, the services received from the employees must be recognised in the financial statements of the subsidiary *when the services are received.*

Questions for the IFRIC:

29. Does the IFRIC agree that the subsidiary should recognise the employee services when the services are received?

30. If not, when should the services be recognised and why?

ISSUE 3 - HOW SHOULD THE SERVICES RECEIVED FROM THE EMPLOYEES BE MEASURED IN THE FINANCIAL STATEMENTS OF THE SUBSIDIARY?

31. For both cash-settled and equity-settled share-based payment transactions, IFRS 2 requires services received to be measured at fair value.

32. However, the authoritative sources concerning the determination of the fair value of the services received under cash-settled and equity-settled share-based payment transactions are different.

33. For equity-settled share-based payment transactions, paragraph 10 of IFRS 2 states that, if the fair value of the services cannot be determined reliably, the fair value of the services received should be determined by reference to *the fair value of the equity instruments granted at grant date*.

34. For cash-settled share-based payment transactions, paragraph 30 of IFRS 2 requires an entity to measure the fair value of the services received based on the *fair value of the liability incurred*.

35. IFRS 2 Appendix A defines an equity-settled share-based payment transaction as a share-based payment transaction in which the entity receives goods or services *as consideration for equity instruments of the entity* (including shares or share options).

36. Obviously, under Schemes 1 and 2, *no* equity instruments are granted to the employees of the subsidiary. Instead, the employees of the subsidiary are paid in cash amounts that are linked to the price of the equity instruments of either the subsidiary or the parent. Therefore, in the staff’s view, the schemes are essentially cash-settled share-based payment transactions.

37. Consequently, the staff believes that the subsidiary should measure the services received from its employees based on the requirements applicable to cash-settled share-based payment transactions.

Is it feasible to apply the measurement requirements applicable to cash-settled share-based payment transactions *when the subsidiary has no obligation at all*?

38. Based on the terms of the schemes, the subsidiary has no obligation to make the required cash payments to its employees. Consequently, a question arises as to how to apply the measurement requirements applicable to cash-settled share-based payment transactions.

39. The nature of the schemes is that:

- the subsidiary incurs a liability to its employees in return for the services received from its employees; and
- the parent of the subsidiary settles the obligation of its subsidiary without receiving anything from the subsidiary.

40. The parent is involved in the schemes by committing itself to settle the liabilities incurred to the employees of its subsidiary. Consequently, the subsidiary might measure the fair value of the services received from its employees based on the fair value of the corresponding liabilities incurred by the parent.

41. In the staff's view, the group (and the parent) must be able to ascertain the amount of the liability incurred by the parent because the liability must be recognised in both the parent's separate financial statements and consolidated financial statements.

42. Some are concerned that such an approach might imply 'push-down' accounting. Existing IFRSs do not specify whether 'push-down' accounting is allowed or not.

43. However, given the nature of the schemes, it is difficult for the staff to justify why the measurement basis used in the financial statements of the subsidiary would be different from that used in the consolidated financial statements of the parent.

Questions for the IFRIC:

44. Does the IFRIC agree that the subsidiary should measure the services received from its employees under Schemes 1 and 2 based on the requirements applicable to cash-settled share-based payment transactions?

45. If not, how does the IFRIC believe that the services received from the employees should be measured?

ISSUE 4 - HOW TO ACCOUNT FOR THE OTHER SIDE OF THE TRANSACTION IN THE FINANCIAL STATEMENTS OF THE SUBSIDIARY?

46. The credit side of the transaction depends on the intragroup arrangements between the parent and its subsidiary.

47. For example, when the subsidiary is not required to pay anything to the parent, the subsidiary essentially receives some 'contributions' from its parent. Consequently, the subsidiary should record the credit side of the transaction in equity as a contribution from its parent for the following reasons:

    - Clearly, the subsidiary has no obligation to make the required cash payments to its employees. Nor does the subsidiary have an obligation to its parent that makes the required cash payments to its employees. Therefore, in the financial statements of the subsidiary, the subsidiary should not recognise a liability.

    - Paragraph 7 of IAS 18 *Revenue* defines revenue as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

    - Paragraph 70 of the *Framework for the Preparation and Presentation of Financial Statements* states: 'Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liability that result in increases in equity, other than those relating to contributions from equity participants'.

48. The staff recommends the IFRIC *not* to address *in detail* how to account for the credit side of the transaction. The credit side of the transaction depends on the intragroup payment arrangements that vary case-by-case.

49. This suggestion is consistent with the approach adopted in IFRIC 11 *IFRS 2 – Group and Treasury Share Transactions*. Paragraph 5 of IFRIC 11 states: 'There may be an arrangement between a parent and its subsidiary requiring the subsidiary to pay the parent for the provision of the equity instruments to the employees. This Interpretation does *not* address how to account for such an intragroup payment arrangement.'

50. BC12 of IFRIC 11 states: 'The IFRIC discussed whether the Interpretation should address how to account for an intragroup payment arrangement requiring the subsidiary to pay the parent for the provision of the equity instruments to the employees. The IFRIC decided *not* to address that issue because it did not wish to widen the scope of the Interpretation to an issue that relates to the accounting for intragroup payment arrangements generally.'

Questions to the IFRIC:

51. Does the IFRIC agree that any possible ways forward should not address how the credit side of the transaction should be accounted for? In the staff's view, the credit side of the transaction depends on the intragroup payment arrangements between the parent and its subsidiary.

SUMMARY OF THE ABOVE STAFF RECOMMENDATION

52. Regarding the financial statements of the subsidiary, the staff believes that Scheme 1 is within the scope of IFRS 2 in accordance with paragraph 6 of IFRIC 8.

53. The staff believes that Scheme 2 (with a similar nature to Scheme 1) should also be within the scope of IFRS 2.

54. Since both schemes are essentially cash-settled and share-based, the staff believes that the subsidiary should measure the services received from its employees based on the requirements applicable to cash-settled share-based payment transactions.

55. The staff believes any possible ways forward should *not* address in detail how the credit side of the transaction should be accounted for. The credit side of the transaction depends on the intragroup arrangements between the parent and its subsidiary.

POSSIBLE WAYS FORWARD

56. The staff identifies at least three possible ways forward:

- Method 1 – The IFRIC should *not* take the issues onto its agenda. Paragraphs 10 and 11 of IAS 8 require an entity to refer to IFRSs that apply to similar transactions. Taking into account the nature of Schemes 1 and 2 and all relevant IFRS requirements, supporters of Method 1 believe that the subsidiary should measure the services received from its employees based on the requirements applicable to cash-settled share-based payment transactions.

- Method 2 – The IFRIC should amend IFRIC 11 to clarify the following:

    - Scheme 2, in the financial statements of the subsidiary, is within the scope of IFRS 2; and
    - The subsidiary should measure the services received from its employees under Schemes 1 and 2 in accordance with the requirements applicable to cash-settled share-based payment transactions.

- Method 3 – The IFRIC should refer the issue to the Board to ask the Board to amend paragraph 3 of IFRS 2 and to make consequential amendments to IFRIC 11.

57. None of the above methods address Issue 4 in detail, that is, how the credit side of the transaction should be accounted for.

58. Expected timetable for *Method 2* is as follows:

Tasks	Expected time
1) The IFRIC's agreement on the proposed amendments to IFRIC 11.	September 2007 IFRIC meeting.
2) Publication of the IFRIC's proposed amendments to IFRIC 11.	By end of September 2007.
3) Two-month comment period	The comment period will expire at the end of November 2007.
4) The IFRIC's approval of the revised Interpretations	January IFRIC 2008 meeting
5) Publication of the revised Interpretations	By the end of Feb 2008. Expected effective date for the revised interpretations is 1 May 2008.

59. Under Method 3, the Board might consider amending IFRS 2 and IFRIC 11. The staff does not believe that it will be possible to include the proposed amendments in the first exposure draft of the Annual Improvements Process[2]. As a result, the effective date of the revised Standard and Interpretations will only be *after 2009*.

60. *The staff recommends Method 1*. The staff believes that Method 1 is the most effective and efficient approach to address the issues. Wording for the proposed tentative agenda decision is set out in Appendix 1. [Appendix 1 omitted from the observer note.]

61. Appendix 2 sets out the proposed amendments to IFRIC 11. [Appendix 2 omitted from the observer note.]

62. Appendix 3 sets out the proposed amendments to IFRS 2. [Appendix 3 omitted from the observer note.]

Questions to the IFRIC:

63. Does the IFRIC agree with the staff recommendation? If not, what alternative does the IFRIC wish to take?

64. Does the IFRIC have any comments on the wording for the proposed tentative agenda decision or proposed amendments to IFRIC 11 and IFRS 2?

[2] The first exposure draft of the Board's Annual Improvements Process is expected to be published in October 2007.

APPENDIX 1 – PROPOSED TENTATIVE AGENDA DECISION
[Omitted from the observer note.]

APPENDIX 2 – PROPOSED AMENDMENTS TO IFRIC 11
[Omitted from the observer note.]

APPENDIX 3 – PROPOSED AMENDMENTS TO IFRS 2
[Omitted from the observer note.]