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International Accounting Standards Board

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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: **September 2007, London**

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

THE PURPOSE OF THIS PAPER

1. A practitioner asked whether the proposed amendments set out in Paper 5 would cover the following arrangement:

   - A subsidiary grants rights to its equity instruments to its employees; and
   - The employees of the subsidiary are entitled to put the equity instruments of the subsidiary to the parent for cash at an amount that is based on the price of the equity instruments of the subsidiary.

2. This paper asks the IFRIC (i) whether it would like the proposed amendments set out in Paper 5 to cover this arrangement and (ii) if so, how the arrangement should be accounted for in the financial statements of the subsidiary.

3. This paper focuses on the financial statements of the subsidiary that receives services from the employees.

4. Due to the time constraint (since the staff was just advised of the example), the discussion in this paper only represents the staff's preliminary view.

TWO ALTERNATIVES

5. Of course, there are many other cases that are similar to the above example. This paper does not address them all.

6. Instead, this paper focuses on a fundamental question that is whether the subsidiary in the above example should consider the put options granted by the parent when it determines how the arrangement should be accounted for in its financial statements.

7. This paper sets out the following alternatives:

   - Alternative 1 – The subsidiary *should not consider the put options granted by the parent* in determining how the arrangement should be accounted for in its financial statements. Under Alternative 1, the subsidiary accounts for the arrangement as *equity-settled*.

   - Alternative 2 – The subsidiary *should take into account the put options granted by the parent* in determining how the arrangement should be accounted for in its financial statements. Under Alternative 2, there are two possible accounting treatments that are set out in paragraph 15.

Arguments for Alternative 1

8. Alternative 1 is primarily based on AG29 of IAS 32 *Financial Instruments: Presentation*.

9. AG29 of IAS 32 states: 'In consolidated financial statements, an entity presents minority interests – ie the interests of other parties in the equity and income of its subsidiaries – in accordance with IAS 1 *Presentation of Financial Statements* and IAS 27 *Consolidated and Separate Financial Statements*. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and

conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (eg a guarantee), the group may not have discretion over distributions or redemption. ***Although the subsidiary may classify the instrument without regard to these additional terms in its individual financial statements***, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole. To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements. ***(emphasis added)***'

10. Based on AG29 of IAS 32, supporters of Alternative 1 believe that the subsidiary should not take into account the put option granted by the parent. This is because the subsidiary does not have any obligation to buy the required equity instruments from its employees even when they exercise the put options.

11. In addition, proponents of Alternative 1 note that, if the parent's participation in arrangements such as those covered by IFRIC 11 and those considered in Agenda Paper 5 was not considered, the subsidiary would probably recognise no employee remuneration expense in its financial statements. However, in the above example, even if the put options granted by the parent were not considered by the subsidiary, Alternative 1 would require the subsidiary to account for the arrangement as equity-settled. Hence, the subsidiary in the above example would recognise the employee remuneration expense in its financial statements (even when it does not consider the put options granted by its parent).

12. Some believe that the requirements in IAS 32 are not relevant for the following reasons:

- IAS 32 generally scopes out obligations under share-based payment transactions to which IFRS 2 applies (see paragraph 4(f) of IAS 32).

- The Board, in the Basis for Conclusions on IFRS 2, acknowledges that several requirements in IAS 32 and IFRS 2 are different.

Arguments for Alternative 2

13. Proponents of Alternative 2 believe that the relationship between the parent and the employees is established on the basis that the employees provide services to the subsidiary. In other words, the parent issues put options to the employees because they provide services to its subsidiary. In such a circumstance, supporters of Alternative 2 believe that the subsidiary should consider the put options granted by the parent in determining how the employee services received should be accounted for in its financial statements.

14. In addition, in the arrangements described in Paper 5, the IFRIC concluded that those arrangements should be within the scope of IFRS 2 and that the subsidiary should account for the arrangements as cash settled, even though the subsidiary does not have any obligation to make the required cash payments to the employees.

15. Under Alternative 2, there are two possible treatments:

    - Option 1 – the subsidiary should account for the arrangement as cash-settled in accordance with paragraph 31 of IFRS 2[1]; or
    - Option 2 – the subsidiary should account for the arrangement based on paragraphs 35 – 40 of IFRS 2. Some argue that the arrangement effectively provides the employees of the subsidiary with compound financial instruments (ie the right to receive equity instruments of the subsidiary or the right to receive cash). Consequently, the subsidiary should account for both the equity and debt components of the instrument in its financial statements.

16. Under Alternative 2, the subsidiary would apply the proposed amendments set out in Paper 5 to account for the cash-settled share-based payment arrangement under Option 1 (or the debt element under Option 2).

[1] Paragraph 31 of IFRS 2 states: 'Or an entity might grant to its employees a right to receive a future cash payment by granting to them a right to shares (including shares to be issued upon the exercise of share options) that are redeemable, either mandatorily (eg upon cessation of employment) or *at the employee's option*.'

QUESTION FOR THE IFRIC

17. Does the IFRIC wish the proposed amendment set out in Paper 5 to address the arrangement described in paragraph 1? If not, how would the IFRIC change the proposed wording in Paper 5 to explicitly scope out the arrangement?

18. Alternatively, if the IFRIC wishes the proposed amendment to address this arrangement, which alternative does the IFRIC prefer? If the IFRIC prefers none of the alternatives suggested in this paper, how would the IFRIC account for the arrangement in the financial statements of the subsidiary?

19. If the IFRIC prefers Alterative 2, does the IFRIC believe that the proposed amendment set out in Paper 5 should be changed? If so, what changes would the IFRIC suggest?