



MALAYSIAN INSTITUTE
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PROUD HOST:



World Congress
of Accountants 2010

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FINANCIAL REPORTING STANDARDS IMPLEMENTATION COMMITTEE

FRSIC Consensus 7

Accounting Treatment for Granting of ESOS by Parent Company to Subsidiary's Employees and Subsequent Recharge by the Parent

Introduction

FRSIC Consensus 7 "Accounting Treatment for Granting of ESOS by Parent Company to Subsidiary's Employees and Subsequent Recharge by the Parent" was developed by the Financial Reporting Standards Implementation Committee ("FRSIC") and issued by the Malaysian Institute of Accountants ("MIA" or "Institute") on 27 March 2008.

The Consensus contained herein is issued as part of the Institute's initiatives to promote best practices in compliance with the highest standards in financial accounting.

FRSIC CONSENSUS 7**ACCOUNTING TREATMENT FOR GRANTING OF ESOS BY PARENT COMPANY TO SUBSIDIARY'S EMPLOYEES AND SUBSEQUENT RECHARGE BY THE PARENT**

FRSIC Consensus is guidance issued by MIA and shall be regarded as best practice. It should be read in conjunction with the respective applicable accounting standards.

Members of MIA are expected to observe compliance to the consensus issued. In exceptional circumstances where departure is necessary, members shall be prepared to justify the departure.

FRSIC Consensus need not be applied to immaterial items. Nothing in the FRSIC Consensus is to be construed as amending or overriding the accounting standards or other statements adopted or issued by the MASB and other relevant laws.

The Issue

1. FRS 2, Share Based Payment deals with accounting for share based payment transactions. However, FRS 2 does not address the accounting treatment of a transaction where a parent grant rights to its equity instruments to its subsidiary's employees and recharges the subsidiary for the equity instrument.
2. Areas where guidance would be necessary relating to the above are as follows:
 - 2.1 A parent grants rights to its equity instruments direct to its subsidiary's employees. The parent recharged the subsidiary for its equity instruments granted.
 - 2.2 A parent grants rights to its equity instruments direct to its subsidiary's employees. The parent recharged the subsidiary at an amount which is higher than the fair value of the equity instruments at grant date.
 - 2.3 In the case where the amount of recharge by the parent is less than the amount of equity contribution from the parent [in the books of the subsidiary], whether the remaining balance of the equity contribution from the parent is considered a distributable reserve under the Companies Act?

- 2.4 In the case where the subsidiary grants share options on its own shares to its own employees and there is a balance in the ESOS reserve after the vested equity instruments have not been exercised and have lapsed :
- which component of equity should the ESOS be transferred to,
 - whether the amount transferred can be considered distributable under the Companies Act.

Consensus and Basis of Consensus

3. The Committee decided that the guidance will focus solely on the accounting aspects of the issue and will not be addressing the related tax implications, if any. This guidance also does not deal with the preparation and presentation of consolidated financial statements.
4. The guidance is based on the following illustration:

A parent grants 200 share options to each of 100 employees of its subsidiary. The share options granted vest on the grant date. Assume the fair value of the options at grant date is RM1. The accounting entries in the subsidiary for the above transaction will be:

5. **Upon parent granting share options to employees of its subsidiary**

5.1 In the subsidiary's book

Based on IFRIC 11, the accounting entries in the subsidiary's book for the above transactions should be:

Dr. Remuneration expense	
[200 options x 100 staff x RM1]	RM 200,000
Cr. Equity contribution from parent	RM 200,000
[Being recognition of remuneration expense based on the fair value of the options at grant date]	

- 5.1.1 The subsidiary recognises the services received [services rendered by its employees] as an expense or capitalized as an asset [where appropriate] and recognised a corresponding equity contribution from the parent.

- 5.1.2 From the perspective of the financial statements of the group, the above is an equity settled share-based payment transaction as an entity within the group grants rights to its equity instruments to the group's employee.
- 5.1.3 BC11 of IFRIC 11 states that "The IFRIC noted that the parent has an involvement in the arrangement by committing itself to provide the employees of the subsidiary with its equity instruments. To meet the requirement in IFRS 2 paragraph 3, the IFRIC believed that it was appropriate in this particular situation for the subsidiary in its own financial statements to apply the same measurement basis as the parent uses in its consolidated financial statements.
- 5.1.4 Accordingly, the IFRIC concluded that, provided that the transaction is accounted for as equity-settled in the consolidated financial statements of the parent, the services received from the employees should be measured using the equity-settled basis in the financial statements of the subsidiary. Correspondingly, to reflect the parent's granting of rights to its equity instruments to the employees of the subsidiary, the IFRIC decided that the subsidiary should recognise in its equity a contribution from the parent equal to the amount at which the services from the employees are measured".

5.2 In the parent's book

The accounting entries in the parent's book for the above transactions should be:

Dr. Investment in subsidiary (Equity contribution to a subsidiary)	RM 200,000
Cr. ESOS Reserve	RM 200,000

[Being recognition of equity contribution to a subsidiary]

- 5.2.1 In this case, the parent received consideration in the form of an increased investment in the subsidiary. Since the subsidiary received services rendered by its employee without having to make any payments for it, the consideration received by the parent is in the form of an increase in the value of the subsidiary. Hence, the parent recognises an increase in investment in subsidiary, with a corresponding increase in equity contribution to subsidiary.

6. Upon the parent recharging its subsidiary for the parent's equity instrument granted [where applicable]

6.1 In the subsidiary's book

The accounting entries in the subsidiary's book for the above transactions should be [assuming the parent recharges its subsidiary \$200,000]:

Dr. Equity contribution from parent	RM 200,000
Cr. Bank	RM 200,000
[Being payment to the parent for the inter-company charge]	

As the recharge is related to the initial share based payment, the recharge should be treated as an adjustment to the equity contribution from the parent.

6.2 In parent's book

The accounting entries in the parent's book for the above transactions should be:

Dr. Bank	RM 200,000
Cr. Investment in subsidiary	RM 200,000

As the recharge is related to the initial share based payment, the recharge should be treated as an adjustment to the investment in subsidiary.

7. **If the parent recharged its subsidiary at an amount greater than the fair value of the equity instruments as at grant date, say RM 300,000.**

7.1 In the subsidiary's book

The accounting entries in the subsidiary's book for the above transactions will be:

Dr. Equity contribution from parent	RM 200,000
Dr. Equity	RM 100,000
Cr. Bank	RM 300,000
[Being payment to the parent for the inter-company charge]	

The excess between the amount paid for the inter-company charge and the equity contribution from parent represents a distribution to the parent.

7.2 In the parent's book

The accounting entries in the parent's book for the above transactions should be:

Dr. Bank	RM 300,000
Cr. Investment in subsidiary	RM 200,000
Cr. Other Income / investment in subsidiary	RM 100,000

The excess between the amount received from the subsidiary arising from the inter-company charge and the investment in subsidiary of RM 200,000 represents a distribution from the subsidiary.

8. Equity Contribution from parent

- 8.1 Under Section 365 of the Companies Act 1965 (Act), dividends can only be out of profits of a company. No definition has been provided for the term "profits" in the Act.
- 8.2 The Framework for Preparation of Financial Statements defines "Profit" as "...the residual amount that remains after expenses [including capital maintenance adjustments, where appropriate] has been deducted from income".
- 8.3 "Income" is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- 8.4 "Expenses" are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.
- 8.5 The equity contribution from the parent would not have fallen within the definition of income and hence would not be part of profits. If indeed the equity contribution from the parent cannot be considered as "profits" under the Companies Act, then any distribution from this component of shareholders' fund cannot be considered as dividend under the Companies Act.

- 8.6 Pursuant Section 60(2) of the Act, a capital reduction under Section 64 of the Act applies only when there is a reduction in paid up share capital or share premium. Share premium arises “Where a company issues shares for which a premium is received by the company whether in cash or in the form of other valuable consideration a sum equal to the aggregate amount or value of the premiums on those shares....” [Section 60(2) of the Act].
- 8.7 It would therefore appear that the equity contribution from parent is neither paid up share capital nor share premium of a company. Accordingly, we view that any reduction of equity contribution from parent should not be considered as a capital reduction.
- 8.8 Based on the above, if the recharge by the parent is neither a dividend nor a capital reduction, the adjustment arising out of the recharge should be considered as a mere accounting adjustment to equity.

9. ESOS Reserve

- 9.1 The above ESOS reserve is not the same as that of the earlier “Equity contribution from parent”. The ESOS reserve is akin to considerations received from the employees for the right to buy the shares of the company at the exercise price. It is in fact payments received for call options written by the Company. For all intent and purposes, it is like a payment received by the company for the issue of warrants to employees.
- 9.2 When a share option is not exercised and lapsed, FRS 2 allows the corresponding ESOS reserve to be transferred to another component within equity.
- 9.3 To the company, when a share option lapsed, there are no further obligations or commitments to the share option holder.
- 9.4 This ESOS reserve is also not share capital in nature because the former option holders are not entitled to any of the net assets of the company. In addition, this ESOS reserve will also not meet the definition of share premium. In substance, the lapsing of the share option represents a benefit to the ordinary shareholders.

- 9.5 Based on the above therefore:
- (a) the ESOS reserve that relates to those lapsed share options should be transferred to retained earnings, and
 - (b) this ESOS reserve is distributable.

Issuance Date of this Consensus

10. This Consensus is issued on March 27, 2008.

References

FRS 2 "Share-based Payment"

IFRIC 11 "IFRS 2 - Group and Treasury Share Transactions"

Companies Act 1965