

## TREATMENT OF COMPANY SHARE TRUSTS IN CONSOLIDATED GROUP FINANCIAL STATEMENTS

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1. The central question addressed is whether companies control their related share trusts in the manner contemplated by Statement of Generally Accepted Practice IAS 27(AC 132) – *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*. If a company controls its share trust then the share trust should be consolidated which impacts upon the group financial statements and the reported earnings per share.
2. IAS 27(AC 132) provides the following of relevance:

*".04 Control (for the purpose of this statement) is the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.*

*A subsidiary (for the purpose of this statement) is an enterprise that is controlled by another enterprise (known as the parent).*

*.09 A parent that issues consolidated financial statements should consolidate all subsidiaries ....."*
3. Statement of Generally Accepted Accounting Practice IAS 19(AC 116) – *Employee Benefits* is also relevant in assessing the matters under consideration. IAS 19(AC 116) is to be applied in accounting for employee benefits which includes "equity compensation benefits". In this regard IAS 19(AC 116) provides:

*".145 Equity compensation benefits include benefits in such forms as:*

*(a) shares, share options and other equity instruments, issued to employees at less than the fair value at which those instruments would be issued to a third party; and ...*

*.146 This statement does not specify recognition and measurement requirements for equity compensation benefits."*

(The statement does, however, provide for various disclosure requirements with regard to the above).
4. For completeness, it is also necessary to consider the Interpretation of Statements of GAAP SIC 12(AC 412) – *Consolidation - Special Purpose Entities*. However SIC 12(AC 412) specifically excludes equity compensation plans.
5. Typical trust deeds of share trusts approved by the JSE normally contain provisions similar to the following:
  - 5.1 the directors of the company establish the rules for the administration of the share scheme and the trust;

- 5.2 any trustee who is a director of the company vacates office if that person ceases to be a director, unless otherwise determined by the directors;
  - 5.3 on the termination of the share trust, any surplus remaining in the trust is to be paid over the company and any shortfall owing to the company will constitute a loss borne by it or its subsidiaries;
  - 5.4 the directors of the company control the allocation of shares to employees of the company group;
  - 5.5 the trust is not entitled to make any profit on the re-sale of shares acquired by it and no such profit accrues to it, such profit being ceded to the company or its subsidiaries.
6. The commonly raised arguments for non-consolidation and further explanations thereof are as follows:
- 6.1 it has been argued that the activities of the trust are conducted on behalf of the employees. However, it is clear that the activities of the trust are conducted on behalf of the company / group - it is the company directors who, in terms of the trust deed (and common sense), ultimately control the affairs of the trust and the allocation of the assets of the trusts to employees. The employees are rewarded based on their historic and/or prospective contribution to the group, and thus the financial reality is that the trust exists ultimately for the benefit of the group;
  - 6.2 in legal form, trustees do have decision-making powers to control the trust and its assets but, for accounting purposes, that is no different from directors of a subsidiary having those powers - the directors are the appointees of the parent company. The appointment of the trustees of the share trust is likewise controlled by the related company;
  - 6.3 it has been argued that the company does not intend to obtain any benefits from the trust's activities. However, the entire purpose of the establishment of the trust is to incentivise and reward the employees of the company / group for the very purpose of ensuring benefits for the group. As regards profit which the trust may make, the ordinary trust deed is clear as set out above - ultimately this is for the account of the company. The fact that the trust may actually make (or intend to make) no profit has no bearing upon whether the trust is controlled in the manner contemplated by IAS 27(AC 132) and should be consolidated.
  - 6.4 it has been argued that the employees or beneficiaries of the trust have the right to obtain the majority of the benefits of the trust. This is not so per the ordinary trust deed and could not commercially be sensible. Unless and until the shares (and not *options* on the shares) are allocated to employees, the trust obtains any benefit of those shares (dividends, capital appreciation or otherwise). Employees ordinarily have no rights to any "benefit" of the trust.

- 6.5 it has been argued that the company does not gain any benefit from the financial performance of the trust. This is not in accordance with the ordinary trust deed and not in accordance with financial reality. If a profit arises in the trust, it is for the benefit of the company / group in terms of the ordinary trust deed. Moreover, any dividends paid on shares held by the trust would commonly be used to reduce the loan payable by the share trust to the company, ie. the cash flows back to the group. This cash flow also commonly arises in respect of proceeds on sales of shares held by the trust;
  - 6.6 it has been argued that the company does not bear any of the risks of the trust other than a recoverability risk of the loan to the trust. However, the ordinary trust deed provides that the risk of the trust (ie. any loss made) is borne by the company / group.
  - 6.7 it has also been suggested that the exclusion in IAS 19(AC 116) of measurement / recognition provisions in respect of employee equity benefit plans justifies the non-consolidation. The exclusion of employee equity benefit plans from the measurement and recognition provisions in IAS 19(AC 116) is no justification for the treatment of the share trust as a financial asset and not as a subsidiary in terms of IAS 27(AC 132). IAS 19(AC 116) is completely unrelated to consolidation issues - it deals with an entirely different subject matter. The difficult issue in relation to measurement and recognition of employee equity benefit plans does not relate to a consolidation issue but to questions of the timing and the manner in which the benefits are to be recognised.
  - 6.8 it has been contended that there are no (company issued) shares under the company's control for which to account. However, in substance and financial reality, the company clearly controls the trust. The trust controls the company shares held by it and thus the company shares held by the trust are ultimately under the control of the company itself. The trustees, who are appointed by the directors of the company (and not the employees), are entitled to vote those shares at any meeting of the company. It is thus manifest that the company controls its own issued shares to the extent held in the share trust. In substance, the control position is no different if the trust had been a subsidiary of the company. For clarity, it is noted that an allocation of an option to take up shares does not amount to an allocation of the shares and carries a very different connotation and transfer of risk and benefit. Until shares are allocated (ie. sold or given) to employees or an option to acquire the shares is exercised by an option holder, the control of the shares remains with the trust;
  - 6.9 the exclusion of employee equity benefit plans in SIC 12(AC 412) does not justify the accounting and treatment adopted by the company in any way and does not suggest that IAS 27(AC 132) does not apply.
7. It is clear from the above that the financial and operating policies are ultimately controlled by the related company.

8. In addition, one must have regard to the practical financial realities that a share trust is created to incentivise and reward the employees of the company / group and commercially and in substance it is clear that the group controls the related share trust and intends to benefit from its existence.
9. Having regard to the above, a share trust should be treated as a subsidiary for the purposes of IAS 27(AC 132) and consolidated in the group financial statements of the company in the manner required by IAS 27(AC 132).
10. For completeness, it is noted that the consolidation of the share trust also achieves meaningful and fair reporting and the reflection of financial reality. It is trite as a reporting accounting principle that an entity should not report to itself and should not reflect transactions with itself in its group financial statements. The consolidation of a company's share trust covers these issues. In **group** financial statements the typical loan receivable by a company from its share trust, any income earned from the trust, (eg. administration fees and interest) and dividends paid by the company to the trust should be eliminated on consolidation. In the group financial statements the trust's cost of the shares it holds in the company reduces the group shareholders' equity to that attributable to the company shareholders to which the company is reporting.
11. An effect of the non-consolidation of a share trust is to reflect an earnings per share based upon the full number of shares in issue (including those controlled by the company itself). However, earnings per share data should be based upon that number of shares held by the parties to whom the company is reporting (ie. excluding the number of shares held by the trust).
12. The allocated (but not exercised) options on the shares held by the trust and on further shares should be properly dealt with in the diluted earnings per share disclosure in terms of IAS 33(AC 104) – *Earnings Per Share* (if dilutive).
13. In summary, the consolidation of the trust is required in terms of IAS 27(AC 132), and proper consolidation of the trust achieves the reflection of financial reality, fair and faithful representation as contemplated by AC100 – *Preface to Statements of Generally Accepted Accounting Practice* and IAS 1(AC 101) – *Presentation of Financial Statements*.
14. It is also necessary to consider the provisions of the Companies Act:
  - 14.1 section 1(3)(a) of the Companies Act sets out the circumstances in which a company is deemed to be a subsidiary of another company. This includes a situation where there is a majority of the voting rights or the right to appoint or remove directors holding the majority of voting rights;
  - 14.2 section 1(3)(c) provides that:

*"A body corporate or other undertaking which would have been a subsidiary of a company had the body corporate or other undertaking been a company shall be*

*deemed to be a subsidiary of that company."*

- 14.3 it is apparent that the trust falls into the "other undertaking" contemplated in section 1(3)(c) and having regard to the provisions of the normal trust deed, it seems clear that the trust would be deemed to be a subsidiary of the company in terms of the Companies Act. In terms of section 289 of the Companies Act, the share trust should have been included in the consolidated group financial statements of the company (meeting the definition of subsidiary in the Act).

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