Dr. Alexander Schaub
Director General
European Commission
Directorate General for the Internal Market

1049 Brussels

26 April 2004

Dear Dr. Schaub,

Re: Adoption of IFRS 2 *Share-based Payment*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of IFRS 2 *Share-based Payment* as published by the IASB on 19 February 2004.

IFRS 2 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, other assets, or equity instruments of the entity. Until IFRS 2 was issued, there was no International Financial Reporting Standard covering the recognition and measurement of shares/options granted to employees or other parties despite the fact that share (option) plans have become a common feature of employee remuneration. IFRS 2 becomes effective for annual periods beginning on or after 1 January 2005, with earlier application encouraged.

EFRAG has evaluated IFRS 2, including its Basis for Conclusions and the consequential amendments to other IFRSs. Our evaluation is based on input from standard setters and market participants in accordance with EFRAG's due process.

EFRAG supports the IASB conclusion that an expense should be recognised even though the share-based payment transaction does not require the entity to sacrifice any cash or other assets. Under an equity-settled share-based payment transaction, in consideration for the issue of equity instruments, the entity receives resources that should be recognised. The expense arises from the consumption of the resources, not from the issue of equity instruments.

While there is valid concern about the sensitivity and reliability of the currently available valuation techniques needed to estimate fair values, it is a fact that the absence of a standard on the recognition and measurement of share-based payment transactions would continue to impair not only the relevance and reliability of financial statements, but also their comparability and credibility by omitting a potentially significant component of the total cost of employee services. Uncertainties inherent in estimates of the fair value of share-based payment arrangements are generally no more significant than the uncertainties inherent in measurements of, for example, provisions, goodwill impairment, loan loss reserves, deferred tax assets, pensions and other post-employment benefit obligations. For those items, as well as in many others involving the use of estimates, companies are required to use appropriate measurement techniques, relevant data, and management judgment in the preparation of financial statements. EFRAG concluded that the concerns regarding the reliability of the existing option pricing models are mitigated by the extensive disclosure requirements and do not outweigh the relevance criterion of having share-based transactions recognised in the income statement and balance sheet.

EFRAG is pleased that the IASB has adopted our proposal not to refer to any specific option pricing model (such as Black-Scholes-Merton) or any specific kind of option pricing model (e.g. binomial model) in the body of the standard. If market prices are not available, which is most often the case for employee share options, IFRS 2 requires the use of an option pricing model to estimate what the price of the equity instruments would have been on the measurement date in an arm's length transaction between knowledgeable, willing parties.

The standard lists six input factors that, as a minimum, need to be taken into account when using an option pricing model. The concern was raised that these requirements effectively reinstate the family of models represented by Black-Scholes-Merton. EFRAG concluded that this is not the case since:

(i) the standard actually points out the different reasons why the Black-Scholes-Merton formula might not be the appropriate model to be applied;

(ii) the standard states that other factors (besides the six mandatory input factors) that knowledgeable, willing market participants would consider in setting the price shall also be taken into account.

Further, when deliberating the IASB's exposure draft, EFRAG commentators raised a concern about only one of the six mandatory input factors. This was expected volatility of the share price, for instance in the case of newly listed or non-listed companies when it was argued the standard should allow adjustments to correct any discrepancies that the volatility generates. The final standard explains that the fact that the expected volatility (and other model inputs) might vary over the option's life should be considered when estimating the fair value of the options at grant date. In this respect, it should be noted that certain companies have recently changed their option pricing model to better take account of the characteristics of employee share options. Consequently, EFRAG supports the IASB approach not to put forward any specific model because (i) there is no particular option pricing model that is regarded as theoretically superior to others and (ii) there is a risk that any model specified might be superseded by improved methodologies in the future. Obviously, the new standard should be kept under review as practical implementation experience further develops.

EFRAG commentators have complained that, while the benefit for the recipient can be exactly the same, a share-based payment transaction needs to be accounted for differently depending on the method of settlement. Instead, they suggest that the definition of a liability should be modified so that all types of obligations, in whichever form settled, are included in liabilities. The IASB acknowledged this concern as well as the fact that the suggestions to change the definitions of liabilities and equity have not been fully explored. The IASB concluded that these suggestions should not be considered in isolation, because changing the distinction between liabilities and equity affects all sorts of financial interests, not just those relating to employee share plans. For instance, it would be difficult to justify conceptually why a share option sold to a non-employee would qualify as equity while an employee share option would not. In the IASB's view all of the implications of any suggested changes should be explored in a broader project to review the definitions of liabilities and equity in the Conceptual Framework. The IASB indicated that if such a review resulted in changes to the definitions, the Board would then consider whether IFRS 2 should be revised. In this respect, it should be noted that both EFRAG and the IASB consider the revision of the Framework as a Board priority.

While the IFRS 2 disclosure requirements remain extensive, we are happy to note an elimination of certain proposed disclosure requirements that we considered burdensome for preparers and which could have obscured the key messages to the users of financial statements. Furthermore, as mentioned above, the extensive disclosure requirements are necessary to cope with the concerns regarding the reliability of the existing option pricing models.

The comprehensive Basis for Conclusions that accompanies IFRS 2 explains that the IASB worked with the American standard setter (FASB) after that body added to its agenda a project to review US accounting requirements on share-based payment. The EFRAG comment letter, dated 10 March 2003, on the IASB exposure draft ED 2 *Share-based Payment* highlighted the strong desire from several EFRAG commentators to achieve global convergence on the recognition and measurement method in accounting for share-based payment transactions. EFRAG is pleased that the 31 March 2004 exposure draft of the FASB reflects a substantial amount of convergence between the positions of the IASB and FASB,

There are no exceptions to the scope of IFRS 2, other than for transactions to which other IFRS apply. EFRAG welcomes the clarification in the implementation guidance (IG 17 – example 11) that, to the extent that the rights given to employees involve a material amount, IFRS 2 shall also be applied to so-called broad-based employee share purchase plans.

In summary, EFRAG is supportive of the new standard and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards that:

i. it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
ii. it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, we believe that it is in the European interest to adopt IFRS 2 *Share-based Payment* and, accordingly, we recommend its adoption.

We should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman