

EFRAG consultation on IFRS2 - Share-based payment

Response from Intellect

Intellect is the trade body for the UK based information technology, telecommunications and electronics industry. Our 1,000 members employ more than 1.1 million people and make a contribution to the UK economy accounting for around 10% of GDP.

Intellect welcomes the opportunity to comment on this consultation. Intellect member companies fully support the EU's policy of adopting common accounting standards (Regulation 1606/2002)¹. This can help making European financial markets more efficient by enhancing transparency and comparability of financial statements across EU Member States.

As part of this process, the International Accounting Standards Board (IASB) has recently put forward the International Financial Reporting Standard on Share-Based Payment. It is now up to EU Member States to review the standard and decide whether or not it meets the requirements set out in Regulation 1606/2002. In brief, accounting standards need to be **“conducive to the European public good” and meet the criteria of “understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management”**. The two questions facing EU decision makers when reviewing a proposed standard are: (1) Does the standard contribute to the attainment of stated EU public policy goals; and, (2) will the standard provide investors with solid and reliable information with which to make investment decisions.

Intellect has a number of serious concerns with the proposed standard. In our view, it is very doubtful whether the standard as currently drafted meets the criteria for EU adoption.

1. Understandability, relevance, reliability and comparability

First of all, many commentators dispute whether issuance of stock options constitute a transaction which is suitable to reflect in an entity's income statement. This school of

¹ Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

thought holds that issuing stock options represent a transaction between current and future shareholders. The potential negative effects on existing shareholders is thus reflected in potential dilution of earnings-per-share.

EFRAG itself raised the concern in its 2002 response to the IASB's discussion paper on Share-Based Payment². EFRAG recommended *"investigation into the conceptual framework difficulties (...)"* and argued that *"[i]n a subject as significant as this it is important that IASB should be able to demonstrate that its solution is consistent with the Framework. In particular, it needs to address the distinction between liabilities and equity and the definition of expenses (...)"*.

The IASB has taken the view that stock options are indeed an expense and has proceeded to issuing a standard. It has done so despite EFRAG's advice from January 2002, that a standard based on disclosure should be developed, whilst all the difficult conceptual and practical issues were further investigated.³ A European Commission expert group reached conclusions similar to EFRAG's in a report on the legal and regulatory environment for stock options in Europe in June 2003⁴. The EC expert group stated that whilst the need for an expensing standard is less than obvious, there is a need for a common method for disclosure of all relevant information pertaining to stock options in annual reports.

Whether or not one agrees with the premises of IASB's decision to issue an expensing standard, it is key to identify a valuation method that satisfies the criteria set out in the Regulation. IFRS2 singularly fails to do this, and this represents the most serious concern with IFRS2.

EFRAG has itself, in its previous statements, identified this problem: *"In addition to the conceptual issues there are significant practical difficulties in measuring the value of share options that have performance conditions, are not freely transferable and, in some cases, relate to unquoted shares. For example, we would wish to be reassured that option-pricing models such as Black-Scholes which were designed for traded options produce results which are relevant and reliable enough for inclusion in company financial statements"*.

On this problem, the Confederation of British Industry argued: *"support for recognising a cost is conditional on there being a rigorous and reliable regime to measure the cost in accordance with general accounting principles. We remain uncertain whether valuation methods do exist which will satisfy this test of reliability, particularly share based schemes in unlisted companies. There is also the issue of lack of tradeability of share options, and having regard to the fact that the Black Scholes model was not developed with long term*

² EFRAG comment letter to IASB on Share-Based Payment, 14 January 2002

³ Ibid.

⁴ European Commission DG Enterprise: "Employee Stock Options: The legal and administrative environment for Employee Stock Options in the EU - Final Report of the Expert Group" June 2003.
http://www.europa.eu.int/comm/enterprise/entrepreneurship/support_measures/stock_options/index.htm

share options in mind, but short-term freely tradeable options. Empirical evidence shows that there are problems with using Black-Scholes and binomial models for these options.”⁵

Recognising that existing valuation models were not suitable, in its March 2003 response to the IASB consultation on Exposure Draft 2⁶, EFRAG recommended the removal of reference to the Black-Scholes type of model from the final standard, and urged it replaced with ‘the most relevant generally accepted option pricing model’. This advice obviously assumes that a generally accepted valuation model could be identified.

Regrettably, the IASB has not produced any such model, but seems to have sidestepped the issue. While reference to Black-Scholes has been struck, no other valuation model has been put forward. Instead, IFRS2 simply instructs preparers of accounts to use all of the variables contained in the Black-Scholes model. The practical result is that companies with stock option programmes will be forced to apply a valuation methodology which has been proven inadequate to deal with these instruments.

This does not seem to be an adequate solution to the problem, and we question whether this approach meets the criteria set out in Regulation 1606/2002.

2. European public good – need for proper impact assessment.

The second criterion is whether the proposed standard is conducive to the European public good, i.e. whether it contributes to European policy goals. There is considerable evidence to suggest that introduction of a standard for expensing stock options without a reliable and trusted valuation methodology will cause companies to scale back the use of broad-based employee stock options schemes. Companies will most likely restrict stock options to executive and managerial levels. This would be unfortunate, as broad-based employee stock options schemes have been used with considerable success by companies in the ICT sector (and other innovative industries) to attract, motivate and retain talented employees. Such schemes help align shareholder and employee objectives, and contribute to enhance the productivity of entrepreneurial and innovative companies. The European Commission has a stated objective of increasing this sort of ‘employee financial participation’.⁷ There is reason to fear that IFRS 2, if adopted in its current form, would impede, rather than promote, the objectives of the EU ‘Lisbon Agenda’.

CBI raised this concern in its 2003 submission, referring particularly to UK Government policy goals on stock options: *“The UK Government, like many others, has a policy of promoting saving, as well as wider share ownership, and promotes such policy by granting tax advantages to approved share schemes. Such schemes are therefore not remuneration and should not be subject to a charge in the P&L account.”* (CBI, 2003).

⁵ Confederation of British Industry comment letter on Exposure Draft 2 Share-Based Payment, March 2003

⁶ EFRAG comment letter ED 2 Share-based Payment, 10 March 2003

⁷ European Commission Communication on the promotion of employee financial participation (COM (2002) 364. The Communication was fully endorsed by the European Parliament and Council of Ministers.

These considerations raise doubt as to whether IFRS 2 can be said to meet the requirement set out in Regulation 1606/2002. No assessment of the likely economic impact of the standard has been carried out by the IASB or any other body. We feel it would be essential to carry out a thorough assessment as part of the EU review process.

Recommendations:

On the basis of the above observations, we recommend rejection of IFRS 2 as it is currently drafted. The crucial valuation issue needs to be properly addressed, and a thorough assessment of the possible impact on the European economy and competitiveness is necessary.

We wish to reiterate that we agree with the need to provide transparent and complete information for financial markets regarding use of stock options, and to do so in a consistent manner across the European Union. We therefore agree with EFRAG's conclusion from January 2002 that a standard for full disclosure of stock options programmes would be desirable.

It is also necessary to note the process under which the standard has been created. In July 2003, European Finance Ministers concluded that there was an urgent need to enhance the adoption process for IAS/IFRS and instructed the Commission to initiate reform⁸. The concerns expressed by the Finance Ministers are similar to the ones we present in this document: the need for any adopted IFRS/IAS to be of the highest quality and the need for assessing the economic impact of such standards. On the basis of the Council conclusions the Commission initiated a review of the due process concerning adoption of IAS/IFRS, and this review is now producing concrete changes. EFRAG's own "Proposals for the Enhancement of the Role and Working Process of EFRAG" acknowledges the need to take into account "*strategic political and/or economic implications with the input of other stakeholders*" and announces the intention to set up an Advisory Forum to undertake such analysis. We would consider it appropriate for IFRS 2 to be made subject to an enhanced review process in order to address the concerns referred to above.

We are hopeful that EFRAG will take the views expressed in this letter into account when producing its final endorsement advice. We remain at your disposal for further comment and information.

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⁸ Conclusions of ECOFIN, 15 July, 2003, p. 14