Brussels, 12th December 2002

EICTA POSITION ON THE ACCOUNTING OF STOCK OPTIONS IN THE CONTEXT OF PROMOTING BROAD-BASED EMPLOYEE STOCK OPTION PROGRAMMES IN THE EU

1. Executive summary

- EICTA[1] believes that broad-based employee stock options programmes are an important tool to promote entrepreneurship and to increase the EU's competitiveness.
- EICTA welcomes the EU's initiatives to promote increased use of broad-based employee stock options programmes while recognising the shortcomings of the current EU regulatory framework in this regard.
- EICTA believes that the EU should have a common standard for accounting of employee stock options that provides users with meaningful, accurate and reliable financial information and that does not discourage the use of employee stock options.
- The International Accounting Standards Board's proposal for accounting of stock options through expensing will fall short of meeting these requirements.
- EICTA proposes that the EU should adopt a standard that requires companies to disclose, on a regular basis, extensive and accurate information on stock options. This would provide users with true and fair high quality information and would not contravene the EU's efforts to promote broad-based stock option programmes.

2. The EU's objective to promote broad-based employee stock options programmes is a central part of its economic and social goals

At the European Council of Lisbon in March 2000 the Member States of the European Union set themselves the goal of making Europe the most competitive and dynamic knowledge-based economy in the world. Promoting entrepreneurship will be a key factor in achieving this ambitious goal.

[1] As of 1 October 2001, EICTA has merged its activities with EACEM, the European Association of Consumer Electronics Manufacturers. The new joint association is called EICTA - European Information, Communications and Consumer Electronics Technology Industry Association. It combines 45 major multinational companies as direct members and 28 national associations from 18 European countries. The new EICTA altogether represents more than 10,000 companies all over Europe with more than 1.5 million employees and revenues of over 190 billion Euro.

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Employee stock options programmes have been identified as an instrument that plays an important role in promoting entrepreneurship in the EU.

The participation of employees through broad-based employee stock options programmes provides important potential benefits to companies, employees and the economy as a whole. It also improves the motivation of employees, strengthens their commitment, increases productivity and improves competitiveness and profitability. Furthermore, employee financial participation is also an instrument for recruiting and keeping staff.

Financial participation through employee stock options programmes also plays an important role in the development of European capital markets and notably risk capital markets. This has been widely recognised by the Commission in a recent policy document on employee financial participation[2]. In this Communication the Commission further recognises that there is a huge gap between the EU and the US with regard to "largely unused potential for the further development of financial participation as part of an overall strategy aimed towards stimulating the growth of new, dynamic companies" and that "the promotion of financial participation is thus also part of the structural reforms needed to realise Europe's potential for growth, employment and social cohesion."

Recognising the importance of broad-based employee stock-options programmes, EICTA welcomes the initiatives of the EU institutions in this area. However, regulatory issues raised in this position paper need to be addressed to ensure that the EU's objectives are not jeopardised.

3. The regulatory environment which impedes use of broad-based employee stock options programmes in the EU

EICTA members operate on an international level and many have broad-based employee stock options programmes in place for employees in different countries. As a result, trans-national treatment of stock options become increasingly problematic.

Whilst many aspects of the existing regulatory environment in the EU and its Member States effectively impede increased use of broad-based employee stock options programmes in Europe such as double taxation of employees when moving from a country to another while holding stock options as well as certain aspects of securities law, this document focuses on the new EU-wide approach to how stock options should be accounted for.

EICTA's preliminary views on accounting for broad-based employee stock options is outlined below. Most importanly, EICTA urges the EU to ensure that new EU rules on stock options accounting have to meet both EU standards on the quality of the financial information – as outlined in the existing EU Directives on accounting and the new EU Regulation on the Application of International Accounting Standards (2002/0044 (COD)) - and be in-line with the EU's efforts to encourage the use of broad-based employee stock options programmes.

4. Accounting for broad-based employee stock options programmes

[2] Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions, On a framework for the promotion of employee financial participation, COM (2002) 364, final, page 10.

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EICTA believes that it is important that the EU adopts a common standard for accounting employee stock options which contributes to increased use of broad-based employee stock options programmes, while providing all stakeholders with meaningful, accurate and reliable financial information.

EICTA acknowledges the recent debate on the new rules for accounting of stock options, which stems from the adoption of the new EU Regulation on the Application of International Accounting Standards (2002/0044 (COD)) and the IASB's draft proposal for a new international accounting standard on “Share-based payments” as explained below.

- In June 2002, the EU adopted a Regulation on the Application of International Accounting Standards (2001/0044 (COD)) that will require all EU companies to prepare their consolidated accounts in accordance with International Accounting Standards (IAS) from 2005 onwards. New IAS, such as the proposed standard on employee stock options, have to be endorsed by a new EC Committee, the Accounting Regulatory Committee (ARC), in order to enter into force in the EU. The ARC is chaired by the Commission and composed of Member States' representatives.

  A precondition for endorsement of new IAS by the ARC is that their application will result in a true and fair view of the financial position and performance of enterprises, that they are not contrary to the European public good and that they meet the basic criteria – as stipulated in the above mentioned Regulation - with regard to the quality of information required for financial statements to be useful to users. If these conditions are not met, the ARC should reject new IAS.

- On 7 November 2002, the International Accounting Standards Board (IASB) adopted a so-called “exposure draft” for a new International Accounting Standard (IAS) on “Share-based payments” which, if adopted, will regulate how all EU companies listed in the EU will have to account for employee stock options programmes in their income statements as of 2005.

  - The IASB proposes that, in principle, all “share-based payment” transactions should be recognised in companies' financial statements, resulting in an expense in the income statement when the goods or services are consumed. EICTA would note however, that there is no consensus that the award of an employee stock option result in the consumption of an enterprise's asset that is required for the recording of an expense. Many experts would argue that the cost of employee stock options is to the shareholders of the enterprise who agree to a dilution of their ownership to align their incentives with those of the company's employees. This does not impact the financial performance of an enterprise as the cost is already reflected in the earnings per share computation through the dilutive impact on the number of shares used in the calculation. Consequently, the recording of an expense could, in effect, result in an inappropriate double-charge against earnings per share.

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- Furthermore, the IASB proposes that when an observable market price for stock options does not exist, an option-pricing model should be used to estimate the fair value of share options. In almost all cases, no market price exists for employee stock options, which means that complicated option-pricing models will have to be developed and applied. Option-pricing models inevitably involve judgemental assumptions, such as share price volatility and dividend yields, which significantly impairs the reliability of the estimated charge that should be inserted into company accounts.

EICTA believes that the contrived and highly complicated nature of calculations involved in determining a charge for “share-based payments” using IASB’s proposed approach represents an inaccurate accounting solution as the figure that will appear in the accounts will be less accurate, not reflect a true and fair view of the financial position and performance of enterprises and may not meet the basic EU criteria with regard to the quality of information required for financial statements to be useful to users.

Furthermore, EICTA is concerned that the IASB proposal, if adopted, would discourage use of broad-based employee stock options programmes. If the IASB's proposal was to be adopted, EICTA believes that there would be negative, unintended consequences beyond the immediate group of concerned stakeholders (employees, shareholders and other users). Consequently, the ARC should carefully assess the proposed IAS in the light of this as

- the IASB's proposal would put EU companies that offer broad-based employee stock options programmes at a disadvantage to companies based in jurisdictions that do not require expensing;
- the standard, if adopted by the EU, could have a severe impact on start-ups and small and medium-sized enterprises (SMEs), which are dependent on their ability to attract and keep highly-skilled labour force. European companies that consider that employee ownership is a critical factor in the company's ability to improve a company's performance, may not be able to continue using broad-based stock option programmes;
- it is essential that companies which are listed both in the EU and in the U.S. face equal, if not even identical, reporting requirements. Global convergence of accounting rules is of crucial importance.

In view of the above, EICTA believes that it is important that the ARC recognises that new IAS regarding accounting of employee stock options does not meet the basic requirements set out in the EC Regulation.

EICTA intends to comment in detail on the IASB’s exposure draft in a position paper . Broadly speaking, EICTA underlines the importance of disclosure of financial information regarding stock options as outlined in the following section.

5. True and fair high quality financial information in relation to employee stock options.

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EICTA believes that disclosure of financial information enhances the accountability for and the transparency of companies' financial performance and governance as a whole and should, therefore, be used with regard to stock options. The importance of disclosure of financial information has also been recognised by the EU's High-Level Group of Company Law Experts, which outlines the benefits of disclosure in a clear manner in its report published on the 4th November :

> "Disclosure requirements can sometimes provide a more efficient regulatory tool than substantive regulation through more or less detailed rules. Such disclosure creates a lighter regulatory environment and allows for greater flexibility and adaptability. Although the regulatory effect may in theory be more indirect and remote than with substantive rules, in practice enforcement of disclosure requirements as such is normally easier. The Group believes that the EU, in considering new – and amending existing – regulation of company law, should carefully consider whether disclosure requirements are better suited to achieve the desired effects than substantive rules."[3]

EICTA believes that full public disclosure of stock options to shareholders and other stakeholders on a regular basis is preferable to recognition of estimated amounts in companies' income statements. EICTA, therefore, proposes that a disclosure standard that would require companies to provide extensive and accurate information on stock options, and other forms of equity participation by employees, should be adopted by the EU.

EICTA is looking forward to discussing this issue with the all stakeholders including the European Commission, members of the EU's Accounting Regulatory Committee (ARC), the International Accounting Standards Board (IASB) and the European Financial Reporting Advisory Group (EFRAG).

[3] The final report of the EU High-Level Group of Company Law Experts, published 4 November 2002, page 34.

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