EFRAG
European Financial Reporting Advisory Group

**Draft for comments**
**Comments should be sent to Commentletter@efrag.org**
**by 7 January 2007**

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

XX January 2007

Dear Mr Holmquist

## Adoption of IFRIC 11 *IFRS 2 Group and Treasury Share Transactions*

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 IFRIC 11 *IFRS 2 Group and Treasury Share Transactions* (IFRIC 11), which was published on 2 November 2006. The Interpretation was issued in draft as D17 and EFRAG commented on that draft.

Under IFRS 2 *Share-based Payment*, the way in which a share-based payment transaction is accounted for depends on whether it is equity-settled or cash-settled. All share-based payment transactions will be equity-settled transactions, cash-settled transactions or a hybrid of the two. IFRIC 11 addresses four main issues.

(a) The first two are whether the following transactions should be accounted for as equity-settled or as cash-settled under the requirements of IFRS 2:

    (i) an entity grants to its employees rights to equity instruments of the entity (for example share options), and either chooses or is required to buy equity instruments from another party, to satisfy its obligations to its employees; and

    (ii) an entity's employees are granted rights to equity instruments of the entity, either by the entity itself or by its shareholders, and the shareholders of the entity provide the equity instruments needed.

    IFRIC 11 concludes that, when an entity receives goods or services as consideration for its own equity instruments, the transaction should be classified as equity-settled regardless of how the equity instruments needed are obtained, of whether the employee's rights to the entity's instruments were granted by the entity itself or by its shareholders(s), or of whether the share-based payment arrangement was settled by the entity itself or by its shareholders(s).

(b) The third and fourth issues concern share-based payment arrangements that involve two or more entities within the same group. In particular, it sets out how the following arrangements should be classified:

(i) A parent entity grants rights to equity instruments of itself directly to the employees of its subsidiary.

(ii) A subsidiary grants rights to equity instruments of its parent to the subsidiary's employees.

IFRIC 11 requires the arrangements described in (i) to be classified as equity-settled provided it is also classified as equity-settled in the consolidated financial statements of the parent. It also requires the arrangements described in (ii) to be classified as cash-settled

IFRIC 11 becomes effective for annual periods beginning on or after 1 March 2007, with early application permitted.

EFRAG has carried out an evaluation of IFRIC 11. [As part of that process, EFRAG issued a draft version of this letter for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and EFRAG's discussions of technical matters are open to the public.]

EFRAG has concluded that IFRIC 11 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:

- 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
- 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, EFRAG believes that it is in the European interest to adopt IFRIC 11 and, accordingly, EFRAG recommends its adoption. (EFRAG's reasoning is explained in the attached 'Appendix—Basis for Conclusions'.)

On behalf of the members of EFRAG, I 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**

## Appendix
## Basis for Conclusions

*This appendix sets out the basis for the conclusions reached and for the recommendation made by EFRAG in the attached letter.*

1 When evaluating IFRIC 11, EFRAG asked itself four questions:

(a) Is there an issue that needs to be addressed?

(b) If there is an issue that needs to be addressed, is an Interpretation an appropriate way of addressing it?

(c) Is IFRIC 11 a correct interpretation of existing IFRS?

(d) Does the accounting that results from the application of the IFRIC meet the criteria for EU endorsement?

2 IFRIC 11 addresses four main issues arising out of the application of IFRS 2. Those issues are referred to in the covering letter in paragraphs (a)(i) (henceforth 'Issue 1'), (a)(ii) (Issue 2), (b)(i) (Issue 3), and (b)(ii) (Issue 4).

**Is there an issue that needs to be addressed?**

3 It is clear from the discussions that EFRAG has had during its meetings, from the comment letters that it has received and from the experiences that EFRAG members have had working with IFRS 2 that the issues addressed in IFRIC 11 are causing uncertainties and other problems in practice.[1] There is furthermore evidence to suggest that these uncertainties and problems are leading to differences in practice that can be significant. For those reasons, EFRAG concluded that the issues addressed in IFRIC 11 *do* need to be addressed.

**Is an Interpretation an appropriate way of addressing those issues?**

4 Two of the issues addressed in IFRIC 11 (Issues 1 and 2) are simple matters of interpretation of the existing requirements of IFRS 2. EFRAG believes that an IFRIC Interpretation is the most appropriate way of addressing those issues.

5 Issues 3 and 4 can be addressed only by 'extending' or applying by analogy the detailed definitions and requirements of IFRS 2 to transaction-types that those definitions and requirements do not currently address.[2] It is within IFRIC's remit to so this; the Preface to International Financial Reporting Interpretations for example describes IFRIC's role as including providing guidance on newly identified financial reporting issues not specifically addressed in IFRS.

---

[1] That is particularly so of the three issues that arise out of the application of paragraph 3 of the standard (Issues 2 to 4). That paragraph extends the scope of the standard to arrangements that, although probably not strictly share-based payment arrangements as defined, are in substance share-based payment arrangements. The problem is that the detailed definitions and requirements in IFRS 2 seem to assume that all the arrangements within the scope of the standard meet the definition of a share-based payment transaction; as a result, there is little material in the standard on how to apply its detailed requirements to arrangements that fall within the scope of the standard by virtue of paragraph 3.

[2] For example, under IFRS 2, the way in which a share-based payment transaction is accounted for depends on whether it is an equity-settled transaction or a cash-settled transaction; and the assumption underlying the standard is that all share-based payment transactions will be equity-settled transactions, cash-settled transactions or a hybrid of the two. Yet the arrangements described in Issues 3 and 4, though clearly within the scope of IFRS 2, meet neither the definition of an equity-settled transaction nor the

6 However, the Preface also makes it clear that IFRIC should not reach a consensus that changes or conflicts with IFRSs or the Framework, and some commentators were concerned that, in addressing issues 3 and 4, IFRIC was amending the definitions of 'equity-settled arrangements' and 'cash-settled arrangements'.

7 The approach that IFRIC appears to have adopted in IFRIC 11 is to say that certain arrangements not falling within either definition should be accounted for in the same way as equity-settled transactions and certain other arrangements also not falling within either definition should be accounted for in the same way as cash-settled transactions. Thus, IFRIC has not amended the definitions—it has instead provided guidance on the principles that should be applied to similar transactions. In EFRAG's view, it is reasonable to use an Interpretation to provide such guidance.

**Issues 1 and 2**

*Is IFRIC 11 a correct interpretation of existing IFRS?*

8 The consensus IFRIC reached on Issues 1 and 2 was that a share-based payment arrangement in which an entity receives goods or services as consideration for its own equity-instruments should always be classified as an equity-settled transaction, regardless of the other arrangements involved.

9 EFRAG believes that this is a correct interpretation of IFRS 2. IFRS 2 defines an equity-settled share-based payment transaction as a transaction in which the entity receives goods or services as consideration for its own equity instruments, and in the circumstances described in Issues 1 and 2 the entity *is* receiving goods or services as consideration for its own equity instruments.

*Does the accounting that results from the application of this part of the consensus meet the criteria for EU endorsement?*

10 The principle underlying the definition of 'equity-settled' and therefore the consensus reached on Issues 1 and 2 is that, for the purposes of the accounting:

(a) it is irrelevant whether it is the entity itself that grants rights to its equity instruments to its employees or whether it is its shareholder, and

(b) it is irrelevant how the equity instruments are to be obtained to settle the arrangement. They could for example, be new shares specially issued for the purpose or they could be existing shares either bought in the open market or specifically transferred by shareholders for the purpose.

11 EFRAG supports the use of a principle-based approach. It did though consider carefully whether the appropriate principle was being applied.

(a) It is a matter of fact that, under existing IFRS, some share-based payments involve the entity in issuing an equity instrument and others involve the entity in incurring a liability. It is also a matter of fact that, under existing IFRS, equities are accounted for differently from liabilities. In particular, equity is measured once—on initial recognition—but is not subsequently

definition of a cash-settled transaction. Therefore, in order to make it possible for IFRS 2 to be applied consistently to such arrangements IFRIC has, in developing IFRIC 11, had to decide how best to extend or apply the definitions in IFRS 2 to cover such arrangements.

remeasured.  Liabilities, on the other hand, are remeasured as estimates of the eventual settlement amount are revised.

(b) It follows from this that, if two arrangements are identical except that one results in the sponsor issuing equity instruments and the other results in the sponsor taking on a liability, existing IFRS requires them to be accounted for differently.[3]  It has been previously accepted that this accounting result is consistent with the criteria for EU endorsement.

(c) The definitions of equity-settled and cash-settled in IFRS 2 reinforce this principle by helping us to understand whether the sponsor has issued equity instruments or whether it has incurred a liability.  When EFRAG recommended that IFRS 2 should be endorsed for use in the EU, it concluded that the definitions and the foreseeable accounting results of those definitions met the criteria for EU endorsement.[4]

12 EFRAG therefore considered whether the application of these definitions to the arrangements described in Issues 1 and 2 would produce accounting results that are so out of line with what one would normally expect that it makes it questionable whether this part of the consensus meets the criteria for EU endorsement.  As EFRAG has not found any evidence to suggest that is the case—on the contrary the accounting is in line with what was expected at the time it recommended IFRS 2 for endorsement—it has concluded that this part of the consensus meets the criteria.

**Issue 3**

13 Issue 3 concerns how to account, in the individual financial statements of the subsidiary, for an arrangement that involves a parent entity granting rights to equity instruments of itself directly to the employees of its subsidiary.  Should be accounted for like an equity-settled arrangement or like a cash-settled arrangement?

*Is IFRIC 11's consensus on Issue 3 a correct interpretation of existing IFRS?*

14 As already mentioned, in order to address Issue 3, it is necessary to decide whether an arrangement that meets neither the definition of an equity-settled share-based payment transaction nor the definition of a cash-settled share-based payment transaction is best accounted for like an equity-settled transaction or like a cash-settled transaction.  In this context, it is therefore probably wrong to talk about *correct* interpretations; it is probably better to ask whether the consensus is reasonable from a purely technical perspective.

15 In effect what IFRIC was seeking to do when developing this part of the consensus was to decide which category of share-based payment transaction an 'Issue 3 arrangement' is more like for the purposes of the individual financial statements of the subsidiary.

---

[3] Consider for example the following arrangements.  Two companies offer exactly the same share-based payment scheme to their employees, except that whilst one is required to deliver equity shares bought in the market to its employees, the other is required to deliver cash to its employees equivalent in amount to the value of those equity instruments.  Thus, from the point of view of the two companies, they have made a promise to their employees that will be met by paying out exactly the same amount of cash in both cases.  But, because (a) one is an equity-settled transaction and the other a cash-settled transaction and (b) equity and liabilities are accounted for differently under existing IFRS, the two arrangements will be accounted for differently.

[4] We say 'foreseeable' because, when evaluating an IFRS or Interpretation, it is inevitable that EFRAG focuses on the transactions that already exist or are foreseeable that will fall within its scope.

16 IFRIC concluded that it is more like an equity-settled arrangement and should therefore be accounted for in the same way as equity-settled transactions, provided that the arrangement is accounted for as equity-settled in the consolidated financial statements of the parent. EFRAG agrees with this conclusion for the following reasons.

(a) The arrangement is nothing like a cash-settled arrangement because the reporting entity does not incur a liability. (IFRS 2 defines a cash-settled arrangement as one "in which the entity acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price (or value) of the entity's shares or other equity instruments of the entity.")

(b) On the other hand, the arrangement is a bit like an equity-settled arrangement in that it will involve an increase in the subsidiary's equity (because the parent's payment to the subsidiary's supplier of goods or services will be accounted for as a capital contribution from the parent to the subsidiary).

*Does the accounting that results from the application of this part of the consensus meet the criteria for EU endorsement?*

17 Again EFRAG considered whether the application of this part of the consensus would produce accounting results that are so out of line with what one would normally expect that it makes it questionable whether it meets the criteria for EU endorsement. EFRAG believes that the accounting is reasonable and has therefore concluded that this part of the consensus meets the criteria.

**Issue 4**

18 Issue 4 concerns how to account, in the individual financial statements of the subsidiary, for an arrangement that involves a subsidiary granting rights to equity instruments of its parent to the employees of the subsidiary. Should be accounted for like an equity-settled arrangement or like a cash-settled arrangement?

*Is IFRIC 11's consensus on Issue 4 a correct interpretation of existing IFRS?*

19 For the reasons give in paragraph 14, rather than asking whether IFRIC 11's consensus on Issue 4 is a correct interpretation of existing IFRS, it is again probably better to ask whether the consensus is reasonable from a purely technical perspective.

20 In effect what IFRIC was seeking to do when developing this part of the consensus was to decide whether for the purposes of the individual financial statements of the subsidiary the 'Issue 4 arrangement' is more like an equity-settled arrangement or a cash-settled arrangement.

21 IFRIC concluded that it is more like a cash-settled arrangement than an equity-settled arrangement and should therefore be accounted for in the same way as a cash-settled transaction. EFRAG agrees with this conclusion.

(a) As explained in paragraph 16(a) above, in normal circumstances the essence of a cash-settled arrangement is that it causes the reporting entity to take on an obligation to deliver to the supplier something other than its own equity instruments. In an Issue 4 arrangement, the subsidiary takes on an obligation to provide its employees with the equity instruments of the parent and to the subsidiary those equity instruments are assets.

(b) The essence of an equity-settled arrangement is that it will involve the subsidiary receiving a capital contribution. Under an Issue 4 arrangement, the subsidiary will not receive a capital contribution.

22 On the other hand, some would argue that the arrangements described in Issue 3 are not that different from the arrangements described in Issue 4. Indeed, the only difference is that in one case the grant is made by the subsidiary and in the other by the parent. To some this is not a difference of substance because subsidiary companies do not generally decide unilaterally to grant rights over the equity instruments of its parent; rather, it is a decision taken at group level. Whether it is the parent or the subsidiary that formally grants the rights is simply a matter of administrative convenience or is driven by legal or tax considerations. Yet under IFRIC 11 Issue 3 arrangements are to be treated as equity-settled and Issue 4 arrangements as cash-settled, so they will be accounted for differently.

(a) EFRAG believes that, if different accounting can result from changing the form but not the substance of an arrangement, opportunities will exist to structure intragroup transactions in order to achieve desired accounting results. However, under existing IFRS there already structuring opportunities for intergroup transactions, particularly as such transactions are not always carried out on normal commercial terms. Any 'form over substance' concerns need to be judged against that background.

(b) EFRAG notes that this 'problem' is not caused by IFRIC 11; rather it is caused by the existing literature's insistence that equity is accounted for in a different way to liabilities.

(c) Finally, EFRAG also notes that—as explained in paragraph 21—it agrees with IFRIC's view that Issue 4 arrangements are more like cash-settled arrangements than equity-settled arrangements.

23 Having considered these issues, EFRAG has concluded that, on balance, the consensus reached on Issue 4 is reasonable.

*Does the accounting that results from the application of the IFRIC meet the criteria for EU endorsement?*

24 EFRAG has considered whether the application of this part of the consensus would produce accounting results that are so out of line with what one would normally expect that it makes it questionable whether it meets the criteria for EU endorsement. EFRAG believes that the accounting is reasonable and has therefore concluded that this part of the consensus meets the criteria.