

In February of 2004 the International Accounting Standards Board (IASB) released International Financial Reporting Standards (IFRS) 2 Share-Based Payment. Companies are increasingly using share-based payments in the form of shares and options as a method of employee compensation, and until the introduction of IFRS 2 there was no guidance on the recognition and measurement of these transactions. In general, share options were not recorded as an expense but were simply disclosed in the financial statements.



IFRS 2 SHARE-BASED PAYMENT

IFRS 2 essentially covers all transactions in which goods or services are exchanged for equity instruments in the business (including the option to receive equity instruments, or amounts based on the price of equity instruments). Goods or services may include the receipt of assets or the benefit from services, including services from employees of the company. Share incentive and share option schemes for employees and directors therefore fall under the scope of IFRS 2.

Most transactions involving share-based payments will require the equity instruments issued to be recorded at fair value and will result in a charge to the Profit and Loss account. The calculation of fair value will require detailed analysis of the specific characteristics of the instruments awarded and IFRS 2 is clear that in the case of share options, "...use of the Black-Scholes-Merton technique may not adequately reflect the fair value of the options and more sophisticated option pricing models may be required."

IFRS 2 became effective on January 1, 2005. All publicly quoted companies in Europe now have to apply IFRS as their primary GAAP and therefore compliance with IFRS 2 is mandatory.

In the United States the Financial Accounting Standards Board (FASB) released Statement of Financial Accounting Standard 123 (SFAS 123R) - Share-Based Payments - an amendment of Statements No. 123 and 95. This statement requires companies to expense the fair value of share-based payments, including employee stock options (ESOs) measured as of the grant date using an option pricing model. The result is convergence of U.S. GAAP with the accounting treatment for share-based payments laid out in IFRS 2.

Duff & Phelps professionals have the knowledge, skills, expertise, ability and global resources to provide you with the independent, high quality financial advisory services you require to make decisions with confidence.

IFRS 2 Share-Based Payment

How do I determine the fair value of equity instruments?

Frequently a market price is not readily available for equity instruments issued as share-based payments. This may be the case because shares granted are not publicly listed and/or options granted include terms and conditions which are not applicable to traded options. In these cases, IFRS 2 requires the use of a fair value methodology to value these instruments. Regarding the valuation of shares, this typically involves the Income approach or the Market Comparables approach. For the valuation of share options, the choice of an appropriate option pricing model is less straightforward.

The Black-Scholes-Merton model is the most commonly used option pricing model in practice. However, the option pricing model used must be capable of taking into account factors that knowledgeable, willing, market participants would consider when concluding on the fair value. The Black-Scholes-Merton approach is therefore not considered appropriate in many cases where options have been awarded. In particular, the following characteristics (typical for any employee option plan) make an alternative approach more appropriate:

- The options have a relatively long life
- The options can only be exercised between the vesting date and the expiration date
- The options are frequently exercised early
- Specific features of the employees, such as probability of early termination of employees' contracts or the employees' average age, must be incorporated

A more sophisticated model such as a binomial option pricing model is more appropriate in reaching a reliable estimate of the fair value of these options. Through the binomial approach it is possible to model more complex option characteristics, thereby actually reflecting the realities of the option plan.

As the Black-Scholes-Merton model simplifies the assumptions underlying an option, it can significantly misstate the fair value of the options, resulting in an incorrect representation in the financial statements of the company.

How can Duff & Phelps assist?

Duff & Phelps has considerable experience in the valuation of complex equity instruments using several option pricing techniques including the traditional Black-Scholes-Merton model and the binomial model. Based on the above, we have additionally developed detailed binomial models, tailor-made to incorporate the specifics of employee share option plans. We are able to further customize these models to accurately reflect the precise terms of your option plans, while also incorporating the exercise characteristics of employees, the probability of lapsed options and other relevant facts and circumstances.

Duff & Phelps is a leader in preparing objective, independent, analytically rigorous and thoroughly documented valuations for financial reporting purposes. Our European offices are supported by the largest valuation consulting practice in the United States to address your specific valuation needs. Our unparalleled experience in the valuation of equities and options combined with our experience in consulting with European companies uniquely qualifies us to assist in meeting the requirements of IFRS 2. Dynamically merging our valuation, financial reporting and industry knowledge, we offer companies a unique capability in addressing the changing demands of your business.

About Duff & Phelps

Duff & Phelps is a leading independent financial advisory firm, offering a broad range of consulting and investment banking services, including financial reporting and tax valuation, fixed asset and real estate consulting, M&A advisory, fairness and solvency opinions, ESOP and ERISA advisory services, legal business solutions and dispute consulting.

Duff & Phelps has more than 650 employees, serving clients worldwide through offices in the United States, Europe and Asia. Duff & Phelps professionals specialize in a broad range of industries, with expertise in automotive, consumer products, energy, financial services, health care, industrial products, media and entertainment, pharmaceuticals, technology, telecommunications and utilities.

Since 1932, Duff & Phelps has been committed to delivering independent advice and service of exceptional quality, integrity and objectivity to a broad range of public and private companies located throughout the world.

For further information regarding our services, please contact us at 1-866-282-8258. You may also visit our Web site at www.duffandphelps.com.

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