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International Accounting Standards Board
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Dear Ms. Crook,

ED2 SHARE-BASED PAYMENT

I am writing to give my comments on ED2: "Share-based payment", which are summarised below with specific reference to employee options.

Fair Value assessment

ED2 proposes that the fair value of the options granted be evaluated. This fair value is then expensed to the profit and loss account over a period.

In arriving at the fair value of the option there could be some estimate regarding share price growth. If no such estimate is made the calculated fair value could be minimal or even nil (as would be the case if the option grant price and share market price are equal at the date of grant, and no increase is assumed).

This estimate, which underpins the fair value, is subjective. If market sentiment weakens (as has been seen recently) the previously calculated fair value calculation could be materially overstated. It could even mean that, despite the employee delivering the targets set for exercise of the options, those options are worthless as the share price has not increased in the market. Nonetheless, ED2 requires a charge to be made to the profit and loss account. Moreover, BD2 does not allow for on-going correction of the fair value calculation. This will cause significant anomalies in a company's profit and loss account and could even be seen as misleading.

Reflection of Increased Market Value

As discussed above, options are usually only of any worth if the employee's efforts achieve recognition in the form of an increase in the market value of the entity's shares over the grant price an increase in the market value of the whole entity.

However, ED2 does not propose to reflect this increase in the entity's worth. Balance sheets will continue to be prepared under the historical cost convention. They will however contain an additional "reserve" being the other side of the amount expensed to date of the fair value of the options. What this new reserve represents is hard to define. Is it a distributable reserve? Is it a liability? Is it shareholders funds?

Setting its classification aside, there is no doubt that there is a mismatch between a fair value charge to the profit and loss account and the historical cost balance sheet. There is no proposed recognition of the overall increase in worth of the entity that would be necessary in order for the options to have any value and consequently precipitate a fair value charge.

As both the fair value of the options and the increased market value of the entity are contingent upon a market recognition of an entity's increased worth, both should be recognised either by way of note, or by inclusion in the financial statements. This would match the cost against the benefit that cost is designed to create. To look at it the other way no increase in market value means no value to the options means no fair value charge.

Unnecessary complexity

A number of accounting standards have been released which, in the real world, are just too complicated (e.g. Financial Instruments) or end up being discounted (e.g. Goodwill). Although purchased goodwill is now capitalised on the balance sheet, most brokers, banks, M&A practitioners etc remove it and any related amortisation when evaluating an entity's underlying performance and worth.

The contingent and subjective nature of the fair value charge would undoubtedly generate similar adjustment by such users. Furthermore, I question whether the extensive and detailed amount of explanatory disclosure required to understand the basis of the fair value charge improves the clarity and usefulness of a company's accounts.

In summary, therefore, I do not believe that a subjective fair value charge to the profit and loss account whilst maintaining an historical cost balance sheet, is correct. It might be possible to show a separate statement comparing a contingent fair value charge to the corresponding contingent increase in market value of the entity as a whole. However, I believe that given these alternatives the best solution remains the disclosure by way of note as it currently stands

Yours sincerely,

J L D Harris
Group Finance Director, Armour Group plc.