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Dear Ms Crook

I attach a hard copy of my comments on ED2, e-mailed to you today. The draft was circulated to me under the auspices of ITNEA.

I am not an accountant but have, for most of the last twenty-five years, been a non-executive director of companies, both private and public, and have thus spent a fair amount of my time using, reviewing, or approving company accounts. Being an engineer by training, I expect the accounts to bear a clear relationship to the underlying reality; re-anchoring accounts which have become confused by financial engineering has been a significant part of my work, especially when a member of an audit committee or when assessing other companies.

I mention this background because it has influenced my approach to the exposure draft. I hope that my comments may be useful.

Yours sincerely

JJ Miles

ED2 share-based payments

The avowed intention of the draft IFRS is to equate the effect on expenditure (and thus on profit and the balance sheet) of services, goods or other assets (collectively "Services") paid for in shares instead of in cash. That intention is appropriate; the basis of equivalence should be that of an issue of shares – whether by rights, by a placing or otherwise - which would have been used to pay for the transaction.

But the mechanics of the proposed standard are unduly complex and do not achieve the levels of quality, transparency, and comparability set out as the Objective in the first paragraph (11) of the introduction.

In quasi-cash accounting for transactions paid for in shares, there are two timing elements: valuation and recognition.
In general, valuation should always take place when the "contract" is entered into, just as though it were a cash transaction. Variable elements such as performance-related bonus or inflation escalators should again be dealt with on the same basis as they would in a cash transaction.

Since the currency in which the transaction will be settled is shares, the valuation should always be based on the value of the shares at the time when the "contract" is entered into. With a quoted company, that is easy; it is recognised that, with a private company, surrogate valuation methods may be unavoidable.

ED2 contemplates a variety of actuarial computations to be used in arriving at "fair value"; that is inappropriate. Such a methodology is costly, opens the door to manipulation, and obscures the transparency and comparability which are enshrined in the Objective. A reader of the company's Accounts should be able to see clearly the value ascribed, its relationship to the share price, and to the Services being bought. If, as a result of a failure to vest, of surrender of options, or of some other variation along the way the price paid differs from that contemplated at the outset, that is simply a fact of life. Of course the company should provide for any real increase in the cost of the Services, just as it would for any other potential predicted cost increase, but no special actuarial measures are needed.

Recognition should, as is contemplated in ED2, take place at the time of acquisition of the Service, progressively if that is the reality. However, ED2 requires a Service which, because the shares fail to vest or the options to be exercised, incurs no cost should still be recognised. That obscures the transparency and the connection to the reality of the transaction. A cash-settled Service wherein, for some reason, payment is never made is not recognised as a cost to the company; nor should a similar share-based transaction.

There will inevitably be a period between establishment of the "contract" and recognition of the associated expenditure, and the potential liability needs to be recognised by a pool of reserved shares, similar to a pool of share options. Since there may well be an interval between recognition of the expense and issue of the associated shares, there will need to be more than one class within the pool: potential liabilities (similar to capital expenditure committed but not yet incurred); and liabilities recognised but for which the shares have not yet been issued (effectively creditors). Shares which fail to vest or to be exercised will fall back from a later to an earlier sub-pool.

In conclusion, this paper does not attempt to review ED2 section by section since much of the complexity of the exposure draft would cease to exist were the methodology to be simplified along the lines suggested. Some aspects of the treatment proposed here are consistent with those in the draft. No view is expressed on the tax treatment of share-based payment since that will follow whatever the then current tax accounting rules may be.

The vitally important thing is that the standard should establish practices which are transparent, reasonably consistent, and clearly anchored in the reality of the transaction; they will, as a corollary, be simple.