CL 220

Comment letter from British Airways

FAO - Paul Ebling
Accounting Standards Board
Holborn Hall
100 Gray's Inn Road
London WC1X 8AL

7 March 2003

Dear Sir,

FRED 31- Share Based Payment

We enclose our comments on the proposals included in the exposure draft including responses to the questions included in the preface.

In general terms whilst we agree with the principle of convergence of accounting practices, we have concerns over the nature of some of the suggested proposals included within the exposure draft. We are opposed to a continuous transition from UK GAAP to IFRS over the next three years as we believe a piecemeal adoption process does not facilitate comparability or transparency between financial statements.

We have limited our responses to questions where we have specific comment; where we have no issue with the proposal, we have not included a response.

Our responses to the detailed questions are as follows:

Q1 The ASB is proposing to require the adoption in the UK of a standard based on the proposed IFRS from the effective date in the IFRS (which is expected to be accounting periods beginning on or after 1 January 2004). Do you agree with this approach?

We agree with the principle of convergence to improve the comparability of accounts between different accounting jurisdictions however we are opposed to implementing a new UK standard ahead of the adoption of all International Financial Reporting Standards on 1 January 2005. This could potentially result in the UK being inconsistent with continental European companies and Australian companies if the UK undertake early adoption.

Q3 The IASB has concluded that its standard should apply to all types of share-based payment transactions, including SAYE-type share purchase plans. The ASB does not believe there are any additional UK considerations that would justify a different conclusion being reached in the context of UK accounting. Therefore, like the IASB the ASB is proposing that the

standard should apply to all types of share-based payment transactions. Do you agree with this proposal ?

Whilst we support the ASB's attempt to quantify the goods and services received in exchange for granting share options, we disagree with the inclusion of Save as You Earn schemes ('SAYE'). SAYE schemes are not viewed by employers as remuneration for services. The schemes are offered on a voluntary basis to all employees to encourage greater participation and involvement in the company. At British Airways, SAYE is viewed as 'benefit' similar to staff travel concessions and a charge to the profit and loss (if any) should be limited to the cost incurred by the employer for providing this benefit not the fair value of services received.

Q5 The ASB is proposing that, when the share-based payments standard is implemented in the UK, the ASB should withdraw UITF Abstract 10 'Disclosure of directors' share options', UITF Abstract 13 'Accounting for ESOP Trusts', and UITF Abstract 17 'Employee benefit trusts and other intermediate payment arrangements'.

(a) Will these amendments to existing UK requirements be sufficient to enable entities to adopt the proposed standard without being in breach of an existing requirement ?

(b) Are any of the amendments unnecessary for this purpose ?

UITF 25 requires the accrual for National Insurance Contributions to be calculated by assuming that the company's share price will remain unaltered from the share price ruling on the balance sheet date. This is not consistent with the approach in the exposure draft for cash-settled share-based payments. Accordingly, UITF 25 should be amended to be in line with whatever is in the final standard on cash-settled share-based payments.

UITF 13 will need to be replaced with new guidance for companies that have set up ESOP trusts to purchase the company's own shares.

IASB questions:

Q1 Paragraphs 1-3 of the draft IFRS set out the proposed scope of the IFRS. There are no proposed exemptions, apart from for transactions within the scope of another IFRS. Is the proposed scope appropriate? If not, which transactions should be excluded and why?

As stated in our response to ASB's question 3, we disagree with the inclusion of Save as You Earn schemes ('SAYE') on the basis that they are not considered part of an employees remuneration for services.

Q3 For an equity-settled share-based payment transaction, the draft IFRS proposes that, in principle, the entity should measure the goods or services received, and the corresponding increase in equity, either directly, at the fair value of the goods or services received, or indirectly, by reference to the fair value of the equity instruments granted, whichever fair value is more readily determinable (paragraph 7) to measure share-based payment transactions at fair value. For example, there are no exemptions for unlisted entities.

Is this measurement principle appropriate? If not, why not, or in which circumstances is it not appropriate?

The measurement principal of 'fair value' prescribed in the exposure draft is appropriate in most circumstances. As stated in our response to ASB question 3, we do not believe a fair value basis is appropriate for SAYE option grants. At British Airways, SAYE is viewed as a 'benefit' similar to staff travel concessions and a charge to the profit and loss (if any) should be limited to the cost incurred by the employer for providing this benefit not the fair value of services received.

Q4 If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured directly, the draft IFRS proposes that fair value should be measured at the date when the entity obtains the goods or receives the services (paragraph 8).

Do you agree that this is the appropriate date at which to measure the fair value of the goods or services received? If not, at which date should the fair value of the goods or services received be measured? Why?

We agree that the date the entity obtains the goods or receives the services is the appropriate date when measuring transactions with parties other than employees provided all performance or delivery conditions have been satisfied.

Q5 If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured by reference to the fair value of the equity instruments granted, the draft IFRS proposes that the fair value if the equity instruments granted should be measured at grant date (paragraph 8).

Do you agree that this is the appropriate date at which to measure the fair value of the equity instruments granted? If not, at which date should the fair value of the equity instruments granted be measured? Why?

We agree that the initial measurement of the fair value of the equity instruments granted should be grant date. However, we believe the standard should allow for adjustments in future periods for lapses, forfeiture and for changes in management's assumptions on the possibility of not satisfying the performance criteria. This approach would also remove the exposure draft's current inconsistency between cash-settled share based payment transactions (which allows the liability to be updated to reflect changes in estimates) and equity-settled share based payment transactions.

Q10 In an equity-settled share-based payment transaction, the draft IFRS proposes that having recognised the services received, and a corresponding increase in equity, the entity should make no subsequent adjustment to total equity, even if the equity instruments granted do not vest or, in the case of options, the options are not exercised (paragraph 16). However, this requirement does not preclude the entity from recognising a transfer within equity, ie a transfer from one component of equity to another.

Do you agree with this proposed requirement? If not, in what circumstances should an adjustment be made to total equity and why?

We do not agree with the exposure draft's restriction on subsequent adjustments to total equity if the equity instruments granted to not vest or, in the case of options, the options are not exercised.

As discussed in our response to IASB question 5 we believe the exposure draft should allow for adjustments in future periods for lapses, forfeiture and for changes in management's assumptions on the possibility of not satisfying the performance criteria. This approach would ensure the charge recognised in the profit and loss and the corresponding entry in equity reflects the movement in equity for the actual amount options exercised. Without this subsequent adjustment, there is potential for an entry to remain in equity indefinitely even after the vesting date has passed.

Q13 If a grant of shares or options is conditional upon satisfying specified vesting conditions, the draft IFRS proposes that these conditions should be taken into account when an entity measures the fair value of the shares or options granted. In the case of options, vesting conditions should be taken into account either by incorporating them into the application of an option pricing model or by making an appropriate adjustment to the value produced by such a model (paragraph 24).

Do you agree that vesting conditions should be taken into account when estimating the fair value of option or shares granted? If not, why not? Do you have any suggestions for how vesting conditions should be taken into account when estimating the fair value of share or option granted?

We agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted. However the current lack of guidance in the exposure draft on how to adjust the fair value to reflect such vesting conditions could result in subjective and inconsistent methods being adopted by entities. We would therefore support further implementation guidance being included in the future standard.

Q16 The draft IFRS does not contain prescriptive guidance on the estimation of the fair value of options, consistently with the Board's objective of setting principles-based standards and not to allow for future developments in valuation methodologies.

Do you agree with this approach?

Whilst we do not support a prescriptive approach to standard setting, we believe further guidance is required in areas that are particularly subjective and open to manipulation. As discussed in our response to IASB question 13, we would support additional implementation guidance on how vesting conditions should be taken into account when estimating the fair value of options or shares granted.

Q18 If an entity cancels a share or option grant during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied), the draft IFRS proposes that the entity should continue to recognise the services rendered by the counterparty in the remainder of the vesting period, as if that grant had not been cancelled. The draft IFRS also proposes requirements for dealing with any payment made on cancellation and/or a grant of replacement options, and for the repurchase of vested equity instruments.

Are the proposed requirements appropriate? If not, please explain why not and provide details of your suggested alternative approach.

As previously discussed in our response to IASB questions 5 & 10 we do not agree with the exposure draft's restriction on subsequent adjustments to total equity if the equity instruments granted do not vest or, in the case of options, the options are not exercised.

Q19 For cash-settled share-based payment transactions, the draft IFRS proposes that the entity should measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settles, the entity should remeasure the fair value of the liability at each reporting date, with any changes in value recognised in the income statement.

Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

We agree with the proposed requirements to re-measure the fair value of the liability at each reporting date for cash-settled share-based payment transactions and recommend that such an approach be adopted for equity-settled share based payment transactions.

Q21 The draft IFRS proposes that an entity should disclose information to enable user of financial statements to understand:

- **the nature and extent of share-based payment arrangements that existed during the period,**
- **how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined, and the effect of expenses arising from share-based payments transactions on the entity's profit or loss.**

Are these disclosure requirements appropriate? If not, which disclosure requirements do you suggest should be added, deleted or amended (and how)?

We have strong concerns over the appropriateness of the disclosure requirements surrounding the fair value assumptions. For option schemes with performance criteria based on future EPS growth, share price and future dividends, disclose of management's assumptions could be considered 'forward looking statements' and could be price sensitive. We do not believe this was the intention of standard setters and recommend that this be addressed before the final standard is issued.

Q24 In developing the Exposure Draft, the Board considered how various issues are dealt with under the US standard SFAS 123 Accounting for Stock-Based Compensation, as explained further in the Basis for Conclusions. Although the draft IFRS is similar to SFAS 123 in many respects, there are some differences. The main differences include the following:

a) Apart from transaction within the scope of another IFRS, the draft IFRS does not propose any exemptions, either from the requirement to apply the IFRS or from the requirement to measure share-based payment transactions at fair value. SFAS 123 contains the following exemptions, none of which are included in the draft IFRS:

- **Employee share purchase plans are excluded from SFAS 123, provided specified criteria are met, such as the discount given to employees are relatively small;**

- **SFAS 123 encourages, but does not require, entities to apply its fair value measurement method to recognise transaction with employees; entities are permitted to apply instead the intrinsic value measurement method in Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees (paragraphs BC75-BC74 in the Basis for Conclusions give an explanation of minimum value); and**

- **Unlisted (non-public) entities are permitted to apply the minimum value method when estimating the value of share options, which excludes from the valuation the effects of expected share price volatility (paragraphs BC75-BC78 in the Basis for Conclusions give an explanation of minimum value).**

b) **For transaction in which equity instruments are granted to employee, both SFAS 123 and the draft IFRS have a measurement method that is based on fair value of those equity instruments at grant date. However:**

- **Under SFAS 123, the estimate of the fair value of an estimate instrument at grant date is not reduced for the possibility for forfeiture due to failure to satisfy the vesting conditions, whereas the draft IFRS proposes that the possibility of forfeiture should be taken into account in making such an estimate.**

- **Under SFAS 123, the transaction is measured at the fair value of the equity instruments issued. Because equity instruments are not regarded as issued until any specified vesting conditions have been satisfied, the transaction amount is ultimately measured at the number of vested equity instruments at grant date. Hence, any amounts recognised for employee services received during the vesting period will be subsequently reversed if the equity instruments granted for forfeited. Under the draft IFRS, the transaction is measured at the deemed fair value of the employee services received. The fair value of the equity instruments granted is used as a surrogate measure, to determine the deemed fair value of each unit of employee service received. The transaction amount is ultimately measured at the number of units of services received during the vesting period multiplied by the deemed fair value per unit of service. Hence, any amounts recognised for employee services received are not subsequently reversed, even if the equity instruments granted are forfeited.**

c) **If, during the vesting period, an entity settles in cash a grant of equity instruments, under SFAS 123 those equity instruments are regarded as having immediately vested, and therefore the amount of compensation expense measured at grant date but not yet recognised is recognised immediately at the date of settlement. The draft IFRS does not require immediate recognition of an expense but instead proposes that the entity should continue to recognise the services received (and hence the resulting expense) over the remainder of the vesting period, as if that grant of equity instruments had not been cancelled.**

d) **SFAS 123 does not specify a measurement date for transactions with parties other than employees that are measured at the fair value of the equity instruments issued. Emerging Issues Task Force Issue 96-19 Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services requires the fair value of the equity instruments issued to be measured at the earlier of (i) the date a performance commitment is reached or (ii) the date performance is complete. This date might be later than grant date, for example, if there is no performance commitment at**

grant date. Under the draft IFRS, the fair value of the equity instruments granted is measured at grant date in all cases.

e) **SFAS 123 require liabilities for cash-settled share appreciation rights (SARs) to be measured using an intrinsic value measurement method. The draft IFRS proposes that such liabilities should be measured using a fair value measurement method, which includes the time value of the SARs, in the same way that options have time value (refer to paragraphs BC70-BC81 of the Basis for Conclusions for a discussion on intrinsic value, time value and fair value).**

f) **For a share-based payment transaction in which equity instruments are granted, SFAS 123 requires realised tax benefits to be credited direct to equity as additional paid-in capital, to the extent that those tax benefits exceed the tax benefits on the total amount of compensations expense recognised in respect of that grant of equity instruments. The draft IFRS, in a consequential amendment to IAS 12 (revised 2000) Income Taxes, proposes that all tax effects of share-based payment transactions should be recognised in profit or loss, as part of tax expense.**

For each of the above differences, which treatment is the most appropriate? Why? If you regard neither treatments as appropriate, please provide details of your preferred treatment.

For difference (a) point one, we agree with SFAS 123 for the reasons stated previously in IASB question 3. For all other points we agree with FRED 31.

For difference (b) point one, we agree with FRED 31 however we agree with SFAS 123 on point two for the reasons stated previously in our response to IASB question 10.

For difference (c) we agree with SFAS 123 for the reasons stated previously in our response to IASB question 10.

For difference (d) we agree with FRED 31 provided the fair value is then adjusted in later periods for changes in assumptions or for the receipt of goods or performance of services.

For difference (e) we agree with FRED 31.

For difference (f) we agree with FRED 31.

Conclusion

In conclusion, whilst we reaffirm our general support for international convergence of accounting requirements to improve comparability of financial statements we have raised concerns about a piecemeal transition process. We prefer the alternative approach of full adoption in 2005 with the current focus being on improving IAS and planning for its implementation.

Our specific concerns on FRED 31 relate to :

- the inclusion of Save As You Earn Schemes;
- determining the fair value of options at grant date without any further adjustments in later periods for lapses or forfeiture;
- disclosure of dividend and future earnings assumptions; and
- the need for further implementation guidance on how performance criteria is to be reflected in the fair value of options granted.

We urge the ASB and IASB to reconsider the exposure draft in light of our comments above.

Yours Sincerely

John Rishton
Chief Financial Officer