

Accounting for Employee Benefits

and Stock-Based Compensation Under IFRS

Implications and Considerations for U.S. Companies

Over the next few years, companies in the U.S. will need to assess the implications of differences between International Financial Reporting Standards (IFRS) and U.S. GAAP as the two sets of standards converge. In 2011, we should learn whether this convergence will include a requirement that publicly held companies in the U.S. adopt IFRS in the not-too-distant future. Understanding those differences — focusing in particular on near-term changes to IFRS — can help companies develop a convergence strategy and manage balance sheet and income statement volatility.

This paper explores the key differences between IFRS and U.S. GAAP in accounting for employee benefits and stock-based compensation. It looks not just at the existing rules, but also at changes contemplated by the International Accounting Standards Board (IASB).

Accounting for Employee Benefits

The accounting for employee benefits is addressed by IAS 19, *Employee Benefits*. IAS 19 classifies employee compensation and benefits as:

- *Short-term benefits* — benefits that are expected to be paid within one year after employees provide the service for which they are being compensated, such as pay, medical coverage provided to active employees, vacation pay, sick pay, and profit sharing and bonuses payable within the next 12 months
- *Postemployment benefits* — benefits, other than termination benefits, that are payable after completion of employment, such as pensions, retiree medical and life insurance benefits, and continuation of medical and/or life insurance coverage after employment
- *Other long-term benefits* — benefits, other than postemployment and termination benefits, such as sabbaticals, long-term disability, deferred

compensation and long-term incentive plans (other than those tied to stock performance) that are expected to be paid more than 12 months after the end of the period in which employees provide the related service

- *Termination benefits* — benefits paid upon involuntary termination or pursuant to an “open window” (i.e., a short-term offer providing incremental compensation or benefits for voluntary termination)

The most significant of these benefits are postemployment benefits, which will be the primary focus of our discussion. It will be followed by a brief description of the accounting for other benefits.

Postemployment Benefits

The accounting for retirement and other postemployment benefits is in an evolutionary state. Like the Financial Accounting Standards Board (FASB), the IASB believes greater transparency would be achieved by immediately recognizing changes in the funded position of retirement plans on the plan sponsor’s balance sheet and comprehensive income statement, and enhancing financial statement presentation and disclosures. The two boards also believe that the measurement of benefit obligations should be revisited, particularly in light of the increased use of less traditional retirement plan designs.

As the next step in this evolution, the IASB plans to issue an Exposure Draft of proposed changes to IAS 19 in late March 2010. That Exposure Draft is the first phase of a more comprehensive reconsideration of the accounting for postemployment benefits and will be limited in scope to recognition, presentation and disclosure issues. It is expected to result in a formal amendment to IAS 19 in 2011 that would be effective in 2013, although companies could choose to apply the amended standard earlier.

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Current Differences Between IAS 19 and U.S. GAAP

While there are many similarities between the accounting for benefits provided after termination or retirement under IAS 19 and U.S. GAAP, there are six key differences. Under IAS 19:

- The effect of plan changes is recognized immediately for benefits that are vested, and amortized over employees' future service to their vesting date for benefits that are not yet vested. This results in much more rapid recognition — in fact, immediate recognition of much or all of the cost of a benefit improvement or savings from a benefit reduction, in most cases.
- While gains and losses may be recognized through P&L immediately or on a delayed basis (with some differences from U.S. GAAP), a third alternative allows gains and losses to be recognized immediately through other comprehensive income (OCI). This is noteworthy because, unlike U.S. GAAP, the amounts charged to OCI are not "recycled" through P&L. Thus, the resulting balance sheet effect is similar to U.S. GAAP, but without the income statement volatility arising from gain/loss recognition.
- The fair value of plan assets is used in determining the expected return on plan assets; there is no concept of a smoothed asset value. Currently, this may result in a lower expected return on plan assets than under U.S. GAAP for companies that use a smoothed asset value. This is because the fair value of assets is likely to be lower than a market-related value of plan assets that phases in recent asset gains and losses.
- The expected return on plan assets component of the net benefit cost is adjusted to reflect actual contributions and benefit payments (when those amounts are materially different from the expected contributions and benefit payments). It is arguably more logical to adjust the expected return on plan assets for actual contributions than to recognize a return on expected contributions that the company opts not to make in the current year.
- Rather than aggregating the components of cost, employers may choose to bifurcate them and report them in different line items in the income statement.

For example, employers may choose to report service cost as an operating cost, but report interest cost and the expected return on plan assets as financing costs.

- The postemployment benefit asset (e.g., prepaid pension cost) reported on the balance sheet is limited to unrecognized costs plus the economic benefit of any plan surplus that is recoverable through a reduction in future contributions and/or reversion of any plan surplus (net of related costs, including excise taxes). The applicability of the asset ceiling for U.S. plans is still the subject of debate, but it is clearly an issue for plans in Canada and parts of Europe.

Expected Near-Term Changes to IAS 19

The IASB expects to issue an Exposure Draft in late March 2010, proposing several substantive changes to IAS 19. The proposed changes are expected to include:

- *Net interest income or expense* would be measured by applying the discount rate to the plan surplus or deficit. This new measure would replace interest cost and the expected return on plan assets.
- *Immediate recognition of all past service cost and gains and losses.* The effect of plan changes would be recognized through P&L. However, assuming the IASB moves forward with its view that the comprehensive income statement must be presented as a single statement,* gains and losses would be included as a "remeasurement effect" reported in OCI. In this case, it is possible that gains and losses could be required to be recognized through OCI in the interim financial statements.

Similar to the current accounting treatment, the difference between the actual return on plan assets and the estimated return would be included in gains and losses. However, the estimated return would be based on the plan's discount rate (usually, high-quality bond rates), rather than a rate of return that considers the plan's asset allocation.

The resulting balance sheet effects would essentially mirror the balance sheet under U.S. GAAP, but with a ceiling on the asset that could be recognized for certain overfunded plans. However, immediate

*The FASB and IASB are working jointly on a project on financial statement presentation, including the format of a statement of comprehensive income. An exposure draft of the proposed standard with respect to the format of the comprehensive income statement is expected to be issued in late March 2010.

recognition of the effect of plan changes (and gains and losses, if the IASB were to converge with the U.S.) through P&L would introduce more volatility to the income statement than under U.S. GAAP.

- *Disaggregation of the components of cost into:*
 - An employment component (current and past service cost and curtailment effects), which would be included in operating costs
 - A financing component (net interest cost), which would be included in financing costs
 - A remeasurement component (actuarial gains and losses, including settlement effects), which would be shown separately, net of tax effects, in OCI
- *Enhanced disclosures, including sensitivity information and information useful in assessing liquidity risk and market risk associated with the plan assets;* some of the disclosures likely to be proposed are more extensive than those currently required under U.S. GAAP

Other Benefits

The accounting for short-term benefits is generally comparable to the accounting most companies follow under U.S. GAAP. The cost and liability for benefits that accumulate with service are to be accrued over the period they are earned, with gains and losses expensed immediately. The cost and liability for benefits that do not accumulate with service are recognized when the triggering event occurs. The benefit obligation and cost are not discounted.

The accounting for long-term benefits under IFRS is also generally comparable to the accounting most companies follow under U.S. GAAP, except the obligation and cost are required to be discounted based on high-quality corporate bond rates. The cost and liability for long-term disability benefits that do not accumulate with service are recognized when the triggering event occurs. In all other cases, the cost and liability for long-term benefits are to be accrued over the period they are earned, with gains and losses and the effects of any plan changes expensed immediately.

The IASB will soon issue an amendment to IAS 19 that more closely aligns the accounting for termination benefits with U.S. GAAP. As a result of these changes, which will be effective in 2011 but can be adopted early, the accounting for termination benefits will generally be consistent under IAS 19 and U.S. GAAP.

Stock-Based Compensation

The basic principles underlying the accounting for stock-based compensation are generally the same under U.S. GAAP and IFRS 2, *Share-Based Payment*, with the exception of the following noteworthy differences:

- *Scope* — IFRS 2 applies to all stock-based awards to employees and nonemployees, including awards from ESOPs. Under U.S. GAAP, the measurement date, and measurement and recognition of cost, differ for grants to employees, awards to nonemployees (such as independent contractors or other advisors) and ESOP awards. Grants to nonemployees generally result in mark-to-market accounting under U.S. GAAP (until the date the agreed-upon services have been provided), and special accounting rules apply to ESOPs. Under IFRS 2, the cost of awards to nonemployees are measured at fair value at the date the services are provided and recognized over the required service period, like stock-based awards to employees.
- *Service period over which compensation cost is recognized* — Explicit guidance is provided under U.S. GAAP for determining the grant date of an award and the explicit, implicit and derived service periods used in determining the service period over which the cost of an award should be accrued. IFRS 2 is less prescriptive than U.S. GAAP, leading to potential differences in the grant date (for accounting purposes) and ambiguities in the period over which the compensation cost is to be recognized.
- *Attribution of compensation cost for awards with graded vesting* — Unlike U.S. GAAP, IFRS 2 does not permit a straight-line attribution approach for service-based awards with graded vesting. Instead, each tranche is treated as a separate grant.
- *Payroll taxes* — Payroll taxes are accrued under IFRS 2 as the related compensation cost is recognized. This contrasts with U.S. GAAP, which requires recognition of payroll taxes when the event triggering the tax payment (e.g., exercise date for nonqualified options or vesting date for restricted stock) occurs.
- *Accounting for certain types of award modifications* — Under U.S. GAAP, award modifications are categorized based on the expectation — immediately before and after the modification — that the award will vest. For example, a Type III modification is

one where the expectation an award will ultimately vest changes from “improbable” to “probable.” Generally, total compensation cost under U.S. GAAP for a modified award may not be less than the fair value of the award at the original grant date, except in the case of a Type III modification. For these modifications, the compensation cost is based on the fair value of the modified award at the modification date, which may be less than the fair value of the award at the original grant date. IFRS 2 makes no such distinction; total compensation cost is at least equal to the fair value of the award as of the grant date (i.e., the number of modified awards expected to vest, times the fair value of the awards at the original grant date) — even for improbable-to-probable modifications. In addition, the effects of any modifications that increase the fair value of the share-based payment arrangement must be recognized. This incremental cost is equal to the increase in the fair value of the award as measured immediately before and after the modification.

- **Deferred tax effects** — Like U.S. GAAP, IFRS 2 requires employers to recognize the deferred tax effects as compensation cost is recognized. However, under U.S. GAAP, the deferred tax asset is based on the compensation cost that has been recognized through P&L (i.e., based on the fair value of the award at the date it was granted). In contrast, under IFRS 2 the deferred tax asset (and, therefore, tax expense) is adjusted at the end of each reporting period based on the intrinsic value of the award at that date. As a result, under IFRS 2, the expected excess tax benefits are recognized as additional paid-in capital as they arise, rather than reflecting any actual excess tax benefits all at once when the award is settled.
- **Windfall tax benefits or tax benefit shortfalls** — “Windfall” tax benefits (where the tax deduction related to an award exceeds the compensation cost recognized) and tax benefit “shortfalls” (where the compensation cost recognized for an award exceeds the related tax deduction) are tracked separately for each award under IFRS 2, but in the aggregate under U.S. GAAP. In addition, under IFRS 2, a windfall tax benefit is recognized in equity whereas a tax benefit shortfall is recognized in P&L. Under U.S. GAAP, a tax benefit shortfall first reduces the accumulated windfall in equity, with only the residual recognized through P&L.

- **Employee stock purchase plans (ESPPs)** — The safe harbor under U.S. GAAP — which enables employers in many situations to avoid expensing shares purchased by employees through an ESPP if the purchase discount does not exceed 5% on the purchase date — does not exist under IFRS 2. As a result, under IFRS 2, any discount from the fair value of stock purchased by employees through an ESPP must be recognized as compensation cost.

Transition to IFRS

IFRS 1, *First-Time Adoption of International Financial Reporting Standards*, addresses how companies are to account for the initial application of IFRS. With limited exceptions, IFRS 1 requires that an entity that changes its basis of accounting from a national GAAP (such as U.S. GAAP) to IFRS must do so by retroactively restating the prior year(s) as though the IFRS in effect at the reporting date had always been followed. The cumulative effect of the change is recognized through beginning retained earnings of the earliest year presented, and the comparative financial statements therefore reflect consistent application of IFRS.

Example: A company adopting IFRS in 2015 would have to determine the beginning balances of its assets, liabilities and equity accounts as of January 1, 2013 (the date of transition) in accordance with IFRS in effect in fiscal 2015. Retained earnings as of January 1, 2013 would be adjusted for changes between the amounts recognized under U.S. GAAP and the amount to be recognized under IFRS.

The following exceptions are provided for determining the transition effect of adopting IAS 19 and IFRS 2 when adopting IFRS for the first time:

- Employers may choose to treat all unamortized gains and losses under U.S. GAAP as though they had been immediately recognized through P&L prior to the transition date, regardless of the gain/loss recognition policy the employer chooses to follow prospectively.
- Employers need not apply IFRS 2 to awards granted on or before November 7, 2002 that have vested at the date of transition to IFRS or to liabilities settled before that date.

Final Thoughts

Understanding IFRS and how they would affect your financial results is critical to developing a successful convergence strategy. For your benefits and share-based compensation plans, this encompasses collecting information about your plans, reaffirming plans considered to be material, identifying implementation issues, assessing your accounting options (if any) and selecting accounting policies, evaluating risk mitigation strategies, reconsidering performance measures and monitoring IASB decisions.

We look forward to working with you as you assess the implications of convergence with IAS 19 and IFRS 2.

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