

Executive Compensation

Bulletin

What You Need to Know About IFRS 2 Accounting for Share-Based Payments

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The Securities and Exchange Commission (SEC) has approved a Policy Statement and Work Plan to study convergence of U.S. Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS) over the next several years. A decision on whether to require publicly held companies in the U.S. to adopt IFRS is expected to be made in 2011.

Whether or not the adoption of IFRS is mandated, companies in the U.S. will need to assess the implications of differences between IFRS and U.S. GAAP as the two sets of standards converge. Understanding those differences can help companies develop a convergence strategy and manage balance sheet and income statement volatility.

For the most part, the accounting for stock-based compensation is similar under U.S. GAAP (ASC 718, formerly FAS 123(R)) and IFRS 2, but there are some noteworthy exceptions. This article describes and provides examples of key differences.

The Big Picture

Several years after the Financial Accounting Standards Board (FASB) issued FAS 123, the IASB issued a proposed standard addressing the accounting for share-based compensation. In an effort to improve the transparency of financial reporting and maximize the opportunity to converge the U.S. and international accounting standards, the FASB and IASB agreed to work concurrently on a project to converge the accounting for stock-based compensation. The outcomes of this collaboration — FAS 123(R), now ASC 718, and IFRS 2 — are therefore quite similar in their fair-value approach to recognizing the cost of stock-based compensation. Consequently, converging with and possibly adopting IFRS accounting for these costs should be much simpler than for other areas, such as accounting for pension and other postretirement benefit costs.

The good news is that the basic principles underlying FAS 123(R) generally apply to IFRS 2 as well, specifically:

- The application of option pricing models for purposes of establishing a baseline fair value
- Adjustments for forfeitures
- The "incremental value" concept applied to modifications

Converging with and possibly adopting IFRS accounting for stock-based compensation costs should be much simpler than for other areas.

Notwithstanding these similarities, however, companies should be aware of the differences, primarily related to:

- Scope (i.e., stock-based awards covered by the standards)
- Service period over which compensation cost is recognized
- Attribution of compensation cost (for awards with graded vesting) to service periods
- Awards permitting tax withholding
- Deferred tax effects
- Payroll taxes
- Accounting for certain types of award modifications
- Accounting for employee stock purchase plans (ESPPs)

This article discusses each of these differences.

Awards Covered by the Standards

ASC 718 applies to awards made to employees and members of the board of directors whose compensation is provided solely in return for services rendered in that capacity. The per-share value of such awards is determined as of the grant date and remains fixed thereafter. The per-share value of grants made to nonemployees who do not serve in the capacity of a director generally result in mark-to-market accounting until the agreed-upon services have been provided.

IFRS 2 applies to all stock-based awards, including employees, directors and nonemployees providing services to the company. The fair value of awards to employees is based on the fair value of the equity instrument at the grant date. However, for transactions with nonemployees, the fair value will be based on the value of the goods or services received if they can be reliably determined; otherwise, the measured fair value of the equity instrument at the date the services are received is to be used.

Example: A member of the board of directors receives a special award of 5,000 shares on January 1, 2010, for providing legal advice. The shares vest in five years. This award is not in return for services rendered as a board member, but rather because of special expertise at the law firm where the member is employed. The value of the services is more reliably measurable based on the equity award.

Under U.S. GAAP (ASC 505-50, *Equity-Based Payments to Non-Employees*), the award would generally receive mark-to-market accounting until the date the agreed-upon services have been provided. Under IFRS 2, by contrast, the award would generally be measured at the average price during the year. The closing price of the stock on the date of grant is \$50. Every year thereafter, the stock price fluctuates as shown in the illustration below, with the accompanying results:

December 31, ...	Stock Price	Annual Expense		Cumulative Cost	
		U.S. GAAP	IFRS	U.S. GAAP	IFRS
2010	\$52.500	\$52,500	\$51,250	\$52,500	\$51,250
2011	55.125	57,750	53,812	110,250	105,062
2012	49.625	38,625	52,375	148,875	157,437
2013	52.125	59,625	50,875	208,500	208,312
2014	\$54.750	\$65,250	\$53,438	\$273,750	\$261,750

Service Period Over Which Compensation Cost Is Recognized

U.S. GAAP (ASC 718) offers detailed guidance for determining the service period over which cost is to be recognized and identifies conditions that govern the inception and completion dates.

Specifically, the standard notes that the requisite service period may be explicit, implicit or derived, depending on the circumstances governing an award's vesting or exercise terms. (For example, a derived service period would be applicable primarily for awards with market conditions, while an explicit service period would exist when the award has a specific vesting date.) An overriding condition for identifying the grant date is that the recipient begin to be affected by the risks and rewards of equity ownership.

IFRS 2 is less prescriptive than U.S. GAAP in this respect, leading to potential differences in the grant date and ambiguities in the length of the service period over which cost is to be recognized.

IFRS 2 is less prescriptive than US GAAP in defining the service period over which cost is recognized.

Attribution of Compensation Cost to Service Periods

U.S. GAAP (ASC 718) provides for a choice in how compensation cost for service-based awards with graded vesting is recognized over the requisite service period. Specifically, companies may attribute the compensation cost on a "straight line" basis or treat the award as multiple separate awards, recognizing cost separately for each tranche. Straight-line attribution tends to smooth out the cost, while treating the award as separate tranches front-loads a substantial portion of the cost to the earlier years in the requisite service period.

IFRS 2 does not permit a straight-line attribution approach for service-based awards with graded vesting; rather, each tranche is treated as a separate grant.

Example: A grant of 5,000 service-based restricted shares made on January 1, 2010 vests in equal installments on the first through the fifth anniversary of the award. The grant date fair value of the shares is \$50 each (\$250,000 in total). The company chooses to apply the straight-line attribution method under U.S. GAAP. Under IFRS 2, however, the award must be treated as five grants of 1,000 shares each, vesting at the end of each year from 2010 to 2014, as shown below:

Year	Annual Expense	
	U.S. GAAP	IFRS
2010	\$50,000	\$114,167
2011	50,000	64,167
2012	50,000	39,166
2013	50,000	22,500
2014	50,000	10,000
Cumulative Expense	\$250,000	\$250,000

Awards Permitting Tax Withholding

U.S. GAAP (ASC 718-10) classifies awards allowing a net-share settlement (i.e., payment is withheld to meet the minimum tax withholding requirements) as equity instruments, provided the award would otherwise qualify for equity treatment.

IFRS 2 has no such exception. Amounts withheld to cover the statutory minimum tax are accounted for as a cash settlement of the equity instrument (i.e., fair value is based on the amount withheld); the remainder of award continues to be treated as an equity instrument, provided the award would otherwise qualify for equity treatment.

Deferred Tax Effects

U.S. GAAP (ASC 718-740) requires companies to recognize deferred tax effects as the related compensation cost is recognized. The amount of 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 grant date). If the actual tax deduction exceeds the amount expensed, the excess tax benefit is recognized as additional paid-in capital. If the actual tax deduction is less than the expensed amount, the shortfall is first offset against any accumulated windfalls in additional paid-in capital from excess tax benefits on previous awards; the remaining shortfall (if any) is recognized as income tax expense.

IFRS 2 also requires companies to record the deferred tax effects as compensation cost is recognized. However, unlike U.S. GAAP, the deferred tax asset (and, therefore, tax expense) is adjusted to reflect the current stock price. If the estimated future tax deduction exceeds the cumulative expense recognized, the expected tax benefit on the excess is recognized as additional paid-in capital. This approach recognizes expected excess tax benefits as they arise, rather than all at once when the award is settled. Shortfalls are recognized in earnings without regard to prior windfalls, except with respect to the individual award. It is both administratively more burdensome than the U.S. GAAP requirement and may result in greater short-term volatility in expense.

Example: A company awarded 1,000 shares to an executive on January 1, 2010. The shares vest and are settled on December 31, 2014. The fair value of these shares, measured at \$50 per share on the date of grant, fluctuates over the subsequent service period as shown below. The deferred tax benefit under U.S. GAAP is unaffected by changes in the stock price until the shares finally vest, whereas under IFRS the changes in the stock price result in an immediate adjustment to the deferred tax asset. The illustration assumes a 40% tax rate.

December 31, ...	Stock Price Change	Intrinsic Value	Annual Expense	U.S. GAAP		IFRS	
				Deferred Tax Asset	Windfall (Shortfall)	Deferred Tax Asset	Windfall (Shortfall)
2010	+5%	\$52,500	\$10,000	\$4,000	\$0	\$4,200	\$200
2011	+5%	55,125	10,000	8,000	0	8,820	820
2012	-10%	49,613	10,000	12,000	0	11,907	(93)
2013	+5%	52,093	10,000	16,000	0	16,670	670
2014	+5%	\$54,698	\$10,000	20,000	0	\$21,879	1,879
Settlement					\$1,879		\$1,879

Payroll Taxes

U.S. GAAP (ASC 718) requires recognition of payroll taxes when the event triggering the tax payment occurs (i.e., the vesting date for restricted stock and the exercise date for nonqualified stock options).

IFRS 2 requires recognition of payroll taxes as the underlying compensation cost is recognized. Thus, recognition of the expected payroll tax is accelerated under IFRS.

Accounting for Certain Types of Award Modifications

U.S. GAAP (ASC 718) categorizes award modifications into four types. A Type III modification is one where the expectation that the award will ultimately vest changes from “improbable” to “probable.” Typically, Type III awards lower the performance bar for receiving an award to a level that is reasonably expected to be achievable. In such cases, the actual compensation cost may be less than the value of the grant under the original performance criteria, since the per-share value of the award at the time of the modification (rather than the value of the award at the original grant date) is the relevant base comparison standard.

IFRS 2 does not include the concept of Type I – IV modifications. Instead, the original per-share value of the award at the grant date is retained, with compensation cost based on the revised number of shares expected to vest.

Example: A grant of 5,000 performance-based restricted shares has a fair value of \$250,000 at the time of grant. Halfway through the performance cycle, the company concludes it is unlikely that the original performance conditions will be satisfied. As a result, the company decides to revise the award terms. Based on the modified terms, it becomes probable that the shares will vest. At the modification date, the fair value of the original award is determined to be \$200,000, and the fair value of the modified award is \$205,000.

U.S. GAAP categorizes award modifications into four types for accounting purposes; IFRS 2 treats all modifications the same.

Assuming the modified conditions are met, a compensation cost of \$205,000 will be recognized under U.S. GAAP — even if the original conditions are met. However, under IFRS 2, the incremental value of \$5,000 at the modification date would be added to the original compensation cost measure of \$250,000, with a total cost of \$255,000 recognized if all 5,000 shares of the modified award vest.

Accounting for Employee Stock Purchase Plans (ESPPs)

U.S. GAAP (ASC 718) contains a safe harbor that permits companies to avoid expensing shares purchased by employees under ESPPs, as long as the purchase discount does not exceed 5% of the fair value of the stock on the purchase date. In order to benefit from this safe harbor, substantially all employees must be eligible to participate in the plan on an equitable basis, and the purchase conditions may not include any option like “lookback” features.

IFRS 2 does not have a safe harbor for ESPPs; any discount from fair value of the stock must be recognized as compensation expense.

Example: A company maintains an ESPP under which employees may purchase the company’s stock at a 5% discount from market price (e.g., \$50 of stock may be purchased for \$47.50, a \$2.50 savings). The company is not required to expense the \$2.50 discount under U.S. GAAP, but is required to recognize it as compensation cost under IFRS 2.

Looking Ahead

For the most part, the measurement and recognition of stock-based compensation cost are substantially the same under U.S. GAAP and IFRS. There are, however, a few differences, as described above, that may be noteworthy for a company’s stock-based plans. Although there is little that can be done from a plan design standpoint to mitigate the differences (except perhaps for ESPPs and switching from graded vesting to cliff vesting), publicly held companies should understand those differences and the effect they may have on the cost recognized for their stock-based compensation plans if U.S. companies are required to adopt IFRS, or the U.S. and IFRS accounting standards for these costs are further converged.

If adoption of IFRS is mandated, companies would be required to present financial statements for the current and two preceding years, as normally required by the SEC rules. This means that a calendar-year company adopting IFRS in 2016, for example, would have to determine the beginning balances of its assets, liabilities and equity accounts in accordance with IFRS as of January 1, 2014 (the date of transition) in order to determine the cost for 2014 and thereafter under IFRS.

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