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IFRSs and share-based compensation plans

Increasingly, U.S. executives — in finance, tax, human resources, and beyond — are looking closely at the movement toward International Financial Reporting Standards (IFRSs) as a single set of globally accepted accounting principles. Several recent developments have heightened attention, including the August 2008 announcement by the Securities and Exchange Commission (SEC) of its intention to issue a proposed "roadmap" for mandatory transition to IFRSs and to consider possible rule changes that would allow some companies the option to early adopt IFRSs for years ending on or after December 15, 2009.

IFRS adoption presents both challenges and opportunities. For many companies, the implications extend well beyond accounting and financial reporting. A shift from U.S. Generally Accepted Accounting Principles (U.S. GAAP) to IFRSs will have a significant impact on share-based compensation plans, requiring companies to examine carefully the issues — from the potential change in pretax financial statement income and impact on taxation to systems and plan design implications.

Take note of four key areas of difference between U.S. GAAP and IFRSs

As companies assess or prepare for a shift from U.S. GAAP to IFRSs, four key differences between the standards that affect share-based compensation plans will need to be understood:

- Income tax accounting
- Valuation and expense amortization
- Balance sheet classification
- Payroll tax accounting

The complexity of these issues requires sufficient lead time for analysis, as well as careful coordination among tax, human resources, finance, and other functions to understand the implications and determine the most appropriate courses of action.

Income tax accounting: Expect volatility in the income statement, balance sheet, and effective tax rate

The difference: Under U.S. GAAP, the deferred tax asset (DTA) for a stock option is determined based on the option's fair value on the date the option is granted. Although a stock option may be "out of the money," a DTA is still recorded under U.S. GAAP and the DTA is generally not adjusted for changes in the fair value of the underlying stock prior to the exercise or expiration of the option right. Under IFRSs, the DTA is based on the tax deduction that would be available based on the current share price at each reporting date, and thus, where the tax deduction is based on intrinsic value a DTA is recognized only when the option has become "in the money."

Financial reporting implications: Because the DTA for share-based payments under IFRSs is remeasured at each reporting date, fluctuations in the fair value of the stock will result in an adjustment to the DTA that can cause volatility in the effective tax rate. In fact, for those companies that issue compensatory options with a strike price equal to the fair value of the stock on the grant date, appreciation in the value of the stock will be required in order to recognize a tax benefit for the financial statement compensation expense. The sidebar below provides an example of the difference in the deferred tax calculation under U.S. GAAP and IFRSs. Similar to U.S. GAAP, the tax benefit of the tax deduction in excess of the financial statement compensation expense under IFRSs is recorded as a credit to equity. Unlike U.S. GAAP under which the shortfall between the tax deduction and the compensation cost recognized is recorded as a debit to equity to the extent prior excess tax benefits exist, under IFRSs the shortfall is recorded as income tax expense.

Currently, whether there is a tax deduction associated with share-based compensation and whether it arises in the same accounting period as the financial statement expense varies from country to country. In many countries, a recharge of share-based compensation to a subsidiary is required to obtain a tax deduction. Establishing a recharge is often accomplished by the execution of a reimbursement arrangement between a parent company and its subsidiary. Among countries that have adopted IFRSs for statutory reporting, few have clarified whether a tax deduction for share-based payments is deductible absent a recharge, or whether a recharge is deductible if the income statement expense is based on IFRSs rather than the recharge. Countries are likely to begin clarifying these issues soon.

Tax accounting processes and systems implications: IFRSs will add complexity to the tax department's accounting processes supporting share-based compensation. Income tax accounting under U.S. GAAP does not require reconciliation of the accounting charge and the corporate tax deduction until an option is exercised or a restricted stock award vests. Under IFRSs, the amount of the potential tax deduction for outstanding awards at each reporting date will need to be tracked with appropriate adjustment of the related DTA. The income tax accounting will depend on the deduction available under the tax law in the country in which the expense is recognized. The deductible amount, the calculation methodology, and the timing of deductions will have to be assessed in each jurisdiction.

Deferred tax calculation example

On January 1, 2007, a company grants 1,000 options with a grant-date fair value of $10. The awards vest at the end of the fourth year of service and have an exercise price of $23. The share price on December 31, 2007, is $25. The company's tax rate is 40 percent.

Under U.S. GAAP, the company calculates the 2007 DTA based on the fair value of the options on the grant date:

(1,000 options x $10 x ¼ vesting) x 40% = $1,000

Under IFRSs, the company calculates the DTA based on the intrinsic value of the option at the December 31, 2007, reporting date:

(1000 options x ($25-$23) x ¼ vesting) x 40% = $200

In this example, the tax benefit under IFRSs, which is based on the value of the underlying stock on the reporting date, is substantially less than the tax benefit under U.S. GAAP.

Valuation and expense amortization: Avoid unwanted surprises

The difference: While book compensation expense for options under both IFRSs and U.S. GAAP is calculated using a valuation model (e.g., Black Scholes or a lattice-based model), the accounting for share-based payments with graded vesting will likely result in a different impact to pre-tax financial statement income under IFRSs. IFRSs require companies to estimate a separate fair value for each vesting tranche of an option and to begin amortizing expense for all tranches on the grant date. Under U.S. GAAP, the fair value of the entire award can be estimated in the aggregate, or each tranche can be valued separately, and amortization can be on a straight-line or accelerated basis for awards that vest based on the completion of a required service period. Most enterprises, however, have historically used the aggregate valuation method and straight-line amortization under U.S. GAAP and are likely to experience an acceleration of financial statement amortization expense in a conversion to IFRSs.

Potential income statement implications: Valuing individual tranches of an option award will require companies to estimate the expected term of each tranche and determine other valuation inputs, such as expected volatility of the stock for each tranche. A tranche-by-tranche valuation generally results in a higher value for the later-vesting tranches (i.e., a long-term option is generally more valuable than a short-term award), and the later vesting tranches are more often forfeited than the earlier tranches. Thus, amortization expense under the IFRS approach should be carefully assessed to ascertain the potential impact on pretax earnings.

Systems implications: As an organization develops its IFRS conversion strategies, it may need to consider changes to existing systems and technology to support IFRSs. Larger stock plan administrators generally have systems capable of amortizing expense on a straight-line or accelerated basis. Companies should assess their or their administrators' ability to calculate and process a separate fair value for each vesting tranche and to provide other information required for IFRS reporting.

For multinational companies that use different standards for group reporting and subsidiary reporting, the ability of their centralized systems to apply multiple accounting approaches to each award is important. The sidebar on this page describes how a company may leverage the opportunity presented by the increased global use of IFRSs to standardize and centralize the statutory reporting processes of its non-U.S. subsidiaries.

Balance sheet classification: Liability awards and income statement volatility

The difference: Under both IFRSs and U.S. GAAP, a liability classified award is accounted for differently than an equity classified award in that a liability classified award must be recorded at its current fair value at each reporting date. The rules for determining the appropriate classification as a liability or equity award, however, differ between the two sets of standards. These differences stem from inherent differences in the classification models between the two sets of standards and certain exceptions that are allowed under U.S. GAAP that may not be allowed under IFRSs.

Standardized treatment of stock options sets the stage for centralizing IFRS implementation around the world

A multinational company prepares statutory financial statements in approximately 80 countries in which it operates — including many countries that require or permit the use of IFRSs for statutory reporting.

The company sought to develop a centralized IFRS implementation strategy to improve controls and increase efficiency. To do so, a multifunctional team defined the process for determining the differences between U.S. GAAP and IFRSs and to ensure a consistent application of IFRSs across all subsidiaries.

One of the tools developed in the conversion process enabled the centralized computation of share-based payment accounting, reporting, and disclosure information for each country's compensation awards. The tool provided each subsidiary with its share-based compensation accounting adjustments, expense allocations, tax accounting, and footnote disclosure information, together with the opening balance-sheet conversion adjustments under IFRS 2. Additionally, a detailed document with frequently asked questions was prepared and made available to the applicable subsidiaries, which provided practical explanations of the valuation methodology. The project led to the broader standardization of other processes arising from the company's conversion to IFRSs.

Financial reporting implications: Share-based payment awards that are classified as liability awards will cause volatility in the financial statements as the expense recognized for the award over its vesting period must be recorded at its fair value at each reporting period end. As the classification determination is different between the two sets of standards, companies should pay particular attention to the terms of the share-based payment awards issued and ensure they understand how the terms may impact the classification under the two sets of standards.

Payroll tax accounting: Prepare for new administrative requirements

The difference: Under U.S. GAAP, companies recognize a payroll tax liability for share-based compensation when the liability arises — that is, when options are exercised. Under IFRSs, companies will recognize an accrued liability for payroll taxes as the options vest.

Share-based compensation implications: Under IFRSs a company will accrue social security taxes (or similar tax obligations in foreign jurisdictions) related to share-based payments at each reporting date — a difference that may create significant process changes for some organizations. For example, companies must be prepared to collect employee mobility information and track global payroll tax requirements for outstanding awards. The tax department must ensure that it has the proper processes in place to analyze and manage the accrual of payroll tax liabilities.

Plan early and take a multifunctional view

Understanding the impact of IFRSs on your organization's share-based compensation plans requires a broad, multifunctional perspective — one that can enable employers to address the various accounting, valuation, tax, finance, human resource, and technology implications. Given the level of complexity and the substantial lead time that may be required to implement changes, it is not too early to begin planning.

Steps to take now: Executives in human resources, tax, and finance will need to look closely at the share-based payment implications of an IFRS conversion. This assessment will require a coordinated assessment of the impact on financial reporting, potential modifications of existing equity compensation programs, and systems modifications that will be necessary to accommodate the new recordkeeping requirements. An analysis should include the following steps:

- Understand the potential impact of an IFRS conversion on the DTA and the effective tax rate;
- Estimate the transitional and post-adoption financial statement effect of conversion on amortization expense for share-based payments;
- Review the rules and processes required to support share-based compensation tax deductions in each country, including recharge reimbursements and transfer pricing implications;
- Assess financial system implications, including the reporting and recordkeeping systems of the share-based compensation plan administrator;
- Develop new processes and controls for the accrual of payroll tax liabilities for both domestic and cross-border employees; and
- Conduct IFRS training for human resource, tax, and financial executives to prepare for the road ahead.