Summary of IFRS 2

Why Now?

Why should you care about IFRS 2 now, when U.S. adoption may be years away? First, what is IFRS 2? IFRS 2 is the International Financial Reporting Standard on share-based payments issued by the International Accounting Standards Board (IASB). It's equivalent U.S. accounting standard is Accounting Standards Codification (ASC) Topic 718 issued by the Financial Accounting Standards Board (FASB)… better known as FASB ASC 718 and formerly known as FAS 123(R). IFRS 2 is primarily for non-U.S. companies with foreign subsidiaries, whereby those subsidiaries may be required to report under IFRS 2.

Many countries are already reporting under IFRS and more are adopting every year. Here's a link to the ever-growing list of countries who either require or permit the use of IFRS. Here in the U.S. the decision to adopt IFRS rests with the Securities and Exchange Commission (SEC) and due to various differences between IFRS and U.S. GAAP, there is no certain timetable as to if or when the U.S. will require IFRS. However, certain companies that have foreign subsidiaries are permitted to report their financial data in IFRS in addition to U.S. GAAP. Educating yourself about IFRS 2 will not only ease your transition if and when the U.S. does adopt, but can enable you to better assist your subsidiaries with their IFRS reporting challenges today.

Difference Summary

If you're familiar with FASB ASC 718, some of the key differences from IFRS 2 may make sense to you. If you are brand new to the equity industry and not that familiar with FASB ASC 718, it may be worth your while to read up on that U.S. standard first before reading this. Below are the differences we will briefly touch on:

- Option pricing models
- Tranche-by-tranche valuation
- Tranche-by-tranche accrual (also known as the FIN 28 or "multiple" approach)
- Tax accounting based on mark-to-market intrinsic values instead of grant-date fair value
- Liability treatment of net-settled awards (including RSUs that allow share withholding as a method to pay taxes)
- Accrual for anticipated employer taxes based on intrinsic value
- Non-employee grants receive the same accounting treatment as employee grants
- No safe-harbor ESPP

Option-pricing models

IFRS 2 permits the use of any option-pricing model such Black Scholes (most commonly used) or Binomial/Lattice Models. But unlike FASB ASC 718, which does not explicitly say which model should be used, IFRS 2 expresses a preference for Binomial/Lattice models. Binomial/Lattice models are more sophisticated than the closed-form Black Scholes Model, and they require third party independent valuation experts.

Tranche-by-Tranche Valuation

Under IFRS 2, each tranche or "vesting increment" in your grant must be valued separately; use of a weighted-average expected life (and therefore a single fair value for the entire grant) is not permissible. Since each tranche has a different vest date, it can be anticipated that each tranche therefore has a different expected term, and the length of expected term also drives the input assumptions for volatility and interest rate.

Tip: If your grants currently use monthly vesting, consider switching to vesting schedules with fewer vest dates. Even quarterly vesting will greatly simplify the valuation process, as dealing with 12 to 16 tranches is much more manageable than dealing with the 36 to 48 tranches common with monthly vesting.

Tranche-by-Tranche Accrual

Each tranche is valued separately and also accrued for separately, generally beginning on grant date and ending on the vest date. Straight-line accrual for the entire grant, one of the allowable accrual methods under FASB ASC 718, is not acceptable under IFRS 2. This will generally result in a "front-loaded" accrual, meaning that more of the expense for the award will be recognized early in the life of the grant, since all the tranches generally begin accruing simultaneously on the grant date.

Tips: Again, considering vesting schedules with fewer vest dates will lessen the amount of "front-loading" of your accruals. However, we also point out that since the accrual begins with a larger amount, but tapers off dramatically over the service period of the grant, if your grant patterns are similar each year, the expense patterns will even out over the first few years of adoption, leaving you with a predictable or less volatile accrual over time, which is very similar to a straight-line accrual. Another silver lining to this particular issue is that since this was a permissible accrual method under FASB ASC 718, many equity databases and systems can already support tranche-by-tranche valuation and accrual.

Tax Accounting

IFRS 2 introduces many new complexities and challenges for stock administrators, equity database vendors, and tax departments. Tax accounting under IFRS 2 is very different than what we've become accustomed to under U.S. GAAP, and is likely to cause much more volatility in the income statement, since it is equivalent to "mark-to-market" or what we in the equity industry call "variable accounting" because figures are constantly changing each reporting period based on the intrinsic value (movement in the stock price) of the awards each month and quarter.

Instead of accruing a deferred tax asset (DTA) based on the grant-date fair value of the grant, IFRS 2 requires companies to accrue a DTA based on the intrinsic value of the grant at the end of the reporting period. However, the Deferred Tax Benefit (DTB) is limited to the cumulative tax benefit recognized to date. Let's consider an option for 1,000 shares with an $8 exercise price, $5 grant date fair value (using the Black Scholes Model) and a current market value of $9 and 25% of the vesting period completed. For this option, you'd compare the intrinsic value ($1,000 = 1,000 options x ($9 - $8)) multiplied by a corporate tax rate (40%) by the percentage of the service period completed (25%) to compute the DTA to book ($100). If in the next quarter the option dropped underwater or where the current market value is less than the exercise price, you'd reverse the DTA you booked, since the new intrinsic value is $0. Later, when the grant is 100% vested, the market value is $14. The intrinsic value is now $6,000. When multiplied by the tax rate (40%) and service period (100%) this would be a $2,400 entry to DTB. But since the DTB is capped by the Cumulative Tax Benefit (expense accrued * tax rate * service period) of $2,000, the DTB would be booked up to $2,000 and the excess of $400 would be posted to Additional Paid-in Capital (APIC) or straight to the income statement as income tax expense.

Until March 2016, there was a big difference in that IFRS 2 did NOT have an APIC pool available to offset deficiencies, so any deficiencies went straight to tax expense, impacting your P&L directly, regardless of past excess transactions. In the U.S. this difference was somewhat alleviated when the when the FASB issued new guidance on share-based payments (FASB ASU 2016-09) in March 2016, that in effect eliminated the APIC Pool altogether and also required tax benefits and deficiencies to be recorded to the income statement (See our article FASB ASU 2016-09: Amendments to ASC 718 for more details). But the good news with IFRS 2 is that since the DTA is trued up each quarter to the current market value, the deficiencies are likely to be significantly smaller.

Observations: Under FASB ASC 718, the booking of a realized DTA was completed once the vesting was complete. Under IFRS 2, the DTA and DTB true ups will continue until the award is settled. This will likely mean a great deal of manual effort until the equity databases and systems have been updated to handle these true ups.

Liability Treatment of Net-Settled Awards

Under IFRS 2, awards that allow payment of taxes via share withholding are subject to liability accounting. This difference could be extremely problematic for many firms with RSUs since a large percentage of those companies allow (or require) share withholding as an easy way for participants to pay taxes due at the time shares are delivered (released) with no cash out of pocket. However, the company would be on the hook for a cash outlay to the governmental authority that the tax withholdings are due to.

In theory, this liability treatment is only required for the portion of the award that is "cash-settled" (the shares due for taxes) but as a practical matter may be necessary for the entire award since the number of shares withheld for taxes will vary as the tax rate varies (common in international jurisdictions where a "flat rate" of withholding may not be available).

Let's consider an example: An RSU for 100 shares is granted when the market value is $10 and allows the participant to choose to have shares withheld to cover the tax liability. At the most recent quarter close the market value of the stock is $25. The individual tax rate is say 40%. The taxes due would therefore be $1,000 ($25*100*40%). Hence 40 shares would be required to cover taxes ($1,000 / $25). So, 40 shares should receive liability treatment this quarter and in each subsequent quarter. The shortcut method to derive the number of shares that require liability treatment is to multiply the shares granted by the tax rate.

So, 60 shares would be expensed at the grant-date market value of $10 and 40 shares would be "marked-to-market" each quarter.

Employer Taxes Liability Accrued (Mark-to-Market)

Under FASB ASC 718, the amount of employer taxes to be paid are determined at the time the taxable event occurs (exercise, vesting/release). Under IFRS 2, as with other liabilities the taxes that must be paid by the employer must be forecasted and a liability accrued for them. Since the amount of employer tax to be paid obviously varies each quarter, depending on the market value of the underlying stock, the liability must be "marked up" or "marked down" with the movement of the company's stock price. Essentially this results in "liability accounting" for the employer portion of the payroll taxes. The calculations are the same as they would be for grants that receive liability treatment, but then the calculated gain is multiplied by the applicable employer tax rate.

This calculation becomes even more complicated when you consider that there are sometimes caps on the employer taxes (such as FICA and FUTA in the U.S.); the mark-to-market calculations cannot be performed in a vacuum. The YTD wages for the employee must be known and used to determine the amount of tax remaining to be withheld. If the employee holds several outstanding grants, the hypothetical gain on the other awards must also be considered when computing this liability. Theoretically a first-in-first out (FIFO) approach could be used, counting the hypothetical gain from the oldest grant against the limit before moving to the next oldest grant, but applying a FIFO methodology comes with its own share of headaches since the grants must be related to one another before the calculations can be performed.

Non-Employee Grants

The silver lining of IFRS 2 may be the treatment of non-employee grants. Non-employee grants receive the same equity treatment as employee grants. As you're probably aware, under FASB ASC 718 and its

predecessor standards, the accounting treatment of non-employee grants was governed by FASB ASC 505-50 (formerly EITF 96-18) which required recalculation of the fair value of the grant at each reporting period up until the grant vested. Treatment is complicated further should an employee's status change to non-employee and vice versa and the grant is retained… that also means as of the update to the article that the accounting treatment must also change, prospectively. Under IFRS 2, none of these complications exist and changes of employee status will be accounted for much more simply. But not to be outdone, the FASB released proposed guidance in March 2017 intended to streamline the accounting for equity awards granted to non-employees so that they are similar to equity awards granted to employees and non-employee Board of Directors… primarily no more of this "mark to market" revaluation stuff. Refer to our Accounting Update-March 2017 and our June 2017 SOS Comment Letter to the FASB for more information on this proposed guidance. Hopefully, a final FASB standard is released before the end of December 2017 and it allows early adoption.

No Safe-Harbor ESPP

Under FASB ASC 718, Internal Revenue Code Section-423 qualified ESPPs could be considered non-compensatory (and therefore did not require the booking of compensation expense) as long as the discount on the ESPP did not exceed 5% and there were no "look-back option features". For those companies that adopted "safe-harbor" plans, in an effort to avoid compensation expense, they may now consider eliminating their ESPP all together. However, since participation rates generally dropped sharply when plans were modified to meet the safe-harbor requirements, hopefully this will not impact too many employees. Many companies kept their ESPPs intact with a 15% discount and a 6- to 24-month look-back option feature. This change will obviously not impact those companies.

Questions or comments? Please email us at xtra@sos-team.com

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