



A closer look at share-based
payment plans and IFRS
Accounting differences that matter

A shift from U.S. Generally Accepted Accounting Principles (U.S. GAAP) to International Financial Reporting Standards (IFRS) will pose challenges that span across accounting, tax, systems, and operations for U.S. companies. Differences between the two sets of standards — even in areas where there has been substantial convergence — could result in changes that may ultimately affect a company's financial statements and income tax position.

For example, differences in the accounting for share-based payment awards can create many complexities for companies that are considering adopting IFRS. A closer look at how U.S. GAAP and IFRS differ for share-based payment plans can reveal important issues that companies may need to focus on as they develop an IFRS transition strategy. Some notable differences that can have significant impact include:

- **Classification of share-based payments** – determining whether a share-based payment award is classified as a liability or an equity instrument.
- **Measurement and recognition** – analyzing the effects of graded vesting on the measurement and recognition of the share-based payment expense.
- **Effective tax rate** – understanding the effects of stock price volatility on the calculation of deferred tax assets (DTAs) and the effective tax rate.
- **Information systems** – assessing system capabilities and requirements to track share-based payment reporting at different levels.

Exploring these issues can highlight the types of complexities that are leading some companies to begin planning for IFRS changes today. Key questions that emerge when looking at share-based payments include: how classification and potential earnings volatility impact plan design, as well as how IFRS could impact the information systems requirements.

Classification

Under U.S. GAAP, there are classification rules that permit equity treatment for certain share-based payment awards, which may be settled in cash. Equity treatment of these awards may be desirable from an earnings standpoint, as there is less potential volatility in the income statement. For example, a share-based payment award that provides

an employee with the right to force the company to repurchase underlying shares can still be classified as equity under U.S. GAAP — as long as the employee is required to hold the shares for a “reasonable period of time” to be exposed to the risks and rewards of ownership. According to the bright-line rule in U.S. GAAP, a “reasonable period of time” is generally defined as a period of six months or more.

Under IFRS, such an explicit bright line does not exist because IFRS does not include an exception to the classification rule like U.S. GAAP. Therefore, awards that qualify for equity classification under U.S. GAAP today may be classified as liabilities under IFRS, which would require remeasurement of each reporting period, resulting in potential earnings volatility. As a further example, under U.S. GAAP, a requirement to net settle shares to satisfy minimum statutory withholding requirements does not, by itself, result in liability classification of share-based payment plans. However, under IFRS, “net settlement” of an award to satisfy a tax withholding requirement may result in the estimated tax withholding portion being classified as a liability under IFRS.

As part of IFRS transition planning, companies may want to examine their existing plans and evaluate whether changes are necessary in an effort to preserve equity classification.



Measurement and recognition

Companies familiar with the recognition policy decision under U.S. GAAP (in which compensation cost can be recognized on a straight-line basis for a graded vesting share-based payment award that vests based solely on the provision of service) will need to revisit their expense calculations under IFRS. Unlike U.S. GAAP, IFRS does not provide the option to measure and expense a graded-vesting award (i.e., an option award that vests in tranches over a number of years) as a single award. Therefore, entities with graded vesting awards will need to calculate fair value and record compensation expense for each individual tranche of an option award, causing potential differences in pretax earnings compared to U.S. GAAP. This will often lead to an acceleration of share-based payment expense.

Volatility in effective tax rate

A company will likely need to consider the interplay among share price volatility, the resulting accounting impact on deferred taxes, and the effective tax rate. Under an IFRS model, share price fluctuations can cause effective tax rate volatility. This is because under IFRS, the deferred tax asset calculation is based on the estimated tax deduction at the end of each reporting period; and it is remeasured each reporting period to reflect the change in the current share price. Under U.S. GAAP, this periodic remeasurement of the DTA does not occur until the option is exercised and the deduction is to be claimed. The net result of this difference is a fluctuation of the DTA value (and the effective tax rate) under IFRS, which does not exist under U.S. GAAP.

Information systems impacts

In addition to accounting and tax consequences, technology and systems implications should be considered in IFRS planning, as systems modifications may be necessary. For example, plan administration for finance systems may need to be configured to pull the data necessary to comply with the accounting for graded vesting awards.

Information systems that support share-based payment award administration range from in-house manual spreadsheets, vendor packages, and outsourcing to plan

record keepers. Each system has its own benefits and challenges. However, with the added complexity involved in measuring and recognizing IFRS compensation expense as mentioned above, companies may need to reconsider their approach — and systems — to these calculations. While major software providers have the ability to track graded vesting tranches, one significant software challenge may reside in the need to perform a parallel analysis of each award under both U.S. GAAP and IFRS during the IFRS transition period. Another challenge lies in developing the software capability to handle any plan design changes that may emerge after transition to IFRS.

Companies should consider an IFRS assessment to understand the potential effect that a transition to IFRS will have on share-based payment awards, and determine any changes or enhancements to plans that may be warranted.

Preparing for IFRS

By gaining a better understanding of the nuances of IFRS and what it may mean for share-based payment plans and administration, companies can develop a more effective IFRS transition plan that considers challenges and potential solutions in advance. Delving into the existing share-based plans to identify differences in compensation expense and understand the role fluctuating share prices may play on effective tax rate volatility can help finance and tax personnel determine the resources and tools needed to support a successful transition to IFRS.



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