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IFRS 2 – Beyond Theory: Practical Tips for Your Real-life Challenges

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Anonymous Quote

From a client that considered adopting and examined the standard in detail:

"This makes the FAS123R adoption look like child's play."

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Agenda

Overview of Differences

- Tips for Differences

General Tips from Companies Dealing with IFRS 2 Now

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IFRS in the News…

"The impact is likely to surpass that of the Sarbanes-Oxley Act of 2002..."

"In a recent Deloitte & Touche survey of 200 CFOs and other financial professionals, only 9% said their firms used IFRS, although 42% might adopt global standards if allowed to do so earlier than 2014."

– USA Today, January 5th, 2009

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Countries Adopting (a Selection)

EU

- Austria
- Belgium
- Denmark
- France
- Germany
- Ireland
- Italy
- Netherlands
- Norway
- UK

Australia
Brazil (2010)
Canada (2011)
Chile (2009)
Hong Kong
Israel (except banks)
New Zealand
Russia (banks)
Venezuela

*Information gathered from Deloitte IAS Site: http://www.iasplus.com/country/useias.htm

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Differences

Tranche-by-Tranche
- Valuation
- Attribution Method (aka "Accelerated")

Tax Accounting

Share Withholding

Matching Payroll Tax Liability Treatments

Non-employee Grants

ESPP – no safe harbor

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Valuation

Each tranche must be valued separately
- Different expected term for each tranche
  - Different vest date = different expected exercise date
- Therefore different (dependent on expected term)
  - Interest rate
  - Volatility
- Could interest rate & volatility be non-US?
  - Currency of traded stock denomination

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Attribution Method Graded-vesting

123(R) Allows choice between straight-line accrual or FIN 28/Accelerated Accrual

IFRS 2 requires tranche-by-tranche accrual

- Each tranche accrued from grant date to vest date
- Generally results in "front-loaded accrual"

Remember, this will impact your ESPP too!

- If you have multiple purchases within an offering period

Note: misnomer of 'accelerated'

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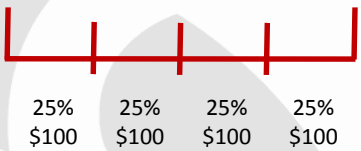
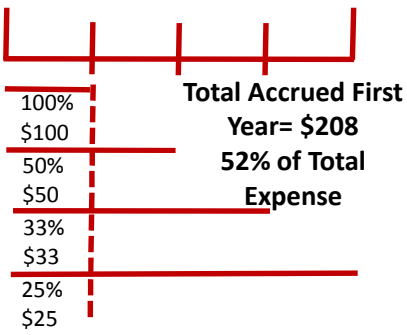
Attribution Method Graded-vesting

Straight-line Attribution
$400 Grant-date
Fair Value
4-year Annual Vesting



Tranche-by-Tranche Attribution
$100 Grant-date
Fair Value per Tranche
4-year Annual Vesting



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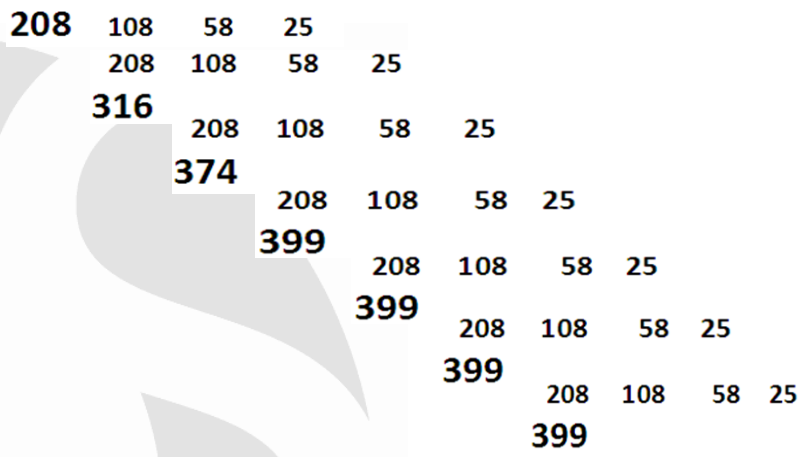
Attribution Method Graded-vesting

The Good News: after an initial ramp-up, expense evens out again



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Tranche-by-Tranche Tips

Tips:

- Consider eliminating or reducing monthly, quarterly, or daily vesting grants
  - 4-Year Monthly vesting = 78% of expense in first year
  - 4-Year Quarterly vesting= 58% of expense in first year
  - (Better for Indian FBT too…)
- For subsidiaries reporting under IFRS now… must use inputs specific to that country
  - Expected Term different for UK employees than US
  - Different audit firms vary on this point, not all require
  - Track location (and therefore) assumptions for grant-date fair value in user-defined field for audit trail

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Tranche-by-Tranche Tips

Tips:

- Assess your system to ensure that it can do accrual tranche-by-tranche
  - Since 123(R) allows tranche-by-tranche as a choice MANY systems can already support
  - If not, workaround could be to enter tranches as separate grants
  - Get finance people on the phone with your vendor
- Consider a separate copy of your database for different IFRS approach
  - If outsourced, talk to your vendor about database copy capabilities

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Tax Accounting

123(R)

Book DTA each qtr based on comp expense recognized

True up at settlement (exercise, vest, expiration, etc.)

Excess (if tax deduction > DTA) increases APIC pool

Deficiency (if DTA > tax deduction) reduces APIC pool OR increases tax expense

IFRS 2

Book DTA each qtr based on intrinsic value (ending mkt value)

Limit: DTA can exceed cumulative tax benefit (exp. to-date * corp tax rate)

- Excess of DTA over DTB (expense * tax rate) = increases APIC

At settlement, small adjustment, but less (trued up each quarter)

No APIC pool

Volatile and unpredictable

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Examples: Mark-to-Market DTA

Grant Date 1/1/09
Option for 1,000 Shares
Price $8
Fair Value $5 per share
Vests in 1 year
Tax Rate 40%

Qtr	Qtr End Date	Qtr End Mkt Value	% Svc Per	Expense Accrued to Date	Cum. Tax Benefit	Total Intrinsic Value at Qtr End	Hypo Tax Benefit	DTB To Date	DTB Entry	Excess to APIC
1	3/31/2009	$9	25%	$1,250	$ 500	$1,000	$400	$100	$100	$0
2	6/30/2009	$7	50%	$2,500	$ 1,000	$0	$0	$0	($100)	$0
3	9/30/2009	$12	75%	$3,750	$ 1,500	$4,000	$1,600	$1,200	$1,200	$0
4	12/31/2009	$14	100%	$5,000	$ 2,000	$6,000	$2,400	$2,000	$800	$400

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Tax Accounting

Observations / Tips:

- Unlike 123(R), accrual of DTA continues PAST the accrual of expense
  - Mark up or mark down based on market movement
  - Under 123(R), after vest, true up only needed if 1) tax rate changes or 2) at time of settlement
- Option expirations won't hit the books so hard
  - True up is ongoing instead of one-time at expiration
  - But, if you had an APIC pool, under 123(R) never hit the P/L at all!
- Use user-defined field(s) instead of "Country" field when calculating DTA
  - Country/subsidiary of grant
  - Country/subsidiary of employment

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Share Withholding

Liability Accounting Required for Share Withholding

- Only required for portion to be "cash-settled"?
  - Some say whole grant, others only a portion, others say equity treatment
  - Perhaps not required at all? (word "on the street"?)
- Liability Accounting Details
  - Fair Value Not set/fixed at grant date
    - Recalculated each quarter based on *current* inputs
  - Expense very volatile
    - Moves up and down with the stock price
    - Unpredictable
    - No cap

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Share Withholding

"The amount of shares that could be issued under the equity-settled SARs and the value of each share issued is variable. IFRS 2.BC106 notes that if the debt/equity requirements of IAS 32 were applied to share-based payment transactions, ***instruments where the number of shares issued is variable would be considered a liability***. They would therefore be treated similar to a cash-settled share-based payment. As a result, IFRS 2.BC110 explains that the debt/ equity requirements in IAS 32, whereby some obligations to issue equity instruments are classified as liabilities, should not be applied for the purposes of the IFRS on share-based payment." [emphasis added]

- Section 2.1.3 of Share-based payments, A guide to IFRS 2, Deloitte, June 2007

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Share Withholding

Tips:

- Switch to selling shares instead of withholding shares to avoid liability
  - Many companies already sell instead of withholding internationally because of difficulty of determining non-US tax rate
  - Make sure your vendor can support (most can), may be some work to implement
  - Will increase dilution
    - Do some modeling in advance to assess impact on dilution
- Talk to your vendor about supporting liability accounting
  - Many can't currently support, but can be calculated in a spreadsheet (just as you do today for cash-settled awards)

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Accrual for Matching of Payroll Taxes

FAS 123(R)

Liability occurs at the time of exercise/vest

- Based on gain at taxable transaction

IFRS 2

Liability accrues over the service period

- Based on market value at end of reporting period
  - Similar to liability accounting for cash-settled awards
  - Trued up at time of taxable transaction

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Accrual for Matching of Payroll Taxes

The Good News:

- Calculation is the SAME as it would be for liability accounting
  - Just multiply "mark-to-market" calculations by social tax rate

The Bad News:

- If social tax is capped (like SS), the accrual is capped too
  - Cannot be performed in the abstract, must know the YTD withholding for each participant at the time the accrual is done
  - FIFO method grant by grant? Multiple grants for the same person, only one Social Tax Limit…

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Non-Employee Grants

Silver lining of IFRS 2:

- Non-employee grants treated the same as employee grants!
- Under FAS 123(R), EITF 96-18 provided guidance on accounting for non-employee grants
  - Fair value not determined until VEST date
  - Re-measured each quarter until vest
  - Contractual term instead of expected term used

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ESPP – No Safe Harbor

Only impacts companies with "safe-harbor" ESPPs

- 5% discount, no lookback
- Not considered "non-compensatory" under IFRS 2
- Fair value calculated and accrued over service period
  - Tranche-by-Tranche valuation & accrual

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Open Issues

Will there be changes to IFRS before adoption is required?

- Some US influencers are strongly opposed to the mark-to-market accounting
  - Some feel it is partially responsible for current economic crisis
- Early adoption may be problematic if changes to the standard are considered
  - May require reworking much of work done for adoption

What accounting standard will private companies use?

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Comparison of IFRS to US GAAP

Area	GAAP	IFRS
Grant-Date Fair Value	Same fair value for different tranches acceptable	Different fair value for each tranche required
Attribution Method	Straight-line or Tranche-by-Tranche – ("Accelerated" or FIN 28)	Tranche-by-Tranche Only
Share withholding	Equity Accounting Allowed	Liability Accounting Required
Tax Accounting	DTA accrued based on grant-date fair value, trued up at settlement	DTA accrued based on intrinsic value at end of each reporting period (not to exceed fair value)
Accrual of Payroll Tax Liability	At time of taxable event (exercise, vest, release, etc.)	Accrued as award vests based on intrinsic value of grant at end of each reporting period
Non-Employee Measurement Date	Vest Date	Grant Date
Non-compensatory ESPP	5% Discount only (no lookback)	No safe harbor, all ESPPs considered compensatory

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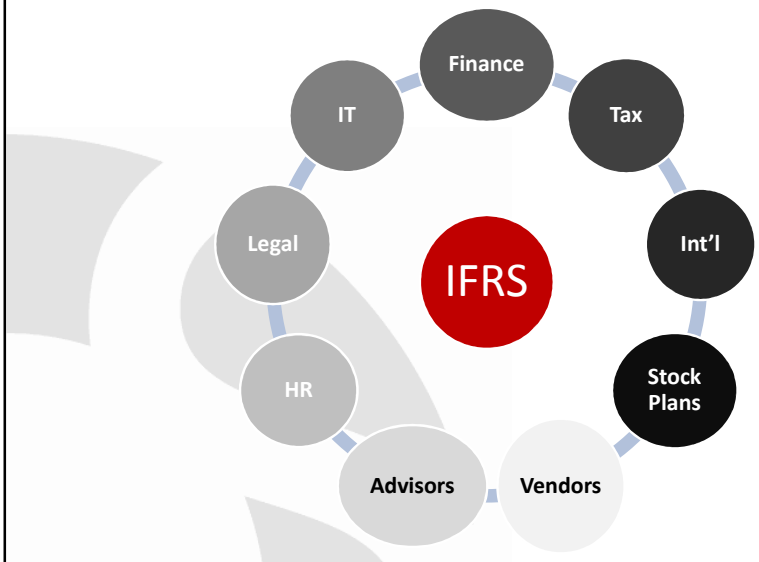
Successful Adoption/Reporting



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The Urge to Merge

Mergers

- Bring over ALL your data, not just outstanding grants, if possible
- OR make sure historic data is someplace you can get to it (convert back up copies of databases to new versions)

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Don't Be Afraid to ASK!

Get to know your vendors' capabilities now

- Understand what the software/platform can and can't do
- If there are functional gaps, try to get a sense of the roadmap for implementation and when the functionality will be available

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Who's Afraid of IFRS 2?

Don't shy away from accounting

- It's not rocket science
- Providing "just the numbers asked for" is likely to result in errors
- Search for "business need"
  - Understand WHY they need the data and WHY they need it in that format
  - Don't just "follow orders" – there may be an easier way to get to correct result, if you're willing to do a little digging

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Tower of Babel

Terminology

- Limited standard terminology in US for equity comp, let alone the rest of the world!
- "Exercisable" vs. "Outstanding"
- "Nonvested Shares"
- May not get it in English
- Start defining terms early
  - Precise definitions
  - Validate them!

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The "IT" Factor

Solutions for your company will vary from others

- Based largely on what your IT group can/will support
- Get IT involved early to start brainstorming solutions
- IT should understand the "business need" too
  - Sometimes they can provide an easier way to get to a better result

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Audits, Controls, and SOX, oh my!

Think about controls for any manual processes from the start, not after the fact

How will access to that spreadsheet be controlled?

How will you ensure data integrity?

How will you prevent accidental deletion?

How will you control changes? (multiple people making changes at the same time)

Consider document control software/version controls

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"Project" Yourself

Hold a cross-functional kick off meeting
- Discuss what others' needs are and when they will need the reports
- Send samples of the reports you have available
- Look for opportunities to provide data in electronic format

Create a project plan/checklist
- Reports required/ tasks to complete
- Due dates & owners
- Status & notes/comments

Update list throughout the project

Review project plan regularly

Obtain sign-off on project plan from all players

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Project Management for IFRS

Hold quarterly meetings
- They should be brief, well-run, with agenda
- As due dates approach, get/give status updates
- Update project plan (Word or Excel) & send out

After it's IFRS Reporting is over… hold a "lessons learned" cross-functional review
- What went well
- What didn't go well
- What to change for next time
- Update your checklist/project plans/audit list
- Do this immediately, while the project is *fresh* in your mind!

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Contact Information

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Appendix

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1st Quarter Entries

Market Value = $9 25% of Service Complete

Expense = $1,250 Cumulative Tax Benefit = $500

Intrinsic Value = $1,000

Hypothetical Tax Benefit = $400 * Svc Complete 25% = $100
(Does not exceed Cumulative Tax Benefit)

Account	Debit	Credit	Calculation	Formula
Expense	$1,250		($5,000*25%)	Total Expense* % of Svc Period
APIC		$1,250		Offset for expense debit
DTA	$100		($1,000*40%* 25%)	Intrinsic Value* Tax Rate * Svc Period
DTB		$100		Offset for DTA debit

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2nd Quarter Entries - Underwater

Market Value = $7 50% of Svc Period Complete

To Date Expense = $2,500 Cumulative Tax Benefit = $1,000

Intrinsic Value = $0

Hypothetical Tax Benefit = $0 * Svc Complete 50% = $0
(Does not exceed Cumulative Tax Benefit)

Account	Debit	Credit	Calculation	Formula
Expense	$1,250		($5,000*25%)	Total Expense* % of Svc Period
APIC		$1,250		Offset for expense debit
DTA		$100		Reverse Prior DTA Booked since grant is underwater (no intrinsic value)
DTB	$100			Offset for DTA credit

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3rd Quarter Entries – Back In-the-money

Market Value = $12 75% of Svc Period Complete

To Date Expense = $3,750 Cumulative Tax Benefit = $1,500

Intrinsic Value = $4,000

Hypothetical Tax Ben = $1,600* 75% Svc Complete = $1,200
(Does not exceed Cumulative Tax Benefit)

Account	Debit	Credit	Calculation	Formula
Expense	$1,250		($5,000*25%)	Total Expense* % of Svc Period
APIC		$1,250		Offset for expense debit
DTA	$1,200		($4,000*40%* 75%) - $0	Intrinsic Value* Tax Rate * Svc Per (less DTA previously booked)
DTB		$1,200		Offset for DTA debit

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4th Quarter Entries – Excess to APIC

Market Value: $14 100% of Service Period Complete

To Date Expense = $5,000 Cumulative Tax Benefit = $2,000

Intrinsic Value = $6,000

Hypothetical Tax Benefit = $2,400 * 100% = $2,400
(Exceeds Cumulative Tax Benefit! Excess to APIC!)

Account	Debit	Credit	Calculation	Formula
Expense	$1,250		($5,000*25%)	Total Expense* % of Svc Period
APIC		$1,250		Offset for expense debit
DTA	$1,200		($6,000 * 40% * 100%) - $1,200	(Intrinsic Value* Tax Rate * % Svc Period) less DTA prev. booked
DTB		$800	MIN(($6,000 OR $5,000) * 40% * 100%)) - $1,200	(Lesser of: (Intrinsic Value OR Fair Value) * tax rate * % of Svc Per) MINUS previously booked
APIC		$400		Offset for DTA excess over DTB

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Exercise Entries – Excess I

Exercise occurs 2 weeks after vest date (no additional DTA accrual necessary in subsequent quarters)

Exercise Market Value = $13.50

Gain = ($13.50 – Price of $8) * 1,000 shares = $5,500

Tax Benefit = $5,500 * 40% Tax Rate = $2,200

DTA Booked = $2,400 is reversed

Account	Debit	Credit	Calculation	Formula
Taxes Payable	$2,200		$5,500 * 40%	Gain * Tax Rate
DTA		$2,400	$6,000 * 40%	(Intrinsic Value at End of Last Quarter * Tax Rate)
APIC	$200			Reverse only part of the previous excess posted to APIC – still excess, but not as great as previously booked

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Exercise Entries – Excess II

Exercise occurs 2 weeks after vest date (no additional DTA accrual necessary in subsequent quarters)

Exercise Market Value = $16

Gain = ($16.00 – Price of $8) * 1,000 shares = $8,000

Tax Benefit = $8,000 * 40% Tax Rate = $3,200

DTA Booked = $2,400 is reversed

Account	Debit	Credit	Calculation	Formula
Taxes Payable	$3,200		$5,500 * 40%	Gain * Tax Rate
DTA		$2,400	$6,000 * 40%	(Intrinsic Value at End of Last Quarter * Tax Rate)
APIC		$800		Increase APIC for “rest of” excess

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Exercise Entries - Deficiency

Exercise occurs 2 weeks after vest date (no additional DTA accrual necessary in subsequent quarters)

Exercise Market Value = $12

Gain = ($12 – Price of $8) * 1,000 shares = $4,000

Tax Benefit = $4,000 * 40% Tax Rate = $1,600

DTA Booked = $2,400 is reversed

Taxes Payable Reduced by $1,600

Account	Debit	Credit	Calculation	Formula
Taxes Payable	$1,600		$5,500 * 40%	Gain * Tax Rate
DTA		$2,400	$6,000 * 40%	(Intrinsic Value at End of Last Quarter * Tax Rate)
APIC	$400			Reverse previous excess posted to APIC
Tax Expense	$400			Offset – Rest of deficiency

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Liability Accounting Example: Unpredictable

Facts:

- RSU granted on 1/1/2009 for 10,000 shares, fair value $5 per share
- Vests on 1/1/2010

Accruals:

Qtr	% Service Period Completed	Market Value	Calculation	Current Period Expense
1st	25%	$7	($70,000 fair value * .25 of service period)	$17,500
2nd	50%	$4	($40,000 fair value * .5 of service period) - $17,500 prior expense	$2,500
3rd	75%	$6	($60,000 fair value * .75 of service period) - $20,000 prior expense	$25,000
4th	100%	$8	($80,000 fair value * 1 of service period) - $45,000 prior expense	$35,000

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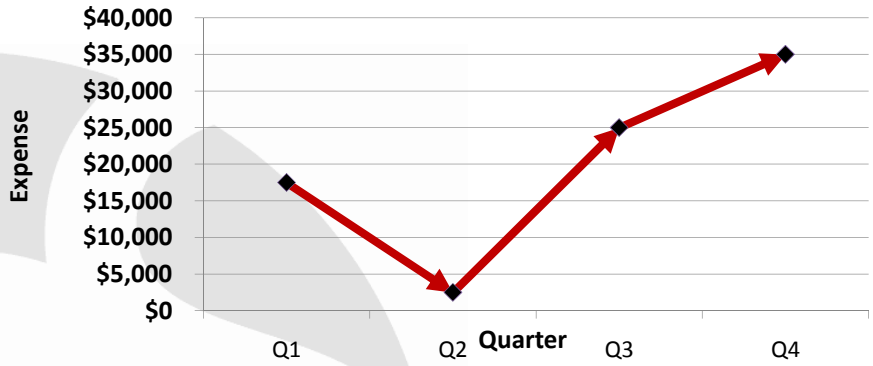
Liability Accounting Example: Unpredictable



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Accrual for Matching of Payroll Taxes Example

Facts:

- RSU granted on 1/1/09 for 10,000 shares, fair value $5 per share
- Vests on 1/1/2010

Accruals:

Qtr	% Service Period Completed	Market Value	Calculation	Current Period Accrual
1st	25%	$7	($70,000 fair value * .25 of service period) * 6.2%	$1,085
2nd	50%	$4	(($40,000 fair value * .5 of service period) - $17,500 prior expense) * 6.2%	$155
3rd	75%	$6	(($60,000 fair value * .75 of service period) - $20,000 prior expense) * 6.2%	$1,550
4th	100%	$8	($80,000 fair value * 1 of service period) - $45,000 prior expense	$2,170

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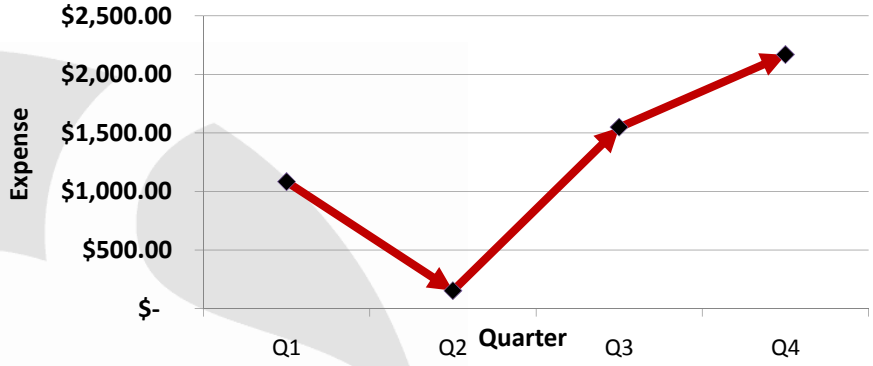
Accrual for Matching of Payroll Taxes



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