

Convergence Towards International Financial Reporting Standards Will Require Comprehensive Review of Executive and Equity Compensation Programs

By Andrew Mandel

Over the past few years, there has been much attention paid to the accounting treatment for equity-based compensation, culminating in SFAS 123R and subsequent interpretations and clarifications. This change led many companies to reconsider and, in many cases, revise their equity compensation strategies, but the impact of SFAS 123R may pale in comparison to another wave of change that is coming. The convergence of U.S. accounting rules with international standards will result in pervasive changes in the measurement and reporting of corporate financial performance.

International Financial Reporting Standards (IFRS) are a set of accounting standards developed by the International Accounting Standards Board (IASB) that are becoming the global standard for the preparation of public company financial statements. Adoption of IFRS will have a pervasive impact on compensation plan design and operation including the way a plan sets performance targets, the measurement of performance against those targets, and the process of accounting for equity-based compensation.

This *InsightOut* discusses:

- The status of the IFRS convergence process in the United States and worldwide, and the likely impact on U.S. companies.
- Three important differences in accounting for equity awards under U.S. Generally Accepted Accounting Principles (GAAP) and IFRS standards that affect reported profitability and, thus, have the potential to affect incentive compensation and equity-based compensation plans.
- How a U.S. company's conversion from U.S. GAAP to IFRS could affect its ability to determine achievement level or ultimate payout of equity grants with performance goals established under GAAP reporting.
- Why U.S. companies must calculate the expense for share-based payments to their employees in other countries

using country-specific assumptions.

THE IFRS CONVERGENCE PROCESS

More than 12,000 companies in nearly 100 nations have adopted IFRS, including listed companies in the European Union (EU). Other countries, including Canada and India, are expected to transition to IFRS by 2011. Some estimate that the number of countries requiring or accepting IFRS could grow to 150 in the next few years. Other countries, such as Japan and Mexico, have plans to converge (i.e., eliminate significant differences with IFRS) their national standards by 2011.

While the United States has trailed in the convergence process, the SEC's recent proposal that U.S. companies be required to adopt IFRS in 2014, or by 2011 for some companies, is accelerating the debate. Despite this seemingly protracted schedule, there are signs of more accelerated effects of this pending change. The Financial Accounting Standards Board's (FASB's) issuance of an Exposure Draft (07 August 2008) that would amend FAS 128 and bring earnings per share calculations in line with IAS 33 demonstrates the incremental progress occurring. The FASB also suspended its discussions regarding changes in accounting for income taxes deciding to instead merge U.S. rules with the international standards, perhaps signaling a more significant and immediate impact of the global accounting movement.

Currently, U.S. companies are required to issue financial statements in accordance with GAAP. Because the transition to IFRS for U.S. public companies is inevitable, however, there may be significant differences in reported earnings ahead. In 2007, the SEC unanimously voted to allow foreign private issuers to file financial statements prepared in accordance with IFRS, as issued by the IASB without reconciliation to GAAP, and many of the resulting changes in companies' reported results were significant.

Although the SEC's discussions about voluntary or mandatory adoption of IFRS has been for U.S. public companies only, many privately held companies may follow suit, even if they are not required to do so. The IASB is developing a version of IFRS for small and medium-sized entities that would minimize the complexity of financial statement preparation yet allow users of those entities' financial statements to assess financial position, cash flows, and performance in accordance with IFRS standards. Companies also may need to convert to IFRS if they are a subsidiary of a foreign company that must use IFRS, or if they have a foreign investor that must use IFRS. U.S.-based companies with non-U.S. operations or affiliates may already be required to prepare financial statements for local purposes (e.g., if they wish to raise capital abroad).

ACCOUNTING FOR SHARE-BASED PAYMENTS

There are three important differences in accounting for equity awards under U.S. GAAP (SFAS 123R) and IFRS (IFRS2) standards that have an impact on reported profitability and, thus, the potential to affect incentive compensation as well as equity-based compensation value.

Accelerated recognition of expense: Under SFAS 123R, companies can elect to recognize compensation expense for awards containing only "service-based" vesting conditions with "graded" vesting on a straight-line, ratable basis instead of expensing over an accelerated tranche-by-tranche basis. IFRS2 requires compensation expense to be recognized on an accelerated tranche-by-tranche basis, similar to the approach required by FIN 28. This increases the early years' recognition of a multi-year expense. While this creates only a timing difference, in the early years of IFRS convergence companies will be recognizing more expense for their equity awards than under GAAP.

Awards with put and call features: For awards with put and call features, under SFAS 123R, liability classification is not required as long as there is a six-month holding period requirement from the date of exercise or vesting. Under IFRS2, awards with put and call features require liability classification regardless of the holding period. This will potentially increase the expense incurred for grants with these features as well as increase the unpredictability of the expense.

Deferred taxes: Under SFAS 123R, deferred taxes are calculated based on the cumulative expense recognized and adjusted upon the ultimate realization of the actual tax benefit. If the tax benefit exceeds the deferred tax asset, the "excess tax benefit" is credited directly to additional paid in capital (APIC). If there is an actual tax benefit below deferred tax assets, the shortfall is charged to APIC to the extent of prior cumulative excess benefits, and to tax expense if there are no prior cumulative excess benefits. IFRS2 does not provide for an APIC pool and no deferred tax asset is created at the date of grant. Deferred taxes are calculated based on the estimated actual tax deduction determined at each reporting date (based on intrinsic value) of each individual award. If the actual tax benefit exceeds cumulative compensation expense, then the income statement impact is determined by the actual expense and tax benefit of each individual award rather than the aggregated impact allowing offsets of shortfalls and windfalls. This results in a potentially higher and more front-loaded expense which will be more volatile and add unpredictability to the income statement. Many companies will be disappointed to find that the time, effort, and cost of calculating the APIC pool will yield no future benefits as the "savings account" feature is removed and the associated expense impact may be significant.

These differences create a cascading complexity: as expense measurement and recognition affects the reported financial performance of a company, one compensation plan — stock option grants, for example — may have an unpredictable impact on another plan — a target-based plan.

PERFORMANCE GOALS

The rapidly increasing prevalence of equity awards with performance features attached means that the deemed performance against goals set years in advance has a direct impact on equity compensation payouts. To the extent there is

a rule change mid-cycle and the plan documentation has not provided for appropriate adjustments, payment windfalls or shortfalls may occur.

As illustrated in the table in the next column, assume that on January 1, 2009, a U.S.-based company grants performance shares to a senior management team. The shares are earned and paid out within 60 days of December 31, 2011 if the company achieves certain earnings per share (EPS) targets.

When the plan is initially established in 2009, the company reports its earnings on a U.S. GAAP basis. But, what if it converts to IFRS reporting standards in 2011? Or what if the company itself remains on a U.S. GAAP basis throughout the three-year period, but one or more of its peer group companies converts to IFRS during the three-year period? In either event, without plan provisions allowing for the adjustment of EPS as defined in the plan and providing specifics as to how such a modification will be determined, there would be uncertainty as to how to determine the achievement level and ultimate payout. To the extent a company wanted to provide for a vesting condition that would vary depending on whether or not IFRS standards became effective during the performance period, it is not certain as to whether or not this would result in adverse accounting results. Under SFAS 123R, the definition of “grant date” requires that an employer and employee have a mutual understanding of the key terms and conditions of an award — including vesting conditions. If a company wishes to establish awards that will vest based on performance targets to be determined under future IFRS standards, it is arguable that such awards will not have been considered granted unless and until the performance targets under IFRS standards are finalized.

For tax reasons, companies also must ensure that the plan explicitly provides for appropriate adjustments for accounting changes that will not be deemed “upward discretion” and render the awards nondeductible under IRC Section 162(m).

OPTION VALUATION: TOMORROW IS HERE

As discussed earlier, there are several significant differences in accounting for equity awards under SFAS 123R versus IFRS2. Companies should be aware that equity-based compensation awards made in 2008 with vesting periods of three years or longer could, depending on the ultimate details of IFRS2

| Achievement Level | Performance Goal | Award Earned |
|-------------------|--|----------------|
| Below Threshold | Less than 4% annualized EPS growth for the three-year period | 0% of Target |
| Threshold | 4% annualized EPS growth for the three-year period | 75% of Target |
| Target | Annualized EPS at or above the median EPS of the company’s peer group for the three-year period | 100% of Target |
| Exceptional | Annualized EPS at or above the 75th percentile EPS of the company’s peer group for the three-year period | 200% of Target |

implementation, affect the company’s reported profitability differently than anticipated at the time of the grant. But this impact may occur sooner than IFRS convergence and, in fact, may already be here.

It may come as a surprise to many companies that they are already subject to IFRS2 if they are granting share-based payments to employees outside the United States in countries that have already adopted IFRS. Because key assumptions in option pricing models may differ across countries, share-based

It may come as a surprise to many companies that they are already subject to IFRS2 if they are granting share-based payments to employees outside the United States in countries that have already adopted IFRS.

payments must be valued using those country-specific assumptions. For example, optionees in another country may have higher turnover rates, resulting in different forfeiture rates, or exercise their options over a longer or shorter period of time creating a different expected life assumption. According to the *iQuantic Buck 2008 Global Long-Term Incentive Survey*, approximately 40 percent of options, shares, and units granted were made to employees outside the United States, accounting for 34 percent of expense. The potential difference in expense for options granted to employees outside the United States, whether higher or lower, will have an impact on companies' reported earnings.

CONCLUSION

Although the required adoption of IFRS standards by U.S. companies would appear to be several years away, the increasing acceptance of such standards means that those involved in developing a company's compensation plans — from the Compensation Director to the VP of HR to the CFO and the Board of Directors' Compensation Committee — must become knowledgeable about how changes to financial reporting will affect these plans. Given that IFRS standards are

currently mandated or permitted in all but a few countries, any company with non-U.S. operations would most likely have a more immediate need to assess its global plans.

About the Author:

Andrew Mandel is a New York-based Principal in Bucks' Compensation Consulting practice. He has more than 17 years experience at a Big Four accounting firm, where he served as a leader in the Transaction Advisory Services' Compensation and Benefits Practice. His consulting experience includes involvement with more than 300 M&A transactions. His expertise covers a range of issues affecting executive compensation, incentive plans, and equity award programs. Andrew's consulting clients have included multinational corporations in diverse industries, private equity firms, and financial institutions. Andrew is a Certified Public Accountant and a Certified Equity Professional (Level 1). He is also a member of the American Institute of Certified Public Accountants and the New York State Society of Certified Public Accountants. Andrew can be reached at 212.330.1146 or andrew.mandel@buckconsultants.com.

... those involved in developing a company's compensation plans — from the Compensation Director to the VP of HR to the CFO and the Board of Directors' Compensation Committee — must become knowledgeable about how changes to financial reporting will affect these plans.