# Stock option awards under IFRS: An analysis of the potential impact

An IFRS publication

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## Tax accounting for stock options under IFRS vs. US GAAP

The differences in the treatment of compensatory stock options under IFRS (“IFRS 2/IAS 12”) compared to US GAAP (“FAS 123R”) will present unique challenges for many US companies. The differences will impact a company’s reported earnings, effective tax rate and cash flows when adopting IFRS.

As under US GAAP, IFRS requires a company to record an expense for employee stock option awards based upon the fair value of the stock option at the grant date. Tax benefits reported under IFRS, however, are based upon the estimated future tax deduction at the reporting date. In most jurisdictions, the tax deduction would be based on the “intrinsic value” of the stock option at exercise, i.e., the stock value in excess of the option exercise price. Consequently, for stock options granted with an exercise price that equals (or exceeds) the fair market value of the shares *no deferred tax asset is recognized under IFRS at the time of the grant* because no inherent tax deduction is present in the award at that time. Tax benefits are only recorded as, and to the extent, the stock price rises. Typically, this will trail, often by a considerable length of time, the recorded compensation expense.

Companies that adopt IFRS will thus often have greater reductions to after-tax earnings for stock option awards prior to the time the award settles than they would have under US GAAP. In addition, there will be volatility in the effective tax rate and deferred tax accounts over the life of the stock options due to the stock price movements in each reporting period. Furthermore, under IFRS, these impacts will be reported in the operating section of the statement of reported cash flows.

Under IFRS, the tax effect of any excess in the estimated tax deduction over the recorded compensation expense is credited (subject to a recognition test) to equity and recorded as a deferred tax asset. Under US GAAP, only the excess tax benefit recognized at the time of exercise is credited to equity (adjusted paid-in capital, or “APIC”). This could result in significantly different impacts on equity and deferred tax accounts during the life of the stock option.

Conversely, if either the estimated or final tax deduction is less than the recorded compensation expense under IFRS, the tax benefit shortfall is charged to equity only to the extent that a tax benefit for that individual stock option award has already been credited to equity. IFRS does not apply the US GAAP concept of an APIC "pool" (also known as a "windfall pool"), which enables tax benefit shortfalls to be offset against aggregated prior windfalls.

## An Example

The foregoing differences in accounting are illustrated by the following simplified example:

On January 1, 2005, Group Holding grants a stock option to an employee. The exercise price is $500, which equals the fair value of the underlying share. The fair value of the stock option at the grant date is $360.

The option contains a cliff vesting term of 3 years. The fair value of the underlying share evolves as follows: $500 as of December 31, 2005, $590 as of December 31, 2006, and $880 as of December 31, 2007.

The employee exercises the option on March 15, 2008 at an intrinsic value of $320. We assume that there is recognition of the deferred tax asset (DTA) and that for FAS 123R purposes there is a $20 available pool of windfall tax benefits.

During the cliff vesting term of 3 years, the calculations for year-ends 2005, 2006 and 2007 respectively are summarized in rows 2 to 4 of the table below. The assumed tax rate is 30%.

| (1) Financial year-end | (2) Book compensation charge (GAAP & IFRS) | (3) Tax benefit in P&L @ 30% (GAAP) | (4 ) Cumulative tax effect on compensation charge | (5) Intrinsic value X % services received (IFRS) | (6) DTA @ 30% (IFRS) | (7) Cumulative Tax benefit in P&L (IFRS) | (8) Cumulative Tax benefit in equity (IFRS) |
|---|---|---|---|---|---|---|---|
| 2005 | $120 | $36 | $36 | $0 | $0 | $0 | $0 |
| 2006 | 120 | 36 | 72 | 60 | 18 | 18 | 0 |
| 2007 | 120 | 36 | 108 | 380 | 114 | 108 | 6 |

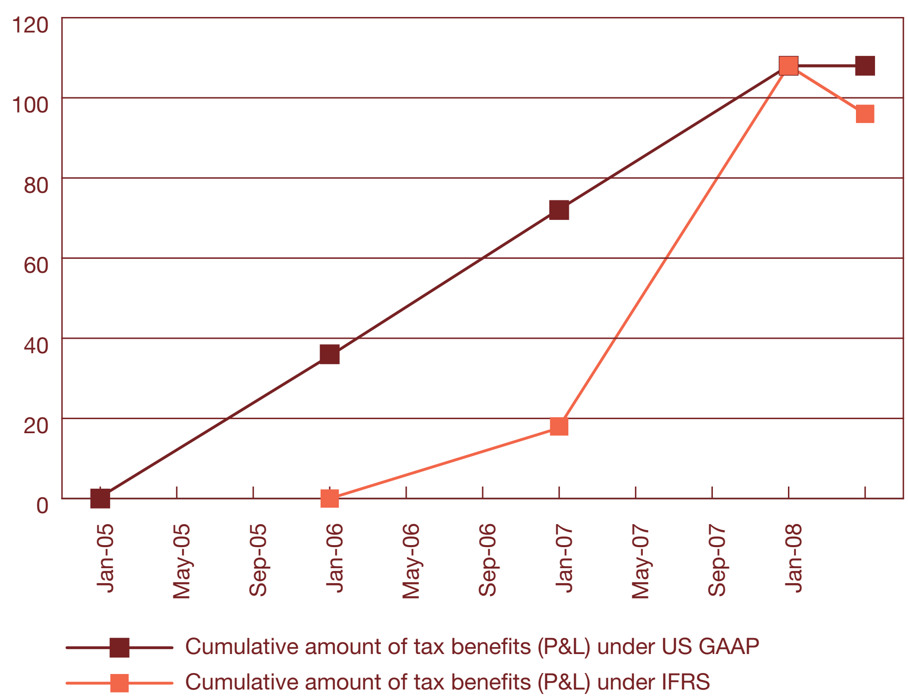
The figure in Column (4) is important under IFRS because the tax benefit recorded in earnings (P&L) may not exceed this cumulative amount.

As of year-end 2007 the estimated tax deduction is $114 (column 6), whereas the cumulative tax effect of the book compensation expense (column 4) is only $108. Consequently, the positive difference of $6 is credited to equity.

Upon exercise of the option, the cumulative tax P&L benefit under IFRS will be limited to the actual tax benefit of $96 (i.e., $320 x 30%). The actual tax deduction of $320 is less than the cumulative book compensation charge of $380. As a result, the entire amount of the actual tax benefit is recorded in the P&L. The $6 of excess tax benefit previously recorded through equity is reversed and the remaining shortfall is charged to the P&L. Under US GAAP, however, the windfall pool of tax benefits of $20 can be used to offset the $12 (i.e., $108–$96) shortfall. Consequently, the cumulative tax P&L benefit for US GAAP purposes would be $108 (i.e. $96 + $12) under FAS 123R.

The following graph, based on the figures of the above example, further illustrates the impact of IFRS on both the amount and the volatility of the tax benefits recognized in earnings.

**Tax P&L impact over time**




## Other accounting and systems-related considerations

Certain pre-tax stock option accounting differences under IFRS could, similarly, increase the bottom-line costs reported as a result of stock option awards. These include:

- *The accounting treatment for stock options with graded vesting features* (accelerated amortization): IFRS 2 does not include the straight-line method as an alternative attribution method for stock options with a service condition and graded vesting features. A company would account for such options under the graded vesting approach, which would give rise to an accelerated compensation expense.

- *The accounting treatment of social charges:* Under IFRS, social charges, such as payroll taxes levied on the employer in connection with stock-based compensation plans, are expensed in the income statement while the stock options are outstanding. The liability is measured at each balance sheet date based upon the fair value of the outstanding stock options. During the vesting period, the liability accrues as the compensation expense is recognized; beyond the vesting period, the liability continues to accrue until the option is exercised. Under US GAAP, a liability for the employer's payroll taxes on employee stock-based compensation is recognized on the date of the event triggering the measurement and payment of the tax (generally the option exercise date).

In addition to accounting requirements, employee stock option plans and other share-based payment plans must also consider the differing tax systems worldwide and their impact on tax deductibility of stock options and other compensation-based rewards.

Under IFRS, significantly more information will have to be tracked to recognize tax benefits appropriately (see column 5 through column 8 of the above example). The example above assumes that the estimated future tax deduction is based on the "intrinsic value" of the stock option. For a multinational company, the calculations are more complicated given the varying tax rates and tax laws among taxing jurisdictions. Accordingly, companies may be unable to utilize a single calculation for all of their options. From a systems and processes perspective this will bring additional challenges. Systems that have been used to track or compute book-tax differences, record the tax treatment of stock options, or calculate the tax provision will need to be modified or replaced.

## Concluding Thoughts

Nearly 100 countries currently require or permit the use of IFRS. The European Union, Australia, Canada, Brazil, India, Japan, China, Russia and other major markets have either already converted to IFRS or are in the process of doing so. One projected timeline estimates that IFRS could be mandatory in the US by 2013-2015, while early adoption may be available as early as 2009.

US companies looking ahead to IFRS adoption should model the impact of IFRS on existing and new share-based payment plans. The consequences of a move to IFRS will be important as the move may affect cash taxes and will certainly significantly impact financial reporting, systems and processes.

# Contacts

This white paper is intended not just to inform but to raise questions. Clients of PricewaterhouseCoopers may want to open a dialogue about IFRS with their PwC engagement partner or the primary authors of this paper who welcome any questions about the tax implications of IFRS: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