

IFRS Conversion: Pension, OPEB and Stock-based Compensation Issues

Part of PwC's webcast series on IFRS*
Hosted by PwC's Human Resource Services Practice

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Today's agenda

- Introduction
 - IFRS background and timeline
- *Section 1: IFRS for stock-based compensation – accounting*
 - accounting differences between FAS 123R and IFRS2
- *Section 2: IFRS for stock-based compensation – tax*
 - differences related to the measurement of deferred tax assets
 - other implications
- *Section 3: IFRS for pensions and other employee benefits*
 - differences between US accounting and IFRS related to pension plans, retiree health and other post-employment benefits
 - proposed changes to IFRS
 - balance sheet and income statement impact

Introducing our panelists

Moderator

- Ken Kuykendall, US IFRS Tax Partner

Panelists

- Murray Akresh, Partner, Human Resource Services, New York
- Bill Dunn, Partner, Human Resource Services, Philadelphia
- Cindy Fraterrigo, Director, Human Resource Services, Chicago

SEC Roadmap

- On November 14th the SEC published for public comment a proposed “Roadmap” for US companies to adopt IFRS
 - Comment letter deadline extended to April 20, 2009
- The proposed Roadmap includes several milestones leading to the SEC making a final decision in 2011 regarding mandatory IFRS reporting for US issuers
- The proposed Roadmap contemplates a phased transition to IFRS starting in 2014

SEC Roadmap (continued)

- Under the proposal, a limited number of US issuers may elect to early adopt for years ending on or after 12/15/2009
- As part of the SEC's proposed 2011 evaluation, it may expand the eligibility criteria to allow additional issuers to use IFRS prior to the mandatory transition date
- Recent comments by the new administration have been measured with respect to IFRS

Stock-based compensation: IFRS2 vs. FAS 123R Accounting

- Key Similarities
 - Equity awards
 - Liability awards
 - Option pricing model used
 - Forfeiture accounting
- Key Differences:
 - Income tax and payroll tax accounting (see next section)
 - Expense attribution and measurement
 - Net share withholding
 - Separate subsidiary financial statements
 - Transition
 - Numerous other differences

Stock-based compensation: IFRS2 vs. FAS 123R

Accounting (continued)

Operational issues

- Companies will need to determine the changes to internal and external systems, procedures and recordkeeping
 - Specifically, companies should focus on mark-to-market requirements for net share withholding and payroll taxes, and for deferred taxes
 - Transition measurements may also be difficult
- We currently know of no major external US providers who currently have systems fully applicable under IFRS, but this may change in the future
- Significant effort will be required

Polling Question #1

Do you permit employees to cover minimum statutory withholding for income taxes using net share settlement?

- a) Yes for all awards
- b) Yes for restricted stock or restricted stock units only
- c) Yes for stock options only
- d) No
- e) Not sure or not applicable and PwC participants

Polling Question #2

Do you grant stock-based compensation to employees of non-US subsidiaries that apply IFRS for local financial statements?

- a) Yes
- b) No, but expect to apply IFRS in next year or two to non-US subsidiaries
- c) Not sure or not applicable (no foreign subsidiaries) and PwC participants

Q&A

Accounting for stock-based compensation under IFRS

IFRS2 and income taxes for equity compensation

- IFRS2 provides that no tax deduction benefit can be recognized for income statement purposes based upon the value of the award (e.g., for options the grant date Black Scholes value which is used under FAS 123R to book deferred tax assets (DTA's))
- Instead a deferred tax asset is recognized only if and when the award generates intrinsic value that could be deductible for tax purposes
- This creates a mark to market effect where DTA's are adjusted for share value changes
 - DTA up to tax benefited accounting expense recorded to earnings
 - DTA beyond that recorded in APIC
- Individual true-up process means no APIC pool

IFRS2– Example of tax implications

- On 1/1X1, option is granted at exercise price of \$10 when shares are worth \$10
- Fair value of award is \$5, options cliff vest at 12/31/x3
- Company tax rate is 40%
- Shares are valued as follows:
 - \$10 at close of x1
 - \$12 at close of x2
 - \$16 at close of x3
- Option is exercised on 2/1/x4 when shares are worth \$14
- APIC pool of \$100 exists under FAS 123R

IFRS2– Example (continued)

- Under FAS 123R the company will amortize the \$2 DTA as a benefit to earnings over three years.
 - While there was ultimately a shortfall (\$4 deduction compared to \$5 accounting expense), the shortfall is covered by the APIC pool, so the ultimate p&l benefit remains \$2
- The IFRS results are as follows:
 - *Close of x1*: no entry because no intrinsic value
 - *Close of x2*: \$2 intrinsic x 40% rate = \$.8 DTA benefit to earnings
 - *Close of x3*: \$6 intrinsic x 40% rate = \$2.40 total DTA, but \$2 of that DTA is recorded to earnings and \$.40 increases APIC (earnings benefit is limited to accounting expense x tax rate)
 - *At exercise*: \$4 intrinsic x 40% rate = \$1.6 total DTA. So, \$.40 APIC DTA is reversed, and \$.40 of p&l DTA is reversed
- As a result, the income statement benefit under IFRS is \$1.6, while under FAS 123R it was \$2 (because of available pool)
- Also IFRS entries (and p&l effect) reflect volatility in underlying shares

Other IFRS2 issues

- Companies must accrue employer payroll tax liabilities for outstanding awards
- Companies that chargeback their equity compensation costs must accrue the chargeback liability based upon the equity award value
- Companies who “net settle” their equity compensation for withholding taxes must treat the estimated tax withholding portion as a liability award
- IFRS2 does not require a company to reclassify excess tax benefits to the financing section of the cash flow statement

Polling Question #3

How does your company intend to deal with the more intense data and systems requirements for tracking deferred taxes related to stock option awards under IFRS?

- a) Handle internally; systems are already configured to capture IFRS data
- b) Handle internally; systems will need to be adjusted
- c) Handle externally through a third party vendor; vendor will address software configuration issues
- d) Combination of both internal and external
- e) Not material to our company
- f) Not applicable (PwC participants)

Polling Question #4

Do you think the earnings volatility of equity compensation will cause you to reexamine your use of equity-based incentive compensation?

- a) No
- b) Yes, we will reduce our use of equity compensation
- c) Have yet to consider this issue
- d) Not sure or not applicable and PwC participants

Q&A

Tax implications for stock-based compensation

IFRS for pensions and other employee benefits

- Companies will need to make decisions
 - apply standard on prospective basis from transition date
 - gain/loss recognition
 - presentation on income statement
- Companies will need to understand key differences in standards
 - including potential changes to IAS 19 under proposed exposure draft

IFRS for pensions and other employee benefits (continued)

- Key differences on Income Statement
 - Timing and recognition for the following:
 - gains and losses*
 - impact of plan changes*
 - special events*
 - No smoothed market-related value of assets permitted
 - Net periodic benefit cost may be disaggregated into operating/nonoperating cost*

**subject to new rules currently being deliberated by IASB*

IFRS for pensions and other employee benefits (continued)

- Key Differences on Balance Sheet:
 - Funded status recognition
 - Non-vested impact of plan change not recognized in equity
 - Balance sheet asset ceiling test for overfunded plans
- Key Differences on Measurement of Obligations and Assets:
 - Discount rate in countries with no deep market for high quality corporate bonds
 - Bid prices used to measure securities in an active market
- Other Differences – likely company/plan specific

IFRS for pensions and other employee benefits (continued)

- IASB deliberations (Exposure Draft expected late 2009)
 - Immediately recognize impact of plan changes and gain or loss in P&L
 - Disaggregation of benefit cost into operating, financing and remeasurement components
 - Guidance on how to measure and where to report expense components
 - New standard scheduled to be issued in 2011, effective in 2013
- Key considerations
 - Accounting in accordance with IASB's tentative conclusions will result in significantly increased volatility to income statement

Polling question #5

Do you have defined benefit pension plans that will be accounted for under IAS 19?

- a) Yes, we have defined benefit plans.
- b) Yes, we have defined benefit plans but they are frozen to future benefit accruals or will be frozen to future benefit accruals in near future.
- c) No, we do not have defined benefit plans.
- d) Not sure or not applicable and PwC participants.

Polling question #6

If IAS 19 requires companies to immediately recognize gains or losses in the income statement, would you consider changing your defined benefit plan design or investment strategy?

- a) Yes. We would consider changing investment strategy to minimize volatility.
- b) Yes. We would consider changing the plan design.
- c) Yes. We would consider changing both.
- d) No. Volatility to the income statement does not have a strong impact on our company.

Q&A

IFRS for pensions and other employee benefits

Business transformation approach – Benefits and compensation

Implications of IFRS adoption to benefits and compensation arrangements are likely to be significant beyond accounting:

- Plan Design
- Valuation
- Tax efficiency and compliance
- Regulatory considerations
- HR Transaction services – M&A due diligence, post merger integration
- Administrative and data collection systems
- Human Resources controls and processes
- Human Resources Effectiveness

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