# Stock Compensation Under U.S. GAAP and IFRS: Similarities and Differences

*By Josef Rashty and John O'Shaughnessy*

The SEC has a longstanding commitment to the goal of a single set of high-quality global accounting standards. SEC Chairman Mary Schapiro commented that supporting the development of a single set of high-quality accounting standards is, in many respects, "only the beginning of the discussion, not the end." Incorporating International Financial Reporting Standards (IFRS) into the U.S. financial reporting system would involve a "significant undertaking" that includes consideration and deliberation of whether such a change is in the best interest of U.S. investors and markets, according to Schapiro. While the SEC does not yet have all the information necessary to make a decision regarding IFRS now, Schapiro says that it remains "on a steady path" to be in a position to make such a determination.

This article provides a comparison between the guidance under U.S. GAAP and IFRS for stock compensation accounting.

## Stock Compensation

The guidance for stock compensation, Accounting Standards Codification (ASC) 718, *Compensation–Stock Compensation*, and IFRS 2, *Share-based Payment*, are largely converged standards. The general framework is common to both GAAP and IFRS:

- Require a fair value-based approach in accounting for stock compensation.
- Apply to transactions with employees and nonemployees.
- Require that the fair value of stocks to be measured based on market price, if available, or be estimated using an option pricing model, such as Black-Scholes-Merton.
- Require a similar treatment for modification and settlement of awards.
- Require similar disclosures in quarterly and annual financial reports.

There are, however, significant differences between the two standards, and such differences have made the transition from one standard to the other rather cumbersome.

## Awards with Service Conditions and Graded Vesting

ASC 718 requires that awards with graded vesting and performance or market conditions use the graded-vesting attribution approach, but it also permits companies

to make an accounting policy election regarding the attribution method for awards with service conditions and graded-vesting features. Companies can make an election to recognize compensation costs for awards containing only service conditions and graded vesting either as if the award was multiple awards (graded-vesting attribution method) or on a straight-line basis for the entire award (straight-line attribution method), regardless of the method used to measure the fair value of the awards, either as a whole or each individual tranche.

IFRS 2, on the other hand, does not provide the straight-line attribution method alternative. Companies should treat each tranche of the award as a separate grant. This means that each tranche will be separately measured and attributed to expense over the related vesting period.

For example, Entity A grants 200 options with service conditions at the beginning of Year 1 and determines that the fair value of each option is $10. The options vest in two years and have one year of cliff vesting (i.e., 100 options are vested at the end of Year 1 and an additional 100 options are vested at the end of Year 2). (See *Exhibit 1*.)

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### Accounting for Taxes

ASC 718 (paragraphs 55-15 through 55-22) requires that companies recognize deferred tax assets based on the GAAP amount of stock compensation at the time of grant. If the tax benefit at the time of exercise exceeds the deferred tax assets, the excess ("windfall benefit") will be reflected in equity as a credit. The shortfall of tax benefit, however, will be charged to equity to the extent of prior windfall benefits, and into the income statement thereafter.

In the above example, assuming that the exercise price is $50, the tax rate of Entity A is at 40%, and the stock price is $70 and $80 in Year 1 and Year 2, respectively. Furthermore, the employee exercises options in Year 3 upon full vesting of options at the end of Year 2. The financial information based on ASC 718 (U.S. GAAP, straight line) will be as shown in *Exhibit 2*.

In-the-money nonqualified stock option awards are tax deductible upon their vesting and exercise, under U.S. tax law. IFRS, on the other hand, requires that companies calculate deferred taxes based on the intrinsic value of awards at the end of each period. According to International Accounting Standards (IAS) 12, *Income Taxes*, if the estimated future tax deductions exceed cumulative remuneration expense, the excess is credited to equity. If the tax deductions are less than or equal to cumulative remuneration expense, the excess deferred taxes are recorded in the income statement. This provision of IFRS is different from U.S. GAAP, which allows for the shortfall of tax benefit to be charged to equity to the extent of prior windfall benefits, and into the income statement thereafter.

The financial information based on IFRS 2 (straight line) will be as shown in *Exhibit 3*.

### Equity and Liability Classified Awards

The liability-classified awards differ from equity-classified awards. The liability-classified awards are remeasured at each reporting period at fair value, whereas equity-based awards are measured at fair value at the date of grant. The guidance under U.S. GAAP and IFRS has some differences when it comes to clas-

**EXHIBIT 1**
Graded Vesting

| | Year 1 | Year 2 | Total |
|---|---|---|---|
| Number of options vested | 100 | 100 | 200 |
| Stock compensation: | | | |
| Straight-line method | $1,000 | $1,000 | $2,000 |
| Accelerated method | $1,500 | $ 500 | $2,000 |

**EXHIBIT 2**
Tax Implications, U.S. GAAP

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Deferred tax assets | $ 400[a] | $ 400[b] | $ (800) |
| Additional paid-in capital | $ – | $ – | $(1,600) |
| Deferred tax income | $ (400)[a] | $(400)[b] | $ – |
| Deferred tax expense | $ – | $ – | $ 2,400[c] |
| Current taxes payable | | | $ 2,400 |
| Current tax expense | | | $(2,400) |

a40% tax rate times $1,000 stock compensation in Year 1.
b40% tax rate times $1,000 stock compensation in Year 2.
c([$80 market price less $50 exercise price] times 200 number of shares) times 40% tax rate.

sification of such awards as equity versus liabilities.

For example, an entity grants awards to one of its executives that will be fully vested if the percentage of increase in revenue outperforms the Standard & Poor's (S&P) 500 performance. These awards will be classified as equity under IFRS 2 but as a liability under ASC 718.

*Exhibit 4* reflects a summary of equity versus liability classification under IFRS and U.S. GAAP.

## Transactions with Nonemployees

GAAP definition of an employee is based on the common law definition of an employee, whereas IFRS has a broader definition of an employee that includes individuals who provide services similar to those rendered by employees.

ASC 718 states that for transactions with nonemployees, companies can use either the fair value of the goods or services received, or fair value of the equity instruments, whichever is more reliably measurable. When an entity (whether public or private) grants equity awards to nonemployees, it should apply the provisions of ASC 505-50, *Equity–Equity-Based Payments to Non-Employees*, which requires that nonemployee awards be accounted for at fair value. ASC 505-50-30-6 establishes that stock compensation transactions with nonemployees shall be measured at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable.

IFRS 2, however, requires companies to use the fair value of the goods and services received, and they can only use the fair value of the equity instruments if they cannot reliably determine the fair value of goods and services.

ASC 505-50 requires that if the fair value of the equity instruments, in conjunction with selling goods and services, is used, the earlier of the date at which a commitment by the counterparty is reached or the date at which the counterparty's performance is complete, should also be used. IFRS 2, however, does allow for a performance commitment concept. According to IFRS 2, the measurement date is the date that the entity obtains the goods and services.

**EXHIBIT 3**
Tax Implications, IFRS

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Deferred tax assets | $ 800[a] | $ 1,600[b] | $ (2,400) |
| Equity | $ (400) | $ (1,200) | $ – |
| Deferred tax income | $ (400) | $ (400) | $ – |
| Deferred tax expense | $ – | $ – | $ 2,400 |
| Current taxes payable | | | $ 2,400 |
| Current tax income | | | $ (2,400) |

a ($70 market value less $50 exercise price) times 100 (number of shares) times 40% (tax rate).
b ($80 market value less $50 exercise price) times 200 (number of shares) times 40% (tax rate) less amount recognized in Year 1.

## Type III Modifications (Improbable-to-Probable)

Type III modification changes the expectation about the ultimate vesting of the awards. For example, a company changes a condition that it expects will not be satisfied to a condition that it expects will be satisfied. Consider an award that initially had a performance condition stipulating that it would vest if a particular product's market share increases by 20%—a condition that management had originally expected would not be fulfilled. The company modifies the performance condition, whereby vesting would be achieved if only a 15% increase in the product's market share

**EXHIBIT 4**
Equity Versus Liability Classification, IFRS Versus U.S. GAAP

| IFRS 2 | ASC 718 |
|---|---|
| The awards are classified as liabilities if they are cash settled. | The awards are classified as liabilities if 1) grantor has an obligation to deliver cash or other assets or 2) no equity holder relationship is established—for example, due to other conditions—based on the classification criteria of ASC 480, *Distinguishing Liabilities from Equity*. |
| Puttable shares (excluding contingency puttable shares) are classified as liabilities. | Puttable shares are equity-classified if 1) employee has made a substantial investment and bears the risks and rewards of ownership for a reasonable period of time (six months) and 2) redemption price is at fair value. |
| Compound instruments are broken down to liability and equity portions. | Compound instruments are generally classified as liabilities unless the compound financial instruments are tandem awards. |

occurs—a condition that the company expects will be fulfilled.

In the above example, under ASC 718, the compensation cost for the original unvested award should be zero at the date of the modification, because none of the options are expected to vest. The incremental fair value is equal to the full fair value of the modified award, which represents the total cumulative compensation cost that the company should recognize for the award. On the date it becomes improbable that the service condition of the original award will be satisfied, the company should reverse the compensation cost previously recognized for the unvested award, if any, and then on the modification date recognize compensation cost equal to the full fair value of the modified award. A Type III modification could result in the recognition of a total compensation cost less than the award's grant-date fair value, because at the date of the modification, the original vesting conditions are not expected to be satisfied.

IFRS 2, however, treats Type III modifications differently. If the fair value of the modified awards exceeds the fair value of the original awards, the incremental value should be recognized over the remaining vesting period.

## Fair Value Measurement

The SEC's Staff Accounting Bulletin (SAB) 107 states that IFRS 2 and ASC 718 provide fundamentally similar guidance on fair value measurements. The staff believes that application of the ASC 718 measurement guidance would not generally result in a reconciling item being reported under Item 17 or 18 of Form 20-F for a foreign private issuer that has complied with the provisions of IFRS 2 for share-based payment transactions with employees. In Topic 14-L, however, the staff reminds foreign private issuers that there are certain differences between the guidance in IFRS 2 and ASC 718 that may result in reconciling items (www.sec.gov/interps/account/sab107.htm).

## Conclusion

Even though the guidance for stock compensation under U.S. GAAP and IFRS consists of largely converged standards, the companies that have adopted IFRS have found stock compensation one of the most cumbersome areas to convert. This reflects the challenges that the SEC and U.S. companies are facing in converting to IFRS. A high-level conversion has been achieved; nevertheless, low-level differences remain between the two standards. ❑

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