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A World of Difference: Exploring Stock-Based Accounting Standards and the Impact of New Guidance

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IFRS 2 and ASC 718

- The accounting standards are generally very similar. Under both models:
  - Expense for equity awards is based on the grant date fair value
  - Expense is attributed over the employees’ service period
  - Liability awards are marked-to-market
  - Modifications are treated similarly
  - Awards with retirement eligibility provisions are treated similarly
  - Market-conditions are considered in the grant date fair value

Definition of the grant date – IFRS vs. US GAAP

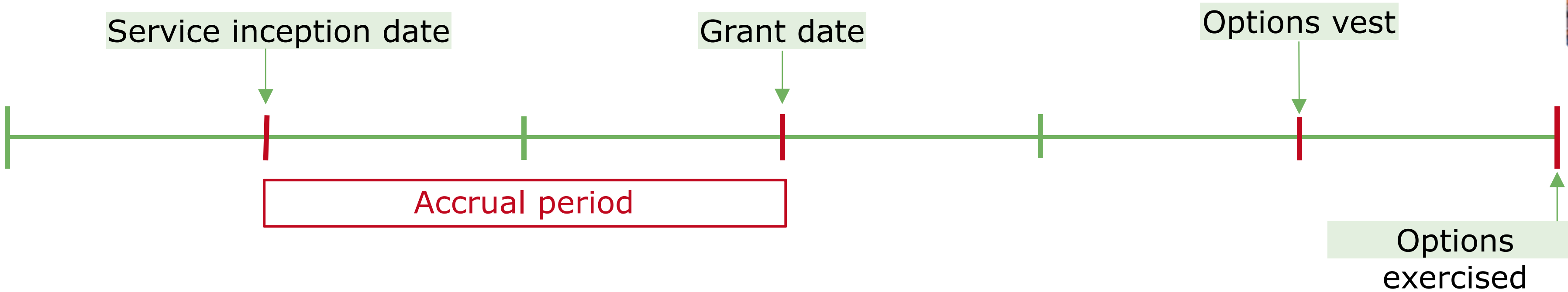
Key difference

IFRS	US GAAP
Conditions necessary to have a grant date: • Mutual understanding • Necessary approval obtained • Company is obligated	Conditions necessary to have a grant date: • Mutual understanding • Necessary approval obtained • Company is obligated • Employees begin to benefit from or be adversely affected by changes in stock price

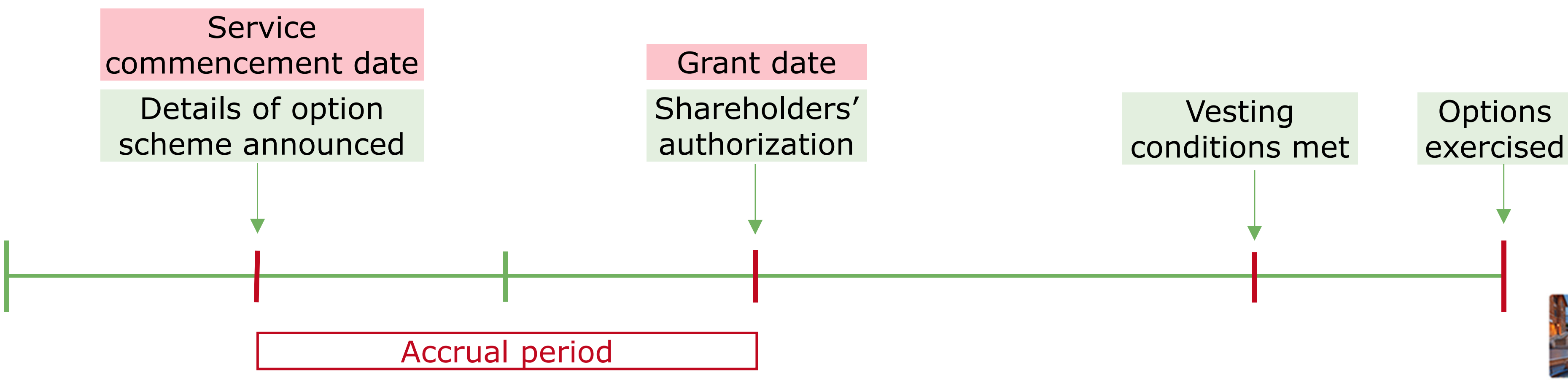
US GAAP also provides practical expedient = grant date is approval date if communicated timely

An accrual may be required before the grant date – US GAAP

"Service inception" conditions met	Grant date definition met
• Award authorized • Service begins before mutual understanding, and • Either – No substantive future service at grant date; or, – Market/performance condition before grant date	• Mutual understanding of key terms • Employee affected by share price changes • Shareholder approval • Employer contingently obligated



An accrual may be required before the grant date – IFRS



- Specific service inception requirements in US GAAP do not exist in IFRS.

An accrual may be required before the grant date – US GAAP0

Example

- Existing deferred profit sharing plan, accrued over 1 year performance period and paid out in cash in the 2 years following the performance year (Y0)
- Plan replaced with a new equity incentive plan (Y1)
- Payments under the new plan will be in the form of Restricted Stock Units (RSUs) granted in the year following the performance year (Y2 and Y3)
- From the grant date, the RSUs will be subject to graded vesting with 50% of the RSUs vesting after 12 months and the remaining 50% of RSUs vesting after 24 months
- The only vesting condition after the performance year is a service condition, meaning the employees have to still be employed for the RSUs to vest 12/24 months after the grant date
- The amount of RSUs being allocated to individual employees is tied to multiple Company Goals (performance conditions) to be achieved in Y0
- The actual amount of equity awards to be granted in Y1 can be anywhere between 0% and 130% of the base salary of an employee as approved by the Compensation Committee at the beginning of Y1

Is authorization and mutual understanding achieved if RSUs are only approved and granted in Y1?

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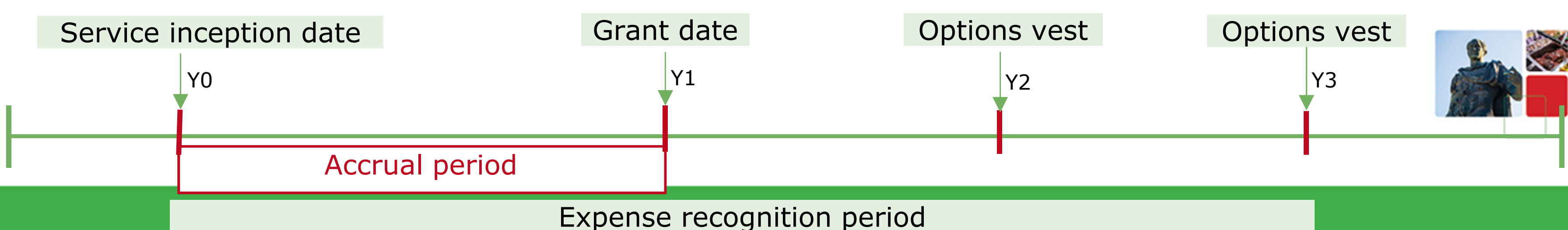
US GAAP (example cont.)

"Service inception" conditions met	**Grant date definition met**

• Award authorized* √ if broad approach applied
• Service begins before mutual understanding √
• Either
  - No substantive future service at grant date; or,
  - Market/performance condition before grant date √
	• Mutual understanding of key terms** √ if broad approach applied
	• Employee affected by share price changes √
	• Employer contingently obligated √

* No guidance in FASB ASC; SEC interpretation accepts a "narrow" or a "broad" approach as an accounting policy choice:
"Narrow" - authorization is the date that all approval requirements are completed (e.g., Compensation Committee approved the award and the number of equity instruments to be issued to individual employees);
"Broad" - the specific terms at the individual employee level need not be known to conclude that the award has been authorized but certain factors need to achieved (e.g., Compensation Committee approved an overall compensation plan or strategy, which is understood by the employees)

** The employees understand the compensation plan and work towards certain goals in an expectation that awards will be granted (e.g., granting of the awards is dependent on the company achieving performance metrics and the employees have an understanding of those performance metrics)



Deferred taxes – IFRS vs. US GAAP

Key difference	
IFRS	**US GAAP**
• Deferred tax asset is based on the expected deduction (typically intrinsic value of the award), adjusted each reporting period • If the cumulative estimated tax deduction exceeds the book expense, the excess is credited to equity	• Deferred tax asset is based on the fair value at the grant date and not adjusted for changes in share price • Under ASU 2016-09, all excess tax benefits and tax deficiencies recognized in income tax expense

Horizon Pharma – A Unique Example

- For our Ireland Business Unit (HPSL) IFRS local financial statements, the same share based payment expense is recorded during the vesting period under IFRS as US GAAP.
- HPSL does not make a payment to PLC (the Parent entity for Horizon) for the fair value of the shares when the RSU’s vest or the share options are exercised, we do not recognize a deferred tax asset in respect of the share based payment expense incurred in HPSL under either US GAAP or IFRS
- Never take a local Tax Deduction, therefore there is no subsequent value measurement, which normally takes place with IFRS

Horizon Pharma Continued

Permanent Difference in HPSL

- We do not recognise deferred tax in respect of stock compensation expense at all. On the basis that HPSL will never receive a tax deduction in respect of stock compensation expense, we do not currently have to consider this.

Journals to Record during Vesting Period

- PLC records IFRS Charge

  DR Investment in sub

  CR SBC equity reserve

- HPSL records IFRS Charge

  DR Share Based Compensation Exp.

  CR Capital Contribution

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Equity-Liability Classification– IFRS vs. US GAAP

Key difference	
IFRS	**US GAAP**
Equity/ liability classification is determined wholly on whether awards are ultimately settled in equity or cash	Complex rules which might: • Require liability classification when settled in shares (e.g., fixed-dollar arrangement settled in variable number of shares) • Require equity classification when cash settlement is likely (e.g., award with put right on mature shares)

Example 1
- Restricted shares which may be put back to company 6 months after vesting
- US GAAP – equity classified
- IFRS – liability classified

Example 2
- Award to be settled in shares worth $100k at vest date
- US GAAP – liability classified
- IFRS – equity classified

Post-vesting performance condition– IFRS vs. US GAAP

Key difference	
IFRS	**US GAAP**
The performance condition is treated as a non-vesting condition -- considered in determining the fair value of the award	Treated as a performance condition – assess probability in expense recognition (not incorporated in valuation)

Example:

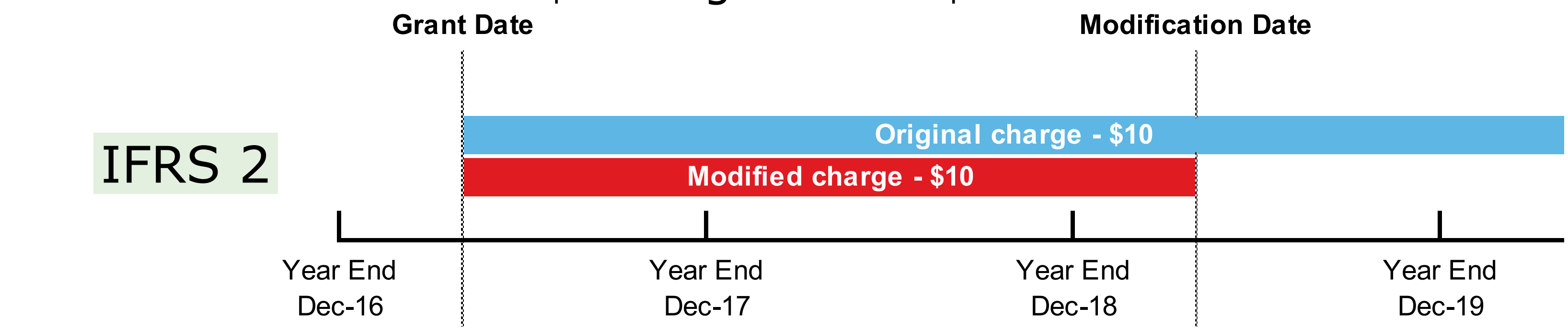
- Retirement eligible RSU award with performance condition measured at end of year 3.
- US GAAP – No impact on valuation. <u>If probable</u>, expense at grant. Otherwise, expense when probable.
- IFRS – Haircut valuation based on performance condition. Expense at grant.

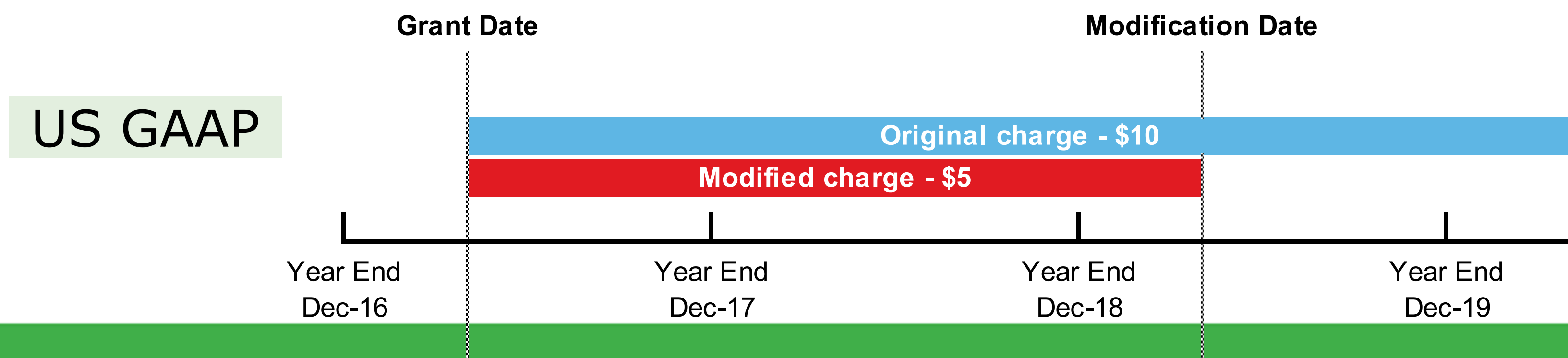
Modifications of awards - IFRS vs. US GAAP

Key difference

IFRS	**US GAAP**
Modifications to vesting terms are treated as a change in estimate of the number of shares expected to vest only • No remeasurement of original grant date fair value • Award's original fair value is recognized over the remaining service period, plus any incremental charge resulting from the modification	An improbable-to-probable "Type III" modification can result in recognition of compensation cost that is more or less than the fair value of the award on the original grant date.

- Accelerated vesting of award, Type III modification
- Assume fair value of $10 at grant and $5 at modification





Valuation of graded awards – IFRS vs. US GAAP

Key difference	
IFRS	**US GAAP**
Separate grant date fair value must be calculated for each vesting tranche of the award	A single grant date fair value may be calculated for the entire award

Graded vesting – IFRS vs. US GAAP

Key difference	
IFRS	**US GAAP**
Graded expense attribution required	Choice of straight-line or graded attribution (for service-only awards)

Percentage of compensation cost recognised each year

	Year 1	Year 2	Year 3	Year 4
Tranche 1	100%	0%	0%	0%
Tranche 2	50%	50%	0%	0%
Tranche 3	33%	33%	34%	0%
Tranche 4	25%	25%	25%	25%

- In addition, where employees are entitled to pro rata shares when they cease employment, graded vesting should be applied under IFRS 2.

Recent/Proposed Guidance

- The IASB issued Classification and Measurement of Share-based Payment Transactions (Amendments to IFRS 2) in June 2016.
  - Effective for annual periods beginning on or after 1 January 2018.
  - Measurement of cash-settled share-based payment transactions that include a non-market performance condition
  - Classification of share-based payments settled net of tax withholdings
  - Modifications of share-based payment transaction from cash-settled to equity-settled

Other Differences

- Measurement of awards granted by nonpublic companies- IFRS does not provide alternatives
- Awards with “other” conditions (i.e., not service, performance or market) - may still be equity classified under IFRS
- Derived service period for deep-out-of-the-money awards – IFRS does not have this concept
- Guidance on volatility and expected term - US GAAP offers additional guidance that IFRS does not contain

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Scope – IFRS vs. US GAAP

Arrangements with non-employees

Key difference	
IFRS	**US GAAP**
Broader definition of "employee" (including non-employees)	Strict legal definition of "employee" Measurement date for non-employees* is at vest (mark-to-market accounting)

* FASB has proposed amendments to non-employee guidance to align with employee accounting

Group situations – IFRS vs. US GAAP

Key difference	
IFRS	**US GAAP**
• Subsidiary grants settled in parent equity treated as cash-settled liability award	• Award would be equity classified

Classification in separate financial statements

Award granted by	Parent	Subsidiary
Award settled in shares of		
Parent	Equity	Cash
Subsidiary	Equity	Equity

Parent

Who has the obligation?

Subsidiary

Group situations – IFRS vs. US GAAP

Key difference	
IFRS	**US GAAP**
• Parent-settled liability awards to subsidiary employees treated as equity classified at subsidiary	• Parent mark-to-market expense is pushed down to subsidiary

Accounting for Forfeitures – IFRS vs. US GAAP

Key difference	
IFRS	**US GAAP**
Forfeiture estimate is factored into recognition of compensation cost	ASU 2016-09 allows policy choice: 1) account for forfeitures as they occur 2) estimate expected forfeitures

Classification – IFRS vs. US GAAP

Net settlement of withholding tax obligations

Key difference	
IFRS	**US GAAP**
Net-settled award must be bifurcated -- split into liability and equity components and accounted for separately*	Equity classified if withholding does not exceed maximum statutory rate for individual in jurisdiction

* Amendment to IFRS 2 effective in 2018 will conform to "prior" US GAAP rules

Social charges – IFRS vs. US GAAP

Key difference	
IFRS	**US GAAP**
Payroll taxes related to share-based payments are expensed over the vesting period based on current values	Payroll tax expense is recognized upon trigger for measurement and payment to the taxing authority (generally exercise date for options or vesting date for restricted stock)

Cash Settled Awards with a Performance Condition– IFRS vs. US GAAP

Key difference	
IFRS	**US GAAP**
For cash settled awards even where the performance condition is not "probable", a liability is recognized based on the fair value of the instrument (considering the likelihood of earning the award)	For cash-settled awards with a performance condition, where the performance condition is not probable, no liability is recognized

Employee Stock Purchase Plans (ESPP)– IFRS vs. US GAAP

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Key difference	
IFRS	**US GAAP**
• ESPPs are compensatory and treated like any other equity-settled share-based payment arrangement (no safe harbor)	If criteria are met, ESPPs are non-compensatory • terms no more favorable than available to all shareholders • discount of 5% or less is safe harbor • no option features (e.g., lookbacks)

Appendix

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Thank You

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