

Accounting for Share-Based Transactions under IFRS

Overview

Share-based transactions are defined as transactions in which a company issues equity instruments (i.e. common shares and stock options) to another party as compensation for goods received or services rendered.

Canadian public companies had previously accounted for share-based transactions under Canadian Generally Accepted Accounting Principles. In February 2008, the Canadian Institute of Chartered Accountants confirmed that public companies will be required to prepare interim and annual financial statements under International Financial Reporting Standards (IFRS) for fiscal years beginning on or after January 1, 2011.

The adoption of IFRS can have a significant impact on the value of share-based compensation expense. Since share-based compensation expense is often one of the largest items on the income statement, a change in the value of share-based compensation expense may negatively impact the company's bottom line and earnings per share, and can put a seemingly profitable company in a loss position. As a result, debt covenant ratios may not be met, management bonuses may not be earned, and investors' confidence may be lost.

Given the potential impacts IFRS may have on companies, it's a good idea for those involved in public companies to have a clear understanding of how to account for share-based compensation transactions under IFRS. Companies should consider structuring their stock options plans in a manner that will reflect the company's financial statements in the most positive light.

There are a number of accounting differences for share-based transactions under CDN GAAP versus IFRS. Furthermore, the accounting treatment for share-based transactions differs between employees and non-employees. The differences are outlined for you, below.

Share-Based Transactions with Non Employees

Measurement of Payment

Under Canadian GAAP, share-based payments to non-employees are measured based on the more reliably measurable amount of either the fair value of the goods or services received or the fair value of the equity award.



Fair value is defined as the amount of consideration that would be agreed upon between either not connected or associated knowledgeable and willing parties. The common practice is to recognize compensation based on the fair value of the equity award as share prices are publicly available for publicly traded companies, thereby making the fair value of the award a more reliably measurable amount. Conversely, the fair value of the goods or services received may be difficult to measure especially if there is not an active market for the goods or services.

Under IFRS, share-based payments to non-employees are measured based on the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the fair value of the goods or services received cannot be estimated reliably, the transaction is measured by referring to the fair value of the equity instruments granted, measured at the date the entity obtains the goods or the counterparty renders services. However, it should be noted that there is a presumption that the fair value of the goods or services can be estimated reliably unless one proves otherwise.

In some cases, it may be difficult to demonstrate that goods or services have been received. For instance, an entity may have issued shares to a charity. In the absence of specifically identifiable goods or services, there is a presumption that an unidentifiable good or service has been received (or is to be received).

Share-Based Transactions with Employees

Measurement Date

Under IFRS, compensation is recognized when services commence. Note that the service date may precede the grant date in situations where the terms and conditions of the employee's stock option agreement are not finalized before the employee's start date. In this scenario, under IFRS, management will need to make its best estimate as to what the fair value of the compensation is when the employee commences services. On the grant date, the fair value is re-measured and adjusted.

Under CDN GAAP, compensation cannot be recognized before the grant date. Therefore, in the scenario described above, compensation is recognized when the options are granted, rather than when the employee commences services.

Vesting Installments

Vesting is defined as earning of rights. An employee's share-based compensation becomes vested at the date on which the employee receives the right to the share and is no longer contingent on the employee remaining in the service of the company. Under IFRS, when a share-based payment award vests in installments, each installment is accounted for as a separate arrangement. This is also known as "graded vesting".



Example:

A company grants 1,000 stock options with an expected life of three years on January 1, 2011 with 25% vesting on the grant date, 50% vesting on the first anniversary and 25% vesting on the second anniversary. In this scenario, the stock options granted will be measured in three different tranches:

- 250 stock options with a life of three years
- 500 stock options with a life of two years
- 250 stock options with a life of one year

The expectation of graded vesting is that a larger share-based compensation expense would be recognized upfront resulting in reduced net income and earnings per share and lower share-based compensation expense would be recognized in future periods.

Under CDN GAAP a company can elect to recognize graded vesting or the straight line method.

Number of Equity Instruments to Vest

Under CDN GAAP the common practice is to recognize compensation, assuming that all instruments granted will vest. The effect of forfeitures will be recognized as they occur. Forfeiture is defined as an employee's failure to earn a vested right to a share-based compensation award because the specified vesting requirements are not satisfied (i.e. the employee is terminated). However, under CDN GAAP the company also has the option to recognize compensation based on the number of equity instruments expected to vest, although this method is rarely practiced.

Under IFRS, compensation is recognized based on the number of equity instruments expected to vest.

Example:

At the beginning of year one, a company grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. The company estimates that the fair value of each option is \$15. If we assume that 40 employees leave during year one, the company estimates that a further 70 employees will leave during years two and three.

In year one, share-based compensation for the period is as follows:

- $(500 - 40 \text{ employees left in year one} - 70 \text{ employees expected to leave in years two and three}) \times 100 \text{ options} \times \$15 \times 1/3 = \$195,000.$

For more information on share-based transactions under IFRS, contact your Manning Elliott representative.

