

ESOP Direct



ESOP VISTAS

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Editors' Letter

Dear Readers,

We come across several companies who are actively thinking on re-pricing or modifying the terms of their underwater options. Keeping in line with the global trend, most of the options granted by Indian companies in the last 15-18 months are underwater between 20% to as much as 200% depending on the stock price movements.

We have covered this subject of re-pricing in depth in our December newsletter, where we have highlighted the need for considering the accounting implications of re-pricing before implementing any decision.

In this issue of ESOP Vistas, we are glad to present the accounting aspects of Re-pricing in greater detail. In the coming years accounting in India is going to get more complicated when compliance with IFRS becomes mandatory. Accounting for ESOPs is one area where Indian companies will see a significant change with Fair value accounting becoming mandatory. Re-pricing of options now will also have an impact when Indian companies move to IFRS. We have covered this angle as well in this issue.

While not much is being written or discussed about this subject, we are glad to make the issuer companies aware of the finer aspects to help them take a balanced decision.

As usual we will be glad to answer any queries or clarifications that you may need.

Happy reading!!

Team ESOP Direct

You can get in touch with us at consulting@esopdirect.com.

Re-pricing

The Accounting Perspective

- Garima Sharma*

Re-pricing - the most talked about word in recent times for reviving the value of stock options in the hands of employees.

Several companies are modifying the terms of grant so as to make stock options attractive again. Terms like exercise price, vesting period, exercise period, etc. are being changed in such a manner that the employees are at least at-the-money, if not in-the-money.

While such modifications are beneficial to the employees, they generally involve a cost to the company. **The accounting charge that will hit the companies' books of accounts should also be considered while deciding on the method or alternative to be adopted for modification.**

Here we present how different methods of re-pricing (also known as Modifications) will impact the accounting treatment under the Indian GAAP. Very soon all the Indian companies will be moving to IFRS. We shall cover the treatment under IFRS in our next Newsletter.

Regulations governing Accounting

There are two basic guiding regulations in India -

1. SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 (SEBI Guidelines)
2. Guidance Note on Share-based payments issued by the Institute of Chartered Accountants of India (Guidance Note)

SEBI Guidelines is mandatory for all listed companies. It covers the general accounting for stock options and does not comment on accounting for alternative instruments like phantom options and stock appreciation rights.

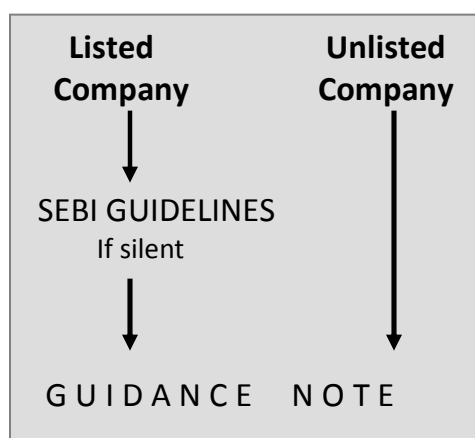
The Guidance Note is recommendatory in nature but is more detailed and covers accounting for equity based instruments and cash based instruments.

Where SEBI Guidelines are silent on accounting, the Guidance Note shall prevail.

Both the regulations cover accounting of ESOPs to employees only.

Currently, there are no regulations in India which cover accounting for share-based payments to consultants and non-employees. However, this issue will be resolved by the applicability of IFRS in 2011.

Before we get into the accounting complications on modifications, let us briefly discuss the general methods of accounting.



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Methods of accounting

There are two methods permissible under the Indian GAAP accounting -

1. Intrinsic Value Method
2. Fair Value Method

Both these values are to be computed as on the date of grant and are not changed later, even if the assumptions used in the computation change later.

Under the Intrinsic Value method, the Intrinsic Value as on the date of grant is written off over the vesting period of the grant.

$$\text{Intrinsic Value} = \text{Market price on the date of grant} - \text{Exercise price}$$

If the grants are given at the current prevailing market price (which is the general trend), the intrinsic value becomes zero. So, companies do not have any accounting charge. In India, majority of the companies follow intrinsic value method as there is no cost to account for on the grant of options.

Fair Value method considers the Fair Value of the options computed using an option-pricing model (Black Scholes, Binomial, etc.) for the purposes of accounting. The Fair Value of the option is calculated by inserting the following 6 inputs into the option-pricing model -

1. Market Price
2. Exercise Price
3. Volatility
4. Risk-free rate
5. Expected life
6. Dividend Yield

Simplified, the formula for fair value computation can be summarized as -

$$\text{Fair Value} = \text{Intrinsic Value} + \text{Time Value of money}$$

So in case of market price grants, even though the intrinsic value is zero, there would be some time value which gets factored into the fair value and it is generally higher than zero.

All employee share-based payments are subdivided into 3 categories based on the method in which they are settled. These are -

- i. Equity settled (Stock Options, Share Purchase Plans, Restricted Stock)
- ii. Cash settled (Stock Appreciation Rights, Phantom Stock Options)
- iii. Plans with Cash alternatives

For equity settled instruments, an expense equal to the Fair Value / Intrinsic Value will be written off over the vesting period with a corresponding credit to the equity account, generally, the Stock Options Outstanding Account.

For cash settled instruments, a liability account is created for such settlement of options or other instruments.

In Plans with cash alternatives, who has the choice of settlement will decide the accounting treatment. If the choice of settlement is with the employee, then the Plan will be accounted for as cash settled plan. However, if the choice of settlement is with the employer, then the Plan would be accounted for as equity settled plan unless the settlement in shares has no commercial substance.

Accounting for Re-pricing

Re-pricing is the word commonly used in India for any change in the Plan features, be it change in exercise price, vesting terms or other conditions. In the Accounting parlance the term used is Modification - covering any change in the terms and conditions of the Options granted.

The SEBI Guidelines allow companies to re-price their options, if they are underwater. However, it does not mention anything further on modifications. The Guidance note covers modifications completely, not only re-pricing, but change in vesting period or other terms. Since the Guidance Note is more comprehensive, **for accounting treatment of modifications, the Guidance Note shall prevail.**

SEBI Guidelines -

“7.5 A company may reprice the options which are not exercised, whether or not they have been vested if ESOSs were rendered unattractive due to fall in the price of the shares in the market.

Provided that the company ensures that such re-pricing shall not be detrimental to the interest of employees and approval of shareholders in General Meeting has been obtained for such re-pricing.”

On modification of the terms of grant, the increase in the Fair value pre modification and post modification is required to be accounted for. This difference is called ‘incremental cost’. This ‘incremental cost’ is nothing but the incremental benefit being passed on to the employees on modification.

The total expense that would need to be accounted for on modification is -

- i. Portion of the grant date Fair Value of the options over the original vesting period, **plus**
- ii. Incremental cost resulting from the modification over the new vesting period.

So, the total expense of the employee share-based payments that have been modified is, at least, the grant date Fair Value.

This is the general rule. However, there is a deviation from that rule if the performance or service conditions

(vesting conditions) are not expected to be satisfied at the date of modification.

Guidance Note -

“24. The enterprise should recognize, as a minimum, the services received measured at the grant date fair value of the shares or stock options granted, unless those shares or stock options do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. This applies irrespective of (a) any modifications to the terms and conditions on which the shares or stock options were granted, or (b) a cancellation or settlement of that grant of shares or stock options. In addition, the enterprise should recognize the effects of modifications that increase the total fair value of the employee share-based payment plan or are otherwise beneficial to the employee.”

The accounting for modification of the vesting conditions of the options is consistent with the general modification guidance. If as a result of the modification, a company conveys additional value to the holder of an award, then the company must record incremental compensation cost for those options.

Let's consider an example, 1,000 options have been granted on the following terms -

Date of grant	April 1, 2006
Exercise price	Rs.200
Market Price	Rs.200
Vesting period	4 years equally
Exercise period	3 years from vesting
Volatility assumed	30%
Dividend yield	0%
Grant date fair value	Rs.70
Grant date Intrinsic Value	0

The Company follows the fair value method and chooses to follow the straight line accounting for graded vesting options and records the cost in the following manner -

Date of Grant	1-Apr-06	Straight-line basis	Vest 1 1-Apr-07	Vest 2 1-Apr-08	Vest 3 1-Apr-09	Vest 4 1-Apr-10
Number of Options	1,000					
Fair Value	70	Vesting %	25%	25%	25%	25%
Total Compensation Cost (Rs)	70,000	Compensation Cost	17,500	17,500	17,500	17,500

On Feb 1, 2009, the market price falls down to Rs.120. The options are underwater by Rs.80 (Rs.200-Rs.120) or by 40%.

The company decides to re-price its options at Rs.120 keeping the other terms of grant the same. The accounting charge then would need to consider the incremental cost.

Date of Modification	1-Feb-09
Fair Value pre modification	9
Fair Value post modification	30
Incremental cost per option	21

Number of Options Outstanding	1,000
Total Incremental Cost (1)	21,000

Cost already amortised	49,583
Cost remaining to be amortised (2)	20,417

Total cost to be amortised post modification (1 + 2)	41,417
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Under the fair value method, Rs.49,583 (Rs.17,500 for vest 1 + Rs.17,500 for vest 2 + Rs.17,500 x 10 / 12 for vest 3) has already been written off as on the date of modification. The amount that is remaining for amortization is Rs.20,417 (Rs.70,000 less Rs.49,583).

On modification of the exercise price from Rs.200 to Rs.120, the fair value of the option would increase from Rs.9 to Rs.30. This implies an additional cost of Rs.21 per option as incremental cost.

The company would have to write off Rs.41,417 as compensation cost over the remaining vesting period of 1 year and 2 months.

There is another alternative available to companies, wherein there would be no incremental cost to be accounted for. This is by reducing the number of options in proportion to the increase in the fair value. These are called “value for value” option exchange programs in the US.

Had the company accounted for the options using the Intrinsic Value method, there would not have been any accounting as at the date of grant. This is because, as on the date of grant, the Intrinsic Value of the options is zero. However, on modification, there would be certain factors that need to be considered.

Guidance Note –

“40.For accounting for employee share-based payment plans, the intrinsic value may be used, *mutatis mutandis*, in place of the fair value as described in paragraphs 10 to 39.”

The Guidance Note states that Intrinsic Value can be substituted for Fair Value for the purposes of accounting.

The intrinsic value pre modification and post modification needs to be computed and any incremental cost arising out of the modification would be accounted for. In our example above, if the Company had followed the Intrinsic Value method of accounting, the following would be the cost to record -

Dates	Grant	Pre Modification	Post Modification
	1-Apr-06	1-Feb-09	1-Feb-09
Market Price (Rs)	200	120	120
Exercise Price (Rs)	200	200	120
Intrinsic Value per option (Rs)	0	-80	0

There is no incremental cost as on the date of modification, as the intrinsic value pre modification is negative. This also means that there would be no accounting for any additional cost as a result of the modification of the exercise price.

What is the date of modification?

In the above example, we assume that the date of modification is February 1, 2009. However, in practice, there can be more than one dates that can be called the date of modification. It could be the date of shareholder approval or the date of the Compensation Committee or Board resolution for modification or the date the communication of the modification is made to the employees.

The date of modification that should be considered for calculating the compensation cost would be the date on which the Compensation Committee or the Board resolves to modify the outstanding options after obtaining shareholder approval, if required.

Other Forms of Modifications -

Modification to the terms of the grant like vesting period, exercise period are also to be accounted for.

Under Intrinsic Value method, these changes would not have any impact as they are not considered in the computation of Intrinsic Value.

However, these changes impact the Fair Value of the options and they would have to be accounted for in the same manner as re-pricing. The excess of Fair Value post modification over that of pre modification has to be accounted for as incremental compensation cost.

The various forms of modifications and their accounting implications are summarized in the table below -

(FV/IV = Fair Value / Intrinsic Value)

Sr. No.	Modification	Accounting Implication
1.	Increase in FV/IV post modification as compared to pre-modification	Account for the grant date FV/IV over the original vesting period. In addition, an incremental cost is accounted for over the new vesting period.
2.	Decrease in FV/IV post modification as compared to pre-modification	Account for the grant date FV/IV over the original vesting period.
3.	Increase in number of shares or options	Account for the grant date FV/IV over the original vesting period. In addition, the FV/IV of the additional options is recorded over the vesting period of the additional options granted.
4.	Decrease in number of shares or options	Account for the grant date FV/IV over the original vesting period. The reduction in the number of options is treated as cancellation and their FV/IV is recognized immediately as on the date of modification.
5.	Any other modification beneficial to the employee. For e.g., decrease in vesting period or eliminating a performance condition (other than a market condition).	Account for the grant date FV/IV over the new vesting period. The new vesting conditions are considered while estimating the number of options that would eventually vest.
6.	Any other modification <u>not</u> beneficial to the employee. For e.g., increase in vesting period or adding a performance condition (other than a market condition).	Account for the grant date FV/IV over the original vesting period. The new vesting conditions are <u>not</u> considered while estimating the number of options that would eventually vest.
7.	Cancellation of options	Treated as acceleration of vesting, grant date FV/IV is accounted immediately as on the date of cancellation.
8.	Cash settlement of options	Cash paid in excess of FV/IV is be accounted as an expense.
9.	New options granted in replacement of cancelled options	Treated as a modification of the original grant of options. Accounting treatment same as for modification 1 as discussed herein.

Areas of Conflict

The Guidance Note covers the accounting for employee share-based payments quite comprehensively but there are certain areas which need clarity. These are discussed here:

i. Scope limited to employees

The scope of the Guidance Note is limited to accounting for share-based payments to employees. It does not cover accounting for share-based payments to non-employees.

However, with IFRS becoming applicable in 2011, this problem will be taken care of. IFRS - 2 on Share-based Payments covers accounting for all share-based payments to both employees as well as non-employees.

ii. Measurement date

The Guidance Note mentions that the Fair Value / Intrinsic Value of the shares or options granted should be measured on the date of grant, which should be the measurement date. However, it does not define the measurement date. Paragraph 16 states that -

“16. An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted.”

This concept works for plain vanilla stock options grant where the exercise price is known as at the date of grant.

However, sometimes the exercise price of stock options may not be known as at the date of grant, for example, when the exercise price is linked to IPO price or market price as on the date of vesting.

Since there is no guidance available under the Indian regulations, we can rely on the guidance provided in FAS 123(R) / IFRS, which states that in the above case, companies would be required to estimate the exercise price and account for it on the date of grant. This estimate would have to be reviewed at each reporting date and consequently, the accounting charge would vary in each reporting period.

iii. Intrinsic Value accounting for modifications

For accounting for modifications under the Intrinsic Value method, as per the Guidance Note, the difference between the Intrinsic Value pre modification and Intrinsic Value post modification is to be accounted for as incremental cost.

However, in case of re-pricing, the Intrinsic Value pre modification may be negative, which means no value. So, on re-pricing to the current market price, there would be no accounting implication.

Dates	Grant	Pre Modification	Post Modification
	1-Apr-06	1-Feb-09	1-Feb-09
Market Price (Rs)	200	120	120
Exercise Price (Rs)	200	200	120
Intrinsic Value per option (Rs)	0	-80	0

In the example above, the intrinsic value pre modification is negative Rs.80. If the outstanding options were re-priced to the current market price of Rs.120, then there would be no intrinsic value cost to be accounted for. But, the intrinsic value is increasing by Rs.80. This is the amount of benefit passed on to the employees.

Few companies, who have re-priced their options, may argue that negative value is no value at all and so, have not accounted for any cost in the books of accounts.

Under Intrinsic Value accounting for modifications as given in the Guidance Note, it is unclear whether this cost of Rs.80 should be accounted for as incremental cost. The Guidance Note talks about accounting for Fair Value pre and post modification. It also mentions that Intrinsic Value can be used in place of Fair Value for the purposes of accounting.

So, the argument persists that accounting for modifications under Intrinsic Value assumes that a negative value is no value at all and then there would be no incremental cost to account for.


What happens when IFRS - 2 becomes applicable?

IFRS - 2 which deals with Share-based Payments will become applicable in the financial year 2011-12. Reporting for the year 2010-11 would also need to be restated for the purposes of comparison.

IFRS - 2 was made applicable internationally from January 1, 2005. The Rules to transition then had applied the IFRS to all options granted after November 7, 2002 and had not vested on the effective date. Companies had to account for all options granted in previous 2 years on the Fair Value method.

In India, these rules have not yet been made clear by the Institute of Chartered Accountants of India. Depending on these transition rules, there may be serious accounting implications which could include restatement of accounts of prior years using the Fair Value method.

IFRS - 2 makes it mandatory for the companies to account for the Fair Value of share-based transactions. For options that are modified, accounting would include the grant date fair value of the options and the incremental cost.

Currently, companies can choose to account for intrinsic value of options on modification but from 2011, they will have to adopt Fair Value of the options for accounting purposes. Also the accounts of the previous years will have to be restated and the Fair Value compensation cost would need to be accounted for, to adjust the opening balance of retained earnings. So, companies should consider modifying the options in such a way that the Fair Value cost is the least possible, for example “value for value” exchange 

IFRS – 2 Share-based Payments -

“55. For all grants of equity instruments to which this IFRS is applied, the entity shall restate comparative information and, where applicable, adjust the opening balance of retained earnings for the earliest period presented.”