



# ESOP Vistas

March 2005



Dear readers,

Hope you all had a happy and a safe holi.

A lot of steam has been generated in the last one year on accounting for employee stock options. Especially so in the international context, with the Financial Accounting Standards Board (FASB) pushing for mandatory expensing of fair value of options. Different opinions were aired for and against this approach, with the US semiconductor industry vehemently opposing mandatory expensing of options.

Dust has settled down (for now?) on the international front, with FASB deciding to implement what it has been advocating for quite some time now. It has issued Statement of Financial Accounting Standards No. 123 (revised 2004), which makes expensing of fair value of options mandatory.

As the sun rises on the April Fool's Day, employee stock options in India would have a detailed framework for their accounting. The Institute of Chartered Accountants of India (ICAI) has released a Guidance Note on Accounting for Employee Share-based Payments, which would come into effect from the 1<sup>st</sup> of April 2005. This document is far more comprehensive than the existing accounting framework provided by SEBI (ESOS & ESPS) Guidelines, 1999. It clarifies important issues such as grant date, performance-based vesting and accounting of stock options granted through a Trust. However, it does not make fair value expensing mandatory, and keeps it optional.

We provide a bird's eye view of the Guidance Note and its impact on accounting for stock options in India. This is a quick and dirty note aimed at giving you a glimpse of the change that has taken place.

Though a Guidance Note, strictly, is recommendatory in nature, unlike an Accounting Standard that has to be compulsorily followed by the companies, it might be a good idea to follow it from the perspective of good corporate governance.

Happy reading.

**Tarun Gulati**

Vice President

tarun@esopdirect.com



# let there be light

Surbhi Mehta

## Current Law

At present, accounting for Employee Stock Option Schemes (ESOS) and Employee Share Purchase Schemes (ESPS) is governed by the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999. Schedule I & Schedule II of these guidelines specify the accounting policies for ESOS and ESPS respectively.

## Guidance Note - The New Messiah

Companies would now have some more guidance in respect of the accounting for employee stock options. The Institute of Chartered Accountants of India (ICAI) has issued a Guidance Note on Accounting for Employee Share-based Payments. The Guidance Note *recommends* the expensing of employee stock options, stock appreciation rights and the shares offered under the ESPP according to the fair value method, although it permits the use of the intrinsic value method with extensive fair value disclosures.

The Guidance Note also recommends detailed disclosures and provides a more comprehensive guidance on the measurement of the fair value of stock options.

## Scope and Applicability

The Guidance Note is applicable to employee stock option plans, employee stock purchase plans and stock appreciation rights. Interestingly, a transfer of shares or stock options of an enterprise by its shareholders to its employees would also now qualify as an employee share-based payment. Thus, it is no longer limited to only those stock option grants where the underlying shares are issued afresh (and thus increase the paid-up capital of the company).

**The Guidance Note is applicable for all grants made on or after 1st April 2005.**

(Surbhi Mehta is an Assistant Manager, Consulting at ESOP Direct. She can be reached at [surbhim@esopdirect.com](mailto:surbhim@esopdirect.com))



The Guidance Note will be applicable to employee share based payment plans, the grant date in respect of which falls on or after April 1, 2005.

### Salient Features

The specifications in the Guidance Note are more comprehensive than those issued by SEBI. A number of aspects like performance conditions, modifications to the terms and conditions of the grant of shares or stock options and earnings per share implications, which have not been specifically covered under the SEBI guidelines, have been dealt with in the Guidance Note.

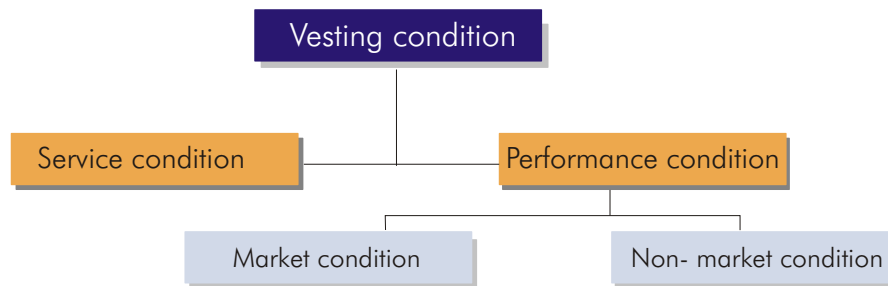
#### *Grant Date*

The Guidance Note defines grant date, which was not defined in the SEBI Guidelines. According to the Guidance Note, Grant date is the date at which the enterprise and its employees agree to the terms of an employee share-based payment plan. Thus, in the normal course, it would be the date on which the agreement is signed by the two parties. If that agreement is subject to an approval process, grant date is the date when that approval is obtained.

To take an example, suppose grant letters are issued to the employees on March 25, 2004 and agreements are signed on and dated April 4, 2005. In this case, April 4, 2005 would be considered as the grant date and the grant would fall under the scope of the Guidance Note. If, however, this grant is subject to the approval by the shareholders at their AGM to be held on August 25, 2005, then the Grant Date would be August 25, 2005 if the shareholders approve the grant.



### *Vesting conditions*



The Guidance Note specifies that vesting can be contingent on service as well as performance conditions. Performance conditions can be market or non-market conditions. If service or non-market performance conditions are not satisfied and consequently no instruments vest, no expense should be recognized in the books of account. However, in case of market condition based vesting, expense should be recognized if all conditions other than the market condition are satisfied (even if the market condition is not satisfied). Thus, expense is recognized even if no options vest (since vesting was linked to fulfilment of the market condition), so long as all service and non-market performance conditions are satisfied.

### *Modification to the terms and conditions of share based payment plan*

The enterprise should recognise, as a minimum, the services received measured at the grant date 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. The enterprise should also recognise the effects of modifications that increase the total value of the options or are otherwise beneficial to the employees.

### *Accounting treatment for lapsed options:*

The Note suggests that in a situation where vested options lapse on the expiry of the exercise period, the balance standing to the credit of the relevant equity account should be transferred to general reserve. This is different from the treatment suggested by SEBI Guidelines, where the amount should be reversed by a credit to employee compensation expense.



### *Accounting for ESOPs administered through Trust*

The Guidance Note suggests that the stock option compensation cost should be recognised in the books of the enterprise rather than in the books of the Trust. The companies need not consider the Trust created for the purpose of administering employee share based compensation plans in the preparation of Consolidated Financial

---

**The accounts of the ESOP Trust need not be consolidated. But the expense should be recognised in the books of the company.**

---

This is because the Accounting Standard 21, "Consolidated Financial Statements" requires consolidation of only those controlled enterprises which provide economic benefits to the enterprise and therefore, consolidation of entities, such as Gratuity Trust, Provident Fund Trust, etc. is not required.

The Guidance Note clarifies that the nature of a Trust established for administering ESOP is similar to that of a Gratuity Trust or a Provident Fund Trust as it does not provide any economic benefit to the enterprise in the form of, say, any return on investment.

### Impact

SEBI (ESOS & ESPS) Guidelines are applicable only to listed companies, and currently there are no such guidelines issued for unlisted companies. The Guidance Note issued by the ICAI would apply to listed as well as unlisted companies.

Companies can continue to account for the existing grants and all grants made before April 1, 2005, as per SEBI Guidelines. All grants made on April 1, 2005 or later would fall within the scope of the Guidance Note.

For calculating the stock option compensation, the Guidance Note gives companies the freedom to opt for intrinsic value method and disclose the Fair Value of options granted. Now that accounting for performance - based vesting has been clarified, companies can structure more exotic options rather than sticking to the plain vanilla version. This can help optimise dilution as only those who meet the performance conditions would be eligible for shares. 🏠



## Comparative analysis

Parameters	Guidance Note	SEBI Guidelines	FAS 123 (R)
Applicability	Listed and Unlisted Companies	Listed Companies	Listed and Unlisted Companies (following US GAAP Accounting)
Eligibility	Beyond its scope	Permanent employees. Promoters and consultants excluded	Employees and suppliers
Grant Date	The date at which the enterprise and its employees agree to the terms of an employee share-based payment plan	Not Defined	The date at which an employer and an employee have a mutual understanding of the terms of a stock-based compensation award.
Performance based Vesting	Specified	Not Specified	Specified
Accounting treatment for lapsed options	The balance standing to the credit of the relevant equity account should be transferred to general reserve	The amount is reversed by a credit to the employee compensation expense	The amount cannot be reversed
Modification to the terms and conditions of share based payment plan	Detailed	Not Specified	Detailed
Accounting method in case of Graded Vesting Schedule	Accelerated method	Accelerated method	Straight Line or Accelerated method



Tickle your grey cells

- |                               |            |
|-------------------------------|------------|
| 1. CCCCCC                     | Seven Seas |
| 2. ABCDEFGHIJKLMNOPQRSTUVWXYZ | _____      |
| 3. LU CKY                     | _____      |
| 4. AID ←<br>AID<br>AID        | _____      |
| 5. CYCLE<br>CYCLE<br>CYCLE    | _____      |
| 6. KNEE<br>LIGHTS             | _____      |
| 7. PRO / MISE                 | _____      |
| 8. Economy                    | _____      |
| 9. UP 8                       | _____      |
| 10. 1,2,3,4.....38,39,40 LIFE | _____      |

STPI Building , Plot No.1, 2nd floor, Pune Infotech Park,  
Hinjewadi, Pune - 411 027, India.  
Phone : +91 20 2293 2380 / 3438 / 3430 Fax : +91 20 2293 2165