



ESOP Direct

Whitepaper

Impact of New Accounting Rules on Employee Stock Options

1 Introduction

The Institute of Chartered Accountants of India (ICAI) along with the National Advisory Committee on Accounting Standards has chosen to adopt convergence with IFRS as opposed to embracing the same as-is. ICAI has modified the IFRS by issuing the Indian Accounting Standards (IND AS), keeping in view the legitimate, administrative and financial environment in India.

As per the notification issued by the Ministry of Corporate Affairs, **Companies (Indian Accounting Standards) Rules, 2015** (here in after referred as “New Rules”) has come into effect from April 01, 2015.

Accounting for Share based payment transactions (for simplicity referred to as ESOP accounting in this Newsletter), is addressed in IND AS 102. As in the case of other aspects of accounting, impact due to change in ESOP accounting, will also be significant and calls for detail analysis and scrutiny. At a broader level it also calls for reviewing the entire strategy and thinking around Equity based compensation, the instrument, quantum and design.

The impact this change will have on the financial statements needs to be addressed from multiple dimensions:

- What does IND AS 102 prescribe? How are the companies expected to transition?
- How do my Accounts get impacted by the existing schemes?
- Do I need to relook at the Plan design while making Grants in future?
- What are drivers that would decide my future course of action?
- How have companies globally handled the transition and accounting impact?

We will address all these and other relevant issues in a series of Newsletters and Webinars in the coming couple of months.

In this Newsletter we are focusing on the impact of the provisions and transition on Company's financial statements.

2 IND AS 102 vis-à-vis SEBI Guidelines and ICAI's Guidance Note

Some of the differences between the IND AS 102, SEBI Guidelines and ICAI's Guidance Note are as follows:

Particulars	IND AS 102	SEBI Guidelines	Guidance Note
Method of Accounting	Requires Fair Value method of accounting and in exceptional situations allows Intrinsic Value method, where companies are not in a position to calculate Fair Value of the Options.	Allows both Intrinsic and Fair Value method of Accounting.	Allows both Intrinsic and Fair Value method of Accounting.
Reversal of Cost for cancelled options	Requires reversal of cost for Unvested cancelled Options only	Allows reversal of cost for both Vested and Unvested Options cancelled.	Allows reversal of cost for Unvested cancelled Options.
Amortization of Cost	Graded Vesting method is required for amortization of cost over vesting period	Allows both graded and Straight Line Method for amortization of cost	Allows both graded and Straight Line Method for amortization of cost
Accounting Entry	No need to create Deferred Compensation account	Deferred Compensation is required to be created at the time of grant.	No need to create Deferred Compensation account
Disclosure Requirement	Impact on Basic and Diluted EPS is required to be disclosed	Impact on Basic and Diluted EPS is required to be disclosed	Impact on Basic and Diluted EPS is required to be disclosed
Consolidation of ESOP Trust	Consolidation required with the Company	As per Expert Advisory Opinion Consolidation is required.	Does not require Consolidation of Trust with the Company.

Significant impact of IND AS 102 would be on the way ESOP cost is calculated. While almost all the Indian companies hitherto used the Intrinsic value method and disclose the impact of Fair value, going forward the Accounting will have to be done using the Fair value method. In other words, what was so far disclosed in the Notes to Accounts will now hit the P&L. The Balance Sheet impact would continue to remain same – the charge will be added to Share Premium in the Reserves.

The requirement to follow only Graded vesting method, will impact the timing of the charge. While in a straight line method, the charge was equated over the vesting period, under the Graded vesting it will be front ended, with almost half of the charge hitting in the first year.

For those companies having Trusts to administer the Plans, consolidation of Trust accounts with the Company statements, would now be mandatory.

3 Impact of the changes on Financial statements

New provisions will impact the existing outstanding Grants as well as new Grants under the existing schemes. The real impact would depend on the exercise price at which Grants have been made or share-holder approvals taken. Generically it can be said that the incremental impact will be high if the existing Grants are at Market price with Intrinsic Value accounting.

With respect to the new Grants under the existing schemes, companies will need to evaluate the impact vis-à-vis designing a new plan within the framework of SEBI Regulations / Companies Act that would reduce the accounting charge without compromising the attractiveness to the employees.

It is however certain that going forward, accounting implications will be the key determinant while designing the Plan features.

Detail analysis of the impact and transition process is explained in the following paras.

4 Transition from SEBI Guidelines / Guidance Note to IND AS 102

The ICAI issued IND AS 101, which deals with the first time adoption of IND AS. First time adoption has its own challenges. One has to prepare an opening IND AS Balance Sheet on the date of transition. This is the starting point for adopting IND AS.

IND AS 102 – Share based payment transactions Para D2 of IND AS 101 has given the prospective effect of IND AS 102, and only encourage the retrospective effect of IND AS 102.

IND AS 102 will not apply to Options that are vested before the transition date and will be applicable for the Unvested Options on the date of transition.

Illustration

Company A has granted 1,000 options on January 01, 2013 with 25% vesting each year. The vesting schedule is as follows:

January 01, 2013	January 01, 2014	January 01, 2015	January 01, 2016	January 01, 2017
Options Granted	Vest - I	Vest - II	Vest - III	Vest - IV
1,000	250	250	250	250

Say, the Company was following the Intrinsic Value method of accounting is now adopting IND AS from April 01, 2016.

Status of the options as on April 01, 2016 :

Vested Options – 750 Options

Unvested Options – 250 Options

As the Company has already accounted for the options vested as on the transition date under earlier method of accounting, no additional recognition of accounting cost is required for the same. The additional recognition of accounting cost will be applicable only for unvested options i.e. 250 Options.

Following points should be considered by the Companies at the time of transition:

- 1) Vest-wise Fair Value of the Options for Accounting;
- 2) Graded Vesting Method;
- 3) Accounting charge till the time of Transition under Fair Value method; and
- 4) Forfeiture Rate for cancellation of Unvested Options.

5 Illustrative Scenarios

5.1. Company “A” is following Intrinsic Value Method of Accounting

1) Company has granted 1,000 Options to the employees. And all Options were vested before the date of Transition.

No action is required as there were no unvested options on the date of transition.

2) Company has granted 1,000 Options to the employees, with a Vesting Schedule of 50% each year. On the date of transition, 500 Options have been Vested and 500 Options are Unvested. Exercise Price is equal to Market price as on the date of the grant, hence, there is no accounting charge under Intrinsic Value Method, with the following assumptions:

March 31, 2015	March 31, 2016	March 31, 2017
Options Granted	Vest - I	Vest - II
1000	500	500
Intrinsic Value	Nil	Nil
Fair Value	45	55

If Transition Date is April 01, 2016

The Company has to calculate the cost that is required to be amortized, if they follow Fair Value Method with Graded Vesting.

Particulars	March 31, 2016	March 31, 2017	Total
Options Granted	Vest - I	Vest - II	
1000	500	500	1000
Intrinsic Value	Nil	Nil	-
Total Intrinsic Value cost	Nil	Nil	
Fair Value	45	55	-
Total Fair Value cost	22,500	27,500	50,000
Cost Amortized till Transition date	22,500	13,750	36,250
Cost needed to be amortized under IND AS 102	Nil	13,750	13,750

A first time adopter may choose not to apply IND AS 102 to equity instruments that are vested before the date of transition. Hence, cost not amortized till the time of transition is required to be considered.

3) Company has granted 1,000 Options to the employees. Other terms are same as per above illustration except for the exercise price, which is at a discount to the Market Price on the date of grant, with the following other assumptions:

March 31, 2015	March 31, 2016	March 31, 2017
Options Granted	Vest - I	Vest - II
1000	500	500
Intrinsic Value	30	30
Fair Value	65	75

If Transition Date is April 01, 2016

Company has to calculate the cost under Fair Value with Graded Vesting:

Particulars	March 31, 2016	March 31, 2017	Total
Options Granted	Vest - I	Vest - II	
1000	500	500	1000
Intrinsic Value	30	30	-
Total Intrinsic Value cost	15,000	15,000	30,000
Cost Amortized till Transition date using Straight Line Method	15,000	-	15,000
Fair Value	65	75	-
Total Fair Value cost	32,500	37,500	70,000
Cost Amortized till Transition date	32,500	18,750	51,250
Cost needed to be amortized under IND AS 102	Nil	18,750	18,750

Please note that application of IND AS 102 has prospective effect, hence, only cost not amortized till the time of transition is required to be considered in Profit and Loss Account. In the above illustration, the Company needs to amortize Rs. 18,750 instead of 15,000.

5.2. Company “A” is following Fair Value Method of Accounting

1) Company has granted 1,000 Options to the employees. And all Options were vested before the date of Transition.

No action is required as there were no unvested options on the date of transition.

2) Company has granted 1,000 Options to the employees, with a Vesting Schedule of 50% each year. On the date of transition, 500 Options have been Vested and 500 Options are Unvested. Company is following graded vesting for amortization of cost.

No action is required as Company is already following the principles required in IND AS 102.

3) Company has granted 1,000 Options to the employees, with a Vesting Schedule of 50% each year. On the date of transition, 500 Options have been Vested and 500 Options are Unvested. Company is following Straight line method for amortization of cost.

March 31, 2015	March 31, 2016	March 31, 2017
Options Granted	Vest - I	Vest - II
1000	500	500
Intrinsic Value	30	30
Fair Value	65	75

Transition Date is April 01, 2016

Company has to calculate the cost under Fair Value with Graded Vesting:

Particulars	March 31, 2016	March 31, 2017	Total
Options Granted	Vest - I	Vest - II	
1000	500	500	1000
Fair Value	65	75	-
Total Fair Value cost	32,500	37,500	70,000
Cost Amortized till Transition date using Straight Line Method	35,000	35,000	70,000
Cost Amortized if IND AS 102 followed earlier – till transition date	32,500	18,750	51,250
Cost needed to be amortized under IND AS 102	Nil	18,750	18,750

In the above illustration, the Company needs to amortize Rs. 18,750 instead of 35,000.

6 Conclusion

Accounting for Share based payment transactions under IND AS 102 will bring Reporting by Indian companies on par with global standards. As explained above there is no generic answer as to whether this change will impact the financial statements favourably or adversely. The impact needs to be assessed based on the historical grants and data as on the transition date.

Going forward we feel companies will evaluate the accounting impact more carefully before deciding on the instrument.

Fair value accounting has been mandatory in the US and Europe for several years. When the transition happened in those geographies, companies structured their instruments in such a way that accounting charge was not abnormal. Instruments such as RSUs, SARs became more popular as a result of these changes. Indian companies also need to re-calibrate their Equity compensation strategies to address the change.

In the Newsletters that follow we shall be deliberating on some such responses, companies could evaluate.

We hope that you find the information in this newsletter useful in understanding the newly announced accounting rules on ESOPs. In addition, you should be aware that the information provided in the newsletter is presented in a general format and is not a comprehensive summary. With these factors in mind, it is important that you do not consider this note to be legal advice, and do not rely solely on the information provided in the newsletter. We would be pleased to help you review all pertinent information and can assist you in ESOP accounting compliance or in developing a comprehensive strategy to implement Share based employee benefits plan vis-à-vis new accounting rules.

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About ESOP Direct

We are a leading solutions company in the space of equity based compensation. ESOP Direct is a part of the Kirtane Pandit Group comprising the flagship accounting and consulting firm established more than five decades ago, a software services company and a business process consulting company.

As a group, we operate globally through subsidiaries in US, UK, Germany, France and Poland and strategic alliances in over 100 countries.

ESOP Direct has a team of professionals with experience in preliminary analysis, planning, designing and implementation of ESOPs. Each of our consulting team members is a qualified Chartered Accountant/Company Secretary. The team also consists of CPAs and Management graduates including qualified CEPs (Certified Equity Professional) on board. CEP is a US qualification highly recognized in Equity based compensation space globally.

About Our Services

Our service offerings spans the entire life cycle of ESOPs including Plan conceptualization, design, documentation, Plan management, participant services, compliance and reporting. We are the first and the only company in India to offer the full spectrum of integrated on-line stock plan management services., We also offer a web based platform MyEsops, for financial reporting of stock options which includes valuation , expensing and reporting under IFRS, IGAAP & FAS 123R.

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