ESOP Accounting and Disclosure as per ICAI Guidance Note

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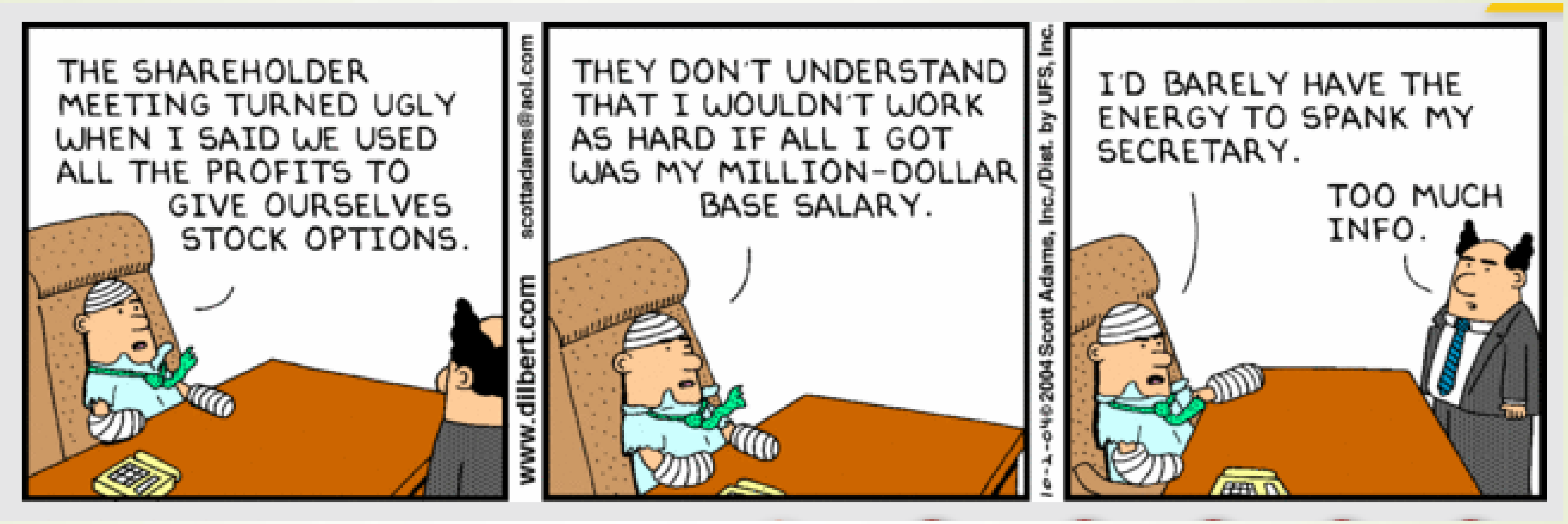
Agenda

- Guidance Note – Key terms
- Guidance Note – Categories and details
- Guidance Note – Intrinsic Value
- Guidance Note – EPS and Disclosure
- ESOPs – Journey in Corporate
- Discussion

Oohh!! Options!!



If the need of the hour is employee options,
Accounting for it cannot be far behind

Guidance Note – Key terms

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- Employee Stock Option is a contract that gives the employees of the enterprise the right, but not the obligation, for a specified period of time to purchase or subscribe to the shares of the enterprise at a fixed or determinable price.
- Employee Stock Option Plan is a plan under which the enterprise grants Employee Stock Options.
- Employee Stock Purchase Plan is a plan under which the enterprise offers shares to its employees as part of a public issue or otherwise.
- Fair Value is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm's length transaction.
- Intrinsic Value is the amount by which the quoted market price of the underlying share in case of a listed enterprise or the value of the underlying share determined by an independent valuer in case of an unlisted enterprise, exceeds the exercise price of an option.

Guidance Note – Categories and Details

Guidance Note – Categories

- Equity-settled: Under these plans, the employees receive shares.
- Cash-settled: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.
- Employee share-based payment plans with cash alternatives: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

Guidance Note – Equity-settled

- **<u>Step 1:</u>** Determining Fair Value of Shares
  - Market prices (with similar terms and conditions)
  - Option Pricing model
  - Models consider
      - the exercise price of the option;
      - the life of the option;
      - the current price of the underlying shares;
      - the expected volatility of the share price;
      - the dividends expected on the shares (if appropriate); and
      - the risk-free interest rate for the life of the option
  - Base for estimates of volatility, exercise behavior and dividends should not be only on historical information without considering the extent to which the past experience is expected to be reasonably predictive of future experience
    - Expected early exercise
    - Expected volatility
      - Newly listed enterprises
      - Unlisted enterprises
    - Expected dividends
    - Risk free interest rate
    - Capital structure effects (potential dilutive effect)

Guidance Note – Equity-settled

- **Step 2:** Recognizing the expense
  - Fair market value is expensed over the period of services received
    - Vesting period
- **Step 3:** Vesting and exercise
  - Issue of shares on receipt of exercise price
    - Consideration
    - Amount in the credit of relevant equity account

Guidance Note – Exceptions

- **<u>Modifications:</u>**
  - Increases the fair value of the options
      - By reducing the exercise price
      - By increasing the number of options granted
      - By reducing vesting period
    - The effects of modification should be recognized
  - Decreases the fair value of the options
    - Should not take in account the decrease in fair value
- **<u>Cancellation/Settlement:</u>**
  - Treated as acceleration of vesting
    - Recognize immediately the services over the remaining period
  - Payments on settlement to be deducted from relevant equity account
- **<u>Lapse:</u>**
  - To be taken to General Reserve

Guidance Note – Cash-settled

- Employees will become entitled to a future cash payment (rather than shares), based on the increase in the share price of the enterprise from a specified level over a specified period of time
  - Recognize as an expense
  - At the fair value of the liability
  - Remeasure the liability at each reporting date, until settled

Guidance Note – Share based with Cash alternative

- Employees granted the right to choose whether a share-based payment plan is settled in cash or by issuing shares
  - Measure, on the grant date, fair value of the employee share-based payment plan presuming that all employees will exercise their option in favor of cash settlement
  - The fair value so arrived at should be considered as the fair value of the liability component
  - The enterprise should also measure the fair value of the employee share-based payment plan presuming that all employees will exercise their option in favor of equity settlement
  - In case the fair value under equity- settlement is greater than the fair value under cash-settlement, the excess should be considered as the fair value of the equity component
  - Otherwise, the fair value of the equity component should be considered as zero

Guidance Note – Ownership percentage

- Lets say company A and company B are both, after lots of hard work, worth $10 billion.
- Long ago Ajay went to work at company A and Bijay went to work at company B.
- Ajay was disappointed that he only got 5,000 options, and they were granted at a price of $4 each. Bijay was very happy – he was granted 50,000 options at only 20 cents each. Who got the better deal?

Guidance Note – Ownership percentage

- Lets say company A had 25,000,000 shares outstanding, and company B had 500,000,000 shares outstanding.
- After many years and 50% dilution in each case, company A has 50,000,000 shares outstanding so they are worth $200 each and Ajay has made a profit of $980,000 on his options ($1 million value minus $20,000 exercise cost).
- Company B has 1 billion shares outstanding, so they are worth $10 each. Bijay's options net him a profit of $9.80 each, for a total profit of $490,000. So while Bijay had more options at a lower exercise price, he made less money when his company achieved the same outcome.

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Guidance Note – Intrinsic Value Method

- Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option
  - If the quoted market price is not available on the grant date then the share price nearest to that date is taken
  - In the case of a non- listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer

Guidance Note – EPS & Disclosure

- **EPS**
- Stock Options should not be included in the shares outstanding till the employees have exercised their right to obtain shares or stock options, after fulfilling the requisite vesting conditions.
- Stock options so granted should be considered as dilutive potential equity shares for the purpose of calculating Diluted Earnings Per Share
  - Diluted Earnings Per Share should be based on the actual number of shares or stock options granted and not yet forfeited, unless doing so would be anti-dilutive.

Guidance Note – EPS & Disclosure

- **Disclosure**
- Method used
  - If Intrinsic value, impact of fair value to be disclosed
- Description of each type of employee share-based payment plan that existed at any time during the period, including the general terms and conditions of each plan, such as vesting requirements, the maximum term of options granted, and the method of settlement
- the number and weighted average exercise prices of stock options for each of the following groups of options:
  - outstanding at the beginning of the period;
  - granted during the period;
  - forfeited during the period;
  - exercised during the period;
  - expired during the period;
  - outstanding at the end of the period; and
  - exercisable at the end of the period
- For stock options exercised, the weighted average share price
- For stock options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life

ESOPs – Journey in Corporate

- Board
- Shareholders
- Secretarial
- Accounting

- Employee
- Secretarial
- Accounting

- Approve the scheme
- Approve the scheme
- Framework
- Arrive at Fair Value
- Expense accounting
- Avail/exercise
- Allotment of shares
- Allocate equity and premium