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 4 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.

## About Qapita

Qapita is a leading provider of Equity Compensation solutions for startups, unlisted and publicly listed companies. Our service offerings cover the entire life cycle of ESOPs including Plan conceptualization, Design, Documentation, Plan management, Compliance and Reporting. We have serviced over 1800+ clients across all industries, domestic and international, listed and unlisted. Our team consists of experienced professionals specialising in conducting preliminary analysis, planning, designing, and implementing ESOPs. Each of our consulting team members is a qualified Chartered Accountant/ Company Secretary, a market leader in Equity Management and Marketplace solutions for unlisted and listed companies in India and South East Asia.

## Get in touch with us


**www.qapita.com**

**+91 86002 63374**

**info@qapita.com**

**Pune | Mumbai | Hyderabad | Bengaluru | Chennai | Delhi | Singapore**