CHAPTER 3

ACCOUNTING FOR EMPLOYEE STOCK OPTION PLANS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the concept and need for Employee Stock Option Plans.
- Learn the accounting treatment of Employee Stock Option Plans.
- Understand the provisions of Guidance Note on Accounting for Share-Based Payments dealing with Employee Stock Option Plans.

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CHAPTER OVERVIEW

- **In a number of countries, shares and share options comprise a significant element of the total remuneration package of senior personnel; a trend encouraged by the current consensus that it is a matter of good corporate governance to promote significant long-term shareholdings by senior management, so as to align their economic interests with those of shareholders. Such plans generally take the forms of Employee Stock Option Plans (ESOPs), Employee Stock Purchase Plans (ESPPs) and Stock Appreciation Rights (SARs).**
- **ESOPs are plans under which an enterprise grants options for a specified period to its employees to purchase its shares at a fixed or determinable price. One advantage of ESOPs as remuneration is that they need not entail any cash cost to the enterprise.**
- **The Guidance Note on Accounting for share based payments established accounting principles for all share based plans including ESOPs.**
- **Unlisted companies, in particular, start-up companies, often give share-based compensation since they cannot afford to pay high salaries to their employees but are willing to share the future prosperity of the company. Several companies also offer share-based payments to non-employees, including various vendors. It is hence important that cost relating to these recognised in the financial statements.**
- **As per Accounting Standard 20, stock options granted pursuant to an employee share-based payment plan, should not be included in the shares outstanding till the time employees have exercised their right to obtain shares or stock options.**
- **There are two methods of valuation for Share Based Payments viz, fair value method or intrinsic value method. The Guidance Note on Accounting for Share Based Payments ("Guidance Note") recommends using fair value method.**
- **For accounting purposes, ESOPs are classified as equity settled, cash settled and plans with cash alternatives.**

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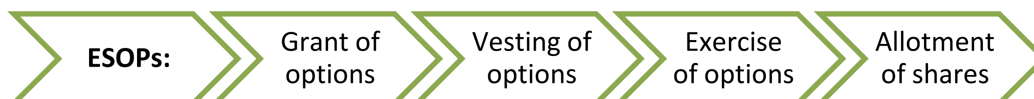
1. EMPLOYEE STOCK OPTION PLANS (ESOP)

ESOP is a plan under which the Company grants employees stock option. Employee Stock Option is a plan that gives the employees of the company, the option for a specified period of time to purchase or subscribe to the shares of the company, at a fixed determinable price.



Under the Companies Act 2013, where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares may be offered to employees under a scheme of employees' stock option, subject to a special resolution passed by the company and subject to such conditions as may be prescribed.

The SEBI (Share Based Employee Benefits) Regulations, 2014 (applicable for listed companies) cover the provisions regarding accounting policies, pricing, disclosures, administration and implementation process of various schemes and other issues relating to Employee Stock Option Scheme (ESOS), Employee Stock Purchase Scheme (ESPS), Stock Appreciation Rights Scheme (SRS), General Employee Benefits Scheme (GEBS) and Retirement Benefit Scheme (RBS). The Regulations stipulate to follow the requirements of the Guidance Note on Accounting for Share Based Payments or Accounting Standards as may be prescribed by the ICAI from time to time including the disclosure requirements prescribed therein.

*A **Share-based payment arrangement*** is 'an agreement between the enterprise (or another group enterprise or any shareholder of any group enterprise) and another party (including an employee) that entitles the other party to receive:

(a) Cash or other assets of the enterprise for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the enterprise or another group enterprise, or

(b) Equity instruments (including shares or share options) of the enterprise or another group enterprise, provided the specified vesting conditions, if any, are met.'

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A share-based payment transaction is 'a transaction in which the enterprise.

(a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement, or

(b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group enterprise receives those goods or services.

The Guidance Note on Accounting for Share Based Payments[1] (2020) is applicable for accounting of ESOPs for all enterprises that are not required to follow Indian Accounting Standards. The provisions of the Guidance Note cover employee stock option plans the grant date in respect of which falls on or after 1 April 2021. An enterprise is not required to apply this Guidance Note to employee stock option plans to equity instruments that are not fully vested as at 1 April 2021. Though the scope of Guidance Note on Accounting for Share Based Payments (may be referred as the Guidance Note in this chapter hereafter) is not restricted to transactions with employees; for the purposes of this chapter, our discussion is restricted to transactions with employees only.

Important terms to be remembered:

Exercise means making of an application by the counterparty for issue of equity instruments (including shares or share options) against the option vested in pursuance of employee stock option plan.

Share option is a contract that gives the holder the right, but not the obligation, to subscribe to the enterprise's shares at a fixed or determinable price for a specified period of time.

Exercise Period is the time period after vesting within which the counterparty should exercise his/her/its right to apply for equity instruments (including shares or share options) against the option vested in him in pursuance of the employee stock option plan.

Expected Life of an Option is the period of time from grant date to the date on which an option is expected to be exercised.

[1] *Pursuant to the issue of Guidance Note on Accounting for Share Based Payments in year 2020, the earlier "Guidance Note on Accounting for Employee Share-based Payments" stands withdrawn.*

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Exercise Price is the price payable by the counterparty for exercising the option granted to him/her/it in pursuance of the employee stock option plan.

Fair Value is the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

Grant Date is the date at which the enterprise and an employee agree to a employee stock option plan, being when the enterprise and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date, the enterprise confers on the counterparty the right to cash, other assets, or equity instruments of the enterprise, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

Measurement date is the date at which the fair value of the equity instruments granted is measured for the purposes of this Guidance Note. For transactions with employees, the measurement date is grant date.

Intrinsic Value is the difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares. For example, a share option with an exercise price of ₹ 15, on a share with a fair value of ₹ 20, has an intrinsic value of ₹ 5.

Share option is a contract that gives the holder the right, but not the obligation, to subscribe to the enterprise's shares at a fixed or determinable price for a specified period of time.

Stock Appreciation Rights are the rights that entitle the employees to receive cash or shares for an amount equivalent to any excess of the market value of a stated number of enterprise's shares over a stated price.

Vest means to become an entitlement. Under an employee stock option plan, an employee's right to receive cash, other assets or equity instruments of the enterprise vests when the employee's entitlement is no longer conditional on the satisfaction of any vesting conditions.

Vesting Period is the period during which all the specified vesting conditions of an employee stock option plan are to be satisfied.

Volatility is a measure of the amount by which a price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The

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volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period.

Equity: It is the residual interest in the assets of an enterprise after deducting all its liabilities.

Why ESOPs?

- Link personal wealth creation to organizational creation
- Attract, reward, motivate and retain talent at the start-up/growth stage
- Deferred compensation strategy and good retirement benefit plan
- Reduction in cash costs – market pays not the Company
- Can be especially important for start-up Companies that are cash starved
- Promote employee ownership culture
- Helpful tool in cash crunch – In case of economic slow-down where companies are low at cash, they can motivate employee by offering ESOPs.

Unlisted companies, in particular, start-up companies, often give share-based compensation since they cannot afford to pay high salaries to their employees but are willing to share the future prosperity of the company. It is hence important that cost relating to these stock option plans get recognised in the financial statements.

What Company sees while granting ESOPs to employees?

- Loyalty, Performance and Designation
- Present and Potential Contribution
- Opportunity Cost

The importance of Employee Stock Option Plan lies in the following advantages which accrue to both the company and the employees:

1. Stock options provide an opportunity to employees to participate and contribute in the growth of the company.
2. Stock options create long term wealth in the hands of the employees.
3. They are important means to attract, retain and motivate the best available talent for the company.
4. It creates a common sense of ownership between the company and its employees.

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1.1 Provisions of Guidance Note on Accounting for Share-Based Payments

Scope of the Guidance Note establishes financial accounting and reporting principles for ESOPs. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

The Guidance Note must be applied to all employee share based plans, including:

(a) equity-settled share-based payment transactions;

(b) cash-settled share-based payment transactions; and

(c) transactions where either the enterprise or the supplier of goods or services can choose whether the transaction is to be equity- settled or cash-settled.

The Scope of this Guidance Note extends to employee stock option plans between group enterprises. Within a group of companies, it is common for one member of the group (typically the parent) to have the obligation to settle an employee stock option plan in which services are provided to another member of the group (typically a subsidiary). This transaction is within the scope of this Guidance Note for the enterprise receiving the services (even though it is not a direct party to the arrangement between its parent and its employee), the enterprise settling the transaction and the group as a whole. Accordingly, this Guidance Note requires an enterprise to account for a transaction in which it either:

- receives goods or services when another enterprise in the same group (or a shareholder of any group enterprise) has the obligation to settle the employee stock option plan, or
- has an obligation to settle an employee stock option plan when another enterprise in the same group receives the services unless the purpose of the transaction is other than payment for services supplied to the enterprise receiving them.

For the purposes of this Guidance Note, a transaction with an employee in his/her capacity as a holder of shares of the enterprise is not an employee stock option plan .

Example

If an enterprise grants all holders of a particular class of its shares, the right to acquire additional shares or stock options of the enterprise at a price that is less than the fair value of those shares or stock options, and the holder receives such a

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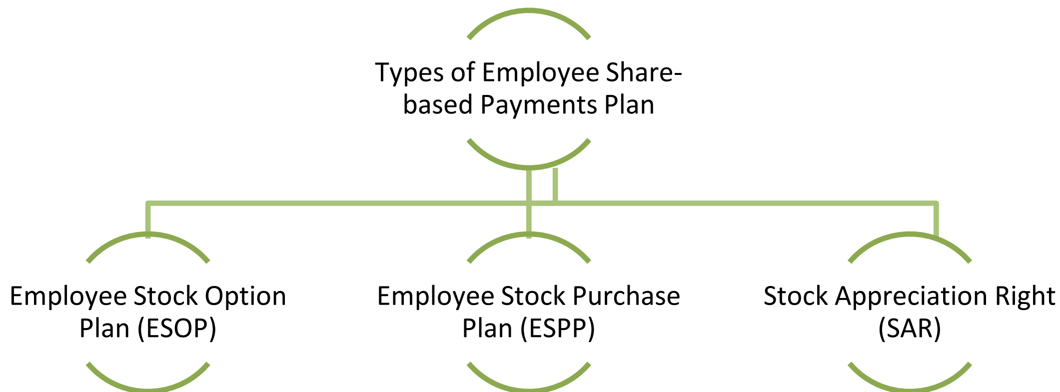
right because he/she is a holder of shares or stock options of that particular class, the granting or exercise of that right is not subject to the requirements of this Guidance Note.



Classification of ESOPs for accounting purpose:

For **accounting purposes**, ESOPs are classified into the following categories:

- **Equity-settled** employee stock option plan is an employee stock option plan in which the enterprise receives services as consideration for its own equity instruments (including shares or share options), or receives services but has no obligation to settle the transaction with the employee.
- **Cash-settled** employee stock option plan is an employee stock option plan in which the enterprise acquires services by incurring a liability to transfer cash or other assets to the employee for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the enterprise or another group enterprise.
- **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.

Accounting Procedure

An employee stock option plan within the scope for this Guidance Note can be accounted for by adopting the fair value method or the intrinsic value method. The accounting treatment recommended herein below is based on the fair value method as the Guidance Note recommends that accounting for share-based payment plans should be based on the fair value approach.

An enterprise shall recognise the services received in an employee stock option plan when the services are received. The enterprise shall recognise a corresponding increase in equity if the services were received in an equity-settled employee stock option plan, or a liability if the services were received in a cash-settled employee stock option plan. This account resulting from equity increase in an equity-settled employee stock option plan is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as per this Guidance Note.

When the services received in an employee stock option plan do not qualify for recognition as assets, they shall be recognised as expenses.

Equity-settled employee stock option plan

For equity-settled employee stock option plan, the enterprise shall measure the services received, and the corresponding increase in equity, directly, at the fair value of the services received, unless that fair value cannot be estimated reliably. If the enterprise cannot estimate reliably the fair value of the services received, the enterprise shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

Because of the difficulty of measuring directly the fair value of the services received, the enterprise shall measure the fair value of the employee services received by reference to the fair value of the equity instruments granted.

If the equity instruments granted vest immediately, the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to those equity instruments. In the absence of evidence to the contrary, the enterprise shall presume that services rendered by the counterparty as consideration for the equity instruments have been received. In this case, on grant date the enterprise shall recognise the services received in full, with a corresponding increase in equity.

If the equity instruments granted do not vest until the counterparty completes a specified period of service, the enterprise should presume that the services to be rendered by the counterparty as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account. For example:

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(a) if an employee is granted share options conditional upon completing three years' service, then the enterprise shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over that three-year vesting period.

(b) if an employee is granted share options conditional upon the achievement of a performance condition and remaining in the enterprise's employment until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the enterprise shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over the expected vesting period. The enterprise shall estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period shall be consistent with the assumptions used in estimating the fair value of the options granted and shall not be subsequently revised. If the performance condition is not a market condition, the enterprise shall revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

To apply the requirements of the Guidance Note for the purpose of employee stock option plans, the enterprise should recognize an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest. Market conditions, such as a target share price upon which vesting (or right to exercise) is conditioned, should be considered when estimating the fair value of the shares or stock options granted. On exercise of the right to obtain shares or stock options, the enterprise issues share on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

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Vesting Conditions and Non-Vesting Conditions

Vesting Condition is a condition that determines whether the enterprise receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the enterprise, under an employee stock option plan. A vesting condition is either a service condition or a performance condition.

Market Condition is a performance condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price (or value) of the enterprise's equity instruments (or the equity instruments of another enterprise in the same group), such as:

(a) attaining a specified share price or a specified amount of intrinsic value of a share option; or

(b) achieving a specified target that is based on the market price (or value) of the enterprise's equity instruments (or the equity instruments of another enterprise in the same group) relative to an index of market prices of equity instruments of other enterprises.

A market condition requires the counterparty to complete a specified period of service (i.e. a service condition); the service requirement can be explicit or implicit.

Performance condition is a vesting condition that requires:

(a) the counterparty to complete a specified period of service (i.e. a service condition); the service requirement can be explicit or implicit; and

(b) specified performance target(s) to be met while the counterparty is rendering the service required in (a).

The period of achieving the performance target(s):

(a) shall not extend beyond the end of the service period; and

(b) may start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period.

A performance target is defined by reference to:

(a) the enterprise's own operations (or activities) or the operations or activities of another enterprise in the same group (i.e. a non-market condition); or

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(b) the price (or value) of the enterprise's equity instruments or the equity instruments of another enterprise in the same group (including shares and share options) (i.e. a market condition).

A performance target might relate either to the performance of the enterprise as a whole or to some part of the enterprise (or part of the group), such as a division or an individual employee.

Treatment of vesting conditions

A grant of equity instruments might be conditional upon satisfying specified vesting conditions. For example, a grant of shares or share options to an employee is typically conditional on the employee remaining in the enterprise's employment for a specified period of time. There might be performance conditions that must be satisfied, such as the enterprise achieving a specified growth in profit or a specified increase in the enterprise's share price. Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognised for services received if the equity instruments granted do not vest because of failure to satisfy a vesting condition, e.g. the counterparty fails to complete a specified service period, or a performance condition is not satisfied, subject to the requirements in relation to market conditions given below.

To apply the above mentioned requirements, the enterprise shall recognise an amount for the services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the enterprise shall revise the estimate to equal the number of equity instruments that ultimately vested, subject to the requirements in relation to market conditions given below.

Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, shall be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the enterprise shall recognise the services received from a

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counterparty who satisfies all other vesting conditions (e.g. services received from an employee who remains in service for the specified period of service), irrespective of whether that market condition is satisfied.

Treatment of non-vesting conditions

Similarly, an enterprise shall take into account all non-vesting conditions when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with non-vesting conditions, the enterprise shall recognise the services received from a counterparty that satisfies all vesting conditions that are not market conditions (e.g. services received from an employee who remains in service for the specified period of service), irrespective of whether those non-vesting conditions are satisfied.

Treatment after the vesting date

Having recognized the services received in accordance with the provisions of the Guidance Note, and a corresponding increase in equity, the enterprise shall make no subsequent adjustment to total equity after vesting date. For example, the enterprise shall not subsequently reverse the amount recognised for services received from an employee if the vested equity instruments are later forfeited or, in the case of share options, the options are not exercised. However, this requirement does not preclude the enterprise from recognising a transfer within equity, i.e. a transfer from one component of equity to another.

Graded Vesting

In case the options/shares granted under a share-based payment arrangement do not vest on one date but have graded vesting schedule, total plan should be segregated into different groups, depending upon the vesting dates.

Example: Suppose an employee is granted 100 options which will vest @ 25 options per year at the end of the third, fourth, fifth and sixth years. In such a case, each tranche of 25 options would be evaluated and accounted for separately.

Accounting Treatment: Each of such groups would be having different vesting period and expected life and, therefore, each vesting date should be considered as a separate option grant and accounted for accordingly.

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If the fair value of the equity instruments cannot be estimated reliably

In rare cases when the enterprise may be unable to estimate reliably the fair value of the equity instruments granted at the measurement date, the enterprise shall instead:

(a) measure the equity instruments at their intrinsic value, initially at the date the counterparty renders service and subsequently at the end of each reporting period and at the date of final settlement, with any change in intrinsic value recognised in profit or loss. For a grant of share options, the employee stock option plan is finally settled when the options are exercised, are forfeited (e.g. upon cessation of employment) or lapse (e.g. at the end of the option's life).

(b) recognise the services received based on the number of equity instruments that ultimately vest or (where applicable) are ultimately exercised.

The enterprise shall revise that estimate, if necessary, if subsequent information indicates that the number of share options expected to vest differs from previous estimates. On vesting date, the enterprise shall revise the estimate to equal the number of equity instruments that ultimately vested. After vesting date, the enterprise shall reverse the amount recognised for services received if the share options are later forfeited or lapse at the end of the share option's life.

Modifications to the terms and conditions on which equity instruments were granted, including cancellations and settlements

An enterprise might modify the terms and conditions on which the shares or stock options were granted. For example, it might reduce the exercise price of options granted to employees (i.e., reprice the options), which increases the fair value of those options.

The enterprise shall recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments 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 any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments. In addition, the enterprise shall recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee.

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If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) the enterprise shall account for the cancellation or settlement as an acceleration of vesting and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

(b) any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, i.e. as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense. However, if the employee stock option plan included liability components, the enterprise shall premeasure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability.

(c) if new equity instruments are granted to the employee and, on the date when those new equity instruments are granted, the enterprise identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the enterprise shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments. The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments, at the date the replacement equity instruments are granted. The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity in accordance with (b) above. If the enterprise does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the enterprise shall account for those new equity instruments as a new grant of equity instruments.

Cash-settled employee stock option plans

For cash-settled employee stock option plans, the enterprise shall measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise shall premeasure the fair value of the liability at

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the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period.

For example, an enterprise might grant share appreciation rights to employees as part of their remuneration package, whereby the employees will become entitled to a future cash payment (rather than an equity instrument), based on the increase in the enterprise's share price from a specified level over a specified period of time. Or an enterprise might grant to its employees a right to receive a future cash payment by granting to them a right to shares (including shares to be issued upon the exercise of share options) that are redeemable, either mandatorily (e.g. upon cessation of employment) or at the employee's option.

Employee stock option plans with cash alternatives

For employee stock option plans in which the terms of the arrangement provide either the enterprise or the counterparty with the choice of whether the enterprise settles the transaction in cash (or other assets) or by issuing equity instruments, the enterprise shall account for that transaction, or the components of that transaction, as a cash settled share- based payment transaction if, and to the extent that, the enterprise has incurred a liability to settle in cash or other assets, or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

Employee stock option plans in which the terms of the arrangement provide the counterparty with a choice of Settlement

If an enterprise has granted the counterparty the right to choose whether a stock option plan is settled in cash or by issuing equity instruments, the plan has two components which includes a debt component (i.e. the counterparty's right to demand payment in cash) and an equity component (i.e. the counterparty's right to demand settlement in equity instruments rather than in cash).

The enterprise shall measure the fair value of the employee stock option plan at the measurement date, taking into account the terms and conditions on which the rights to cash or equity instruments were granted.

The enterprise shall first measure the fair value of the debt component, and then measure the fair value of the equity component—taking into account that the counterparty must forfeit the right to receive cash in order to receive the equity instrument. The fair value of the employee stock option plan is the sum of the fair values of the two components. However, employee stock option plans in which the counterparty has the choice of settlement are often structured so that the fair value

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of one settlement alternative is the same as the other. For example, the counterparty might have the choice of receiving share options or cash settled share appreciation rights. In such cases, the fair value of the equity component is zero, and hence the fair value of the employee stock option plan is the same as the fair value of the debt component. Conversely, if the fair values of the settlement alternatives differ, the fair value of the equity component usually will be greater than zero, in which case the fair value of the employee stock option plan will be greater than the fair value of the debt component.

Employee stock option plans in which the terms of the arrangement provide the enterprise with a choice of settlement

For an employee stock option plan in which the terms of the arrangement provide an enterprise with the choice of whether to settle in cash or by issuing equity instruments, the enterprise shall determine whether it has a present obligation to settle in cash and account for the employee stock option plan accordingly. The enterprise has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance (e.g. because the enterprise is legally prohibited from issuing shares), or the enterprise has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement.

For example, an enterprise may have consistently adopted a policy in the past of granting ex gratia cash compensation to all those employees deemed to be 'good' leavers or all 'good' leavers belonging to certain seniority, in respect of partially vested share options. Such a scheme may be treated as cash-settled for the purposes of this Guidance Note to the extent to which there are expected to be such 'good' leavers during the vesting period.

Another example is that an enterprise having a stock option plan for all its employees and employees of all its foreign subsidiaries around the world. The enterprise may have an option for cash settlement which it always exercises in respect of awards to employees in jurisdictions where it is difficult or illegal to hold shares in the parent. Such a scheme should be treated as a cash-settled scheme in respect of those jurisdictions.

If the enterprise has a present obligation to settle in cash, it shall account for the transaction in accordance with the requirements applying to cash-settled employee stock option plans.

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If no such obligation exists, the enterprise shall account for the transaction in accordance with the requirements applying to equity-settled employee stock option plans.

Employee stock option plans among group enterprises

For employee stock option plans among group enterprises, in its separate or individual financial statements, the enterprise receiving the services shall measure the services received as either an equity-settled or a cash-settled employee stock option plan by assessing:

(a) the nature of the awards granted, and

(b) its own rights and obligations.

The amount recognised by the enterprise receiving the services may differ from the amount recognised by the consolidated group or by another group enterprise settling the employee stock option plan.

The enterprise receiving the services shall measure the services received as an equity-settled employee stock option plan when:

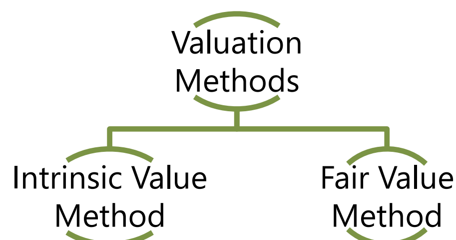
(a) the awards granted are its own equity instruments, or

(b) the enterprise has no obligation to settle the employee stock option plan.

The enterprise shall subsequently remeasure such an equity-settled employee stock option plan only for changes in non-market vesting conditions. In all other circumstances, the enterprise receiving the services shall measure the services received as a cash-settled employee stock option plan.

The enterprise settling a employee stock option plan when another enterprise in the group receives the services shall recognise the transaction as an equity-settled employee stock option plan only if it is settled in the enterprise's own equity instruments. Otherwise, the transaction shall be recognised as a cash-settled employee stock option plan.

Valuation methods – ESOPs



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It is recommended by the Guidance Note that accounting for employee stock option plans should be based on the fair value approach. However, intrinsic value method is also permitted.

Employee Stock Option Plans Administered through a Trust

An enterprise may administer an employee stock option plan through a trust constituted for this purpose. The trust may have different kinds of arrangements, for example, the following:

(a) The enterprise allots shares to the trust as and when the employees exercise stock options

(b) The enterprise provides finance to the trust for subscription to the shares issued by the enterprise at the beginning of the plan.

(c) The enterprise provides finance to the trust to purchase shares from the market at the beginning of the plan.

Since the trust administers the plan on behalf of the enterprise, it is recommended that irrespective of the arrangement for issuance of the shares under the employee stock option plan, the enterprise should recognise in its separate financial statements the expense on account of services received from the employees in accordance with the recommendations contained in this Guidance Note.

Disclosures

An enterprise should describe the method used to account for the employee stock option plans.

An enterprise should disclose at least the following in its financial statements :

(a) A description of each type of employee stock option 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 (e.g., whether in cash or equity). An enterprise with substantially similar types of plans may aggregate this information.

(b) the number and weighted average exercise prices of stock options for each of the following groups of options:

    (i) outstanding at the beginning of the period;

    (ii) granted during the period;

    (iii) forfeited during the period;

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(iv) exercised during the period;

(v) expired during the period;

(vi) outstanding at the end of the period; and

(vii) exercisable at the end of the period.

(c) for stock options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the enterprise may instead disclose the weighted average share price during the period.

(d) for stock options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life (comprising the vesting period and the exercise period). If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

Illustration 1

A Company has its share capital divided into shares of ₹ 10 each. On 1st April, 20X1 it granted 10,000 employees' stock options at ₹ 40, when the market price was ₹ 130. The fair value of options, calculated using an option pricing model, is ₹ 90 per option. The options were to be exercised between 15th March, 20X2 and 31st March, 20X2. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

Show Journal Entries.

Solution

Journal Entries

	Particulars	**Dr.** ₹	**Cr.** ₹
15th March 20X2 to 31st March	Bank A/c (9,500 x 40) Dr. Employee compensation expense A/c [9,500 x 90] Dr. To Equity share capital A/c (9,500 x 10)	3,80,000 8,55,000	 95,000

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20X2	To Securities premium A/c [9,500 x (130-10)] (Being allotment to employees of 9,500 equity shares of ₹ 10 each at a premium of ₹ 120 per share in exercise of stock options by employees)		11,40,000
31st March 20X2	Profit and Loss A/c Dr. To Employee compensation expense A/c (Being transfer of employee compensation expense to profit and loss account)	8,55,000	8,55,000

Illustration 2

ABC Ltd. grants 1,000 employees stock options on 1.4.20X0 at ₹ 40, when the market price is ₹ 160. The fair value of options, calculated using an option pricing model, is ₹ 120 per option. The vesting period is 2½ years and the maximum exercise period is one year. 300 unvested options lapse on 1.5.20X2. 600 options are exercised on 30.6.20X3. 100 vested options lapse at the end of the exercise period.

Pass Journal Entries giving suitable narrations.

Solution

In the books of ABC Ltd.

Journal Entries

Date	Particulars	Dr. (₹)	Cr. (₹)
31.3.20X1	Employees compensation expense account Dr. To Employee stock option outstanding account (Being compensation expenses recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a fair value of ₹ 120 each, amortized on straight line basis over $2\frac{1}{2}$ years) (1,000 stock options x ₹ 120 / 2.5 years)	48,000	48,000
	Profit and loss account Dr.	48,000	

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	To Employees compensation expenses account (Being expenses transferred to profit and loss account at year end)			48,000
31.3.20X2	Employees compensation expenses account	Dr.	48,000	
	To Employee stock option outstanding account			48,000
	(Being compensation expense recognized in respect of the employee stock option i.e. 1,000 options granted to employees, amortized on straight line basis over $2\frac{1}{2}$ years) (1,000 stock options x ₹ 120 / 2.5 years)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at year end)			
31.3.20X3	Employee Stock Option Outstanding A/c (W.N.1)	Dr.	12,000	
	To General Reserve A/c (W.N.1)			12,000
	(Being excess of employees compensation expenses transferred to general reserve account)			
30.6.20X3	Bank A/c (600 × ₹ 40)	Dr.	24,000	
	Employee stock option outstanding account (600 × ₹ 120)	Dr.	72,000	
	To Equity share capital account (600 × ₹ 10)			6,000
	To Securities premium account (600 x ₹ 150)			90,000
	(Being 600 employee stock option exercised at an exercise price of ₹ 40 each)			
01.10.20X3	Employee stock option outstanding account (W.N.2)	Dr.	12,000	

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	To General reserve account (W.N.2) (Being ESOS outstanding A/c on lapse of 100 options at the end of exercise of option period transferred to General Reserve A/c)		12,000

Working Notes:

1. On 31.3.20X3, ABC Ltd. will examine its actual forfeitures and make necessary adjustments, if any, to reflect expenses for the number of options that actually vested. Considering that 700 stock options have completed 2.5 years vesting period, the expense to be recognized during the year is in negative i.e.

No. of options actually vested (700 x 120)	₹ 84,000
Less: Expenses recognized ₹ (48,000 + 48,000)	(₹ 96,000)
Excess expense transferred to general reserve	₹ 12,000

2. Similarly, on 1.10.20X3, Employee Stock Option Outstanding Account will be

No. of options actually vested (600 x 120)	₹ 72,000
Less: Expenses recognized	(₹ 84,000)
Excess expense transferred to general reserve	₹ 12,000

Employee Stock Options Outstanding will appear in the Balance Sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

Illustration 3

Arihant Limited has its share capital divided into equity shares of ₹ 10 each. On 1-10-20X1, it granted 20,000 employees' stock options at ₹ 50 per share, when the market price was ₹ 120 per share. The fair value of options, calculated using an option pricing model, is ₹ 70 per option The options were to be exercised between 10th December, 20X1 and 31st March, 20X2. The employees exercised their options for 16,000 shares only and the remaining options lapsed. The company closes its books on 31st March every year. Show Journal Entries (with narration) as would appear in the books of the company upto 31st March, 20X2.

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Solution

Journal Entries in the books of Arihant Ltd.

			₹	₹
10.12.X1 to 31.3.X2	Bank A/c (16,000 x 50)	Dr.	8,00,000	
	Employee compensation expense A/c (16,000 x 70)	Dr.	11,20,000	
	To Equity share capital A/c (16,000 x 10)			1,60,000
	To Securities premium A/c (16,000 x 110)			17,60,000
	(Being shares issued to the employees against the options vested to them in pursuance of Employee Stock Option Plan)			
31.3.X2	Profit and Loss A/c	Dr.	11,20,000	
	To Employee compensation expense A/c			11,20,000
	(Being transfer of employee compensation expenses to Profit and Loss Account)			

Illustration 4

Ajanta grants 120 share options to each of its 460 employees. Each grant is conditional on the employee working for Ajanta over the next three years. Ajanta has estimated that the fair value of each share option is ₹ 12. Ajanta estimates that 25% of employees will leave during the three-year period and so forfeit their rights to the share options. Everything turns out exactly as expected.

Required:

Calculate the amounts to be recognized as expense during the vesting period.

Solution

Year	***Calculation***	***Expense for Period*** ₹	***Cumulative expense*** ₹
1	55,200 options x 75% x ₹ 12 x 1/3 years	1,65,600	1,65,600
2	(55,200 options x 75% x ₹ 12 x 2/3 years) - ₹ 165,600	1,65,600	3,31,200
3	(55,200 options x 75% x ₹ 12 x 3/3 years) - ₹ 331,200	1,65,600	4,96,800

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An enterprise should review all estimates taken in consideration for valuation of option. The value of options recognized as expense in an accounting period is the excess of cumulative expense as per latest estimates up to the current accounting period over total expense recognized up to the previous accounting period.

Illustration 5

P Ltd. granted option for 8,000 equity shares of nominal value of ₹ 10 on 1st October, 20X0 at ₹ 80 when the market price was ₹ 170. Fair value per option is ₹ 90. The vesting period is 4½ years, 4,000 unvested options lapsed on 1st December, 20X2, 3,000 options were exercised on 30th September, 20X5 and 1,000 vested options lapsed at the end of the exercise period. Pass Journal Entries for above transactions.

Solution

In the books of P Ltd.

Journal Entries

Date	Particulars		(₹)	(₹)
31.3.20X1	Employees compensation expense account	Dr.	80,000	
	To Employee stock option outstanding account			80,000
	(Being compensation expenses for 6 months recognized in respect of the employee stock options i.e. 8,000 options granted to employees at a fair value of ₹ 90 each, amortized on straight line basis over $4\frac{1}{2}$ years [(8,000 stock options x ₹ 90) / 4.5 years] x 0.5]) (W.N.1)			
	Profit and loss account	Dr.	80,000	
	To Employees compensation expenses account			80,000
	(Being expenses transferred to profit and loss account at the year end)			
31.3.20X2	Employees compensation expense account	Dr.	1,60,000	
	To Employee stock option outstanding account			1,60,000

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	(Being compensation expense recognized in respect of the employee stock option i.e. 8,000 options granted to employees, amortized on straight line basis over $4\frac{1}{2}$ years [(8,000 stock options x ₹ 90) / 4.5 years) x 1 year])			
	Profit and loss account	Dr.	1,60,000	
	To Employees compensation expense account			1,60,000
	(Being expenses transferred to profit and loss account at year end)			
31.3.20X3	Employees compensation expense account	Dr.	80,000	
	To Employee stock option outstanding account			80,000
	(Being compensation expense recognized in respect of the employee stock option i.e. 4,000 options, amortized on straight line basis over $4\frac{1}{2}$ years [(4,000 stock options x ₹ 90) / 4.5 years])			
	Employee stock option outstanding account (W.N.2)	Dr.	1,20,000	
	To General Reserve account (W.N.2)			1,20,000
	(Being excess of employees compensation expenses transferred to general reserve account)			
	Profit and loss account	Dr.	80,000	
	To Employees compensation expenses account			80,000
	(Being expenses transferred to profit and loss account at year end)			

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31.3.20X4	Employees compensation expense account	Dr.	80,000	
	To Employee stock option outstanding account			80,000
	(Being compensation expenses recognized in respect of the employee stock option i.e. 4,000 options, amortized on straight line basis over $4\frac{1}{2}$ years [(4,000 stock options x ₹ 90) / 4.5 years])			
	Profit and loss account	Dr.	80,000	
	To Employees compensation expenses account			80,000
	(Being expenses transferred to profit and loss account at year end)			
31.3.20X5	Employees compensation expense account	Dr.	80,000	
	To Employee stock option outstanding account			80,000
	(Being compensation expenses recognized in respect of the employee stock option i.e. 4,000 options, amortised on straight line basis over $4\frac{1}{2}$ years [(4,000 stock options x ₹ 90) / 4.5 years])			
	Profit and loss account	Dr.	80,000	
	To Employees compensation expense account			80,000
	(Being expenses transferred to profit and loss account at year end)			
30.9.20X5	Bank A/c (3,000 × ₹ 80)	Dr.	2,40,000	
	Employee stock option outstanding	Dr.	2,70,000	
	To Equity share capital account (3,000 x ₹ 10)			30,000

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	To Securities premium [(₹ 170 – ₹ 10) x 3,000] (Being 3,000 employee stock option exercised at an exercise price of ₹ 80 each)		4,80,000
	Employee stock option outstanding account Dr. (W.N.3)	90,000	
	To General reserve account (W.N.3)		90,000
	(Being ESOS outstanding A/c transferred to General Reserve A/c on lapse of 1000 vested options at the end of the exercise period)		

Working Notes:

1. At 1.12.X2, 4,000 unvested option lapsed on which till date expenses recognized to be transferred to general reserve = ₹ (80,000 + 1,60,000) x 4,000 / 8,000 = ₹ 1,20,000

2. Expenses charged on lapsed vested options transferred to general reserve

   = 1,000 x ₹ 90 = ₹ 90,000

Illustration 6

Choice Ltd. grants 100 stock options to each of its 1,000 employees on 1.4.20X1 for ₹ 20, depending upon the employees at the time of vesting of options. Options would be exercisable within a year when it is vested. The market price of the share is ₹ 50 each. These options will vest at the end of year 1 if the earning of Choice Ltd. is 16%, or it will vest at the end of the year 2 if the average earning of two years is 13%, or lastly it will vest at the end of the third year if the average earning of 3 years will be 10%. 5,000 unvested options lapsed on 31.3.20X2. 4,000 unvested options lapsed on 31.3.20X3 and finally 3,500 unvested options lapsed on 31.3.20X4. Consider fair value per option is ₹ 30.

Following were the earnings of Choice Ltd in the last 3 years:

Year ended on	*Earning (in %)*
31.3.20X2	*14%*
31.3.20X3	*10%*
31.3.20X4	*7%*

850 employees exercised their vested options within a year and remaining options were unexercised at the end of the contractual life. Pass Journal entries for the above.

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Solution

Date	Particulars		₹	₹
31.3.20X2	Employees compensation expense A/c	Dr.	14,25,000	
	To ESOP outstanding A/c			14,25,000
	(Being compensation expense recognized in respect of the ESOP i.e. 100 options each granted to 1,000 employees at a fair value of ₹ 30 each, amortised on straight line basis over vesting years (Refer W.N.)			
	Profit and Loss A/c	Dr.	14,25,000	
	To Employees compensation expenses A/c			14,25,000
	(Being expenses transferred to profit and Loss A/c)			
31.3.20X3	Employees compensation expenses A/c	Dr.	3,95,000	
	To ESOP outstanding A/c			3,95,000
	(Being compensation expense recognized in respect of the ESOP- Refer W.N.)			
	Profit and Loss A/c	Dr.	3,95,000	
	To Employees compensation expenses A/c			3,95,000
	(Being expenses transferred to profit and Loss A/c)			
31.3.20X4	Employees compensation Expenses A/c	Dr.	8,05,000	
	To ESOP outstanding A/c			8,05,000
	(Being compensation expense recognized in respect of the ESOP- Refer W.N.)			
	Profit and Loss A/c		8,05,000	
	To Employees compensation expenses A/c			8,05,000
	(Being expenses transferred to profit and Loss A/c)			

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20X4-X5	Bank A/c (85,000 × ₹ 20)	Dr.	17,00,000	
	ESOP outstanding A/c [(26,25,000/87,500) x 85,000]	Dr.	25,50,000	
	To Equity share capital (85,000 x ₹ 10)			8,50,000
	To Securities premium A/c (85,000 x ₹ 40)			34,00,000
	(Being 85,000 options exercised at an exercise price of ₹ 50 each)			
31.3.20X5	ESOP outstanding A/c	Dr.	75,000	
	To General Reserve A/c			75,000
	(Being ESOP outstanding A/c on lapse of 2,500 options at the end of exercise of option period transferred to General Reserve A/c)			

Working Note:

Statement showing compensation expense to be recognized at the end of:

Particulars	Year 1 (31.3.20X2)	Year 2 (31.3.20X3)	Year 3 (31.3.20X4)
Number of options expected to vest	95,000 options	91,000 options	87,500 options
Total compensation expense accrued (50-20)	₹ 28,50,000	₹ 27,30,000	₹ 26,25,000
Compensation expense of the year	28,50,000 x 1/2 = ₹ 14,25,000	27,30,000 x 2/3 = ₹ 18,20,000	₹ 26,25,000
Compensation expense recognized previously	Nil	₹ 14,25,000	₹ 18,20,000
Compensation expenses to be recognized for the year	₹ 14,25,000	₹ 3,95,000	₹ 8,05,000

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Illustration 7

At the beginning of year 1, an enterprise grants 10,000 stock options to a senior executive, conditional upon the executive remaining in the employment of the enterprise until the end of year 3. The exercise price is ₹ 40. However, the exercise price drops to ₹ 30 if the earnings of the enterprise increase by at-least an average of 10 per cent per year over the three-year period.

On the grant date, the enterprise estimates that the fair value of the stock options, with an exercise price of ₹ 30, is ₹ 16 per option. If the exercise price is ₹ 40, the enterprise estimates that the stock options have a fair value of ₹ 12 per option.

During year 1, the earnings of the enterprise increased by 12 per cent, and the enterprise expects that earnings will continue to increase at this rate over the next two years. The enterprise, therefore, expects that the earnings target will be achieved, and hence the stock options will have an exercise price of ₹ 30.

During year 2, the earnings of the enterprise increased by 13 per cent, and the enterprise continues to expect that the earnings target will be achieved.

During year 3, the earnings of the enterprise increased by only 3 per cent, and therefore the earnings target was not achieved. The executive completes three years' service, and therefore satisfies the service condition. Because the earnings target was not achieved, the 10,000 vested stock options have an exercise price of ₹ 40.

You are required to calculate the amount to be charged to Profit and Loss Account every year on account of compensation expenses.

Solution

Since the exercise price varies depending on the outcome of a performance condition which is not a market condition, the effect of that performance condition (i.e. the possibility that the exercise price might be ₹ 40 and the possibility that the exercise price might be ₹ 30) is not considered when estimating the fair value of the stock options at the grant date. Instead, the enterprise estimates the fair value of the stock options at the grant date under each scenario and revises the transaction amount to reflect the outcomes of that performance condition at the end of every year based on the information available at that point of time.

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Calculation of compensation expense to be charged every year

Year	***Calculation***	***Expense for the year (₹)***	***Cumulative expense (₹)***
1	10,000 x ₹ 16 x 1/3	53,333	53,333
2	10,000 x ₹ 16 x 2/3	53,334	1,06,667
3	10,000 x ₹ 12 x 3/3	13,333	1,20,000

Reference: The students are advised to refer the bare text of the Guidance Note on Accounting for Share Based Payments to the extent it deals with employee stock option plans.

SUMMARY

- ESOP is an option given to employees of a company to purchase or subscribe the securities offered by the company at a future date, at a predetermined price.
- There are two methods of Accounting for Employee Share Based Payments viz. Intrinsic Value method or Fair Value method. The Guidance Note recommends fair value method but intrinsic value method is also permitted.
- As per the requirements of the Guidance Note an enterprise shall recognize the services received in an employee stock option plan when the services are received. The enterprise shall recognize a corresponding increase in equity if the services were received in an equity-settled employee stock option plan, or a liability if the services were received in a cash-settled employee stock option plan.
- When the services received in an employee stock option plan do not qualify for recognition as assets, they should be recognized as expenses.

TEST YOUR KNOWLEDGE

MCQs

1. For accounting purposes, employee stock option plans are classified as

   (a) Equity settled and cash settled.

   (b) Liability settled and cash settled.

   (c) Equity settled, cash settled and employees stock option plans with cash alternatives.

2. The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares is

   (a) Exercise Price

   (b) Intrinsic Value

   (c) Fair value

3. Which amount would be recognized for employee stock option plans?

   (a) Fair value of services received

   (b) Amount as per agreement

   (c) Fair value of equity instruments issued.

4. In line with the Guidance Note on Accounting for Share based Payments, an enterprise should recognize an amount for the services received from the employees

   (a) during the vesting period based on the best available estimate of the number of stock options expected to vest.

   (b) Immediately.

   (c) during the vesting period proportionately.

5. Which method is recommended for valuation of employee stock option plans by the Guidance Note on Accounting for Share Based Payments?

   (a) Intrinsic Value.

   (b) Fair value.

   (c) Both (a) and (b).

Theoretical Questions

Question 1

What are employees stock option plans as per the Guidance Note on Accounting for Share Based Payments?

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Question 2

Explain the importance of employees stock option plans in the modern time.

Question 3

Define the following terms:

(i) Vesting

(ii) Exercise Period

Question 4

Define the following terms:

(i) Grant date

(ii) Exercise Price

Practical Questions

Question 1

X Co. Ltd. has its share capital divided into equity shares of ₹ 10 each. On 1.4.20X1 it granted 20,000 employees' stock option at ₹ 50 per share when the market price was ₹ 120 per share. Fair value per option was ₹ 70. The options were to be exercised between 15th March, 20X2 and 31st March, 20X2. The employees exercised their options for 16,000 shares only and the remaining options lapsed. The company closes its books on 31st March every year. Show Journal entries (with narration) as would appear in the books of the company up to 31st March, 20X2.

Question 2

S Ltd. grants 1,000 options to its employees on 1.4.20X0 at ₹ 60. The vesting period is two and a half years. The maximum exercise period is one year. Market price on that date is ₹ 90. Fair value per option is ₹ 30. All the options were exercised on 31.7.20X3. Journalize, if the face value of equity share is ₹ 10 per share.

Question 3

A company has its share capital divided into shares of ₹ 10 each. On 1-4-20X1, it granted 5,000 employees stock options at ₹ 50, when the market price was ₹ 140. Fair value per option was ₹ 90. The options were to be exercised between 1-3-20X2 to 31-03-20X2. The employees exercised their options for 4,800 shares only; remaining options lapsed. Pass the necessary journal entries for the year ended 31-3-20X2, with regard to employees' stock options.

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Question 4

On 1st April, 20X1, a company offered 100 shares to each of its 500 employees at ₹ 50 per share. The employees are given an year to accept the offer. The shares issued under the plan shall be subject to lock-in on transfer for three years from the grant date. The market price of shares of the company on the grant date is ₹ 60 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at ₹ 56 per share and fair value per option worked out to be ₹ 6.

On 31st March, 20X2, 400 employees accepted the offer and paid ₹ 50 per share purchased. Nominal value of each share is ₹ 10.

Record the issue of share in the books of the company under the aforesaid plan.

Question 5

JKS Ltd. has its share capital divided into equity shares of ₹ 10 each. On 1.1.20X1 it granted 5,000 employee stock options at ₹ 30 per share, when the market price was ₹ 50 per share. Fair value per option was ₹ 20. The options were to be exercised between 15th March, 20X1 and 31st March, 20X1. The employees exercised their options for 3,600 shares only and the remaining options lapsed. The company closes its books on 31st March every year. Show Journal entries (with narration) as would appear in the books of the company up to 31st March, 20X1.

ANSWERS/HINTS

MCQ

1. (c); **2.** (b) **3.** (c) **4.** (a) **5.** (b)

Theoretical Questions

Answer 1

Employee Stock Option Plans (ESOPs) are plans under which an enterprise grants options for a specified period to its employees to purchase its shares at a fixed or determinable price. ESOPs entitle the employees to receive:

(a) Cash or other assets of the enterprise for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the enterprise or another group enterprise, or

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(b) Equity instruments (including shares or share options) of the enterprise or another group enterprise, provided the specified vesting conditions, if any, are met.

Answer 2

ESOPs are plans under which an enterprise grants options for a specified period to its employees to purchase its shares at a fixed or determinable price. One advantage of ESOPs as remuneration is that they need not entail any cash cost to the enterprise. Unlisted companies, in particular, start-up companies, often give share-based compensation since they cannot afford to pay high salaries to their employees but are willing to share the future prosperity of the company. It is hence important that cost relating to these stock option plans get recognized in the financial statements.

The importance of Employee Stock Option Plan lies in the following advantages which accrue to both the company and the employees:

1. Stock options provide an opportunity to employees to participate and contribute in the growth of the company.
2. Stock options create long term wealth in the hands of the employees.
3. They are important means to attract, retain and motivate the best available talent for the company.
4. It creates a common sense of ownership between the company and its employees.

Answer 3

Vesting means to become an entitlement. Under an employee stock option plan, a counterparty's right to receive cash, other assets or equity instruments of the enterprise vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions.

Exercise Period is the time period after vesting within which the counterparty should exercise his/her/its right to apply for equity instruments (including shares or share options) against the option vested in him in pursuance of the employee stock option plan.

Answer 4

Grant Date is the date at which the enterprise and another party (i.e. an employee) agree to an employee stock option plan, being when the enterprise and the

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counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date, the enterprise confers on the counterparty the right to cash, other assets, or equity instruments of the enterprise, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained..

Exercise Price is the price payable by the counterparty for exercising the option granted to him/her/it in pursuance of the employee stock option plan.

Practical Questions

Answer 1

In the books of X Co. Ltd.

Journal Entries

			₹	₹
15.03.20X2	Bank A/c (16,000 x 50)	Dr.	8,00,000	
to 31.3.X2	Employee stock compensation expense A/c [16,000 x 70]	Dr.	11,20,000	
	To Equity share capital A/c (16,000 x 10)			1,60,000
	To Securities premium A/c [16,000 x (120-10)]			17,60,000
	(Being shares issued to the employees against the options vested to them in pursuance of Employee Stock Option Plan)			
31.3.X2	Profit and Loss A/c	Dr.	11,20,000	
	To Employee compensation expenses A/c			11,20,000
	(Being transfer of employee compensation transfer to Profit and Loss Account)			

Note:

No entry is passed when Stock Options are granted to employees. Hence no entry will be passed on 1 April 20X1.

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Answer 2

Books of S Ltd.

Journal Entries

Date	*Particulars*		*Debit* ₹	*Credit* ₹
31.3.X1	Employees Compensation Expense Account	Dr.	12,000	
	To Employees Stock Option Outstanding Account			12,000
	(Being compensation expense recognized in respect of 1,000 options granted to employees at fair value of ₹ 30 each, amortized on straight line basis over 2½ years) (Refer WN)			
	Profit and Loss Account	Dr.	12,000	
	To Employees Compensation Expense Account			12,000
	(Being employees compensation expense of the year transferred to P&L A/c)			
31.3.X2	Employees Compensation Expense Account	Dr.	12,000	
	To Employees Stock Option Outstanding Account			12,000
	(Being compensation expense recognized in respect of 1,000 options granted to employees at discount of ₹ 30 each, amortized on straight line basis over 2½ years) (Refer WN)			
	Profit and Loss Account	Dr.	12,000	
	To Employees Compensation Expense Account			12,000
	(Being employees compensation expense of the year transferred to P&L A/c)			
31.3.X3	Employees Compensation Expense Account	Dr.	6,000	
	To Employees Stock Option Outstanding Account			6,000
	(Being balance of compensation expense amortized ₹ 30,000 less ₹ 24,000) (Refer WN)			

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	Profit and Loss Account	Dr.	6,000	
	To Employees Compensation Expense Account			6,000
	(Being employees compensation expense of the year transferred to P&L A/c)			
31.7.X3	Bank Account (₹ 60 × 1,000)	Dr.	60,000	
	To Equity Share Capital Account			10,000
	To Securities Premium Account			50,000
	(Being exercise of 1,000 options at an exercise price of ₹ 60)			
31.7.X3	Stock Option Outstanding A/c (₹ 30 x 1,000)	Dr.	30,000	
	To Securities Premium Account			30,000
	(Being the balance in the Employees Stock Option Outstanding Account transferred to Securities Premium A/c)			

Working Notes:

1. Total employees compensation expense = 1,000 x ₹ 30 = ₹ 30,000

2. Employees compensation expense has been written off during 2½ years on straight line basis as under:

   I year = ₹ 12,000 (for full year)

   II year = ₹ 12,000 (for full year)

   III year = ₹ 6,000 (for half year)

Answer 3

In the books of Company
Journal Entries

Date	***Particulars***		***Dr. ₹***	***Cr. ₹***
1-3-X2 to 31-3-X2	Bank A/c	Dr.	2,40,000	
	Employees compensation expenses A/c	Dr.	4,32,000	
	To Equity Share Capital A/c			48,000
	To Securities Premium A/c			6,24,000
	(Being allotment to employees 4,800 shares of ₹ 10 each at a premium of ₹ 130 at an exercise price of ₹ 50 each)			

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31-3-X2	Profit and Loss account Dr. To Employees compensation expenses A/c (Being transfer of employees compensation expenses)	4,32,000	4,32,000

Working Note:

1. Employee Compensation Expenses = ₹ 90 (Fair value per option) x 4,800

   = ₹ 4,32,000/-.

2. The Employees Compensation Expense is transferred to Securities Premium Account.

3. Securities Premium Account = ₹ 50 – ₹ 10 = ₹ 40 per share + ₹ 90 per share on account of discount of option price over market price = ₹ 130 per share = ₹ 130 x 4,800 = ₹ 6, 24,000/- in total.

Answer 4

Fair value of an option = ₹ 6

Number of shares issued = 400 employees x 100 shares/employee = 40,000 shares

Fair value of ESOP = 40,000 shares x ₹ 6 = ₹ 2,40,000

Vesting period = 1 year

Expense recognized in 20X1–X2 = ₹ 2,40,000

Date	***Particulars***		***₹***	***₹***
31.03.20X2	Bank (40,000 shares x ₹ 50)	Dr.	20,00,000	
	Employees stock compensation expense A/c	Dr.	2,40,000	
	To Share Capital (40,000 shares x ₹10)			4,00,000
	To Securities Premium (40,000 shares x ₹ 46)			18,40,000
	(Being option accepted by 400 employees & payment made @ ₹ 56 share)			
	Profit & Loss A/c	Dr.	2,40,000	
	To Employees stock compensation expense A/c			2,40,000

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	(Being Employees stock compensation expense transferred to Profit & Loss A/c)		

Answer 5

Journal Entries in the books of JKS Ltd

			₹	₹
15.03.20X1	Bank A/c	Dr.	1,08,000	
to 31.3.X1	Employee compensation expense A/c	Dr.	72,000	
	To Equity share capital A/c			36,000
	To Securities premium A/c			1,44,000
	(Being shares issued to the employees against the options vested to them in pursuance of Employee Stock Option Plan)			
31.3.X1	Profit and Loss A/c	Dr.	72,000	
	To Employee compensation expenses A/c			72,000
	(Being transfer of employee compensation expenses transfer to Profit and Loss Account)			

Working Notes:

1. No entry is passed when stock options are granted to employees. Hence no entry will be passed on 1 January 20X1.
2. Fair value per option i.e. ₹ 20 per option is the employee cost or employee compensation expense and will be charged to P&L Account for the number of options exercised i.e. 3,600.

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