**Query No. 3**

Subject: ESOP accounting on account of revision of the exercise price.[1]

## A. Facts of the Case

1. A company is a listed company in the manufacturing sector having various businesses (a conglomerate). The company had granted stock options to its employees ('ESOP') in August, 2007 (Year Zero).

2. Total number of options granted originally was 10,000 to be vested over a period of 4 years i.e., 25% each year. Market price of shares of the company on the date of ESOP grant was Rs. 2,800/- per share and exercise price was Rs. 2,000/- per share.

3. On account of attritions / non-fulfillment of eligibility conditions, the number of options has been reduced to 9,000 in year two (2009).

4. The company has followed intrinsic value method for ESOP accounting as provided by the 'Guidance Note on Accounting for Employee Share-based Payments' issued by the Institute of Chartered Accountants of India.

5. The company decides to revise the exercise price as Rs. 1,800/- per share in year two on account of reduction in market price of company's shares. Current market price in year two is Rs. 2,000/- per share.

6. The querist has stated that actual figures have been substituted by rounded-off figures for the sake of simplicity.

## B. Query

7. The querist has sought the opinion of Expert Advisory Committee on the following issues:

(i) Whether any additional charge is to be taken to the profit and loss account under employee cost on revision of exercise price in year two (2009) as mentioned in paragraph 5 above. If yes, what will be the amount and basis thereof? What would be the amount to be charged as employee cost on revision of the exercise price from year two onwards?

(ii) Whether the extra charge in year one (2008) will be adjustable in subsequent charge to the profit and loss account in the remaining vesting period,

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consequent upon reduction in the number of ESOPs eligible for exercise in year two.

(iii) What will be the treatment of the amount credited to the ESOP Outstanding Account against original grant, i.e., Rs. 800 per share (Rs. 2,800 less Rs. 2,000) at the time of exercise of options?

## C. Points considered by the Committee

8. The Committee notes that the employee stock option plan mentioned by the querist is a graded vesting plan since the options vest in tranches over a period of 4 years i.e., 25% for each year. The Committee, however, notes that the basic issues raised by the querist are related to accounting for the effects of revision of the exercise price of the stock options, reduction in the number of ESOPs and treatment of amount credited to ESOP Outstanding Account against the original grant. Therefore, the Committee has examined only these issues and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting for the original plan, detailed aspects of accounting for graded vesting plan etc. Incidentally, the Committee notes that while reduction in the number of options due to attritions/non-fulfillment of eligibility conditions as well as revision of the exercise price took place in year two (2009), the querist has referred to 'extra charge in year one (2008)' in the query raised in paragraph 7(ii) above. It appears that in respect of the extra charge, year referenced should be 'year two (2009)'. Further, the Committee presumes that there is no change in any vesting condition at the time of revision of the exercise price.

9. The Committee notes that while the Institute of Chartered Accountants of India has issued a 'Guidance Note on Accounting for Employee Share-based Payments', (hereinafter referred to as the 'ICAI Guidance Note'), the Securities and Exchange Board of India (SEBI) has issued the 'Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999' (hereinafter referred to as the 'SEBI Guidelines'). Schedule I to the SEBI Guidelines contain accounting aspects of Employee Stock Option Schemes. The Committee has referred to both the ICAI Guidance Note and the SEBI Guidelines for their appropriate application in the extant case.

10. The Committee notes that both fair value method and intrinsic value method are permitted in ICAI Guidance Note and Schedule I to the SEBI Guidelines. The Committee notes that while fair value method is explained in detail in ICAI Guidance Note, application of intrinsic value method simply involves substitution of the term 'intrinsic value' in place of 'fair value'. In this regard, the Committee notes that the last sentence of paragraph 40 of the ICAI Guidance Note reads as below:

"For accounting for employee share-based payment plans, the intrinsic value may be used, *mutatis mutandis*, in place of the fair value as described in paragraphs 10 to 39."

11. The Committee notes that while accounting for modification of terms of stock options is not addressed in SEBI Guidelines, the same is addressed in ICAI Guidance Note. Relevant portions of the ICAI Guidance Note are reproduced below:

**"Modifications to the terms and conditions on which shares or stock options were granted, including cancellations and settlements**

23. 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.

24. The enterprise should recognise, as a minimum, the services received measured at the grant date fair value of the shares or stock options granted, unless those shares or stock options do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. This applies irrespective of (a) any modifications to the terms and conditions on which the shares or stock options were granted, or (b) a cancellation or settlement of that grant of shares or stock options. In addition, the enterprise should recognise the effects of modifications that increase the total fair value of the employee share-based payment plan or are otherwise beneficial to the employee.

25. The requirements of paragraph 24 should be applied as follows:

(a) If the modification increases the fair value of the shares or stock options granted (e.g., by reducing the exercise price), measured immediately before and after the modification, the enterprise should include the incremental fair value granted in the measurement of the amount recognised for services received as consideration for the shares or stock options granted. The incremental fair value granted is the difference between the fair value of the modified shares or stock options and that of the original shares or stock options, both estimated as at the date of the modification. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified shares or stock options vest, in addition to the amount based on the grant date fair value of the original shares or stock options, which is recognised over the remainder of the original vesting period. If the modification occurs after the vesting date, the incremental fair value granted is recognised immediately, or over

the vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to those modified shares or stock options.

…"

12. From paragraph 40 of ICAI Guidance Note, the Committee is of the view that the intrinsic value may be used, *mutatis mutandis*, in place of the fair value mentioned in the treatment for reduction of the exercise price explained in paragraph 11 above. In the querist's case, intrinsic value of the ESOP on the grant date was Rs. 800 (=Rs. 2,800 – Rs. 2,000) per option. Subsequently, in year 2009, immediately before revision of the exercise price, market price of the shares dropped to Rs. 2,000 per share and, consequently, the revision of the exercise price to Rs. 1,800 results in a benefit of Rs. 200 (=Rs. 2,000–Rs. 1,800) to the option holders. Hence, the incremental cost of Rs. 200 per option should be accounted for by the company. The Committee is of the view that incremental cost should be accounted for by the company even though the intrinsic value of the option immediately after the revision of the exercise price *viz.* Rs. 200 per option is less than the intrinsic value of the option on the date of the grant *viz*. Rs. 800 per option. This is because as per paragraph 24, no exception has been provided in the Guidance Note from recognition of incremental cost under any situation.

13. As regards the issue relating to amount to be charged from year 2 (2009) onwards to the profit and loss account on account of revision of the exercise price, the Committee is of the view that it should be the sum of the amount chargeable as per original plan plus the relevant portion of the incremental cost to be expensed. As explained in paragraph 11 read with paragraph 10 above, to the extent that the options have already vested, the incremental cost should be expensed immediately. To the extent that the options have not yet vested, the incremental cost should be expensed from the date of revision of the exercise price until the date when the modified stock options vest. The basis of amortisation of the incremental cost to periods subsequent to the revision of the exercise price should be the same as prescribed in SEBI Guidelines for the amortisation of the original cost. Thus, while period of amortisation for original cost and incremental cost differ, the basis of amortisation for both is same. For example, for a plan where all the options vest at the end of the 4th year, if there is a modification of the award at the beginning of the third year resulting in incremental cost, the original cost will continue to be charged on a straight-line basis till the end of the 4th year, while the incremental cost will be charged on a straight-line basis to years 3 and 4. While this is the general principle to be followed, the Committee notes that in the extant case, the employee stock opinion plan is a graded vesting plan with uniform vesting pattern spread over a period of 4 years. The Committee is of the view that depending on the method adopted for charging the original cost of the graded vesting plan, the incremental cost of unvested options should be attributed to different tranches with different vesting periods or considered as a whole with a single vesting period of the last tranche for applying the principles explained above. As stated in paragraph 8 above, the Committee has not examined the detailed aspects of accounting for graded vesting plan and applicability of the optional

treatment to the querist. In particular, the Committee has not examined the issue of allocation of incremental cost in the context of a graded vesting plan where the pattern of vesting is not uniform.

While applying the above principles, while initial recognition of the incremental cost in the balance sheet should be made in the manner as illustrated in SEBI Guidelines for the initial recognition of the original cost, however, the Committee also notes that in the instant case, there appears to be the lapse of some options before the revision of the exercise price. If so, the Committee is of the view that first, such lapses should be accounted for and thereafter, the incremental cost of the outstanding options should be accounted for as explained above. Accounting for lapses is explained in paragraph 14 below.

14. In respect of reduction in number of ESOPs eligible for exercise in year 2 due to attritions / non-fulfillment of eligibility conditions, the Committee notes that there can be several situations resulting in lapse of either vested options or unvested options or a combination of vested and unvested options. For example, non-fulfillment of eligibility conditions even before the end of the first year will result in lapse of the unvested options only. It is also possible that after partial vesting of some percentage of options (i.e., 25% at the end of year zero), the employee may leave the employment but foregoes his/her right to exercise the vested options either before or after the expiry of the exercise period. This is a case of combination of lapse of vested and unvested options. The Committee notes that clauses (a), (b) and (c) of Schedule I to the SEBI Guidelines prescribe accounting treatment for granted options while clauses (d) and (e) thereof deal with accounting for lapses of unvested and vested options respectively. Clauses (d) and (e) of Schedule I to the SEBI Guidelines are reproduced below:

> "(d) When an unvested option lapses by virtue of the employee not conforming to the vesting conditions after the accounting value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense equal to the amortised portion of the accounting value of the lapsed options and a credit to deferred employee compensation expense equal to the unamortised portion."
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> "(e) When a vested option lapses on expiry of the exercise period, after the fair value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense."

The Committee is of the view that though clause (e) quoted above refers to 'fair value', the treatment specified therein is equally applicable for intrinsic value method with the modification that in place of term 'fair value', 'intrinsic value' should be used. This is because clause (b) of Schedule I to the SEBI guidelines permits both fair value and

intrinsic value method. Further, the Committee is of the view that the accounting treatment mentioned in clause (e) is equally applicable to a case where an employee foregoes his/her right to exercise the option even before the expiry of the exercise period.

15. From the above, the Committee is of the view that reduction in number of ESOPs eligible for exercise in year 2 due to attritions / non-fulfillment of eligibility conditions will result in reduced employee compensation expense in the period of attritions / non-fulfillment of eligibility conditions or in that period as well as future periods till the end of the vesting period or even after the expiry of the exercise period. Depending on the method of accounting adopted for graded vesting plan and retention of right to exercise the vested options, lapse of unvested options may also result in reduced employee compensation expense for future periods only. Thus, while the impact of incremental cost expensed may be in one period or spread over more than one period (see paragraph 13 above) till the end of the vesting period, the reduction in employee compensation expense may be either in one period or more than one period till the end of the vesting period or even after the expiry of the exercise period. While the impact of lapses of vested and/or unvested options reduce the impact of incremental cost expensed, such offsetting effect may or may not be in the same period(s). Since it is the net result of accounting for lapses and accounting for incremental cost expensed, the question of making any separate adjustment mentioned by the querist in the query raised in paragraph 7(ii) above does not arise at all.

16. As regards the treatment of ESOP Outstanding Account on exercise of the option, the Committee notes paragraph 22 of the ICAI Guidance Note, relevant portion of which is reproduced below:

> "22. On exercise of the right to obtain shares or stock options, the enterprise issues shares 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). …"

Thus, at the time of exercise of the option, amount in ESOP Outstanding Account, to the extent that it is related to the options exercised, should be debited along with the consideration received against them (viz., cash/bank account), while Share Capital and Share Premium account should be credited. This is also illustrated in the ICAI Guidance Note as well as in clause (f) of Schedule I to the SEBI Guidelines.

The Committee is of the view that the above treatment applies not only to the amount of Rs. 800 per option credited to the ESOP Outstanding Account against original grant but also to the incremental amount credited to the said account consequent upon the reduction of the exercise price.

## D. Opinion

17. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 7 above:

(i) Yes, incremental cost on account of revision of exercise price is required to be accounted for in respect of outstanding options on the basis of difference between the exercise price measured immediately before and after the revision. As regards the amount to be charged from year 2 (2009) onwards as employee cost on account of revision of the exercise price, it should be the sum of the amount chargeable as per original plan plus the relevant portion of the incremental cost to be expensed. The basis of amortisation of the incremental cost should be same as adopted for amortisation of the original cost as per SEBI Guidelines. See paragraphs 12 and 13 above.

(ii) Extra charge in year 2 (2009) will be the net result of accounting for lapses and accounting for incremental cost expensed as explained in paragraph 15 above.

(iii) At the time of exercise of the option, amount in ESOP Outstanding Account, to the extent that it is related to the options exercised, should be debited along with the consideration received against them (viz., cash/bank account), while Share Capital and Share Premium account should be credited. See paragraph 16 above.