3. ACCOUNTING FOR EMPLOYEE SHARE BASED PAYMENTS

MODEL WISE ANALYSIS OF PAST EXAM PAPERS OF IPCC

MODEL NO.	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16	N-16
Problems	4	4	-	4	-	-	8	-	8	-	-
Theory	-	-	4	-	-	-	-	-	-	-	-

THEORY

Provision: As per Sec. 62 (1) (b) of 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.

Meaning: ESOP is an option given to Directors, Officers or permanent employees of a company to purchase or subscribe the securities offered by the company at a future date, at a pre-determined price.

Importance:

1. **This scheme increases the productivity** as well as motivation employees as it creates sense of ownership among them.
2. **This also Improves employee attitude** towards the company
3. **This will lead to better information sharing,** increased communication, and involvement in decision making by employees.

VARIOUS FORMS OF EMPLOYEES SHARE BASED PAYMENTS:

As per provisions of guidance note on employees share based payments, they are of 3 types:

1. **Employee Stock Option Plan:** It is a plan under which the enterprise grants employees stock option. Employee Stock Option is a contract that gives the employees of the enterprise the right, but not the obligation, for a specified period of time to purchase or subscribe to the shares of the enterprise at a fixed or determinable price.
2. **Employee Stock Purchase Plan:** It is a plan under which the enterprise grants rights to its employees to purchase its shares at a stated price at the time of public issue or otherwise.
3. **Stock Appreciation Right:** It is a right that entitles the employees to receive cash for an amount equivalent to any excess of the market value of a stated number of enterprise's shares over a stated price. The form of payment may be specified when the rights are granted or may be determined when they are exercised. However, in some plans, the employee may choose the form of payment.

FOR ACCOUNTING PURPOSES:

Employee share based payment plans are classified into 3 categories

a. **Equity settled:** Under these plans, the employees receive shares.

b. **Cash settled:** Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.

c. **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.

Note: For the purpose of guidance note, the term employee includes director of the enterprise, whether whole time or not.

IMPORTANT TERMS IN ESOP:

1. **Grant:** Grant means issue of option to the employees under ESOS.
2. **Vesting:** It is the process by which the employee is given the right to apply for shares of the company against the option granted to him in purchase of employee in pursuance of employee stock option scheme (ESOS).
3. **Vesting Period:** It is the time period during which the vesting of the option granted to the employee on pursuance of ESOS takes place.
4. **Option:** Option means a right but not an obligation granted to an employee in pursuance of ESOS to apply for shares of the company at a pre-determined price.
5. **Exercise:** The activity of converting the options granted into shares by paying the required exercise price is known as exercise of options
6. **Exercise Period:** It is the time period after vesting within which the employee should exercise his right to apply for shares against the option vested in him in pursuance of the ESOS.
7. **Exercise Price:** It is the price payable by the employee for exercising the option granted to him in pursuance of ESOS.
8. **Fair value:** A fair value is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable willing parties in an arm's length transaction.
9. **Intrinsic value**: An intrinsic value is the amount by which the quoted market price of the underlying share in case of a listed enterprise or the value of the underlying share determined by an independent value in case of an unlisted enterprise exceeds the exercise price of an option.
10. **Lapse of options:** Options lose their validity in certain circumstances i.e. expiry of the exercise period. These options then cannot be converted into shares and lose their value. Such options are said to have lapsed.

ACCOUNTING TREATMENT OF EQUITY SETTLED EMPLOYEE SHARE BASED PAYMENT PLAN:

In respect of options granted during any accounting period, the accounting value of the options shall be treated as another form of employee compensation in the financial statements of the company.

The accounting value of options shall be:

Numbers of options granted X (Market price – Exercise price*)

(* Exercise price means the price payable by the employee for exercising the option granted to him / her in pursuance of ESOS)

1. **To recognise an appropriate proportion of the total fair value of options/ shares expected to vest as an expense at the end of each accounting period during the vesting period.**

   Employee's compensation expenses A/c Dr.

   To Employee stock option outstanding A/c

   (Being expenses in respect of ESOP recognised during the year)

2. **To transfer employees compensation expense account to profit & loss Account at the end of each accounting period during the vesting period.**

   Profit & Loss A/c. Dr.

   To Employees Compensation Expense A/c

   (Being the transfer of employees compensation expense A/c to P & L A/c).

3. **To record the issue of shares when the options are exercised during exercise period.**

   Bank Account Dr.[No. of options X Exercise price]

Employee Stock Option Outstanding Account Dr. [Note 1]
To Equity Share Capital A/c [Note 2]
To Securities Premium A/c [Note 3]

(Being ………options exercised during……..period)

Note 1: No. of options X Fair value of options

Note 2: Face value per share x Number of options exercised

Note 3: (Market price – Face value) x Number of options exercised

4. To cancel fair value of options lapsed

Employee stock option outstanding A/c Dr. (Note 1)
To general reserve

(Being the fair value of options lapsed transferred to general reserve)

Note 1: No of options lapsed X fair value of each option

DISCLOSURE: Employee stock option outstanding accounts will appear in balance sheet as a part of Shareholders Fund, under the head of Reserves and Surplus in notes to accounts till the cancellation of fair value of options lapsed.

Example 1: X Ltd grants 1,000 options at Rs.60 when the market price is Rs.100. The value of options will be:

1,000 x (Rs.100 – Rs.60) = Rs.40,000

Let us assume that vesting period is two years. It means, the options become exercisable for the first time on expiry of two years.

Date	Particulars	Debit	Credit
End of First Year	Employee compensation expenses A/c Dr. To Employee stock option outstanding A/c (Being expenses in respect of ESOP recognised during year)	20,000	 20,000
End of First year	Profit and Loss A/c Dr. To Employee compensation expenses A/c (Being employee compensation exp. transferred to P & L A/c.)	20,000	 20,000
End of 2nd year	Employee compensation expenses A/c Dr. To Employee stock option outstanding A/c (Being expenses in respect of ESOP recognised during year)	20,000	 20,000
End of 2nd year	Profit and Loss A/c Dr. To Employee compensation expenses A/c (Being employee compensation exp. transferred to P & L A/c.)	20,000	 20,000
End of 3rd year	Bank A/c Dr. Employee compensation expenses A/c Dr. To Equity share capital A/c To Securities premium A/c (Being employees availed the option during the exercised)	60,000 40,000	 10,000 90,000

Note: As per SEBI guidelines, 1999 accounting treatment for ESOS is as follows:

Suppose a company grants 500 options on 1/4/2010 at Rs.40 when the market price is Rs.160, the vesting period is two and a half years, the maximum exercise period is one year. Also suppose that 150 unvested options lapse on 1/5/2012. 300 options are exercised on 30/6/2013 and 50 vested options lapse at the end of the exercise period. The accounting value of the option being:

500 × (160 –40) = 500 × 120 = 60,000

The accounting entries would be as follows:

1/4/2010

Particulars		Debit	Credit
Deferred Employee Compensation A/c	Dr.	60,000	
To Employee Stock Options Outstanding A/c			60,000
(Grant of 500 options at a discount of Rs.120 each)			

31/3/2011

Particulars		Debit	Credit
Employee Compensation Expense A/c	Dr.	24,000	
To Deferred Employee Compensation Expense A/c			24,000
(Amortisation of the deferred compensation over two and a half years on straight-line basis)			

1/5/2012

Particulars		Debit	Credit
Employee Stock Options Outstanding A/c	Dr.	18,000	
To Employee Compensation Expense A/c			14,400
To Deferred Employee Compensation Expense A/c			3,600
(Reversal of compensation accounting on lapse of 150 unvested options)			

31/3/2013

Particulars		Debit	Credit
Employee Compensation Expense A/c	Dr.	8,400	
To Deferred Employee Compensation Expense A/c			8,400
(Amortisation of the deferred compensation over two and a half years on straight-line basis)			

30/6/2013

Particulars		Debit	Credit
Cash A/c	Dr.	12,000	
Employee Stock Options Outstanding A/c	Dr.	36,000	
To Paid-up Equity Capital A/c			3,000
To Secretion Premium A/c			45,000
(Exercise of 300 options at an exercise price of Rs.40 each and an accounting value of Rs.120 each)			

1/10/2013

Particulars		Debit	Credit
Employee Stock Options Outstanding A/c	Dr.	6,000	
To Employee Compensation Expense /General Reserve A/c			6,000
(Reversal of compensation accounting on lapse of 50 vested options at the end of exercise period)			

Employee Stock Options Outstanding and Deferred Employee Compensation Expense would be as follows:

Employee Stock Options Outstanding Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1/5/2012	To Employee Compensation Expense	14,400	1/4/2010	By Deferred Compensation expense	60,000
1/5/2012	To Deferred Compensation expense	3,600			
30/6/2013	To Paid Up Capital Share Premium	36,000			
1/10/2013	To Employee				

	Compensation/General reserve	6,000			
		60,000			**60,000**

Deferred employee compensation expense account:

Date	Particulars	Rs.	Date	Particulars	Rs.
1/4/2010	To ESOS Outstanding	60,000	31/3/2011	By Employee Comp. Expenses	24,000
			31/3/2012	By Employee Comp. Expenses	24,000
			1/5/2012	By ESOS Outstanding	3,600
			31/3/2013	By Employee Comp. Expenses	8,400
		60,000			**60,000**

Note: The balance in employee stock option outstanding account, net of any un-amortised deferred employee compensation is shown separately as part of 'Shareholders' Funds'.

PROBLEMS FOR CLASSROOM DISCUSSION

Problem 1: Basic level: X Co. Ltd. has its share capital divided into equity shares of Rs.10 each. On 1.4.2012 it granted 20,000 employees' stock option at Rs. 50 per share, when the market price was Rs.120 per share. The options were to be exercised between 15th March, 2013 and 31st March, 2013. 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, 2013. **(PM) (Solve problem no 1 of assignment problems as rework)**

Note:____

Problem 2: (PRINTED SOLUTION AVAILABLE) On 1st April, 2012, a company offered 100 shares to each of its 500 employees at Rs.50 per share. The employees are given a 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 Rs.60 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at Rs.56 per share.

On 31st March, 2013, 400 employees accepted the offer and paid Rs.50 per share purchased. Nominal value of each share is Rs.10. **(PM) (RTP)**

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

(Solve problem no 2 and 3 of assignment problems as rework)

Note:____

Problem 3: Exercises of options: HCL grants 1,250 options on 1st April, 2012 at Rs.80 when the market price is Rs.200 and the face value is Rs.10. the vesting period is 3 years. The maximum exercise period is one year. 450 unvested options lapse on 1st May, 2014, 800 options are exercised on 31st August, 2015. Pass necessary journal entries to record the above transactions and Employee Stock Options Outstanding Account and state how these account will be shown in the Balance Sheet. **(May - 2011 Similar Problem)**
(Solve problem no 4 and 5 of assignment problems as rework)

Note:____

Problem 4: **Advanced**: Choice Ltd. grants 100 stock options to each of its 1,000 employees on 1.4.2009 for Rs.20 depending upon the employees at the time of vesting of options. Options would be exercisable within a year it is vested. The market price of the share is Rs.50. 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 31.03.2010, 4,000 unvested options lapsed on 31.3.2011 and finally 3,500 unvested options lapsed on 31.3.2012.

Following is the earning of Choice Ltd:

Year ended on	Earning (in %)
31.03.2010	14%
31.03.2011	10%
31.03.2012	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. **(SM)**

Note:

Problem 5: **(PRINTED SOLUTION AVAILABLE)** At the beginning of year 1, an enterprise grants 300 options to each of its 1,000 employees. The contractual life (comprising the vesting period and the exercise period) of options granted is 6 years. The other relevant terms of the grant are as below:

Vesting Period	3 years
Exercise Period	3 years
Expected Life	5 years
Exercise Price Rs.	50
Market Price Rs.	50
Expected forfeitures per year	3%

The fair value of options, calculated using an option pricing model, is Rs.15 per option. Actual forfeitures, during the year 1, are 5 per cent and at the end of year 1, the enterprise still expects that actual forfeitures would average 3 per cent per year over the 3-year vesting period. During the year 2, however, the management decides that the rate of forfeitures is likely to continue to increase, and the expected forfeiture rate for the entire award is changed to 6 per cent per year. It is also assumed that 840 employees have actually completed 3 years vesting period.

200 employees exercise their right to obtain shares vested in them in pursuance of the ESOP at the end of year 5 and 600 employees exercise their right at the end of year 6 Rights of 40 employees expire unexercised at the end of the contractual life of the option, i.e., at the end of year 6, Face value of one share of the enterprise is Rs.10.Give necessary journal entries. **(RTP)**

(Ans.: Expense to be recognized in year1: 13,69, 010; Year 2: 11,22,740; Year 3: 12,88,250; amount to be transfer to general reserve 1,80,000)

Note:

ASSIGNMENT PROBLEMS

Problem 1: **Basic Level**: A company has its share capital divided into shares of Rs.10 each. On 1-4-2012, it granted 10,000 employees stock option at Rs.40, when the market price was Rs.130. The options were to be exercised between 15-03-2013 and 31-03-2013.

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. **(SM)**

Problem 2: **Accounting treatment for esop-basic level:** Cauvery Software Limited granted 2,000 options on 1st April, 2007 at Rs.50 when the market price was Rs.150. The vesting period is two years.

You are required to:

a. Calculate the value of options

b. Calculate the amount to be amortised every year.

c. Pass necessary journal entries for the year 2007 – 08 and 2008-09.

(Ans.: Value of Options: Rs. 2,00,000; Amount to be recognized every year: Rs. 1,00,000)

Problem 3: S Ltd. grants 1,000 options to its employees on 1.4.2010 at Rs.60. The vesting period is two and a half years. The maximum exercise period is one year. Market price on that date is Rs.90. All the options were exercised on 31.7.2013. Journalize, if the face value of equity share is Rs.10 per share. **(PM)**

Problem 4: ABC Ltd grants 1,000 employees stock options on 1.4.2010 at Rs.40, when the market price is Rs.160. The vesting period is 2½ years and the maximum exercise period is one year. 300 unvested options lapse on 1.5.2012. 600 options are exercised on 30.6.2013. 100 vested options lapse at the end of the exercise period. Pass Journal Entries giving suitable narrations **(SM, Nov-14)**

Problem 5: P Ltd. granted option for 8,000 equity shares of nominal value of Rs.10 on 1st October, 2010 at Rs. 80 when the market price was Rs.170. The vesting period is 4½ year, 4,000 unvested options lapsed on 1st December, 2012, 3,000 options are exercised on 30th September, 2015 and 1,000 vested options lapsed at the end of the exercise period. Pass Journal Entries for above transactions. **(PM)**

ABC ANALYSIS

	A Category	B Category	C Category
Class Room Problems	1	2, 3	4, 5
Assignment Problems	1, 2, 4, 5	3	-

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THE END