CHAPTER 3

ACCOUNTING FOR EMPLOYEE STOCK OPTION PLAN

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Learn the provisions of the Companies Act 2013 regarding employees' stock option.
- Understand the accounting policies of employees' stock option plan.
- Learn the accounting treatment of employees' stock options.
- Learn the provisions of Guidance Note on Employee Share-Based Payments.

CHAPTER OVERVIEW

- **Employee Stock Option Plan (ESOP) is an option given to directors, officers or permanent employees of a company or of its subsidiary, in India or outside India, or of a holding company or associate company of the company to purchase or subscribe the securities offered by the company at a future date, at a concessional price generally.**
- **The company granting options to its employees pursuant to ESOPs will have the freedom to determine the exercise price in conformity with the applicable accounting policies, if any.**
- **There shall be a minimum period of one year between the date of grant of option and the date of vesting of the option.**
- **The term grant (in relation to Employee Stock Option) means the issue of option to the employee under ESOP. The grant date will be the date on which the option is issued.**
- **Vesting Period means the period during which the vesting of the option granted to an employee takes place;**
- **Vesting means the process by which the employee is given the right to apply for the shares of the company against the option granted to him under the ESOP;**
- **"Exercise" means making of an application by an employee to the company for issue of shares against option vested in him under the ESOP.**
- **"Exercise Period" means the time period after vesting within which an employee should exercise his right to apply for the shares vested in him under the ESOP.**
- **Under the Companies Act 2013, there shall be a minimum period of one year between grant of options and vesting of options, hence the exercise period cannot be less than one year from the date of grant of option.**
- **There are two methods of accounting for Employee Share Based Payments viz, intrinsic value method or fair value method.**

1 EMPLOYEES STOCK OPTION PLAN

Under Section 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.

Earlier Securities and Exchange Board of India (SEBI) issued Employees Stock Option Scheme and Employee Stock Purchase Scheme Guidelines (applicable for listed companies) in 1999 under section 11 of the Securities and Exchange Board of India Act, 1992. This guideline has now been replaced by the SEBI (Share Based Employee Benefits) Regulations, 2014* (applicable for listed companies). It covers 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 Regulation stipulate to follow the requirements of the 'Guidance Note on Accounting for Employee Share Based Payments or Accounting Standards as may be prescribed by the ICAI from time to time including the disclosure requirements prescribed therein.

Important terms to be remembered

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 pursuance of employee stock option scheme.
3. ***Vesting Period***: It is the time period between grant date and the date on which all the specified vesting conditions of an employee share based payment plan are to be satisfied.
4. ***Option***: Option means a right but not an obligation granted to an employee for a specified period of time in pursuance of ESOS to purchase or subscribe to the shares of the company at a pre-determined price.
5. ***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.

* *SEBI (Share Based Employee Benefits) Regulations, 2014 has been issued on October 28, 2014 and are applicable from the same date.*

6. ***Exercise Price:*** It is the price payable by the employee for exercising the option granted to him in pursuance of ESOS.
7. ***Intrinsic Value:*** It is the excess of the market price of the share under ESOS over the exercise price of the option (including up-front payment, if any).
8. ***Fair Value:*** It 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.

1.1 PROVISIONS OF GUIDANCE NOTE ON EMPLOYEE SHARE-BASED PAYMENTS

The Guidance Note on Accounting for Employee Share-based Payments establishes financial accounting and reporting principles for employee share-based payment plans, viz., employee stock option plans, employee stock purchase plans and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

For **accounting purposes**, employee share-based payment plans are classified into the following categories:

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

An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices, if available, taking into account the terms and conditions upon which those shares or stock options were granted. If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognized for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognized for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied.

Accounting Procedure

Equity-settled Employee Share-based Payment Plans

An enterprise should recognize as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account 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 recommended in the Guidance Note.

If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognize services received in full with a corresponding credit to the equity account.

If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee 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.

To apply the requirements of the Guidance Note on Employee Share Based Payments, 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 taken into account 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 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). 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.

Cash-settled Employee Share-based Payment Plans

For cash-settled employee share-based payment plans, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in fair value recognized in profit or loss for the period.

Employee Share-based Payment Plans with Cash Alternatives

For employee share-based payment plans in which the terms of the arrangement provide either the enterprise or the employee with a choice of whether the enterprise settles the transaction in cash or by issuing shares, the enterprise is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment plan 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 plan if, and to the extent that, no such liability has been incurred.

Accounting for employee share-based payment plans is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer.

Apart from the above, the Guidance Note also deals with various other significant aspects of the employee share-based payment plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc. The Guidance Note also recommends detailed disclosure requirements.

Variation in Vesting Period

The vesting period, i.e. the time taken to satisfy the vesting conditions can be uncertain. For example, if employees are granted ESOP subject to the condition that the company achieves a 50% market share, the vesting period can be known only when the market share of the company actually reaches the specified 50% level. In these cases, allocation of option value for recognition as expense in a particular accounting period should be based on estimated vesting period. The initial estimate of vesting period on grant date should be reviewed and revised if necessary, at the end of each accounting period. In case of revision of vesting period, the basis of allocation of option value to a particular accounting period should be based on revised estimate of vesting period.

Where the vesting condition is a market condition, e.g. when an option is granted subject to condition that the market price of the share reaches a specified level, the fair value of option is reduced due to the possibility that the vesting condition may not be satisfied. Such fair values are recognised as expense whether or not the market condition is satisfied, over the vesting period estimated on grant date. The estimates of vesting periods are not revised subsequently in these cases.

Graded Vesting

Graded vesting refers to a situation where options under a plan vest on different dates. For example, a plan may provide that shares offered to an employee shall vest in proportion of 2:3:5 in three years commencing from fourth year. Thus if an employee is offered 100 shares under the plan, 20 shares shall vest in year 4, 30 shares shall vest in year 5 and 50 shares shall vest in year 6. In these cases, based on vesting dates, the plan is segregated in into different groups. Each of these groups is then treated as a separate plan with specific vesting period and expected life.

As an alternative to the accounting treatment specified above, in case the options/shares are granted under graded vesting plan with only service conditions, an enterprise has an option to recognise the share based compensation cost on a straight-line basis over the requisite service period for the entire award (i.e., over the requisite service period of the last separately vesting portion of the award). However, the amount of compensation cost recognised at any date must at least equal the portion of the grant-date value of the award that is vested at that date.

An enterprise should make a policy decision as to which accounting treatment to be followed in respect of graded vesting.

Since one of the factors affecting fair value of an option is expected life, the fair value for each group should be computed separately. Fair value of a group is then allocated to accounting periods and recognised as expense for the period with reference to vesting period for the group.

Intrinsic value of an option does not depend on its expected life. Intrinsic value of option per share shall therefore be same for each group. In the same way as fair value, intrinsic value of a group is allocated to accounting periods and recognised as expense for the period with reference to vesting period.

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 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	Bank A/c (9,500 x 40) Dr.	3,80,000	
	Employee compensation expense A/c [9,500 x (130-40) Dr.	8,55,000	
31st March	To Equity share capital A/c (9,500 x 10)		95,000
20X2	To Securities premium A/c [9,500 x (130-10)]		11,40,000
	(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)		

31st March 20X2	Profit and Loss A/c Dr.	8,55,000	
	To Employee compensation expense A/c		8,55,000
	(Being transfer of employee compensation expense to profit and loss account)		

Illustration 2

ABC Ltd. grants 1,000 employees stock options on 1.4.20X0 at ₹ 40, when the market price is ₹ 160. 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.	48,000	
	To Employee stock option outstanding account		48,000
	(Being compensation expenses recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of ₹ 120 each, 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)		
31.3.20X2	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 at a discount of ₹ 120 each, amortised 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 account (W.N.1)	Dr.	12,000	
	To General Reserve account (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	
	To General reserve account (W.N.2)			12,000
	(Being ESOS outstanding A/c on lapse of 100 options at the end of exercise of option period transferred to General Reserve A/c)			

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 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.

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 Dr. (16,000 x 70)	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

An enterprise should review all estimates taken in consideration for valuation of option. The value of options recognised as expense in an accounting period is the excess of cumulative expense as per latest estimates upto the current accounting period over total expense recognised upto 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. 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 discount of ₹ 90 (170-80) 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
	(Being compensation expense recognized in respect of the employee stock option i.e. 8,000 options granted to employees at a			

	discount of ₹ 90 each, 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 at a discount of ₹ 90 each, 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)			
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 at a discount of ₹ 90 each, 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 at a discount of ₹90 each, 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

	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) To General reserve account (W.N.3) (Being ESOS outstanding A/c transferred to General Reserve A/c on lapse of 1000 vested options at the end of the exercise period)	90,000	90,000

Working Notes:

1. Fair value = ₹ 170 – ₹ 80 = ₹ 90

2. 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

3. 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 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.

Following is the earning of Choice Ltd:

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.

Solution

Date	*Particulars*		₹	₹
31.3.20X2	Employees compensation expense A/c	Dr.	14,25,000	
	To ESOS 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 discount 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 ESOS 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 ESOS 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)			
20X4-X5	Bank A/c (85,000 × ₹ 20)	Dr.	17,00,000	
	ESOS 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	ESOS outstanding A/c	Dr.	75,000	
	To General Reserve A/c			75,000
	(Being ESOS 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

Reference: The students are advised to refer the bare text of The Guidance Note on Employee Share Based Payments.

SUMMARY

- ESOP is an option given to whole-time or other directors, officers or 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.
- As per the requirements of the Guidance Note on Employee Share Based Payments, 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.

TEST YOUR KNOWLEDGE

MCQs

1. For accounting purposes, employee share-based payment plans are classified as

   (a) Equity settled and cash settled.

   (b) Liability settled and cash settled.

   (c) Equity settled, cash settled and employees share based payment plans with cash alternatives.

2. Under the Companies Act 2013, there shall be a minimum period of

   (a) two years between grant of options and vesting of option

   (b) one year between grant of options and vesting of option

   (c) six months between grant of options and vesting of option.

3. The excess of the market price of the share under ESOS over the exercise price of the option is
   (a) Exercise Price
   (b) Intrinsic Value
   (c) Fair value
4. Which amount would be recognized for Share based payment?
   (a) Fair value of Share prices/ value
   (b) Amount as per agreement
   (c) Fair value of goods/ services received unless it is not reliably measurable then fair value of share prices would be used

Theoretical Questions

Question 1

What is employee stock option plan? Explain the importance of such plans in the modern time.

Question 2

Define the following terms:

(i) Vesting

(ii) Exercise Period

Practical Questions

Question 1

X Co. Ltd. has its share capital divided into equity shares of ₹ 10 each. On 1.1.20X1 it granted 20,000 employees' stock option at ₹ 50 per share when the market price was ₹ 120 per share. 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. 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 1-1-20X1, it granted 5,000 employees stock options at ₹ 50, when the market price was ₹ 140. 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.

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 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 ₹ 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.

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.

ANSWERS/HINTS

MCQ

[1. (c); 2(b); 3. (b) 4(c)]

Theoretical Questions

Answer 1

Employee Stock Option Plan: It is a plan under which the company grants employee stock options. 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 the shares of the company at a fixed or determinable price which is generally lower than the prevailing market price of its shares.

The importance of these plans 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 2

Vesting means the process by which the employee is given the right to apply for the shares of the company against the option granted to him under the ESOP.

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.

Practical Questions

Answer 1

In the books of X Co. Ltd.

Journal Entries

			₹	₹
15.03.20X2 to 31.3.X2	Bank A/c (16,000 x 50)	Dr.	8,00,000	
	Employee compensation expense A/c [16,000 x (120-50)]	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)			

Working Notes:

1. No entry is passed when Stock Options are granted to employees. Hence, no entry will be passed on 1st April 20X1;
2. Market Price = ₹ 120 per share whereas stock option price = ₹ 50, Hence, the difference ₹ 120 – ₹ 50 = ₹ 70 per share is equivalent to employee cost or employee compensation expense and will be charged to P/L Account as such for the number of options exercised i.e. 16,000 shares.

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 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.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)			
	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)			
31.7.13	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)			
31.7.13	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 (₹ 90 – ₹ 60) = ₹ 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)		
31-3-X2	Profit and Loss account Dr.	4,32,000	
	To Employees compensation expenses A/c		4,32,000
	(Being transfer of employees compensation expenses)		

Working Note:

1. Employee Compensation Expenses = Discount between Market Price and option price = ₹ 140 – ₹ 50 = ₹ 90 per share = ₹ 90 x 4,800 = ₹ 4,32,000/- in total.
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 = ₹ 56 – ₹ 50 = ₹ 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 month

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

Date	*Particulars*		₹	₹
31.03.20X1	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 (40,000shares 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
	(Being Employees stock compensation expense transferred to Profit & Loss A/c)			