

11th Capacity Building Seminar on Retirement Benefits (11th CBRB)

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Actuary's Practical Experience working on the ESOP & Employee Benefits

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Consulting Actuary & Founder, Kandoi & Co



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CA. Kartikey Kandoi, Actuary

- Consulting Actuary & Founder, Kandoi & Co
- Central Council Member of the Institute of Actuaries of India (IAI)
- Special Invitee on the Accounting Standards Board of ICAI for the Council Year(s) 2023-25
- Faculty for Certificate Course on Ind AS (Ind AS 19, 20, 37, 102), Deep Dive Course on Share-based payment (ESOP) by ICAI ASB, Ind AS 19 Employee Benefits for **NFRA**

Kartikey Kandoi is the Founder and Proprietor of the firm “M/s. Kandoi & Co” and offers consultancy services of Actuary & CA. He has a decade of experience in the Actuarial field, including 7 years of post-qualification experience, with a specialization in Employee Benefits.

He is an all-India topper in the subjects 'Special Technical - Employee benefits and Pensions' and 'Core Application - Modelling and Documentation' at the Actuary Exam and has secured 15th All India Rank & 99% in the Accountancy Paper at the CA IPCC Level. He is one of the youngest professionals in India to qualify as an Actuary at the age of 24 after having qualified as a CA at the age of 21. He is youngest Actuary to serve as Council Member of the Institute of Actuaries of India.

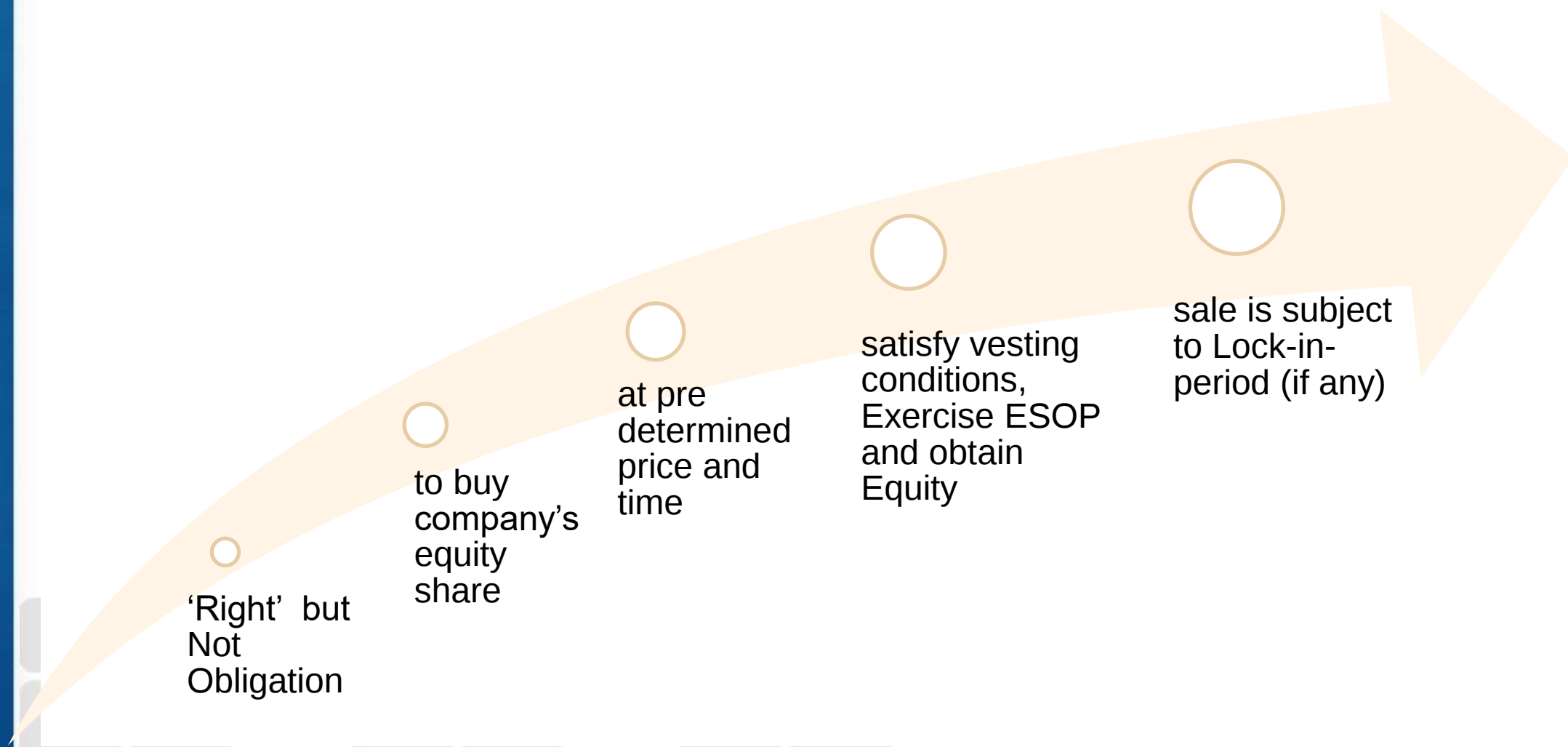
His expertise lies in providing 360⁰ solutions for Actuarial, Accounting, and Advisory globally in Insurance and across industries for Employee Benefits, including ESOPs. He has consulted 100+ companies for ESOP advisory & 600 + companies for Employee Benefits Actuarial Valuation. He provides support to Auditing firms on Actuarial Valuation Review & Training.

Disclaimer



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What is ESOP?



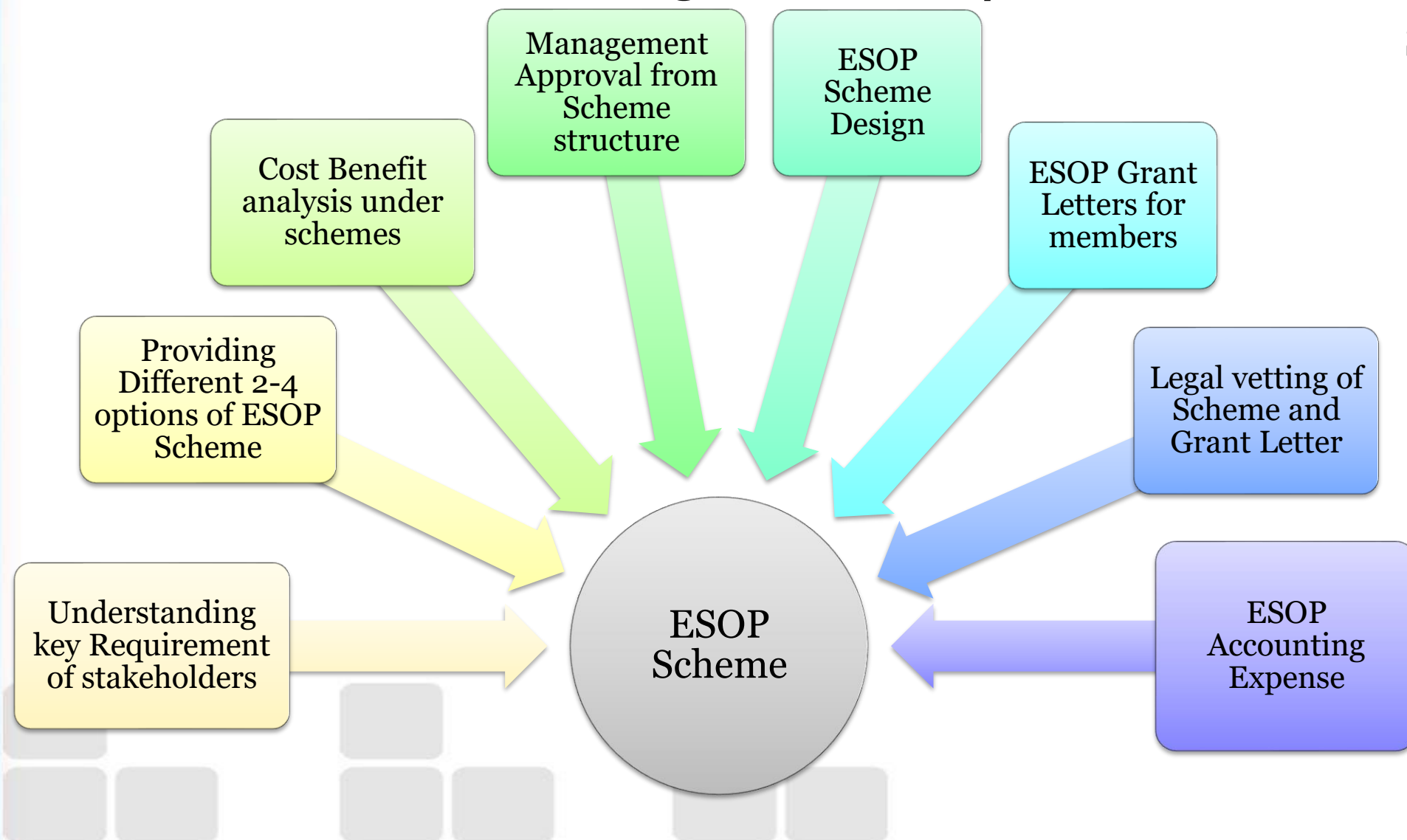
Regulatory Norms – ESOP



Regulatory norms and Accounting principles for ESOP of Indian Companies:

- Companies Act Section 62(1)(b)
- SEBI Share Based Employee Benefits and Sweat Equity Regulations, 2021
- Rule 12 of Companies (Share Capital and Debentures) Rules, 2014
- Special Resolution by Shareholders
- GN on Share-Based Payments issued by ICAI (2020)
- Ind AS 102: Share-Based Payments (Ind AS Accounting)
- IFRS 2: Share-Based Payments (IFRS Accounting)
- ASC 718 and ASC 505-50 for employees and nonemployees, respectively (US GAAP Accounting)

ESOP Scheme Design and Implementation



Valuation and Selection of Method



For ESOP Accounting, we typically requires two valuations:

- Company's share price
- Fair Value of option

Date of Valuation will depend on type of Stock options:

- Equity-settled plan – Grant date fair value
- Cash-settled plan – Grant date and each balance sheet date

Fair Value of option can be determined using following methods:

- Black- Scholes model
- Binomial/Lattice model
- Monte- Carlo simulation model

Amongst the three, Black- Scholes model is a widely used method by Indian listed and non-listed companies.

Key Parameters – ESOP Fair Valuation



- **Share Price on Grant Date** - Closing share price on *Grant date* as per stock exchange or independent valuer report in unlisted companies.
- **Exercise Price of Option** – as per Grant letter can't be less than face value of Equity share.
- **Expected Number of periods to Exercise** - As per para B16 to B21 of Ind AS 102 we need to allow for expected early exercise in contractual life of option while considering expected number of years to exercise in option pricing model. As per para B16 employees are often expected to exercise early due to reasons like to encash worth of ESOP or the condition that ESOP need to be exercised before separation to avoid forfeiture of option.
As per para B18(b) we could allow for factors like average length of similar options in past.

Key Parameters – ESOP Fair Valuation



- **Risk-Free Interest Rate** - As per para B34 of Ind AS 102, Risk free interest rate assumption used as Zero coupon government yield for term consistent to expected exercise period.
- **Dividend Yield** - As per para B34 of Ind AS 102, Dividend yield assumption need to be used in option pricing model.
- **Expected Volatility (annualized standard deviation)** - As per para B22 of Ind AS 102, Expected volatility is expressed as annualised standard deviation. The measure of volatility used in ESOP pricing model is the annualized standard deviation of the continuously compounded rates of return on historical data of daily share price. Further as per para B25 (b) historical volatility should be calculated for term commensurate with expected term of options. As per para B25(d) we need to allow for factors if in past trend share price was extraordinarily volatile due to certain factors.

Accounting Treatment: Equity-settled



- For equity-settled SBPT, the entity shall measure the fair value of the option, and a corresponding increase in equity.
- Recognize expense **over the vesting period using the straight-line** method.
- Measure the fair value of equity instruments granted at the **measurement date**, taking into account terms and conditions upon which those equity instruments were granted.
- Grant of equity instruments may be conditional upon satisfying specified vesting conditions i.e. market and non-market conditions.
 - Adjust market condition in the determination of Fair Value of Stock Option,
 - Adjust non-market conditions (e.g. continued service, achieving performance goal etc) in the number of options ***expected to ultimately vest***.

Modification of Equity settled SBPT



As per para 26 of Ind AS 102, an entity might **modify the terms and conditions** on which the equity instruments 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 (on date of modification). Modification should be beneficial for option holder.

As per para 26 of Ind AS 102, the entity 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. Guidance on applying this requirement is given in Appendix B.

As per para 27 of Ind AS 102, the entity shall **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.

Modification of Equity settled SBPT..

The following steps may be considered for accounting of modified plan :-

Step I : There will be ***no change in the Accounting for original Expense*** which relates to Original Plan.

Step II : *At the time of modification in Plan*, we should ***calculate Additional Expense*** due to reduction in exercise price as follows :-

Fair Value of option with modification	XXXX
Fair value of earlier plan	(XXXX)
Additional Exp.	XXXX

Step III : The amount of Additional Expense will be ***amortized*** over the ***remaining vesting period*** (*Date of modification to vesting date*).

Cancellation of ESOP



As per para 23 of Ind AS 102, vested ESOPs which are not exercised and/or forfeited after vesting, such expense of vested ESOPs **will not be reversed in profit and loss** account. ESOP O/s amount related to such options can be transferred to other equity component (General Reserve).

As per para 28 of Ind AS 102, any **Cancellation** of plan we need to account for it as **acceleration of vesting** and recognise all expense at time of cancellation which otherwise would have been recognised in remaining vesting period.

Para 28: 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 entity 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.

Cancellation of ESOP – Accounting Treatment



First accelerate expense -----

P&L A/c	Dr
To ESOP outstanding Reserve A/c	

Payment for settlement (if any, subject to limit of fair value of instrument on repurchase date) ---

ESOP o/s Reserve A/c	Dr	(limit upto fair value on repurchase date)
P&L A/c	Dr	(excess amount)
To Bank A/c		(Amount paid)

Balance amount in ESOP outstanding Reserve ledger----

ESOP Outstanding A/c	Dr	(Balance in ESOP reserve)
To General reserve A/c		

Employee Transfer to Subsidiary – Accounting Treatment



Recognize as equity settled share based payment as per 43B (b) the entity has **no obligation** to settle the share-based payment transaction.

Subsidiary Books-

Expense A/c Dr

To Equity (Capital Contribution from Parent Company)

(For period of service rendered in subsidiary company)

43C – holding company which is giving own shares to employees of group company shall recognise this as equity settled share based payment.

Holding company Books -

Cost of Investment in Subsidiary A/c Dr

To Equity

(Recognise Grant date fair value for period of service rendered in subsidiary)

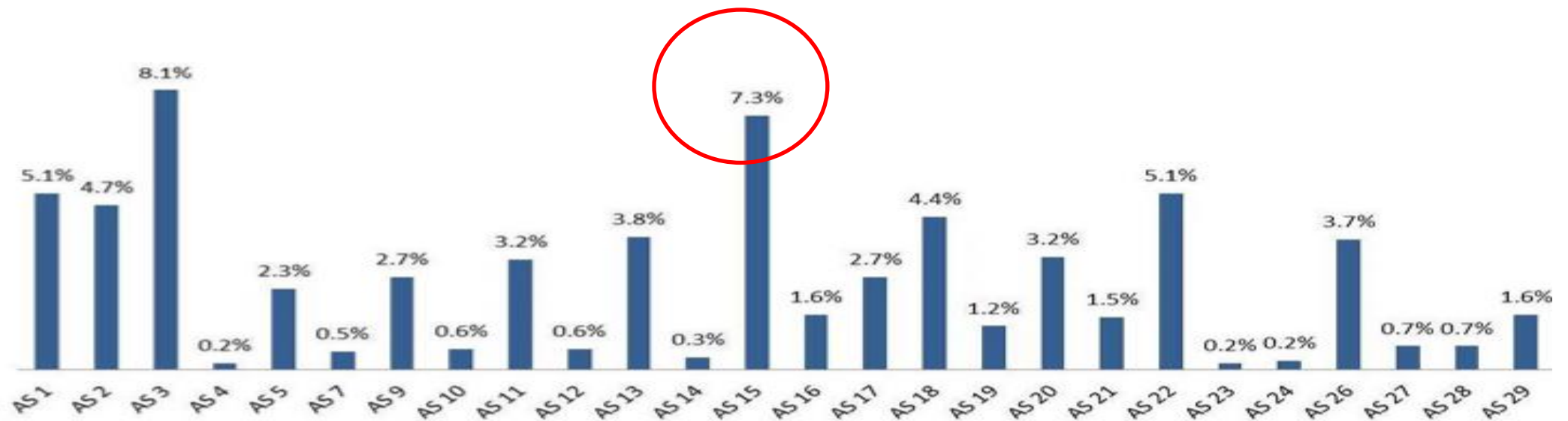
Practical Points/ Issues

- How to Determine Attrition Rate/ Lapse Rate?
- Shall we consider all left employee only or forfeited options
- How to consider Attrition rate of vested ESOP employees
- Expected term of Options
- Amortisation of expense with Monthly/ quarterly Vesting
- ESOP Fair Value where Benefit Payout is Guaranteed or performance linked
- Volatility assumption for newly listed or unlisted companies
- Whether ESOP valuation can be done by Actuary?

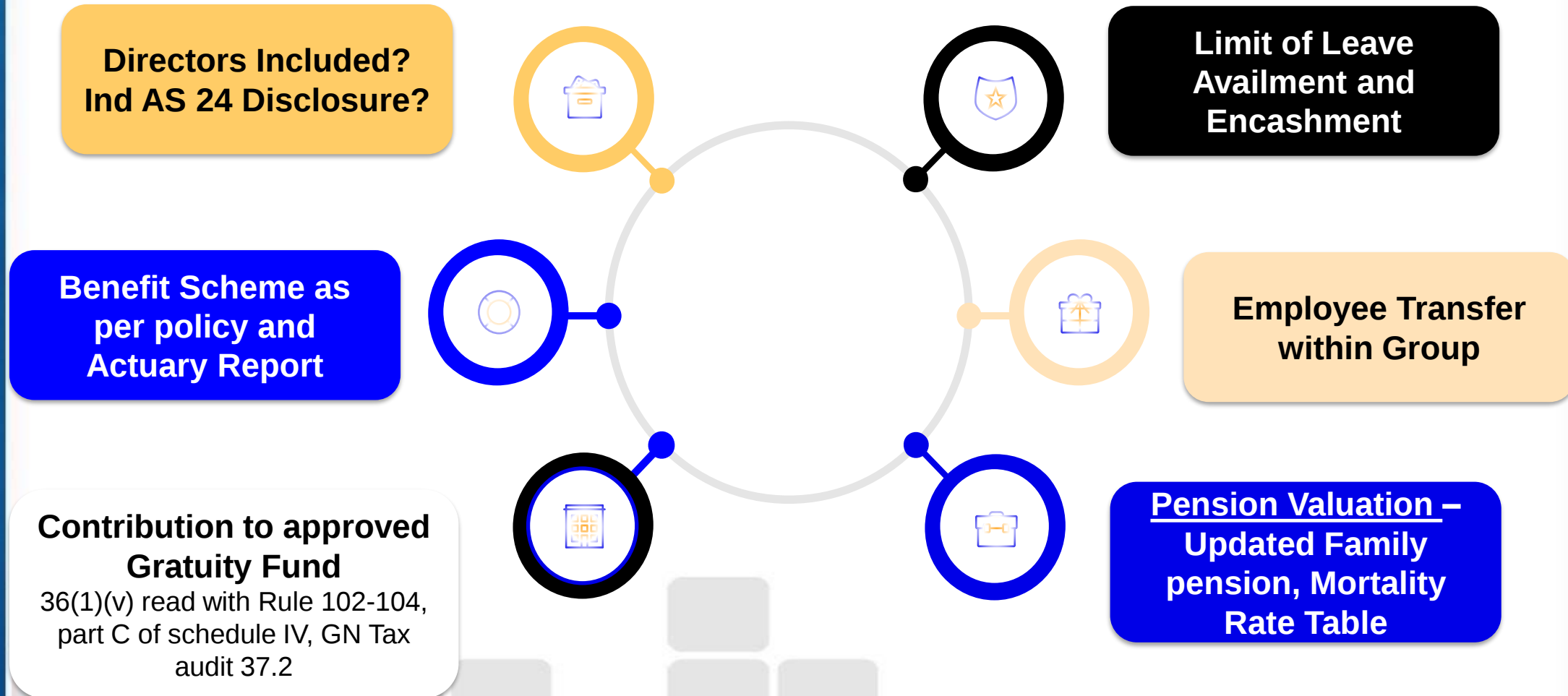
Practical Experience on Employee Benefits

FRRB - AS Non-Compliance summary

Graphical Presentation of Accounting Standards



Practical aspects in Actuarial Valuation



Common Errors Found by FRRB (AS15, Ind AS19)

Non-provisioning of
Gratuity (Matching
Principle)

No disclosure or
inadequate
disclosures post
employment plans

Defined Benefit Plan
wrongly treated as
Defined Contribution
Plan

Non-Disclosure of
expense for Defined
Contribution Plan

Inadequate disclosure
pertaining to Use of
PUCM Method

Actuarial Gain/ loss
recognised
inappropriately

Provision for Long
service awards, Leave
without Actuarial
Method

Frequently Asked Questions



Why company need Actuarial Valuation of Employee Benefits?

Why Provision of **Gratuity** for **Less than 5** years of service?

Leave valuation why CTC when encashment on Basic?

Current Age of Employees 30 years then why expected term for discount rate taken as 5-8 years?

In Pension valuation, we have secured pension with Annuity so why additional provision of Retiree required?

Why provision calculated by actuary is not matching with company excel calculation?

Consequences of Non Compliance

Labour law penalties for non payment of benefits

Companies Act requirement to follow AS 15, Ind AS 19

Auditors to **qualify** Audit Report with quantification if non compliance of AS

Gratuity Funding via '**Approved Trust**' only to ensure Tax deduction

Actuarial Valuation Report required even if funding with Insurer, **Insurer report not AS15.**

Check for Qualification/ CoP, companies can't practice (similar to CA Act)

Q&A and Open Forum Discussion