

# Consolidation of ESOP Trust in the standalone financial statements, Treatment of investment in own shares for EPS calculation in the standalone financial statements and Treatment of ESOP Trust in the financial statements for tax audit purposes

*The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.*

## A. Facts of the Case

1. Company A (the 'company') is listed on stock exchanges in India and has a statutory year end of 31<sup>st</sup> December. In the year 2011, the company started new Employee Stock Option ('ESOP') scheme whereby the employees would be granted options (directly linked to individual, team and company performance) at an exercise price equal to the face value of the share (currently at INR 5). The company has created a Trust for this purpose, also referred to as the 'ESOP Trust' or 'ESOPT'. The ESOP Trust obtains its funds through a loan from the company, which it utilises for the purchase of the company's shares. It receives shares from the company by way of fresh allotment. The ESOP Trust then allocates shares to employees on exercise of their right in exchange of cash and repays its loans. The details of Trustees, Beneficiaries and Benefactor of the Trust are given below:

- a. Trustees : Senior management employees of the company A
- b. Beneficiaries : Company A Employees
- c. Benefactor : Company A

The company records the charge (intrinsic value-grant price) in its own books.

2. The querist has drawn the attention of the Committee to paragraph 45 of the 'Guidance Note on Accounting for Employee Share-based Payments' (the Guidance Note) issued by the Institute of Chartered Accountants of India (the 'ICAI'), which reads as below:

"45. For the purpose of preparation of consolidated financial statements as per

Accounting Standard (AS) 21, 'Consolidated Financial Statements', issued by the Institute of Chartered Accountants of India, the trust created for the purpose of administering employee share-based compensation, should not be considered. This is because the standard requires consolidation of only those controlled enterprises which provide economic benefits to the enterprise and, accordingly, consolidation of entities, such as, gratuity trust, provident fund trust, etc., is not required. The nature of a trust established for administering employee share-based compensation plan is similar to that of a gratuity trust or a provident fund trust as it does not provide any economic benefit to the enterprise in the form of, say, any return on investment."

3. The querist has also drawn the attention of the Committee to Clause 22A.1 of 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'), dealing with accounting for employee stock option scheme ('ESOS') and employee stock purchase scheme ('ESPS') through Trust route, which reads as below:

"In case of ESOS/ESPS administered through a Trust, the accounts of the Company shall be prepared as if the company itself is administering the ESOS/ESPS."

4. The querist has made an analysis evaluating whether the transactions of the ESOP should be included in the standalone financial statements of the company. As per the querist, the following reasons suggest consolidation of ESOP in the separate financial statements of the company:
  - (i) It is noted that the company, being a listed company, accounting by the company in respect of ESOP will have to be in accordance with the SEBI Guidelines on the matter.
  - (ii) Revised clause 22A.1 of the SEBI Guidelines reads as follows:
 

“In case of ESOS/ESPS administered through a Trust, the accounts of the company shall be prepared as if the Company itself is administering the ESOS/ESPS.”

A plain reading of the above Clause shows that SEBI's intent is to make comparable the standalone financial statements of two companies - one which follows the Trust route and the other that issues shares directly to the employees concerned. The appropriate approach would, therefore, be that the accounts of the Trust should be included in the standalone financial statements of the company as if all the transactions of the Trust are those of the company. The standalone financial statements would, thus, be devoid of the effect of executing ESOP scheme through the Trust route. In substance, the activities of the Trust are being conducted on behalf of the company according to its specific business needs. The Trust should be seen as an extension of the company as a branch/agent and, therefore, it is appropriate to view actions that nominally are those of the Trust as actions of the company.
  - (iii) Since under the SEBI Guidelines, the ESOP is to be viewed as a part of the company itself, it follows that the transactions between the two would not be reflected in the standalone financial statements of the company. Rather, the transactions between the ESOP and third parties would be reflected in those financial statements as if these had been carried out by the company itself. This implies that the loan given by the company to ESOP will not appear in the company's standalone financial statements.
5. The main issue arising from the above view is the manner of disclosure of the shares of the company held by ESOP at the year end and the loan given by the company to ESOP. As per the querist, as far as shares held by the Trust at the year end are concerned, these can be reflected in the standalone financial statements of the company. The face value of these shares should be shown as a deduction from share capital and the excess amount paid over and above the face value should be shown as deduction from securities premium with a detailed note explaining the facts. This is on the basis that to the extent own shares are purchased by the company from the market, the Shareholders' Funds stand reduced<sup>1</sup>. *In the books of account, these shares will continue to remain recorded in a separate account and, only for disclosure purposes, they would be shown as deduction from share capital/securities premium. There will not be an accounting entry made in the ledger debiting 'Share Capital/ Securities Premium' and crediting 'Investment in Own shares.'* This is because, such an entry may be construed as effecting a reduction of capital/utilisation of securities premium and, thus, giving rise to attendant legal issues. (Emphasis supplied by the querist.)
6. As per the querist, the ICAI's Guidance Note also recommends the above method of presentation in a situation where the enterprise provides finance to the ESOP Trust for subscription of shares issued by it (i.e., the enterprise) at the beginning of the plan. In case the enterprise provides finance to the Trust for purchasing shares from the market, ICAI's Guidance Note requires loan given to the Trust as asset in the enterprise's balance sheet. However, the genesis of this seems to be in the fact that unlike SEBI Guidelines, ICAI's Guidance Note treats the ESOP Trust as a separate entity. Accordingly, the activities of the trust are not reflected in standalone

<sup>1</sup> Acquisition of own shares of a company by employee welfare trusts (including ESOS/ESPS) from secondary market is no longer possible in view of the recently issued SEBI's Circular No. CIR/CFD/DIL/3/2013 dated January 17, 2013 which has amended 'SEBI Guidelines' and 'Equity Listing Agreement'.

financial statements of the enterprise. Further, as per the Guidance Note, ESOP Trust is not consolidated.

7. However, the company's management is of the view that since both the SEBI Guidelines and the ICAI's Guidance Note require that as the Trust administers the plan on behalf of the company, the company will recognise any expense arising from the employee share-based payment plans as if the company itself is administering the plan. However, it should not incorporate any other balance of the ESOP in the standalone financial statements of the company. Thus, the loan from the company to ESOP Trust will not be eliminated and would appear in the standalone financial statements of the company. In view of paragraph 45 of the ICAI's Guidance Note, the Trust should not be consolidated for the purpose of Consolidated Financial Statements as per Indian Generally Accepted Accounting Principles (GAAPs).
8. Another issue which arises is how to consider investment in own shares in the standalone financial statements of company A for the purpose of calculating basic and diluted earnings per share. The querist has drawn attention of the Committee to paragraph 46 of the ICAI's Guidance Note on Accounting for Employee Share-based Payments, dealing with the issue of EPS, which reads as below:
 

"46. For the purpose of calculating Basic Earnings Per Share as per Accounting Standard (AS) 20, 'Earnings Per Share', shares or stock options granted pursuant to an employee share-based payment plan, including shares or options issued to an ESOP trust, should not be included in the shares outstanding till the employees have exercised their right to obtain shares or stock options, after fulfilling the requisite vesting conditions. Till such time, shares or stock options so granted should be considered as dilutive potential equity shares for the purpose of calculating Diluted Earnings Per Share. Diluted Earnings Per Share should be based on the actual number of shares or stock options granted and not yet forfeited, unless doing so would be anti-dilutive."
- As per the querist, the above seems to suggest that the shares purchased by the Trust from the market should be excluded in calculating weighted average number of outstanding shares for the purposes of basic EPS calculation. However, for purposes of diluted EPS computation, such shares would be considered as potential equity shares.
9. As per the querist, a note should be given in the notes to accounts, which should bring out the requirement of Clause 22A.1 of the SEBI Guidelines pointing out that pursuant to this requirement, the activities of the Trust have been deemed as those undertaken by the company and dealt with accordingly.
10. Considering the above analysis, another issue which requires deliberation is the accounting treatment to be followed in the financial statement prepared under Section 44 AB of the Income-tax Act, 1961 i.e., for the year ended 31<sup>st</sup> March. It is pertinent to note that these financial statements are prepared for a specific purpose for compliance with the Income-tax Act, 1961 and not for the purpose of compliance with any SEBI requirements.
11. The format of Form 3CB requires the tax auditor to state whether the financial statements of the company
 

"... give a true and fair view:-

  - (i) in the case of the balance sheet, of the state of affairs of the assessee as at 31 March, \_\_\_ ; and
  - (ii) in the case of the profit and loss account/ income and expenditure account of the profit/loss or surplus/deficit of the assessee for the year ended on that date."
12. The querist has drawn the attention of the Committee to the following extracts from the 'Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India:
 

"10.5 AS also apply in respect of financial statements audited under section 44AB of the Income-tax Act, 1961. *Accordingly, members should examine compliance with the mandatory accounting standards when conducting such audit.*" [Emphasis added by the querist]

"10.7 The Companies Act, 1956, as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes 'true and fair' view has not been defined either in the Companies Act, 1956, or in any other statute. The Accounting Standards (as well as other pronouncements of the Institute on accounting matters) seek to describe the accounting principles and the methods of applying these principles in preparation and presentation of financial statements so that they give a true and fair view." (The querist has drawn the attention of the Committee to the fact that this has also been reiterated in paragraph 4.15 of the ICAI's 'Code of Ethics'-Eleventh Edition).

13. A question arises as to whether, for the purpose of compliance with the provisions of the Income-tax Act, 1961, the company, being a listed company, should comply with the SEBI Guidelines (as adhered to for the purposes of preparation of annual accounts) or the ICAI's Guidance Note while preparing its financials statements for the year ended 31<sup>st</sup> March. The querist has analysed this issue for the following two situations:

- Companies covered under the provisions of Minimum Alternate Tax ('MAT')
- Companies not covered under the provisions of MAT

#### *Companies covered under the provisions of MAT*

14. The querist has quoted the following portion of MAT provisions<sup>2</sup>:

"115JB. (1) Notwithstanding anything contained in any other provision of this Act, where in the case of an assessee, being a company, the income-tax, payable on the total income as computed under this Act in respect of any previous year relevant to the assessment year commencing on or after the 1<sup>st</sup> day of April, 2010, is less than fifteen per cent of its book profit, such book profit shall be deemed to be the

total income of the assessee and the tax payable by the assessee on such total income shall be the amount of income-tax at the rate of fifteen per cent.

(2) Every assessee, being a company, shall, *for the purposes of this section, prepare its profit and loss account for the relevant previous year in accordance with the provisions of Parts II and III of Schedule VI to the Companies Act, 1956 (1 of 1956):*

Provided that while preparing the annual accounts including profit and loss account,—

- (i) the accounting policies;
- (ii) the accounting standards adopted for preparing such accounts including profit and loss account;
- (iii) the method and rates adopted for calculating the depreciation,

shall be the same as have been adopted for the purpose of preparing such accounts including profit and loss account and laid before the company at its annual general meeting in accordance with the provisions of section 210 of the Companies Act, 1956 (1 of 1956) :

Provided further that where the Company has adopted or adopts the financial year under the Companies Act, 1956 (1 of 1956), which is different from the previous year under this Act,—

- (i) the accounting policies;
- (ii) the accounting standards adopted for preparing such accounts including profit and loss account;
- (iii) the method and rates adopted for calculating the depreciation,

shall correspond to the accounting policies, accounting standards and the method and rates for calculating the depreciation which have been adopted for preparing such accounts including profit and loss account for such financial year or part of such financial year falling within the relevant previous year.

..."

[Emphasis added by the querist].

As is evident from the extracts given above, for the purpose of section 115JB,

<sup>2</sup> There are further amendments to MAT provisions quoted by the querist.

the company is required to prepare profit and loss account as per the provisions of Parts II and III of the Schedule VI to the Companies Act, 1956 using the same accounting policies, accounting standards and the method and rates for calculating the depreciation which have been adopted for preparing such accounts including profit and loss account for such financial year or part of such financial year falling within the relevant previous year.

## *Companies not covered under the provisions of MAT*

15. The next issue relates to the position where section 115JB is not applicable to a company. In this regard, the querist has made reference to paragraph 44 of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the ICAI as per which "the benefits derived from information should exceed the cost of providing it". In the financial statements submitted under the Companies Act, 1956, certain information is disclosed to comply with the statutory requirements. As per the querist, such information may not have a bearing on the true and fair view of the financial statements prepared for tax purposes (Form 3CB). The stakeholders have access to the statutory financial statements. Further, as per the querist, the need of tax authorities seems to be met by the disclosures relevant for a true and fair view and, in this regard, the following portion of paragraph 10.7 of the Guidance Note on Tax Audit discussed in paragraph 12 above is relevant:

"... However, what constitutes 'true and fair' view has not been defined either in the Companies Act, 1956, or in any other statute. The Accounting Standards (as well as other pronouncements of the Institute on accounting matters) seek to describe the accounting principles and the methods of applying these principles in preparation and presentation of financial statements so that they give a true and fair view."

16. Accordingly, as per the querist, in the absence of any clear guidance, an assessee may elect to comply with the ICAI's Guidance Note for

the purpose of preparation of accounts for the year ended 31<sup>st</sup> March whilst complying with the SEBI Guidelines for the purpose of preparation of annual accounts.

## **B. Query**

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

- (i) Whether, in the standalone financial statements of company A for the year ended 31st December, loan given by company A to ESOP should be shown as 'Loans to ESOP' under 'Assets' or operations of ESOP should be included in the standalone financial statements of company A. If operations of ESOP are included in standalone financial statements of the company, then, how to disclose shares of the company held by ESOP?
- (ii) In the standalone financial statements of company A, for the purpose of calculating basic and diluted earnings per share, how to consider investment in own shares?
- (iii) Will the above treatment also be followed in the financial statements prepared under section 44AB of the Income-tax Act, 1961 i.e., for the year end 31st March, i.e., is the company required to follow the requirements of the ICAI's Guidance Note or the SEBI Guidelines?

## **C. Points considered by the Committee**

18. The Committee notes that the basic issues raised by the querist relate to (i) inclusion of the operations of the ESOP Trust ('ESOPOT') in the standalone financial statements of the company, (ii) treatment of investment by ESOP in the shares of the company for calculating basic and diluted earnings per share ('EPS') in the standalone financial statements of the company, and (iii) treatment in the financial statements prepared for tax audit purposes. The Committee has considered only these issues and has not examined any other issue that may be contained in the Facts of the Case. The Committee also notes that the charge on account of ESOP is stated by the querist as 'intrinsic value – grant price' in paragraph 1 above. It seems that the charge is intrinsic



value i.e., 'market price – exercise price' (market price, for this purpose, is as defined in the 'SEBI Guidelines' and exercise price being equal to grant price, which in the extant case is face value of the share). However, this does not affect the opinion of the Committee. Also, the querist has not stated whether the company has allotted shares to ESOP in respect of all the stock options granted or in respect of expected number of vested options likely to be exercised by the employees. However, this does not affect the opinion of the Committee. Further, the Committee wishes to point out that its opinion is expressed purely from accounting point of view and not from any legal point of view, such as, interpreting the provisions of the Income-tax Act, 1961, i.e., expressing any view on computation of income for the purpose of the Income-tax Act, 1961 since as per Rule 2 of the Advisory Service Rules of the Committee, the Committee does not answer issues that involve only interpretation of enactments.

19. The Committee is of the view that, in case of listed companies, if there are certain differences between the 'Guidance Note' issued by the Institute of Chartered Accountants of India and the 'SEBI Guidelines' then to the extent the requirements of the SEBI Guidelines differ from the Guidance Note, the SEBI Guidelines will prevail.

20. The Committee notes Clause 22A.1 of the 'SEBI Guidelines' (also quoted by the querist in paragraph 3 above) which reads as below:

"In case of ESOS/ESPS administered through a Trust, the accounts of the Company shall be prepared as if the company itself is administering the ESOS/ESPS."

Thus, though ESOP itself may prepare its own financial statements, for example, to meet regulatory requirements, the standalone financial statements of the company should portray the picture as if the company itself is administering the ESOP Scheme. The Committee is of the view that this has two results viz., (i) the company should recognise any expense arising from the employee share-based payment plans, and (ii) the operations of ESOP are included in standalone financial

statements of the company insofar as the ESOP is concerned. In such a situation, in the standalone financial statements of the company, 'Loans to ESOP' will not appear at all. Accordingly, the following adjustments are required:

- (i) Loans to ESOP in the books of company should be eliminated against loan from company as appearing in the books of Trust.
- (ii) The amount representing the grant date intrinsic value of the options yet to be exercised by the employees (originally recorded as a debit on issue of shares to ESOP even before the exercise of options by the employees) will be added to 'Investment in shares of the company' and the sum may be described as 'Shares held in trust for employees under ESOP Scheme'. This should be presented as a deduction from Share Capital to the extent of face value of the shares and Securities Premium to the extent of amount exceeding face value of shares. The company should give a suitable note in the Notes to Accounts to explain the nature of this deduction.

21. As regards the issue of calculation of earnings per share ('EPS') in the standalone financial statements of the company, the Committee notes that at present, AS 20, 'Earnings Per Share', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'the Rules') and the Guidance Note complement each other and, hence, both should be considered in a harmonious manner in addressing the issue on EPS calculation. The Committee notes that as per the Facts of the Case, the employees would be granted stock options which are directly linked to individual, team and company performance. The Committee is of the view that such performance-based employee stock options should be treated as contingently issuable equity shares under AS 20. Further, the Committee is of the view that the principles enunciated in AS 20 in respect of options and contingently issuable equity shares are equally applicable for shares allotted to ESOP which, in turn, will be allotted in future to employees on exercise of their options. In reaching this conclusion, the Committee notes the expression '*shares or stock options issued*

to an ESOP Trust' occurring in paragraph 46 of the Guidance Note, reproduced by the querist in paragraph 8 above. [Emphasis added by the Committee]. In the light of the above discussion, the Committee is of the following views:

- (i) For the purpose of calculating basic EPS in the standalone financial statements of the company, shares allotted to the ESOPT should be included in the shares outstanding, only when the employees have exercised their right to obtain shares, after fulfilling the requisite vesting conditions. This is on the basis of paragraph 46 of the Guidance Note, reproduced by the querist in paragraph 8 above, which is also illustrated in Illustration 2 of Appendix VII to the Guidance Note. This is also in accordance with paragraph 34 of AS 20 dealing with contingently issuable shares with an added clarification that exercise of options is also required for inclusion of the shares in calculation of basic EPS.
- (ii) The shares allotted to ESOPT are treated as potential equity shares for the whole or part of a particular reporting period depending on the conditions as prescribed in paragraph 34 of AS 20. In other words, even if the requisite vesting conditions are not fulfilled, shares allotted to ESOPT against granted options should be considered for calculating diluted earnings per share. However, it has to be examined whether they are dilutive and, if so, what should be the number of shares to be treated as dilutive potential equity shares. This should be determined in accordance with paragraphs 35-37 of AS 20. For this purpose, paragraph 47 of the Guidance Note, which supplements paragraph 35 of AS 20, should also be considered.
- (iii) When the shares allotted to ESOPT are considered for calculation of basic and diluted EPS in accordance with principles stated in (i) and (ii) above, they are weighted in accordance with paragraph 43 of AS 20.

The Committee also notes that paragraph 46 of the Guidance Note quoted by the querist in paragraph 8 above deals, inter alia, with the situation where shares or options

are 'issued' to the ESOPT and *not* with the situation where shares are purchased by ESOPT from the market. Consequently, the Committee does not agree with the querist's statement in paragraph 8 above that paragraph 46 of the Guidance Note seems to suggest that shares purchased by ESOPT from the market should be excluded in calculating the weighted average number of outstanding shares for purposes of basic EPS calculation, whereas, for purposes of diluted EPS computation, such shares would be considered as potential equity shares. In fact, Illustration 3 of Appendix VII to the Guidance Note clearly explains that when shares are purchased by the Trust from market, such shares represent the shares that have already been issued by the enterprise and the same should continue to be included in the shares outstanding for the purpose of calculating basic EPS as would have been done prior to the purchase of the shares by the Trust. Since the exercise of stock options granted under the plan does not result into any fresh issue of shares, the stock options granted would not be considered as potential equity shares for the purpose of calculating diluted EPS.

22. As regards the issue on audit under section 44AB of the Income-tax, 1961 (tax audit), the Committee notes section 115JB (2) of the Income-tax Act, 1961, as reproduced in paragraph 14 above and is of the view that in the case of listed companies, the financial statements prepared for statutory audit are relevant for tax audit also, subject to the following:

- (i) While the accounting year of the company in the extant case is calendar year, tax audit is for financial year. Hence, financial statements for the financial year should be prepared and subjected to tax audit. The said financial statements should be in accordance with Accounting Standards notified under the 'Rules' and SEBI Guidelines, while Guidance Note can be followed in respect of matters not addressed in the SEBI Guidelines, in a manner not inconsistent with the SEBI Guidelines.
- (ii) The financial statements for audit under section 44AB of the Income-tax Act,

1961, should be prepared by following the same accounting policies and accounting standards, that have been adopted for preparing the annual accounts that were laid at the annual general meeting of the company in accordance with section 210 of the Companies Act, 1956.

#### D. Opinion

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

- (i) In the standalone financial statements of company A for the year ended 31<sup>st</sup> December, the loan given by company A to ESOP will not appear at all. For presentation and disclosure of shares held by ESOP, see paragraph 20(ii) above.
- (ii) In the standalone financial statements of company A, the treatment of shares allotted to ESOP for calculating basic and diluted EPS should be in the manner explained in paragraph 21 above.
- (iii) See paragraph 22 above.

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| 1 | The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.                                                                                                                                                                                                                                    |
| 2 | The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on April 5-6, 2013. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.                                                                   |
| 3 | The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty two volumes. A CD of Compendium of Opinions containing thirty two volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur. |
| 4 | Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.                                                                                                                                                                                                                                                                   |
| 5 | Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to <a href="mailto:eac@icai.in">eac@icai.in</a>                                                                                                                                               |