IFRS to see firm revisiting ESOP offers

(Source: Mint, New Delhi)By Sangeeta Singh & Surabhi Agarwal, Mint, New Delhi
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With the deadline for India to move towards International Financial Reporting Standards (IFRS) less than three months away, analysts warn that companies will have to revisit their employee stock option plans (Esops) in order to avoid cumulative losses on their profit and loss (P&L) accounts.

In the first phase of IFRS convergence, companies listed on the stock exchanges, including those that trade on overseas exchanges and those with a net worth of `1,000 crore, will adopt IFRS in the quarter beginning 1 April.

Under Indian GAAP (generally accepted accounting principles), Esops are accounted for at the intrinsic value of the stock options at the time they are granted by the employer.
Under IFRS, stock options will be accounted for at fair value, which may be higher than the intrinsic value on the date the Esops are granted.

"Under IFRS, because of the cost that will now be required to be charged to the P&L account, companies may reevaluate their option strategies and consider if granting of options needs to be somewhat reduced/ rationalized," said Jamil Khatri, executive director and head of accounting advisory services at audit and consulting firm KPMG in India.

As a result, experts say, companies are increasingly redesigning their Esops so that their costs are minimized or are even opting to offer employees other rewards in place of Esops.

A large number of Indian companies-from manufacturers to information technology firms-offer Esops to their executives.

An Esop is a performance- linked incentive to employees of a company that gives them the right to buy shares of the company on a predetermined date at a predetermined price.

"Our experience indicates that many companies are re- evaluating their option grant practices. They are also considering giving a mix of cash and bonuses in place of Esops," said Khatri.

Harshu Ghate, managing director of ESOP Direct, a firm that advises employers on Esops and claims to have 400 corporate clients, says companies are looking at optimizing the Esop accounting cost either by offering fewer options with a discounted exercise price or a reduced tenure.

"This helps the company keep the accounting charge under Esop under control. Also, since employees get their options at a discount to market price, they are fine with it as they will get more value even for lesser number of options," said Ghate.

Unlike Khatri, Ghate said it does not make sense to compensate employees through cash since the cash outgo will be large and it becomes a liability as it is accounted for as an actual cost. Esops will continue to be notional and will be added to reserves even under IFRS.

Companies such as Wipro Ltd and Mahindra and Mahindra Ltd have gone in for innovative alternatives, Ghate said.

An official at Wipro, which pre-adopted IFRS in fiscal 2010, said the firm offers Esops at deep discounts and it is already expensing them under US GAAP and Indian GAAP. The official did not want to be identified.

The US GAAP, like IFRS, also recognizes Esops at fair value.
The Wipro official added that firms would, however, become more selective in offering Esops.

Wipro offers its employees what is called an RSU (restric- tive stock unit), which is a derivative on the stock. In simple terms, it means that the benefi- ciary of the Esops gets into an agreement with the company under which the firm promises to pay him the returns on the stock instead of the employee actually owning the stock.

Vineet Nayar, vice-chairman and chief executive officer of HCL Technologies Ltd, said the company was not particularly disturbed by the transition to IFRS and its impact on Esops.

Under the fair value concept, since the employee gets the benefit of the upside to the value of the stock, but is not exposed to the downside, the option has a value. A third-party investor would pay the company a premium for such a benefit.
And the value of this premium that could be earned by the company (but is not charged to the employee) is the fair value of the option.

Pricing models such as Black- Scholes and Binomial are used to calculate the fair value of options under IFRS.

According to Khatri, the Black-Scholes method is the most commonly used pricing model for calculating the value of the option.

“This calculated value is the cost for the company granting the options. This cost needs to be charged to the profit and loss account over the vesting period,“ said Khatri. Vesting period is the period that an employee needs to serve at a company-- typically three-four years--to be able to get the benefit of options.

V. Balakrishnan, chief financial officer at Infosys Technologies Ltd, which adopted IFRS in fiscal 2009, said the firm had stopped offering stock options to employees some six-seven years ago and the shift to IFRS will not have much impact on it.

He, however, added that companies that give stock options to their employees will have to take a charge in their P&L accounts.

“The reason for stopping the practice of giving stock options was because the company had become large and the market situation was also volatile,“ Balakrishnan said.

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