Institute of Actuaries of India

ESOPs and other deferred compensation

Mayur Ankolekar

5th Capacity Seminar, Employment Benefits

August 10, 2017

Indian Actuarial Profession

Serving the Cause of Public Interest

The new DC
Rise of deferred compensation

Coincides with ***data is the new oil.***

Disruptive business models provide a large long-term upside if the right employee team performs over the medium term.

'Medium term' has dominated the engagement narrative between employers and employees.

E.g.
Part of annual bonus as ESOP (established listed companies)
Deferred cash (high growth unlisted companies)
Advance cash (high growth technology companies)

Presentation Objective

1. ESOP History
2. Current trends in EB markets on medium-term employee benefits
3. The new DC (Deferred Compensation):
    a. ESOP variants,
    b. ESOP like but not underlying shares,
    c. Deferred cash,
    d. Advance cash.
4. Sandbox approach of employers: so great care at every valuation
5. Prominent accrual mechanisms e.g. amortise over vesting, recognise upfront
6. Recognition and Disclosure norms
7. Tax implications of attestation

Growth and History of Employee Stock Option Plans (ESOPs)

Agency problem	ESOPs tend to align the different interests by converging the goals of the management with the shareholders
Customized tool	Can be customized at an employee level e.g. how many, when, further incentives and disincentives
Regulatory History	i. **ABP opinion 25**: Defined in the Companies Act. But the ABP opinion issued in **1975** advised not to recognize ESOP as compensation expense as there was **no reliable method** for calculating the value of employee stock options then. ii. **SEBI** Employee Stock Option Scheme & Employee Stock Purchase Scheme Guidelines, **1999** (further amended in 2004, 2008 & 2009)

Growth and History of ESOPs …Contd.

Regulatory History contd.	**iii. FAS 123: issued 1995** encouraged all companies to use the fair value accounting, but continued to permit the use of the intrinsic value based method (no expense recognition) **iv. IFRS 2: issued 2004**, Fair Value accounting **v. FAS 123 R**: (After the Enron scandal, effective from **2005**) now permits only fair value accounting **vi. Ind AS 102**, issued 2015: Fair Value accounting, adapted from IFRS 2
Measurement and recognition	**Measurement:** Fair value is derived from Option-Pricing Models. Ind AS 102 does not specify 'the' option-pricing model to calculate fair value. **Recognition:** Over the vesting period Distinction between equity-settled and cash-settled -Market based conditions: no 'true up' -Non Market-based conditions: 'true up'

ESOP/ ESPS overview

Benefit Description	Accounting Standard	Measurement	Recognition
ESOP/ ESPS	Ind AS 102	Fair value at inception for Share Options and Restricted Shares. Frequency is higher for Share Appreciation Rights and Share-based payments with Cash Alternatives.	Over the vesting period of the option with adjustments necessary for withdrawal, forfeiture and service and performance conditions.

ESOP Variants

Variants like restricted shares, share appreciation rights and share-based payments with cash alternatives require a more sophisticated application and greater professional judgement.

Examples

1. *Measuring restricted shares as compared with a vanilla ESOP will require a culling of the value of the opportunity lost during the additional holding period.*
2. *Share-based payments with cash alternatives are valued as a compound financial instrument i.e., the debt and equity component is separated.*

Frequency-Severity analogy

ESOP Program cost is analogous to a frequency-severity problem statement.

Market conditions e.g. strike, market value of share, volatility, risk-free rate in **FAIR VALUE**

Measure once (at each reporting) for equity settled (cash settled)

Hint: SEVERITY

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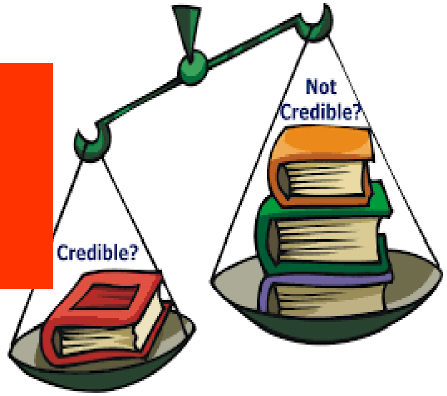
Period cost *after allowing amortization*

Non-market conditions e.g. withdrawal, performance rating in **NO. of AWARDS**

Measure regularly for both equity and cash settled

Hint: FREQUENCY



Deferred Cash

Benefit Description	**Accounting Standard**	**Measurement**	**Recognition**
Deferred cash payment	Ind AS 19	Projected Unit Credit method (paragraphs 67 and 68) to decide the expected present value of the cash payment.	Over the vesting period of the cash payout, with adjustments for employee withdrawal rate, forfeiture and service and performance conditions.

Deferred cash, company value as proxy

Benefit Description	**Accounting Standard**	**Measurement**	**Recognition**
Deferred cash payment linked to a company value proxy	Ind AS 19	Estimated present value of the cash payment. The value is based on the company's value proxy e.g., a certain multiple the change between current and future EBITDA. The expected present value of the cash payment is calculated using the Projected Unit Credit method.	Over the vesting period of the cash payout, with adjustments for employee withdrawal rate, forfeiture and service and performance conditions.

Advance Cash

Benefit Description	Accounting Standard	Measurement	Recognition
Advance cash payment, with claw-back on exit before vesting	Ind AS 19	Estimated cash payment to vest with employees after expected claw-back. Note that the historical cost convention applies as there are no future cash flows.	Over the vesting period of the cash payout, with adjustments for employee withdrawal rate, forfeiture and service and performance conditions.

Deferred Compensation
A Sandbox

Medium-term compensation is also a sandbox of sorts - a tool with course correction embedded within.

Recognition principle

Allow for decrements
e.g. withdrawal rate,
forfeiture.

And increments
e.g. higher vesting,
reload (fine line between measurement and recognition?)

Consider proportionality
e.g. mortality ignored?

Proportionality in ‘Disclosure’

Distinguish between

1. ‘Post-employment (defined) benefits’ and ‘Other long-term employment benefits.’

   Hint: Where actuarial gains and losses are not to be quantified, disclosures are minimal

   Implementation: Paragraph 158, Ind AS 19 does not require specific disclosures about ‘Other Long-term employment benefits.

2. ESOP and ‘Other long-term employment benefits’

   Implementation: ESOP disclosures are elaborate (paragraphs 44 to 52, Ind AS 102)

The actuary's report and tax

Actuaries must weigh the considerations of their attest services in the new DC on stakeholders.

Medium term employee benefit provisions are usually tax-deductible *(exercise great care)*.

Sometimes the tax authorities have deferred the deductibility of ESOP expenses to the time of actual exercise.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