The Research Paper: Employee Stock Ownership Plans (ESOPs): Legality, Taxation and Accounting

Abstract:

The Article Attempts to Highlight Legal, Taxation and Accounting Standards Provisions for ESOPs In Nepal.

ESOPs: Legality, Taxation, and Accounting

"Your employees are your company's real competitive advantage. They're the ones making the magic happen- so long as their needs are being met."
- Richard Branson, founder of the Virgin group.

Introduction

Employee Stock Ownership Plans, abbreviated as ESOPs, is an employee benefit plan that gives workers ownership interest in the company; this interest takes the form of shares of stock. Employers often use ESOPs as a corporate finance strategy to align the interests of their employees with those of their shareholders[1]. Where such interests have been aligned, it has proven to be an effective tool of motivation to employees along with the increment of productivity, commitment, and satisfaction towards the job. To give an instance, the issue of shares to employees after 3 years if the profit of the company grows by 80% over the three years motivates employees to work at full potential so that the shares could vest; moreover, the issue of shares fosters the sense of company's ownership in the minds of employees.

Although ESOPs are widely welcomed in the global context, the issue of ESOPs has not been much popular in the context of the Nepalese corporate world. ESOPs are voluntary programs and are not mandated by law in Nepal. The law restricts the maximum number of shares that can be allotted to employees during the public issue of shares. For instance, a maximum of 0.5% of the total issue in the case of Banks and Financial Institutions[2] and a maximum of 5% in the case of Insurance Companies[3]. Despite being a voluntary scheme, the issue of ESOPs in a few private companies has been able to be the talk of the corporate grapevine, while the allotment of a certain percentage of shares to employees of the issuing company is successful to appear regularly at the news headlines during the public issue of shares.

Legality in Nepal

The lawmakers of Nepal have not yet provided detailed exhaustive legal provisions regarding ESOPs. However, Section 31 of Companies Directives, 2072[4] provides the following regarding shares issued against service contract, which does not explicitly relate to ESOPs, however, closely relates to the shares provided to employees for their service:

(1) Any company can issue shares as a consideration of the service to any service provider against the service received by the company. Example: A company can issue shares equal to the amount determined in the contract between an architect and the company for his service of preparing building construction design.

(2) If shares are to be provided as consideration for any service including consultancy service, it shall be mentioned in the written contract and such contract shall clearly mention the amount of consideration for the service and the number of shares to be issued.

(3) The amount to the extent the shares issued as per sub-section (2) are deemed to be paid up, shall be mentioned in detail in the service contract.

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[1] investopedia.com
[2] Section 9(3) of Banks and Financial Institutions Act, 2073
[3] Section 5(3) of Directives on Registration and Operation of Insurer, 2073
[4] ocr.gov.np (Companies Directives, 2072)

Section 32 of the directives requires a public company to submit an evaluation report for the shares issued in consideration other than cash, within 1 month of issuing such shares.
Section 31(2) of Companies Act, 2063 (First Amendment 2074)[5] has the following provisions for shares allotted in consideration other than cash:
If any shares have been allotted as fully or partly paid-up otherwise than in cash, the company shall file with the Office of Company Registrar:

- A deed constituting the title of the allotter to the shares together with
- Any contract of sale or a contract for services or other consideration in respect of which that allotment was made, and
- A return stating the number and nominal amount of shares so allotted and the extent to which they are to be treated as paid up.

Concessions for ESOPs

1. *No first right to existing shareholders*[6]*:* The existing shareholders shall have the first right to subscribe to the shares issued in proportion to their respective shareholding. However, no shareholder of a company existing, for the time being, shall have the first right over the shares issued for any consideration other than cash, or shares issued under an employee share scheme[7].

2. *No prohibition to provide loans for ESOPs*[8]*:* No company shall provide any loan or financial assistance of any kind to any person for purchasing its own shares or the shares of its holding company[9] or its subsidiary company or getting entitlement to such shares in any manner. However, nothing shall prevent a company from providing loans to any employees of the company to purchase the fully paid-up shares of that company or its holding company or acquire ownership over such shares in any manner, under a scheme of selling shares to its employees.

3. *Issue of shares at discount*[10]*:* A company shall not issue or sell its shares at a discount. However, a company may issue or sell its shares at a discount per an employee share scheme by adopting a special resolution[11] at the general meeting to that effect, not being less than the percentage specified in that resolution[12].

4. *Not required to fulfill securities issue procedures*[13]*:* If a public company is required to increase its share capital and issue its shares publicly, it shall fulfill the procedures specified in the Companies Act and the prevailing law on securities[14]. However, in so issuing bonus shares and right shares that they may be subscribed by its existing shareholders and employees only or issuing shares issued at consideration other than cash or shares issued under the employee share scheme[15], such company shall not be required to fulfill

[5] ocr.gov.np (Companies Act, 2063)
[6] Section 56(9) of Companies Act, 2063
[7] Sec. 56(9) has provided four more situations where 'first right' is not applicable.
[8] Section 62 of Companies Act, 2063
[9] Chapter 13 of the Companies Act has defined holding and the subsidiary relationship between companies.
[10] Section 64 of Companies Act, 2063
[11] Section 74 defines Special Resolution as a resolution adopted by the shareholders representing 75% shares out of the shareholders present in the meeting, voting in favor of the resolution. Further, Section 83 states the cases where a special resolution is required.
[12] Further three conditions are provided in Section 64(2) where shares can be issued or sold at a discount.
[13] Section 56(6) of Companies Act, 2063
[14] Includes Securities Act, Regulations and Directives issued by the Securities Board of Nepal (SEBON).
[15] Along with other situations mentioned in Sec. 56(9) of Companies Act, 2063.

such procedures. Further, it shall not be required to issue a prospectus[16] to issue the securities issued to own workers or employees[17].

5. *Not counted as shareholder for determining the maximum number of shareholders*[18]*:* A private company cannot have more than 101 shareholders. However, any employee, who has purchased a share of a company under scheme of selling shares to employees, or any employee, who has already purchased a share under such scheme but is not in service of the company, for the time being, shall not be counted as a shareholder for determining such maximum number of shareholders in a private company.

A plain reading of the above provisions portrays that ESOPs are legal and can be issued for the service provided by the employees, with a condition that the number of shares to be issued and service to be provided by the employees shall be explicitly contained in the service contract between the company and its employees. The company shall also submit an evaluation report stating how the service of the employees has been evaluated to grant the shares. With the legal compliance, the prevailing laws have also provided few concessions and facilities when shares are issued under ESOPs.

Taxation in Nepal

As ESOPs are being welcomed by corporates across the globe, the companies are looking for guidelines on the taxation impact of ESOPs on both the issuing company and the subscribing employees. Nepalese lawmakers are yet to provide exhaustive guidelines on taxation specifically for ESOPs, however, Income Tax Act 2058[19] contains the provisions that are proximate to the transactions like ESOPs.
(Note: The taxation impact of ESOPs provided in this article is only an opinion of the author, who is a learner of taxation and not an expert in this field. The provisions given are only the ways how the author thinks ESOPs can be dealt with.)

Income Tax Act, 2058 classifies the taxable income of taxpayers on four income heads[20]:
1. Business,
2. Employment,
3. Investment, and
4. Windfall gain

Since ESOPs are related to the employment contract between the employer and the employees, any income relating to them will fall under the head 'Employment' (for the employee) while the expense of ESOP will fall under the head 'Business' (for the employer). Employment income has been dealt by Section 8 of the Act, which states the remuneration received by a natural person[21] from employment in an income year[22] shall be included in determining the taxable income of such person. Section 8(2) enlists explicit items that are included as income under head employment, which contains salary, wage, gift, allowances, retirement payments, payment made on termination of employment, the contribution made by the employer on retirement funds, and so on. Section 8(2)(*Ja*) of the Sub-section states other amounts that shall be included under Chapters 6 and 7 of the Act.

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[16] Prospectus is a document published by the public company under Sec. 23 of the Companies Act inviting offers from the public for subscription or purchase of its shares or debentures.
[17] Section 30(2) of Securities Act, 2063
[18] Section 9(3) of Companies Act, 2063
[19] ird.gov.np (Income Tax Act 2058, including amendments by Finance Act 2078)
[20] Section 5 of Income Tax Act 2058
[21] Includes 'single natural person', 'couple elected under Sec. 50' and 'registered/unregistered proprietorship firm owned by a natural person'.
[22] Income year is defined by Section 2(*Jha*) as, generally, the period between 1st of *Shrawan* of a year (*Bikram Sambat* Calendar) to *Ashadh* end of the next year.

The explicit list of Section 8 does not contain ESOPs, explicitly. However, Chapter 7 provides for quantification, allocation, and characterization of certain items that are to be included in taxable income. Pursuant to Section 27(1) under Chapter 7, any payment made by a person to another person through the transfer of an asset shall be quantified at the market value of such transferred asset. This is the most proximate provision to the transactions like ESOPs, where 'shares' or 'options to purchase the shares' are transferred to the employees, as a consideration for the service provided by them. The taxation impact can be understood with the help of the following examples:

Example 1: Transfer of shares

On 1st *Shrawan* 2074 (grant date[23]), ABC Ltd. granted a scheme to transfer 100 shares (the prevailing market price of the share at the grant date was Rs. 250 per share), free of cost, to each of its 300 employees, who complete five years of service in the company. On 1st *Shrawan* 2079, Mr. A, an accountant in the company, completed five years of service and obtained 100 shares. The market price of the shares reached Rs. 750 per share when the shares were transferred to Mr. A.

Here, the transfer of shares, though free of cost, shall be quantified as per Section 27(1) at the market value of the shares transferred. The quantified amount will be Rs. 75,000 (i.e., Rs. 750 per share x 100 shares) and shall be included in the taxable income of Mr. A under head 'employment' for Income Year 2079/80. The issuing company ABC Ltd. can claim Rs. 75,000 as an expense in determining taxable income from 'business' for the Income Year.

Whether the quantification is based on the market value at the date when the scheme was granted (1st *Shrawan* 2074) or at the date when the shares are transferred (1st *Shrawan* 2079) might be a question. The answer depends on the timing when the taxpayer's income shall be accounted for taxation purposes. Chapter 6 of the Act provides for the 'Tax Accounting and Timing'. Section 22(2) under Chapter 6 states that a natural person shall account for the income received from employment or investment on cash basis[24] i.e., when the person receives or has the right to access the payment. Since the shares are transferred (i.e., payment is made) on 1st *Shrawan*, 2079, the quantification shall be done using the market value on that date.

Unlike the employment income of a natural person, Section 22(3) requires a company[25] to account on accrual basis for taxation purposes. To understand when ABC Ltd. (a company) can claim the quantified expense of ESOP, we need to first understand when an expense can be accounted for under accrual basis, dealt as per Section 24. Pursuant to Sec. 24(2), the following expenses are deemed to be borne by a person under accrual basis while calculating the taxable income:

(a) If the payment is made against any consideration received from any other person, the expense is deemed to be borne in the following situations:
    (1) When the person has an obligation to make the payment,
    (2) The value of the obligation can be estimated on a reasonable basis, **and**
    (3) Consideration has been received from the other person.
(b) Other than the situation stated in clause (a), in all other situations, the expense is deemed to be borne when the payment is made.

In Example 1, ABC Ltd. is said to bear the expense of ESOP under clause (a) of Sec. 24(2). Since the company has obligation to make payment on 1st *Shrawan*, 2079, the value can be determined on that date, and the

[23] When the share scheme is granted to employees
[24] Defined by Section 23 of Income Tax Act 2058
[25] Includes company registered under Companies Act 2063 and other entities defined as company by Section 2(*Dda*) of the Act.

consideration(service) is received from the employee by that date, ABC Ltd. can claim the expense on 1st *Shrawan*, 2079 pursuant to Section 13 of the Act[26].

Example 2: Transfer of options to purchase the shares

On 1st *Shrawan* 2074 (grant date), XYZ Ltd. granted a scheme to transfer 100 options to purchase share of the company after 5 years at an exercise price of Rs. 100 (the prevailing market price of the share at the grant date was Rs. 250 per share) to each of its 300 employees if the profit of the company grows by 70% over the five years period. On 1st *Shrawan* 2079, the financial statements depict that the profit grew by 82% as compared to 5 years ago, hence, the options vested. 200 employees exercised the options while remaining 100 employees allowed the options to lapse[27]. The market price prevailing on 1st *Shrawan*, 2079 was Rs. 750 per share, which means the intrinsic value of the option at that date was Rs. 650 per option (MP[28] Rs. 750 - EP Rs. 100).

Here, the transfer of options shall be quantified at the market value of the option (which is equal to the intrinsic value at the date of exercising the option). The question here is whether the quantification shall be done on the options that have 'vested' (in Example 2, 100 options to 300 employees each) to the employees, or the options that have been 'exercised' by them (100 options by 200 employees each). A plain reading of the text of Income Tax Act 2058 depicts that whatever 'assets' are transferred, they shall be quantified. Since options are assets by their nature, it is interpretable that the market value of options that have 'vested' (in Example 2, 100 options to 300 employees each) should be taken for quantification i.e., Rs. 650x100=Rs. 65,000 shall be included in the income from 'employment' of all 300 employees whom the options have vested. However, such quantification and taxation on the quantified amount do not seem fair and reasonable as it would levy tax on the persons who have not enjoyed the benefits of the arrangement i.e., the ones whom the options have vested but have not exercised them (100 employees). Therefore, lack of clear guidance by lawmakers can create unfair tax treatment and may fail to abide the principle of natural justice. Indian Income Tax Act[29] 2011, which has provided detailed guidance on taxation of such options, states that when the employee has exercised the option, basically agreed to buy; the difference between the Fair Market Value 'FMV' (on exercise date) and exercise price is taxed as perquisite. The employer deducts TDS on this perquisite. This amount is shown in the employee's Form 16 and included as part of total income from salary in the tax return[30]. So, as per Indian Act, quantification will be Rs. 65,000 each to only 200 employees who have exercised the options and remaining 100 employees would face no tax consequence.

Example 3: Allotment of certain percentage of shares during public issue

PQR Ltd. issues 5 lakhs of its shares to the public as approved by the Securities Board of Nepal (SEBON). Out of the total shares, 5% (i.e., 25,000 shares) has been allocated to the employees of the issuing company PQR Ltd. The issue is made at face value of Rs. 100 to all the subscribers, including the employees. The allotment was concluded on 25th *Bhadra* 2079 when each of its 500 employees were allotted 50 shares of the company.

Here, the arrangement is a purchase of 50 shares at Rs. 100 each rather than transfer of shares at less or no consideration, hence, there will be no tax consequence at the date of the allotment of shares. The question of taxation arises only during the sale of the shares allotted. During sale, the sales proceeds (say Rs. 250 per share)

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[26] The entity can claim expense in determining the taxable income for the income year, when the expense is incurred (i) during the income year, (ii) by the entity and (iii) for earning income during the year.

[27] A rational investor would want to exercise the option since the market price of the share is more than the exercise price. However, it is also possible that such option is not exercised due to cash unavailability and other non-financial factors.

[28] MP = Market Price; EP = Exercise Price

[29] Indian Income Tax Act, Department of Revenue, Government of India

[30] "Getting ESOP as salary package? Know about ESOP Taxation" – Article by cleartax.in

will be considered as Incomings[31] and the cost of purchase (Rs. 100 per share) considered as Outgoings[32]. The difference between the Incomings and Outgoings is Net Gain[33] on disposal of Non-Business Chargeable Assets[34].The impact of taxation on sale of shares received under ESOPs is same for Example 1 and 2 as well.

These examples depict how the ESOPs can be dealt with by applying the proximate relevant provisions of Income Tax Act 2058 despite the non-availability of detailed comprehensive guidelines on this matter. Such guideline has been essential to the taxpayers with the gaining popularity of ESOPs arrangements in the corporate world.

Accounting

The accounting of a transaction or event is expected to be dealt by the applicable financial reporting framework, which varies between nations across the globe. Such framework includes the rules, conventions, practices, bases of accounting, and presentation and reporting of a transaction or event. International Financial Reporting Standards (IFRS), issued by the International Accounting Standard Board (IASB)[35] and Generally Accepted Accounting Standards (US GAAP), issued by the Financial Accounting Standards Board (FASB)[36] are the biggest examples of the financial reporting framework.

Nepal's financial reporting framework is in convergence to the International Financial Reporting Standards (IFRS). Accounting Standards Board (ASB Nepal), formed by the Government of Nepal[37], is primarily responsible for setting accounting and financial reporting standards for business enterprises in convergence with the IFRSs[38]. In this process, ASB drafted Nepal Financial Reporting Standards (NFRS) 2013 in line with IFRSs, which is regarded as a historic step in the development of accounting practices promoting accountability, uniformity and comparability of financial transactions and events. As on July 19, 2022, following are the applicable financial reporting standards issued by the Institute of Chartered Accountants of Nepal (ICAN) on recommendation of ASB Nepal:

Applicable Financial Reporting Standards in Nepal with their applicability date[39]

Standards	Applicability Date
NFRS 2018	1st Shrawan 2077
NAS 29, NFRS 9, NFRS 14, NFRS 15, NFRS 16, NFRS 17	1st Shrawan 2078
NFRS for SMEs[40], NFRS for MEs[41], NAS for NPOs[42]	1st Shrawan 2080
IFRIC and SIC[43]	1st Shrawan 2077

Accounting of ESOPs under NFRS

(Note: The study of NFRS develops an expert-level understanding and requires in-depth extensive study of the NFRS content, basis for conclusions, illustrative examples of implementation guidance, application guidance and solution to practical problems. The content provided in this article is only for general understanding of readers with accounting kinship.)

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[31] Section 39 of Income Tax Act 2058
[32] Section 38 of Income Tax Act 2058
[33] Section 36(2) of Income Tax Act 2058; taxed at applicable rates mentioned in Section 95*Ka*(2) of the Act.
[34] Defined by Section 2(*da*) of Income Tax Act 2058
[35] ifrs.org (IFRS Foundation)
[36] fasb.org (FASB)
[37] Under Section 15Ka of Nepal Chartered Accountants Act, 2053
[38] http://www.standards.org.np/asb/ (ASB Nepal)
[39] As per notice of ICAN dated 1st Bhadra 2077 and 10th Shrawan 2078
[40] Small and Medium-Sized Entities, as defined by ASB
[41] Micro Entities, as defined by ASB
[42] Nepal Accounting Standards for Not-for-Profit Organizations
[43] International Financial Reporting Interpretations Committee and Standards Interpretations Committee

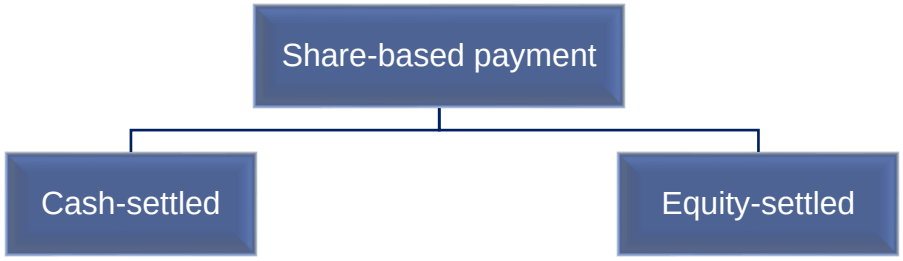
ESOPs are accounted as per NFRS 2 *Share Based Payments*, which defines share-based payment arrangement[44] as an agreement between the entity (or another group[45] entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive:

(a) Cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, or

(b) Equity instruments (including shares or share options) of the entity or another group entity,

provided the specified vesting conditions, if any, are met.

The above definition of the share-based payment arrangement can be illustrated in a chart as follows:



Since the shares or options issued under ESOPs entitles the employees, equity instruments of the issuing entity, they fall under share-based payment arrangement defined by NFRS 2.

Conditions in a Share-based Payment Arrangement

The conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets, or equity instruments of the entity, under a share-based payment arrangement are termed as Vesting Conditions. They are either:

(1) service conditions, which require the counterparty to complete a specified period of service.

(2) performance conditions[46], which require the counterparty to complete a specified period of service and specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time). A performance condition might include a market condition.

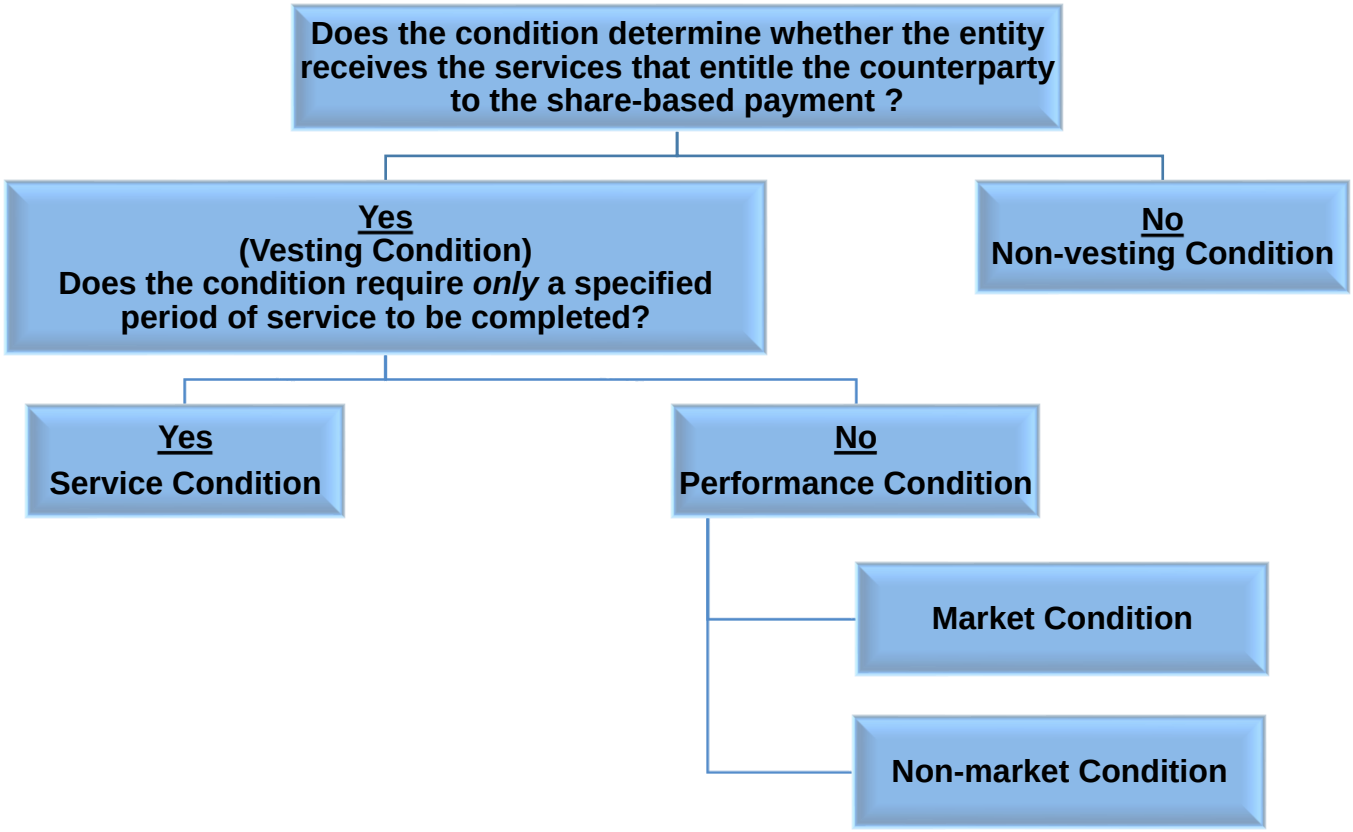
The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied is defined as Vesting Period. This can be illustrated in a chart as follows[47]:

[44] Defined by Appendix A of NFRS 2

[45] Appendix A of NFRS 10 defines group as a parent (an entity that controls one or more entities) and its subsidiaries.

[46] A performance condition has an explicit or implicit service requirement.

[47] Flowchart provided in Implementation Guidance to IFRS 2 – IG4A



The vesting of ESOPs may depend on the conditions imposed by the issuing employer entity. Following are some examples:

Cases	Vesting Condition	Vesting Period
(1) If the employee completes 5 years of service in the entity	Service Condition	5 years
(2) If the profit of the entity grows by 50% over 3-year period	Performance (Non-market) Condition	3 years
(3) If the market price of the entity reaches to Rs. 750 from Rs. 190 today over 3-year period	Performance (Market) Condition	Length Varies (upto 3 years)

To understand the accounting of share-based payment transactions, it is must to understand the vesting condition and the vesting period becase the accounting depends on the such condition and period.

Accounting Basis

Equity is the residual interest in the assets after deducting all its liabilities[48]. Being a residual interest, it is measured based on the value of the corresponding assets/services received.

Equity = Assets - Liabilities

Paragraph 10 of NFRS 2, thus, states: for equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.
For transactions with employees, valuation of service provided by the employees would be a big obstacle and hence corresponding equity could not be measured. That's why, paragraph 10 read along with paragraph 11 provided a way out to avoid such obstacle, which states:

[48] Paragraph 4.63 of NFRS Conceptual Framework

To apply the requirements of paragraph 10 to transactions with employees and others providing similar services, the entity shall measure the fair value of the services received by reference to the fair value of the equity instruments granted, because typically it is not possible to estimate reliably the fair value of the services received, as explained in paragraph 12. The fair value of those equity instruments shall be measured at grant date.

The accounting of equity-settled share-based payment transaction with employees (ESOPs) can be understood with the help of the following examples:

Example 1: Share-based Payment (SBP) with no condition

Case: On 12th Chaitra 2078, ABC Ltd.'s directors, joyous of the company's performance results, announced to grant 100 shares of the company to each of its 200 employees. The fair value of the shares at that date was Rs. 150 per share.

Vesting Condition: None

Vesting Period: None

Grant Date: 12th Chaitra 2078

Accounting: Total share-based payment expense = 100 sharesx200 employeesxRs.150
= Rs. 30,00,000

Journal entry:

Date	Particulars	Debit	Credit
2078-12-12	Employee Benefit Expense----------Dr	30,00,000	
	To SBP Equity		30,00,000
	(Recognition of Share-based payment expense)		
2078-12-12	SBP Equity----------Dr	30,00,000	
	To Equity Share Capital		20,00,000
	(20000 shares x Rs. 100 – face value)		
	To Securities Premium[49]		10,00,000
	(Vesting of equity and Transfer of SBP equity to appropriate account heads)		

Basis[50]: If the equity instruments granted vest immediately, the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to those equity instruments. In the absence of evidence to the contrary, the entity shall presume that services rendered by the counterparty as consideration for the equity instruments have been received. In this case, on grant date the entity shall recognize the services received in full, with a corresponding increase in equity.

Example 2: SBP with a service condition to only 1 employee

Case: On 1st Shrawan 2078, PQR Ltd.'s directors, worried of the managerial employee turnover, with an intention to retain its well-qualified Chief Executive Officer (CEO), announced to grant him 10,000 shares of the company if he stays in the company for 3 years. The fair value of the shares at that date was Rs. 120 per share.

Vesting Condition: Service Condition

Vesting Period: 3 years

Grant Date: 1st Shrawan 2078

Accounting: Total share-based payment expense = 10000 sharesx1 CEOxRs.120
= Rs. 12,00,000

Expense recognized per annum for 3 years = 12,00,000 / 3 = Rs. 4,00,000

[49] Section 29 of Companies Act 2063

[50] Paragraph 14 of NFRS 2

Journal entry (*If the CEO stays for 3 years*):

Date	Particulars	Debit	Credit
2079-03-31	Employee Benefit Expense----------Dr	4,00,000	
	To SBP Equity		4,00,000
	(Recognition of Share-based payment expense)		
2080-03-31	Employee Benefit Expense----------Dr	4,00,000	
	To SBP Equity		4,00,000
	(Recognition of Share-based payment expense)		
2081-03-31	Employee Benefit Expense----------Dr	4,00,000	
	To SBP Equity		4,00,000
	(Recognition of Share-based payment expense)		
2081-03-31	SBP Equity----------Dr	12,00,000	
	To Equity Share Capital		10,00,000
	(10000 shares x Rs. 100 – face value)		
	To Securities Premium		2,00,000
	(Vesting of equity and Transfer of SBP equity to appropriate account heads)		

Basis[51]: If the equity instruments granted do not vest until the counterparty completes a specified period of service, the entity shall presume that the services to be rendered by the counterparty as consideration for those equity instruments will be received in the future, during the vesting period. The entity shall account for those services as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity.

Example 3: SBP with a service condition to only 1 employee but the shares did not vest

Suppose in Example 2 above, the CEO left the company at the beginning of the third year (Y-3) of the granting of share scheme. In such case, the vesting condition has not been fulfilled and hence the shares do not vest at all. It shall be treated as a change in accounting estimate[52] and hence accounted for prospectively.

Expense already booked till Y-2 end = Rs. 4,00,000 + Rs. 4,00,000 = Rs. 8,00,000

(Corresponding equity) *(Y-1)* *(Y-2)*

Journal entry (*If the CEO left after 2 years on 2080-04-31*):

Date	Particulars	Debit	Credit
2079-03-31	Employee Benefit Expense----------Dr	4,00,000	
	To SBP Equity		4,00,000
	(Recognition of Share-based payment expense)		
2080-03-31	Employee Benefit Expense----------Dr	4,00,000	
	To SBP Equity		4,00,000
	(Recognition of Share-based payment expense)		
2080-04-31	SBP Equity----------Dr	8,00,000	
	To Employee Benefit Expense (Income)		8,00,000
	(Reversal of already booked expense as the shares did not vest) – Prospective accounting		

[51] Paragraph 15 of NFRS 2

[52] As defined by NAS 8 *Accounting Policy, Change in Accounting Estimate and Error*

Example 4: SBP with a service condition to more than 1 employee

Case: On 1st Shrawan 2078, XYZ Ltd., aiming to retain its employees, announced to grant 100 shares of the company to each of its 200 employees who complete 3 years of service in the company. The fair value of the shares at that date was Rs. 250 per share.

Vesting Condition: Service Condition

Vesting Period: 3 years

Grant Date: 1st Shrawan 2078

Date	No. of employees	Employees expected to be eligible for the shares
At grant date	200	190
31st Ashadh 2079	195	185
31st Ashadh 2080	193	188
31st Ashadh 2081	189	

Accounting: How many employees will remain in service for 3 years i.e., who will be eligible for the shares? is an important question in this context since the no. of employees determine the no. of equity instruments that will vest and hence it will ultimately determine the expense to be booked over the 3-year period. Whether the no. of employees at the year-end shall be considered or the no. of employees estimated to remain in service for 3 years? Paragraph 19 read along with paragraph 20 has clarified this matter. Paragraph 20 states:

The entity shall recognize an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates.

Hence, the accounting shall be based on estimated no. of employees whom the shares are expected to vest.

	Calculations	Cumulative equity	Expense for the year
Y-1	100 shares x 185 employees x Rs.250 x 1/3	15,41,667 (a)	15,41,667
Y-2	100 shares x 188 employees x Rs.250 x 2/3	31,33,333 (b)	15,91,666 (b-a)
Y-3	100 shares x 189 employees x Rs.250 x 3/3	47,25,000 (c)	15,91,667 (c-b)

Journal entry:

Date	Particulars	Debit	Credit
2079-03-31	Employee Benefit Expense----------Dr	15,41,667	
	To SBP Equity		15,41,667
	(Recognition of Share-based payment expense)		
2080-03-31	Employee Benefit Expense----------Dr	15,91,666	
	To SBP Equity		15,91,666
	(Recognition of Share-based payment expense)		
2081-03-31	Employee Benefit Expense----------Dr	15,91,667	
	To SBP Equity		15,91,667
	(Recognition of Share-based payment expense)		
2081-03-31	SBP Equity----------Dr	47,25,000	
	To Equity Share Capital		18,90,000
	(18900 shares x Rs. 100 – face value)		
	To Securities Premium		28,35,000
	(Vesting of equity and Transfer of SBP equity to appropriate account heads)		

Example 5: SBP with a performance condition and a service condition

Case: On 1st Shrawan 2078, XYZ Ltd.'s management, worried of the company's profit figures, intending to motivate the employees, announced to grant 100 shares of the company to each of its 300 employees if the profit increases by 20% over the next 3 years and the employees remain in service on that date. The fair value of the shares at that date was Rs. 150 per share.

Vesting Condition: Performance Condition (Non-Market) and Service Condition

Vesting Period: 3 years

Grant Date: 1st Shrawan 2078

Employees:

Date	No. of employees	Employees expected to remain for 3 years
At grant date	300	275
31st Ashadh 2079	290	280
31st Ashadh 2080	285	275
31st Ashadh 2081	272	

Profit:

Year	Profit
2078-79	Increased by 12% only but the entity expects the target to be met over next 2 years
2079-80	Profit increased by more 5% and the entity is almost sure that the target will be met
2080-81	Profit increased by total 23% and hence the shares vested to the employees remaining

Accounting:

	Calculations	Cumulative equity	Expense for the year
Y-1	100 shares x 280 employees x Rs.150 x 1/3	14,00,000 (a)	14,00,000
Y-2	100 shares x 275 employees x Rs.150 x 2/3	27,50,000 (b)	13,50,000 (b-a)
Y-3	100 shares x 272 employees x Rs.150 x 3/3	40,80,000 (c)	13,30,000 (c-b)

Journal entry:

Date	Particulars	Debit	Credit
2079-03-31	Employee Benefit Expense----------Dr	14,00,000	
	To SBP Equity		14,00,000
	(Recognition of Share-based payment expense)		
2080-03-31	Employee Benefit Expense----------Dr	13,50,000	
	To SBP Equity		13,50,000
	(Recognition of Share-based payment expense)		
2081-03-31	Employee Benefit Expense----------Dr	13,30,000	
	To SBP Equity		13,30,000
	(Recognition of Share-based payment expense)		
2081-03-31	SBP Equity----------Dr	40,80,000	
	To Equity Share Capital		27,20,000
	(27200 shares x Rs. 100 – face value)		
	To Securities Premium		13,60,000
	(Vesting of equity and Transfer of SBP equity to appropriate account heads)		

Basis[53]: Vesting conditions, other than market conditions, shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because of failure to satisfy a vesting condition, eg the counterparty fails to complete a specified service period, or a performance condition is not satisfied.

The use of estimate over actual profit results is based on paragraph 20 stated above in *Example 4*.

Example 6: Grant of share options with a performance condition in which the length of the vesting period varies

Case: On 1st Shrawan 2078, XYZ Ltd. announced to grant 100 share options exercisable at Rs. 80 to each of its 500 employees if the profit increases as follows (vests when profit target is reached in any of the 3 years):

Year	Profit Increment
2078-79	By 18%
2079-80	By 14% p.a. over 2 years
2080-81	By 10% p.a. over 3 years

The fair value of the options at that date was Rs. 70 per option.

Vesting Condition: Performance Condition (Non-market)

Vesting Period: Varies

Grant Date: 1st Shrawan 2078

Employees:

Date	No. of employees	Employees expected to remain when the options vest*
At grant date	500	490
31st Ashadh 2079	470	440
31st Ashadh 2080	442	417
31st Ashadh 2081	419	

*Profit:

Year	Profit
2078-79	Increased by 14%, so the options did not vest. The company expects that they will vest next year.
2079-80	Increased by 10% p.a. (on average), so the options did not vest. The company expects that they will vest next year.
2080-81	Increased by 10.15% p.a. (on average), so the options vested.

Accounting:

	Calculations	Cumulative equity	Expense for the year
Y-1	100 options x 440 employees x Rs.70 x 1/2	15,40,000 (a)	15,40,000
Y-2	100 options x 417 employees x Rs.70 x 2/3	19,46,000 (b)	4,06,000 (b-a)
Y-3	100 options x 419 employees x Rs.70 x 3/3	29,33,000 (c)	9,87,000 (c-b)

On 2081-04-31, out of 419 employees, only 400 exercised the option while the remaining 19 allowed the option to lapse.

Journal entry:

Date	Particulars	Debit	Credit
2079-03-31	Employee Benefit Expense----------Dr	15,40,000	
	To SBP Equity		15,40,000

[53] Paragraph 19 of NFRS 2

	(Recognition of Share-based payment expense)		
2080-03-31	Employee Benefit Expense----------Dr To SBP Equity (Recognition of Share-based payment expense)	4,06,000	4,06,000
2081-03-31	Employee Benefit Expense----------Dr To SBP Equity (Recognition of Share-based payment expense)	9,87,000	9,87,000
2081-04-31	SBP Equity----------Dr (100 options x 400 employees x 70) Bank/Cash----------Dr (100 options x 400 employees x 80)-exercise price To Equity Share Capital (40,000 shares x Rs. 100 – face value) To Securities Premium (Vesting of equity and Transfer of SBP equity to appropriate account heads)	28,00,000 32,00,000	 40,00,000 20,00,000
2081-04-31	SBP Equity----------Dr (100 options x 19 employees x 70) To Retained Earnings (Transfer of SBP equity to another head within equity) – *See Basis*	1,33,000	 1,33,000

Basis[54]: Having recognized the goods or services received in accordance with paragraphs 10–22, and a corresponding increase in equity, the entity shall make no subsequent adjustment to total equity after vesting date. For example, the entity shall not subsequently reverse the amount recognized for services received from an employee if the vested equity instruments are later forfeited or, in the case of share options, the options are not exercised. However, this requirement does not preclude the entity from recognizing a transfer within equity, ie a transfer from one component of equity to another.

Example 7: SBP with a market condition[55]

Case: On 1st Shrawan 2078, XYZ Ltd.'s management, anxious of the company's share prices, intending to motivate the employees, announced to grant 100 share options to each of its 300 employees exercisable at Rs. 40 if the market price reaches more than Rs. 300 in next 3 years and the employees remain in service on that date. The fair value of the options[56] at that date was Rs. 120 per option.

Vesting Condition: Market Condition and Service Condition

Vesting Period: 3 years

Grant Date: 1st Shrawan 2078

Employees:

Date	No. of employees	Employees expected to remain for 3 years
At grant date	300	275
31st Ashadh 2079	290	280

[54] Paragraph 23 of NFRS 2

[55] A condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price of the entity's equity instruments, such as attaining a specified share price or a specified amount of intrinsic value of a share option, or achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities.

[56] The fair value of the option incorporates the probability of meeting the share price target.

31st Ashadh 2080	285	275
31st Ashadh 2081	272	

Market Price:

Year	Price Target
31st Ashadh 2079	Price target likely to be met.
31st Ashadh 2080	It now seems unlikely that that the target share price will be met. *[See Basis below]*
31st Ashadh 2081	Market price reached Rs. 320.

Accounting:

	Calculations	Cumulative equity	Expense for the year
Y-1	100 options x 280 employees x Rs.120 x 1/3	11,20,000 (a)	11,20,000
Y-2	100 options x 275 employees x Rs.120 x 2/3	22,00,000 (b)	10,80,000 (b-a)
Y-3	100 options x 272 employees x Rs.120 x 3/3	32,64,000 (c)	10,64,000 (c-b)

Journal entry:

Date	Particulars	Debit	Credit
2079-03-31	Employee Benefit Expense----------Dr	11,20,000	
	To SBP Equity		11,20,000
	(Recognition of Share-based payment expense)		
2080-03-31	Employee Benefit Expense----------Dr	10,80,000	
	To SBP Equity		10,80,000
	(Recognition of Share-based payment expense) - *See Basis below*		
2081-03-31	Employee Benefit Expense----------Dr	10,64,000	
	To SBP Equity		10,64,000
	(Recognition of Share-based payment expense)		
Assuming all employees exercised the option			
2081-03-31	SBP Equity----------Dr	32,64,000	
	Bank/Cash----------Dr	10,88,000	
	(100 options x 272 employees x Rs. 40)		
	To Equity Share Capital		27,20,000
	(27200 shares x Rs. 100 – face value)		
	To Securities Premium		16,32,000
	(Vesting/Exercising of equity and Transfer of SBP equity to appropriate account heads)		

Basis: Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date[57].

Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, shall be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the entity shall recognize the goods or services received from a counterparty who satisfies all other vesting conditions (e.g., services received from an employee who remains in service for the specified period of service), *irrespective of whether that market condition is satisfied*[58].

[57] Paragraph 19 of NFRS 2

[58] Paragraph 21 of NFRS 2

In conclusion, if all conditions (except market condition) are met, the options shall be accounted for as if they have vested even though they have not actually vested due to non-fulfillment of the market condition.

Deferred Taxation Implications of ESOPs

The transfer of ESOPs is tax-deductible for the issuing company, quantified at the market value of the shares transferred. *[Note: Readers are advised to go through the author's article on "ESOPs: Taxation" to understand the taxation impact of ESOPs in Nepal]*

It is highly unlikely that the amount of tax deducted will equal the amount charged to profit or loss under NFRS 2, moreover, NFRS 2 spreads the total SBP expense over the vesting period while for tax purpose, the total expense is claimed in a single income year. Because of such timing difference in accounting and taxation, deferred tax is likely to arise. The analysis of deferred taxation shall be based on provisions of NAS 12 *Income Taxes.*

[59]**Temporary differences** are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either:

(a) **taxable temporary differences**, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

(b) **deductible temporary differences**, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Temporary Difference = Carrying Amount – Tax Base

Deferred tax asset arises out of deductible temporary difference while Deferred tax liability arises out of taxable temporary difference.

Paragraph 68A, 68B and 68C of NAS 12 has included a separate section for "Current and Deferred Tax arising from Share-based Payment Transactions". Paragraph 68B states the following:

The difference between the tax base of the employee services received to date (being the amount the taxation authorities will permit as a deduction in future periods), and the *carrying amount of nil*, is a deductible temporary difference that results in a deferred tax asset. If the amount the taxation authorities will permit as a deduction in future periods is not known at the end of the period, it shall be *estimated, based on information available at the end of the period*[60]. For example, if the amount that the taxation authorities will permit as a deduction in future periods is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be *based on the entity's share price*[61] *at the end of the period.*

Further, paragraph 68C states: The amount of the tax deduction (or estimated future tax deduction, measured in accordance with paragraph 68B) may differ from the related cumulative remuneration expense.

Paragraph 58 of the Standard requires that current and deferred tax should be recognized as income or an expense and included in *profit or loss* for the period, except to the extent that the tax arises from (a) a transaction or event that is recognized, in the same or a different period, outside profit or loss, or (b) a business combination. If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item.

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[59] Paragraph 5 of NAS 12

[60] For intrinsic value/market value of options/shares. For no. of options/shares, the expected number shall be considered to have consistency with NFRS 2 Paragraph 20

[61] In case of share options: Intrinsic Value at the end of the period.

In this situation, the excess of the associated current or deferred tax should be recognized *directly in equity*.

The following example[62] illustrates the deferred tax implications on share-based payment transactions:

Case: The entity's tax rate is 40 per cent. The options were granted at the start of year 1, vested at the end of year 3 and were exercised at the end of year 5. Details of the expense recognized for employee services received and consumed in each accounting period, the number of options outstanding at each year-end[63], and the intrinsic value of the options at each year-end, are as follows:

	Employees Service Expense	No. of options at year-end	Intrinsic Value per option
Year 1	1,88,000	50,000	5
Year 2	1,85,000	45,000	8
Year 3	1,90,000	40,000	13
Year 4	0	40,000	17
Year 5	0	40,000	20

Year 1

Deferred tax asset and deferred tax income:

(50,000 × 5 × 1/3* × 0.40) = 33,333

**The tax base of the employee services received is based on the intrinsic value of the options, and those options were granted for three years' services. Because only one year's services have been received to date, it is necessary to multiply the option's intrinsic value by one-third to arrive at the tax base of the employee services received in year 1.*

The deferred tax income is all recognized in *profit or loss* because the estimated future tax deduction of 83,333 (50,000 × 5 × 1/3) is less than the cumulative remuneration expense of 188,000.

Year 2

Deferred tax asset at year-end: (45,000 × 8 × 2/3 × 0.40)	96,000	
Less: Deferred Tax asset at the start of the year	(33,333)	
Deferred Tax Income for the year		62,667*

* This amount consists of the following:

Deferred tax income for the temporary difference between the tax base of the employee services received during the year and their *carrying amount of nil*: (45,000 × 8 × 1/3 × 0.40)	96,000
Tax income resulting from an adjustment to the tax base of employee services received in previous years:	
(a) increase in intrinsic value: (45,000 × 3 × 1/3 × 0.40)	18,000
(b) decrease in number of options: (5,000 × 5 × 1/3 × 0.40)	(3,333)
Deferred Tax Income for the year	62,667

The deferred tax income is all recognized in *profit or loss* because the estimated future tax deduction of 240,000 (45,000 × 8 × 2/3) is less than the cumulative remuneration expense of 373,000 (188,000 + 185,000).

[62] Example 5 of Illustrative Examples for IAS 12, published by IFRS Foundation – www.ifrs.org

[63] Although the example has considered the no. of options outstanding at each year-end, the author believes that the expected number of options to vest should have been considered for consistency with NFRS 2 paragraph 20.

Year 3

Deferred tax asset at year-end: (40,000 × 13 × 0.40)	208,000	
Less: Deferred Tax asset at the start of the year	(96,000)	
Deferred Tax Income for the year		112,000

The deferred tax income is all recognized in *profit or loss* because the estimated future tax deduction of 520,000 (40,000 × 13) is less than the cumulative remuneration expense of 563,000 (188,000 + 185,000 + 190,000).

Year 4

Deferred tax asset at year-end: (40,000 × 17 × 0.40)	272,000	
Less: Deferred Tax asset at the start of the year	(208,000)	
Deferred Tax Income for the year		64,000

The deferred tax income is recognized partly in profit or loss and partly directly in equity as follows:

Estimated future tax deduction (40,000 × 17)	680,000	
Cumulative Remuneration Expense	(563,000)	
Excess Tax Deduction		117,000
Deferred Tax Income for the year	64,000	
Excess recognized directly in equity (117,000 x 0.40)	46,800	
Recognized in profit or loss		17,200

Year 5

Deferred tax expense (reversal of deferred tax asset)	272,000	
Amount recognised directly in equity (reversal of cumulative deferred tax income recognised directly in equity)	46,800	
Amount recognised in profit or loss		225,200
Current tax income based on intrinsic value of options at exercise date (40,000 × 20 × 0.40)	320,000	
Amount recognised in profit or loss (563,000 × 0.40)	225,200	
Amount recognised directly in equity		94,800

Summary

	Statement of Comprehensive Income				Statement of Financial Position	
	Employee Service Expense	*Current Tax Expense (Income)*	*Deferred Tax Expense (Income)*	*Total Tax Expense (Income)*	*Equity*	*Deferred Tax Asset*
Year 1	188,000	0	(33,333)	(33,333)	0	33,333
Year 2	185,000	0	(62,667)	(62,667)	0	96,000
Year 3	190,000	0	(112,000)	(112,000)	0	208,000
Year 4	0	0	(17,200)	(17,200)	(46,800)	272,000
Year 5	0	(225,200)	225,200	0	46,800	0
					(94,800)	
Total	563,000	(225,200)	0	(225,200)	(94,800)	0

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