

CHAPTER 1

Share-based payment vs shareholder transaction

This article discusses some of the critical aspects related to accounting for different types of arrangements with employees and shareholders

Background

In today's evolving corporate landscape, especially among start-ups and private equity-backed entities, it's prominent to find individuals such as co-founders, Key Managerial Personnel (KMPs), etc. holding dual roles—both of employees and of shareholders. If employees or other parties who are also shareholders participate in a transaction with the entity, then it may be difficult to determine in which capacity they act: as suppliers of goods or services to the entity, or as shareholders of the entity. Such individuals often enter into different types of agreements like- a shareholders' agreement that governs their rights and responsibilities as shareholders of the company or/and an employment agreement that outlines their remuneration and service

obligations. While legally distinct, these documents may often be interconnected, making accounting of such instruments challenging.

While Indian Accounting Standards (Ind AS) emphasise evaluating contractual terms and conditions for the classification of instruments, in such situations it may not be sufficient to rely solely on the legal form. Instead, the economic substance of the entire arrangement would determine the appropriate classification and measurement of the instrument accounted in an entity's books of account.

This article discusses some of the key aspects to be considered when assessing the accounting of such instruments issued and how different terms may lead to divergent accounting outcomes.

Evaluation of the instrument

The initial step when such instruments are issued is to evaluate whether the shares have been issued in the capacity as an employee/other parties or as a shareholder. This is an important evaluation from an accounting perspective since Ind AS 102, *Share-based Payment* scopes out transactions with employees or other parties in their capacity as shareholders. In these situations, the transactions are in the scope of Ind AS 32, *Financial Instruments: Presentation* and Ind AS 109, *Financial Instruments*.

This area is highly judgmental requiring careful consideration of individual facts and circumstances. Therefore, a holistic review of the entire contractual framework is necessary to assess the economic substance of the transaction and ensure correct classification under Ind AS 102 or the relevant financial instruments standards.

Factors that may be considered before concluding that a transaction with the entity's employees fall outside the scope of Ind AS 102

include:

- Whether the employees receive equity instruments or equity linked instruments whose value depends on the extent of services provided.
- Whether the rights/interests of employee shareholders differ from those of other investor shareholders.
- Whether employees have been given different/ preferential rights upon an exit event such as an Initial Public Offer (IPO) (in terms of cash or shares) compared to other investors.
- Whether employees lose their rights to shares if they leave the entity, and the shares are repurchased or cancelled.
- Whether a buy-back clause is attached to the instrument for instance, if an employees are given shares at fair value but is required to sell them back at the lower of fair value or purchase price upon leaving the company before a specified date, the arrangement effectively ties the benefit to continued employment.

In case the agreement is outside the purview of Ind AS 102, it should be accounted for as per other accounting standards as per terms of the instrument.

Some of the above principles are illustrated through by way of case studies to provide practical application of the guidance

Case study 1

The Company undertakes a rights issue, i.e. right to acquire additional equity instruments at a discount to all its existing shareholders. As part of the rights issue, certain employees, who also happen to be the shareholders of the Company, receive a right to acquire additional equity instruments at a discount. The terms and conditions of the rights issue applicable to the employee shareholders are same as those applicable to other shareholders. Further, there is no linkage to the continuous employment or any benefit to the employee shareholders (in

the form of discount on acquisition of additional equity instruments of the Company).

It is evident from the given case study that the counterparty (employee shareholder) is acting purely in its capacity as shareholder. Hence, the right issue would not be considered as a share-based payment in the scope of Ind AS 102.

Case study 2

The Company has issued shares to public (fresh issue) in an Initial Public Offering (IPO) at a fixed price per share (offer price). As a reward for past services, the offer includes a reservation of certain equity shares, for subscription by employees at a 10 per cent discount to the offer price. However, this offer is not open to any other category of investors. Further, there are no other conditions attached to the shares other than paying the subscription price. Employee X, who is also a

shareholder of the Company, purchases such a share.

In the given scenario following merits consideration:

- The Company has offered equity shares at a discount to all its employees.
- The offer is available only to the Company's employees.
- Employee X is acting in his/her capacity as an employee because the shares are not offered to other category of shareholders/investors.

Thus, while there are no vesting conditions (i.e., no future service condition attached), this transaction is in the scope of Ind AS 102 because the share discount is granted to the employee in return for services. Accordingly, these shares will be accounted as per Ind AS 102.



Case study 3

Company issues Compulsory Convertible Preference Shares (CCPS) to Shareholder X who is also an employee of the Company. As per the shareholder's agreement (SHA), these CCPS shall convert into variable number of equity shares of the Company based upon valuation of the Company as at the specified date (date of conversion). If the valuation of the Company as at the date of conversion is less than the predetermined threshold, then the CCPS would convert into equity shares in ratio of 1:1. However, if the valuation of the Company as at the date of conversion exceeds the agreed threshold, the conversion ratio shall be 1:2.

Further, the employment agreement provides that if the Shareholder X is not in employment of the Company till the date of conversion, it would represent an event of default. In such a scenario, the CCPS will not be converted into

equity shares.

In the given scenario, based upon a comprehensive and a combined reading of the shareholders agreement and employment agreement, following merits consideration:

- Company has offered equity shares to a shareholder who is also an employee of the company.
- The conversion of bonus CCPS requires the employee to complete a specified service period.
- The benefit available is linked to future performance condition.

Thus, in the given case study, considering there are vesting conditions i.e., future service condition and performance condition (conversion linked to future valuation of the company), this transaction should be accounted as per Ind AS 102.

Key takeaways

The intersection of a shareholders' agreement and an employment contract can blur lines between investment and incentive. In such situations, the correct accounting treatment under the relevant Ind AS is dependent not merely on the legal form of individual agreements, but on the economic substance of the overall arrangement. Some of the key aspects that may be relevant to companies entering to such arrangements are as follows:

- A fragmented or an independent review of contracts may result in misclassification of instruments. Therefore, it is imperative that companies adopt a comprehensive and coordinated approach when evaluating such

transactions. This necessitates robust documentation practices and a collaborative process involving finance, legal, and Human Resources (HR) teams. Each function contributes essential insights—legal provides the framework/arrangement, HR outlines incentive intent, and finance ensures appropriate accounting and disclosure of the instruments issued. This coordination must begin at the planning stage and not after agreements are finalised or instruments are issued. Early involvement ensures that all relevant aspects - legal, financial, and human resource-related - are aligned from the outset.



- Equally important is the exercise of professional skepticism. The management must critically assess whether the stated terms reflect a genuine capital transaction or are effectively linked to services rendered. As the design of equity-based compensation becomes increasingly sophisticated, with multi-layered vesting conditions and performance milestones, a more nuanced, principle-based evaluation is essential.
- Another critical aspect involved is evaluation of regulatory compliances. Rule 12 of the Companies (Share Capital and Debentures)

Rules, 2014, read with Section 62(1)(b) of the Companies Act, 2013 (2013 Act) prohibits inclusion of promoters and certain directors who either themselves or through their relatives or any body corporate hold more than 10 per cent of the outstanding equity shares of the company, issue of shares under Employee Stock Option Scheme (ESOPs). While there are certain exemptions given to start ups, defined under the DPIIT notification GSR 180(E) (and its 2019 amendment) provided specific conditions are met, it is important that when

ESOPs are issued to promoters, these are evaluated carefully. Listed entities are also required to comply with SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 which also prohibit ESOPs issued to promoters and certain directors. While SEBI has proposed certain amendments to these regulations, these are yet to be approved. Given the regulatory restrictions under various regulations, companies must exercise heightened diligence when structuring equity-based compensation involving promoters or significant shareholders.

Ultimately, by assessing the totality of the arrangement, aligning contractual language with applicable accounting guidance, and ensuring strict adherence to regulatory requirements, companies can ensure correct classification of such instruments in the financial statements, thereby promoting transparency in financial reporting, and build stakeholders' confidence through sound governance and well-documented decision-making.

