Practical Aspects of Actuarial Valuations (AS15, Ind AS19) and Insights on ESOP Accounting

Presentation at Western India Regional Council of ICAI

Theme: Seminar on Audit of Insurance Companies & Opportunities for CAs

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Institute of Actuaries of India

A Statutory body established under an Act of Parliament

- In simple words, An Actuary is a business professional who analyzes the **financial consequences** of future uncertainties and Risks. Actuaries use mathematics, statistics, and financial theory to study uncertain future events, especially those of concern to insurance and pension programs.

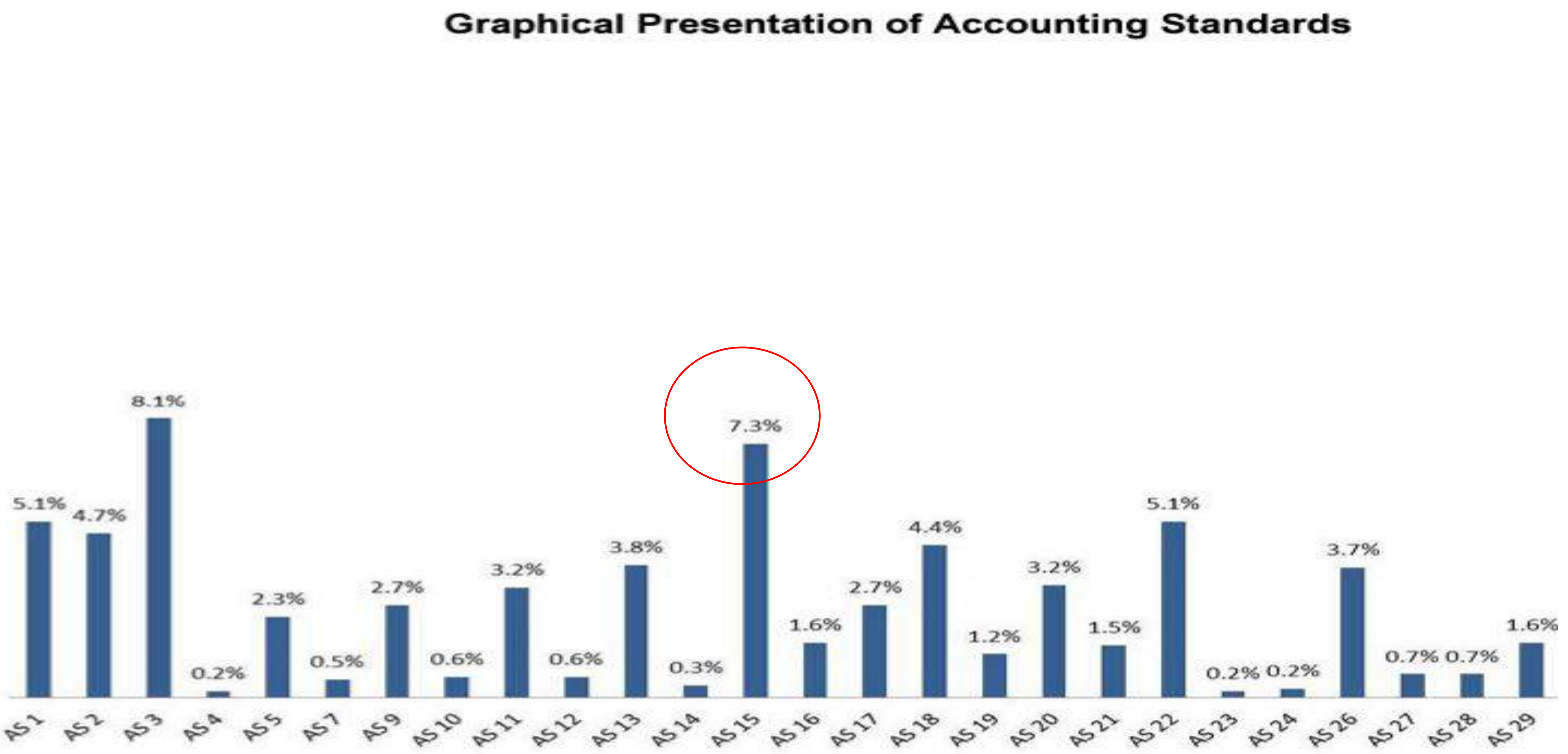
- A career as an Actuary is better described as a "business" career with a mathematical basis than as a "technical" mathematical career.

Agenda

- Importance of Actuarial Valuation
- Regulatory requirements of Gratuity and Leave, it's provision
- Practical aspects of Actuarial Valuation
- ESOP & Ind AS 102 Overview
- Fair Value of ESOP and Accounting Expense
- Opportunities for Professionals
- Q&A and Open Forum Discussion

Importance of Actuarial Valuation

AS Deficiencies identified by Financial Reporting Review Board of ICAI



Types of Employee Benefits

Classification of employee benefits

Short-term Benefits	**Post-Employment Benefits**	**Other Long-term Benefits**	**Termination Benefits**
Examples: - Salary & Wages - ST Compensated Absences like: 1. Paid annual leave 2. Paid sick leave 3. Short-term disability 4. Maternity leave - ST Profit-sharing & Bonus - Non-monetary benefits: 1. Access to medical care 2. Housing	Defined Benefit: - Gratuity - Pension - Post-employment life insurance - Post-employment medical care Defined Contribution: - EPF Contribution to RPFC - NPS - DC Pension	Examples: - Long-term Paid Absences - Long-term disability benefits - Long-term Bonus - Deferred Incentive - Phantom Stock	Examples: - Voluntary Retirement

Types of Employee Benefits

Classification of employee benefits

Short-term Benefits

Examples:
- Salary & Wages
- ST Compensated Absences like:
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  2. Paid sick leave
  3. Short-term disability
  4. Maternity leave
- ST Profit-sharing & Bonus
- Non-monetary benefits:
  1. Access to medical care
  2. Housing

Post-Employment Benefits

Defined Benefit:
- Gratuity
- Pension
- Post-employment life insurance
- Post-employment medical care

Defined Contribution:
- EPF Contribution to RPFC
- NPS
- DC Pension

Other Long-term Benefits

Examples:
- Long-term Paid Absences
- Long-term disability benefits
- Long-term Bonus
- Deferred Incentive
- Phantom Stock

Termination Benefits

Examples:
- Voluntary Retirement

Actuarial Valuation for Provision

Poll Question : (Applicability of AS15)

Question: Let say a company have more than 10 Employees. For Gratuity, Actuarial Valuation Provision by Projected Unit Credit Method as per AS15 is required for which category of companies?

a) Listed companies

b) Non SMC companies

c) SMC and Non SMC companies All

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c) SMC and Non SMC companies All

Correct answer: (c) SMC and Non SMC companies All

Summary of AS 15 Applicability – "**Companies**"

Type of Benefits	**Provision Required**	**Provision as per Actuarial Valuation – PUCM Method**	**Detailed Disclosure in Notes to Accounts**
A. Short-Term	✔	✕	✕
B. Post-Employment – Defined Benefits (e.g. Gratuity, Pension)			
Non-SMC Company	✔	✔	✔
SMC Company	✔	✔	✕
C. Other Long-Term (e.g. Leave, Long Service Award)	✔	✔	✕
D. Termination Benefit	✔	✕	✕

Definition of SMC and Non-SMC Company (turnover and borrowing are criteria) as Applicable:

Link to Definition

- Accounting period till 31.03.2021: http://www.mca.gov.in/Ministry/notification/pdf/Notification_GSR_739.pdf
- Accounting period on or after 01.04.2021: https://egazette.nic.in/WriteReadData/2021/227890.pdf (Page 329)

For Small and Medium sized Companies (SMC),
Detailed Disclosure are exempted, though provision is required as per "**Actuarial Valuation PUCM Method**".

Summary of AS 15 Applicability – “Non Company Entities”

Particulars	Level I	Level II	Level III	Level IV
Applicability of AS 15 - Employee Benefits	Full Applicable	With Exemptions	With Exemptions	With Exemptions
Gratuity/ Leave/ Long Service Award				
A. **Provision** in accounts Required?	Yes	Yes	Yes	Yes
B. Provision as per **Actuarial Valuation PUCM Method**?				
Employees 50 or more:	Yes	Yes	Yes	Exempted
Employees Less than 50:	Yes	Exempted	Exempted	Exempted
C. **Detailed Disclosure** for Gratuity?	Yes	Exempted	Exempted	Exempted

Definition for Applicability of Level I/II/III/IV - Non Corporate Entities *for Accounting periods commencing on or after April 1, 2020* as Issued by ICAI: https://resource.cdn.icai.org/64269asb51535.pdf

Link to Definition

In case *Actuarial Valuation is exempted* for specific class of entities, such entities may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method.

Regulatory requirements of Gratuity and Leave, it's provision

Gratuity Actuarial Valuation

Regulation

- Gratuity Act, 1972
- All Organisations
- More than 10 Employees
- 5 Years vesting
- 20 lakhs limit

Accounting

- Accrual Principle
- AS 15/ Ind AS 19
- Actuarial Valuation as per PUC method
- **Mandatory** for **all size Companies**
- Provision **even if** service **less than 5 years**

Taxation

- Allowed on Payment basis
- Contribution to 'Approved Gratuity Fund' Allowed [36(1)(v)]
- Contribution limit 8.33% (Rule 103)

Audit

- SA 620 refers to using work of Actuaries
- AS 15/ Ind AS19 implementation maximum deficiency as per FRRB

All ***companies having 10+Employees*** *need to make Provision for* ***Gratuity as per Actuarial Valuation method PUCM*** *to comply with AS15/ Ind AS19.*

Leave Actuarial Valuation

Regulation

- Respective State's Shop Establishment Act
- Factories Act
- Carry forward of Leave upto specific limit?
- Encashment on separation?

Accounting

- Accrual Principle
- AS 15/ / Ind AS 19
- Mandatory for All companies
- Actuarial Valuation PUC method (Para 49,65)
- Actuarial Valuation provision if **long term carry forward**

Taxation

- Allowed on Payment basis
- Contribution to Group Leave policy, No tax benefit

Audit

- SA 620 refers to using work of Actuaries
- AS 15/ Ind AS 19 implementation maximum deficiency as per FRRB

Maharashtra, Karnataka, Delhi shop act – limit 45 days
Factories Act 1948, Rajasthan shop act – limit 30 days
Gujarat shop act– limit 63 days
(encashment in all above)

Practical aspects of Actuarial Valuation

Practical aspects in Audit of Actuarial Valuation

Directors Included?
Ind AS 24 Disclosure?

Leave Availment and Encashment

- **Different Limit ?**
- **Different Salary ?**

Benefit Scheme as per policy and Actuary Report

Employee Transfer within Group

Current and Non-Current Liability

- **Unfunded Plan**
- **- Funded Plan**

Plan Assets

- **Accrued Interest**
- **Trust bank balance**

Common Errors Found by FRRB (AS15, Ind AS19)

- Non-provisioning of Gratuity (Matching Principle)
- No disclosure or inadequate disclosures post employment plans
- Defined Benefit Plan wrongly treated as Defined Contribution Plan
- Non-Disclosure of expense for Defined Contribution Plan
- Inadequate disclosure pertaining to Use of PUCM Method, Assumptions
- Actuarial Gain/ loss recognised inappropriately
- Provision for Long service awards, Leave without Actuarial Method

Issues Found by Quality Review Board (QRB) [SA 620]

Not evaluating whether :

- the actuary has the necessary competence, capabilities and objectivity for the auditor's purposes and
- the relevance and reasonableness of the assumptions and methods used by him (Para 9, 12).

(Ref: QRB Report on Audit Quality Review - 2021-22 - (02-11-2022) ICAI Website)

Possible Solution to this:
Auditor can check/ ask for the qualification/ CoP of member providing actuarial valuation report. As per the Institute of Actuaries of India, Fellow Actuary having valid Certificate of Practice can practice in this field as proprietor or partnership firm, company is not allowed to practice as per Actuaries Act.

Reasonableness of Assumption should be checked, for example company having Actual Attrition rate of 15% - 20% p.a. consistently but 2% p.a. Attrition assumption is used. This can be checked by performing assumption analysis at overall level and may require thorough analysis at regular intervals from Company/ Actuary.

Consequences of Non Compliance

- Labour law penalties for non payment of benefits
- **Companies Act** requirement to follow AS 15, Ind AS 19
- Auditors to **qualify** Audit Report with quantification if non compliance of AS
- Gratuity Funding via '**Approved Trust**' only to ensure Tax deduction
- Actuarial Valuation Report required even if funding with LIC, **LIC report not AS15**.
- Check for Qualification/ CoP, companies can't practice (similar to CA Act)

ESOP & Ind AS 102 Overview

Regulatory Norms – ESOP

Regulatory norms and Accounting principles for ESOP of Indian Companies:

- Companies Act Section 62(1)(b)
- Securities and Exchange Board of India (Share Based Employee Benefits and Sweat Equity) Regulations, 2021
- Rule 12 of Companies (Share Capital and Debentures) Rules, 2014
- Special Resolution by Shareholders
- GN on Share-Based Payments issued by ICAI (2020)
- Ind AS 102: Share-Based Payments (Ind AS Accounting)
- IFRS 2: Share-Based Payments (IFRS Accounting)
- ASC 718 and ASC 505-50 for employees and nonemployees, respectively (US GAAP Accounting)

What is ESOP?

‘Right’ but Not Obligation

to buy company’s equity share

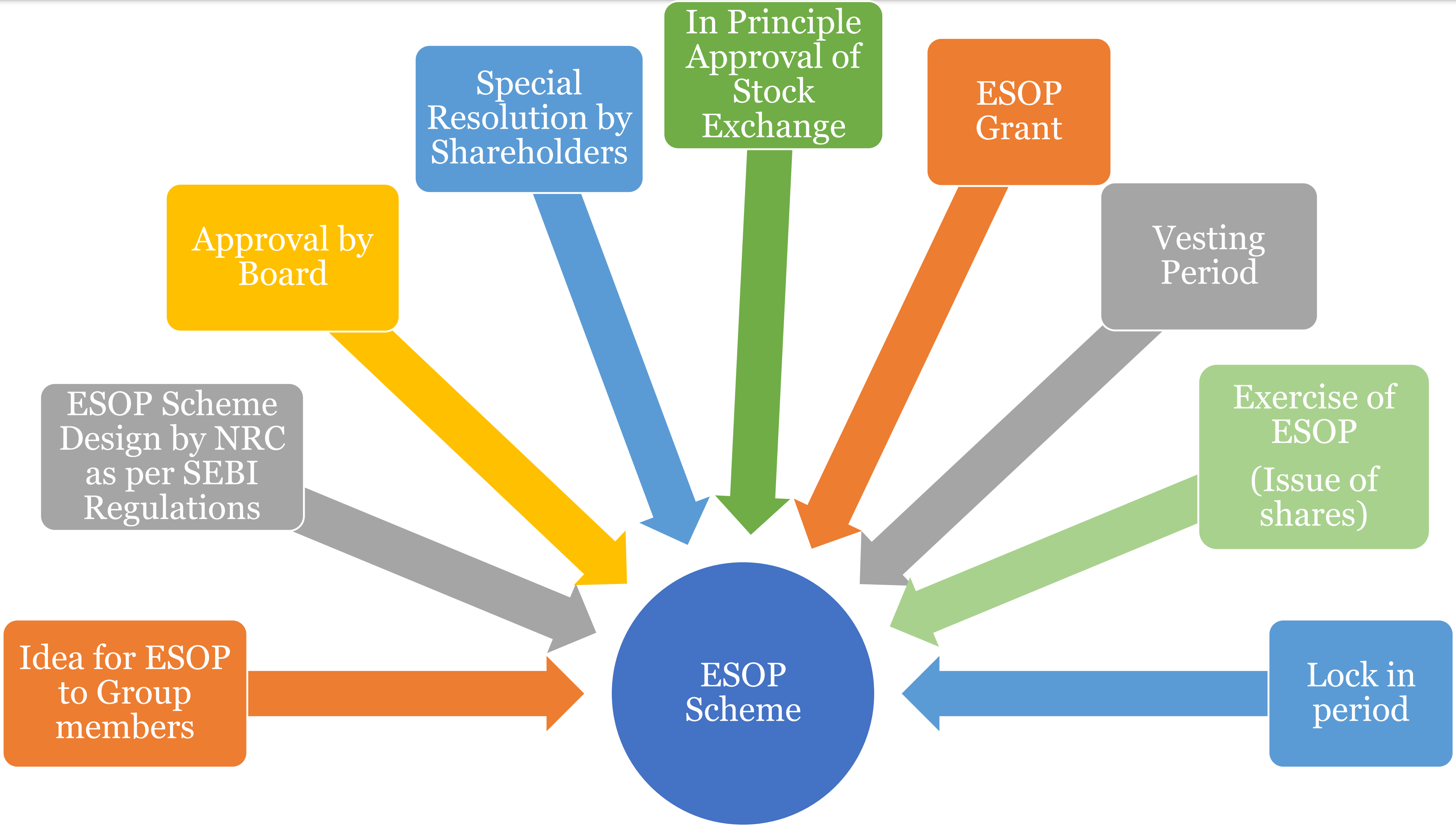
at pre determined price and time

satisfy vesting conditions, Exercise ESOP and obtain Equity

sale is subject to Lock-in-period (if any)

Grant of options → Vesting of options → Exercise of Vested options → Allotment of Shares

ESOP Implementation/ Lifecyle – Stages



ESOP is a Right and Not the obligation for Employees to become growth gears of the Company

Fair Value of ESOP and Accounting Expense

Fair Value of Stock Options (ESOP, ESPS, SAR)

For ESOP Accounting, we typically requires two valuations:

- Company's share price
- Fair Value of option

Date of Valuation will depend on type of Stock options:

- Equity-settled plan – Grant date fair value
- Cash-settled plan – Grant date, each reporting date, settlement date

Fair Value of option can be determined using following methods:

- Black- Scholes model
- Binomial/Lattice model
- Monte- Carlo simulation model

Amongst the three, Black- Scholes model is a widely used method by Indian listed and non-listed companies.

Accounting Treatment: Equity-settled SBPT

- For equity-settled SBPT, the entity shall measure the fair value of the option (Ind AS102), and a corresponding increase in equity.

- In case of entities following ICAI GN they are allowed to follow Intrinsic value method with Fair value disclosure in Notes to Accounts.

- Recognize expense **over the vesting period using the straight-line** method for **options expected to vest**.

- Measure the fair value of equity instruments granted at the **measurement date**, taking into account terms and conditions upon which those equity instruments were granted.

- Grant of equity instruments may be conditional upon satisfying specified vesting conditions i.e. market and non-market conditions:

    - Adjust non-market conditions (e.g. continued service, achieving performance goal etc) in the *number of options* ***expected to ultimately vest,***
    - Adjust market condition or non-vesting condition in the determination of Fair Value of Stock Option.

Accounting Treatment: Equity-settled SBPT

Timing

- Goods: when received
- Services: When obtained

Recognition (debit entry)

- Expenses
- Asset (if goods/services qualify as asset)

Recognition (credit entry)

- Increase in equity (for equity—settled SBP)
- Liability (for cash—settled SBP)

Accounting Treatment: Equity-settled SBPT - Example

Question: Company Granted 10,000 options (equity settled) to CEO, having vesting period of 2 years, Grant Date Fair value 20 per share.

Calculate the accounting expense for both years.

Solution:

As only 1 member and entity expect member to continue for vesting period, expected options to vest = 10,000 options

Total cumulative ESOP cost = 10,000 * 20 = 200,000

Expense for Year 1 = 100,000 (ESOP Expense P&L A/c Dr to ESOP Reserve A/c)

Expense for Year 2 = 100,000 (ESOP Expense P&L A/c Dr to ESOP Reserve A/c)

Treatment of Vesting Conditions (Equity-settled plan)

Para 19, 20 of Ind AS 102

- **Vesting Conditions**
  - Service Condition
    - Consider in **Options Expected to Vest**
  - Non Market Performance Condition
    - Consider in **Options Expected to Vest**
  - Market Performance Condition
    - Consider in Fair Value of Option (measured at Grant date)
- **Non Vesting Condition**
  - Non Vesting Condition
    - Consider in Fair Value of Option (measured at Grant date)

ICAI GN (2005) v/s ICAI GN (2020)

Particulars	ICAI GN (2005)	ICAI GN (2020)
Scope (Non - Employees)	No specific guidance	Specific coverage of non-employees (for example, customers or vendors)
Group share-based payment arrangements	No specific guidance	GN 2020 deals extensively with group-wide share based payment transactions
Historical Volatility – Unlisted company	Option of considering the historical volatility of **zero**	GN 2020 **removed** this option

ICAI GN (2020) Effective date- This Guidance Note applies to share-based payment plans the grant date in respect of which falls on or after April 1, 2021.

Poll Question : (ESOP Expense Recognition - Attrition Rate)

Q1. In your experience, have you considered **future expected Attrition rate** to determine ESOP Expenses as per Ind AS102/ ICAI GN ?

a) Yes
b) No
c) Not calculated ESOP expense

Q2. A limited Granted Equity settled ESOPs with **vesting period of 2 years** to 100 employees, at end of year 1, 10 employees left, provision at end of 1 year should be made for how many employees?

a) 100
b) 90
c) less than 90 (considering future expected Attrition)

Q3. If we have to calculate Attrition rate per annum to determine ESOPs Expected to Vest, which of the following would be best suited option to calculate Attrition rate:

a) Number of Employees Left/ Number of Total Employees Options Granted
b) No of ESOPs Forfeited (Unvested) of Left Employees/ Total No of ESOPs Granted

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a) Number of Employees Left/ Number of Total Employees Options Granted
b) No of ESOPs Forfeited (Unvested) of Left Employees/ Total No of ESOPs Granted

Correct answer : Q2 – option c less than 90 (considering future expected Attrition)
Question 3 – option b - No of ESOPs Forfeited (Unvested) of Left Employees/ Total No of ESOPs Granted

ESOP Accounting : Modification, Cancellation

Modification of Equity settled SBPT

As per para 26 of Ind AS 102, an entity might **modify the terms and conditions** on which the equity instruments were granted. For example, it might reduce the exercise price of options granted to employees (i.e. reprice the options), which increases the fair value of those options (on date of modification). Modification should be beneficial for option holder.

As per para 26 of Ind AS 102, the entity shall recognise the effects of modifications that increase the total fair value of the share- based payment arrangement or are otherwise beneficial to the employee. Guidance on applying this requirement is given in Appendix B.

As per para 27 of Ind AS 102, the entity shall **as a minimum** the services received measured at the **grant date fair value** of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date.

Modification of Equity settled SBPT - Example

Lets say company A Limited Granted ESOP on 1st April, 2021 at exercise price of 100 with vesting period of 3 years. At time of Grant of ESOP, company share price was 150 Rupees and ESOP was attractive to employees as this was in the money option.

After 1 year, share price fall to 70 Rupees and entity feels that this fall in share price is permanently hence ESOP becomes in attractive to employees and loses the purpose of ESOP as long term retention tool, as now this is out of the money option.

To make it more attractive, company reduced exercise price from 100 rupees earlier to 40 rupees, this reduction in exercise price will **increase fair value of option on date of modification.**

On date of modification, entity needs to account for this change in ESOP plan as modification in line with para 26-27 of Ind AS102.

Amortisation of Incremental fair value over time from date of modification to vesting date.

Cancellation of ESOP

As per para 23 of Ind AS 102, **vested ESOPs which are not exercised** and/or forfeited after vesting, such expense of vested ESOPs will **not be reversed in profit and loss account**. ESOP O/s amount related to such options can be transferred to General Reserve.

As per para 28 of Ind AS 102, any **Cancellation of plan** we need to account for it as **acceleration of vesting** and recognise **all expense at time of cancellation** which otherwise would have been recognised in remaining vesting period.

Para 28: If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

Cancellation of ESOP – Accounting Treatment

1) First accelerate expense ------

P&L A/c	Dr	(Charge expense now for remaining term)
To ESOP outstanding Reserve A/c		

2) Payment for settlement (if any, subject to limit of fair value of instrument on repurchase date) ---

ESOP outstanding Reserve A/c	Dr	(limit upto fair value on repurchase date)
P&L A/c	Dr	(excess amount if any)
To Bank A/c		(Amount paid)

3) Balance amount in ESOP outstanding Reserve ledger----

ESOP Outstanding A/c	Dr	(Balance in ESOP reserve)
To General reserve A/c		

Employee Transfer to Subsidiary – Accounting Treatment

Recognize as equity settled share based payment as per 43B (b) the entity has **no obligation** to settle the share-based payment transaction.

Subsidiary Books-

Expense A/c Dr

To Equity (Capital Contribution from Parent Company)

(For period of service rendered in subsidiary company)

43C – holding company which is giving own shares to employees of group company shall recognise this as equity settled share based payment.

Holding company Books -

Cost of Investment in Subsidiary A/c Dr

To Equity

(Recognise Grant date fair value of equity instruments for period of service rendered in subsidiary)

When employee leave group and then for benefit which is unvested that time, above entry will be reversed that time.

Opportunities for CAs

Related Opportunities for Professionals

- ESOP Scheme Design, ESOP Valuation as Valuer
- ESOP Regulation Compliance Certificate every year (by Practicing CS)
- Approved Gratuity Fund (Section 36(1)(v) read with Part C of Schedule IV):
  - Gratuity Trust Set up,
  - Gratuity Trust Income Tax Approval,
  - Gratuity Trust Yearly Audit
- Funding from Insurance company
- Labour Law Consulting & Leave Policy Design
- Demand Supply Gap of Actuaries

Q&A and Open Forum Discussion

Contact us

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Appendix

AS Applicability for Companies – SMC and Non-SMC definition

Particulars	Non-SMC#	SMC
Securities Listed in India or Outside India	✔	✖
Bank, Financial Institution, Insurance company	✔	✖
Turnover in Previous Year	$\geq$ 250 cr	< 250 cr
	Or	and
Borrowing at anytime in Previous Year	$\geq$ 50 cr	< 50 cr
Holding/ Subsidiary of above	✔	✔

Earlier for accounting period till 31 March, 2021, limit of turnover was 50 cr and for borrowing 10 cr, which is now increased to 250 cr and 50 cr respectively.

Definition of SMC and Non-SMC Company (turnover and borrowing are criteria) as Applicable:

- Accounting period till 31.03.2021: http://www.mca.gov.in/Ministry/notification/pdf/Notification_GSR_739.pdf
- Accounting period on or after 01.04.2021: https://egazette.nic.in/WriteReadData/2021/227890.pdf (Page 329)

Back to Discussion

Kindly note that criteria for classification is different for Companies (issued by MCA) and Non-Company Entities (issued by ICAI)

AS Applicability for Non Company Entities - Level I/II/III/IV

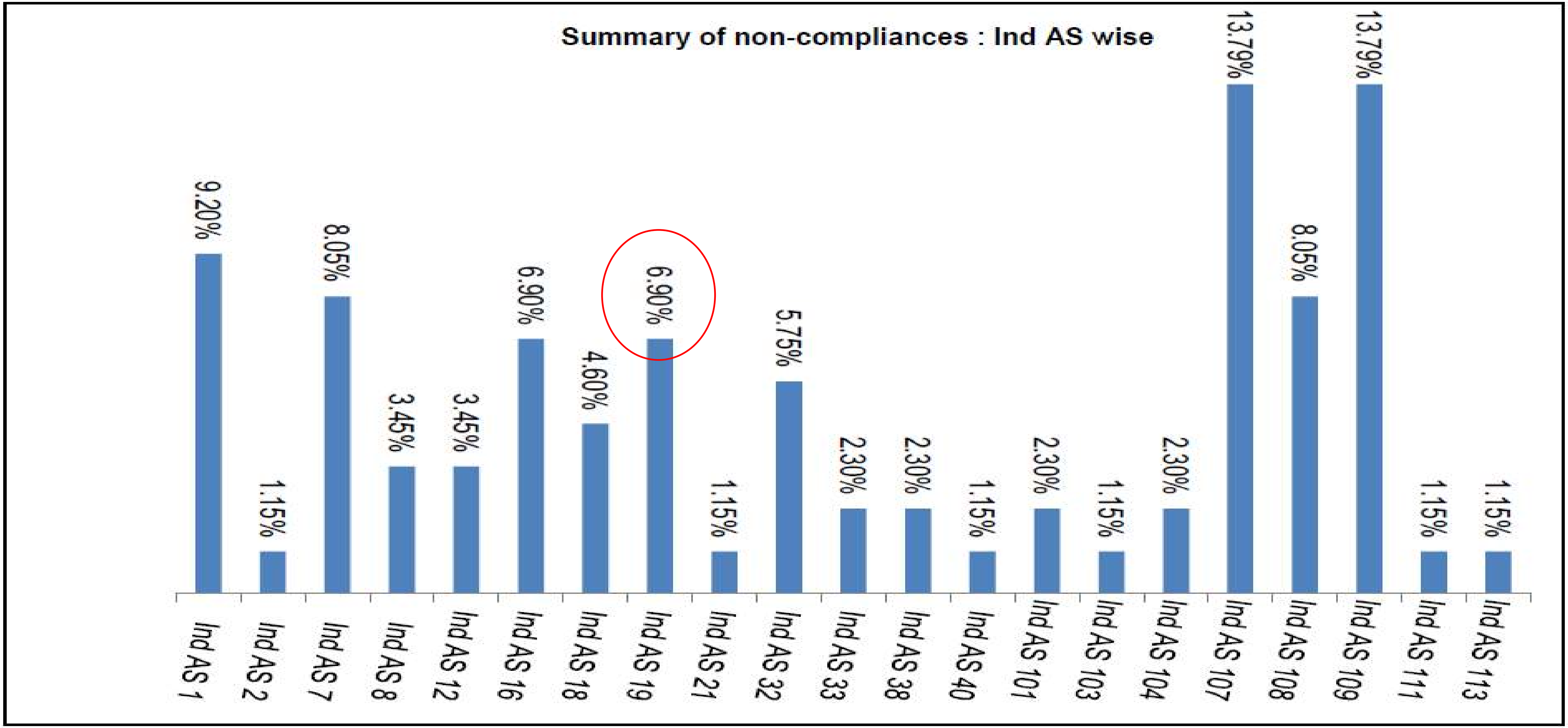
Particulars	Level I	Level II	Level III	Level IV
Securities Listed in India or Outside India	✓	✕	✕	✕
Bank, Financial Institution, Insurance	✓	✕	✕	✕
Turnover in Previous Year	≥ 250 cr	50 cr - 250 cr	10 cr - 50 cr	< 10 cr
Borrowing at anytime in Previous Year	≥ 50 cr	10 cr - 50 cr	2 cr - 10 cr	< 2 cr
Holding/ Subsidiary of above	✓	✓	✓	✓

Definition for Applicability of Level I/II/III/IV - Non Corporate Entities *for Accounting periods commencing on or after April 1, 2020* as Issued by ICAI: https://resource.cdn.icai.org/64269asb51535.pdf

Back to Discussion

Above classification is applicable for *Non Company Entities* e.g. Partnership firm, LLP etc. They need to follow Accounting Standards as issued by ICAI.

Ind AS Deficiencies identified by Financial Reporting Review Board of ICAI



Summary of Ind AS 19 Applicability

Type of Benefits	Provision Required	Provision as per <u>Actuarial Valuation – PUCM Method</u>	<u>Detailed</u> Disclosure in Notes to Accounts
A. Short-Term	✓	✗	✗
B. Post-Employment			
Defined Contribution (e.g. Contribution to EPFO, NPS)	✓	✗	✗
Defined Benefits (e.g. Gratuity, Pension)	✓	✓	✓
C. Other Long-Term (e.g. Leave, Long Service Award)	✓	✓	✗
D. Termination Benefit	✓	✗	✗

In case of Ind AS 19 - No exemption from Detailed Disclosure

Group Share Based Arrangements

Group share-based payment awards - Example

One member of the group (typically, the parent) has obligation to settle a share-based payment transaction in which services are provided to another member of the group (typically a subsidiary).

For example, within a multinational group, shares in the listed parent entity may be granted to the employees of various subsidiary entities located around the world.

In some other cases, a listed subsidiary may have obligation to settle a share-based payment transaction in which services are provided to another member of the group (including the parent).

Group share-based payment awards - Classification

As per para 43B of Ind AS 102, the **entity receiving the goods or services** shall measure the goods or services received as an **equity-settled** share-based payment transaction when:

- the awards granted are its *own* equity instruments, or
- the entity has *no obligation* to settle the share-based payment transaction.

In all other circumstances, the entity receiving the goods or services shall measure the goods or services received as a cash-settled share-based payment transaction.

As per para 43C of Ind AS 102, the **entity settling a share-based payment transaction** when another entity in the group receives the goods or services shall recognise the transaction as an equity-settled share-based payment transaction *only if it is settled in the entity's own equity instruments*. Otherwise, the transaction shall be recognised as a cash-settled share-based payment transaction.

Classification – Summary (Services received by subsidiary)

Award is given by	what is award	Parent Consolidation	Parent Standalone	Subsidiary Standalone
Parent	shares of parent company	Equity settled	Equity settled	Equity settled
Parent	Cash based on Parent 's share	Cash settled	Cash settled	Equity settled
Parent	shares of Subsidiary	Equity settled	Cash settled	Equity settled
Parent	Cash based on Subsidiary 's share	Cash settled	Cash settled	Equity settled
Subsidiary	shares of parent company	Equity settled	NA	Cash settled
Subsidiary	Cash based on Parent 's share	Cash settled	NA	Cash settled
Subsidiary	shares of Subsidiary	Equity settled	NA	Equity settled
Subsidiary	Cash based on Subsidiary 's share	Cash settled	NA	Cash settled