# ESOP

Employee Stock Option Plan

# What are ESOPS?

- **Granting Stock Options:** Companies grant stock options to their employees as a part of their compensation package. These options give employees the right, but not the obligation, to purchase a specific number of company shares at a fixed price. This fixed price is usually set at the current market value of the company's stock at the time of granting the options.
- **Vesting Period:** To encourage employee loyalty and commitment, ESOPs often come with a vesting period. This means that employees need to stay with the company for a certain period of time before they can exercise their stock options. Vesting periods can vary and might include cliff vesting (where employees need to stay for a certain period before any options vest) or gradual vesting (where options vest gradually over time).
- **Exercise Period:** After the vesting period, employees can choose to exercise their vested stock options. Exercising means purchasing the company shares at the predetermined exercise price. If the current market price is higher than the exercise price, employees can buy the shares at a discount. This provides them with an opportunity for financial gain.
- **Motivation and Ownership:** ESOPs are often used as a tool to motivate employees by tying their financial interests to the company's performance. When employees become partial owners of the company, they are more likely to work harder and contribute to the company's success. This feeling of ownership can lead to increased engagement, improved performance, and a stronger commitment to the company's goals.
- **Sense of Belonging:** As you mentioned, ESOPs can also foster a sense of belonging and loyalty among employees. When they have a stake in the company's success, they tend to feel more connected to its overall mission and vision. This can lead to a positive work environment and higher morale.
- **Tax Implications:** The tax treatment of ESOPs can vary depending on the jurisdiction and specific plan details. In some cases, there might be tax advantages for both the company and the employees. However, it's important for employees to understand the tax implications of exercising their options, as they might be subject to taxation upon exercise and further taxation upon selling the shares.

ESOPs can be a win-win situation for both employees and companies. Employees have the potential to benefit financially from the company's growth, and companies can use ESOPs to retain and motivate talented employees while aligning their interests with the company's success.

# What does Companies Act, 2013 say about ESOPs?

Chapter IV The Companies (Share Capital and Debentures) Rules, 2014 – **Rule 12 : Issue of Employee Stock options**

A company, other than a listed company, which is not required to comply with Securities and Exchange Board of India Employee Stock Option Scheme Guidelines shall not offer shares to its employees under a scheme of employees' stock option (hereinafter referred to as "Employees Stock Option Scheme"), unless it complies with the following requirements, namely:-

(1) the issue of Employees Stock Option Scheme has been approved by the shareholders of the company by passing a special resolution.

*Explanation:* For the purposes of clause (b) of sub-section (1) of section 62 and this rule "Employee" means-

- (a) a permanent employee of the company who has been working in India or outside India; or
- (b) a director of the company, whether a whole-time director or not but excluding an independent director; or
- (c) an employee as defined in clauses (a) or (b) of a subsidiary, in India or outside India, or of a holding company of the company [1][Omitted] but does not include-
- (i) an employee who is a promoter or a person belonging to the promoter group; or
- (ii) a director who either himself or through his relative or through any body corporate, directly or indirectly, holds more than ten percent of the outstanding equity shares of the company.
- ["Provided that in case of a startup company, as defined in notification number [3][G.S.R. 127(E), dated 19th February 2019 issued by the Department for Promotion of industry and Internal Trade], Ministry of Commerce and Industry Government of India, Government of India, the conditions mentioned in sub-clause (i) and (ii) shall not apply up to [4][ten years] from the date of its incorporation or registration."]

(2) The company shall make the following disclosures in the explanatory statement annexed to the notice for passing of the resolution-

- (a) the total number of stock options to be granted;
- (b) identification of classes of employees entitled to participate in the Employees Stock Option Scheme;
- (c) the appraisal process for determining the eligibility of employees to the Employees Stock Option Scheme;
- (d) the requirements of vesting and period of vesting;
- (e) the maximum period within which the options shall be vested;
- (f) the exercise price or the formula for arriving at the same;
- (g) the exercise period and process of exercise;
- (h) the Lock-in period, if any ;
- (i) the maximum number of options to be granted per employee and in aggregate;
- (j) the method which the company shall use to value its options;
- (k) the conditions under which option vested in employees may lapse e.g., in case of termination of employment for misconduct;
- (l) the specified time period within which the employee shall exercise the vested options in the event of a proposed termination of employment or resignation of employee; and
- (m) a statement to the effect that the company shall comply with the applicable accounting standards .

(3) The companies granting option to its employees pursuant to Employees Stock Option Scheme will have the freedom to determine the exercise price in conformity with the applicable accounting policies, if any.

(4) The approval of shareholders by way of separate resolution shall be obtained by the company in case of-

- (a) grant of option to employees of subsidiary or holding company; or
- (b) grant of option to identified employees, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option.

(5) (a) The company may by special resolution, vary the terms of Employees Stock Option Scheme not yet exercised by the employees provided such variation is not prejudicial to the interests of the option holders.

- (b) The notice for passing special resolution for variation of terms of Employees Stock Option Scheme shall disclose full of the variation, the rationale therefor, and the details of the employees who are beneficiaries of such variation.

(6) (a) There shall be a minimum period of one year between the grant of options and vesting of option:

- Provided that in a case where options are granted by a company under its Employees Stock Option Scheme in lieu of options held by the same person under an Employees Stock Option Scheme in another company, which has merged or amalgamated with the first mentioned company, the period during which the options granted by the merging or amalgamating company were held by him shall be adjusted against the minimum vesting period required under this clause;
- (b) The company shall have the freedom to specify the lock-in period for the shares issued pursuant to exercise of option.
- (c) The Employees shall not have right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to them, till shares are issued on exercise of option.

(7) The amount, if any, payable by the employees, at the time of grant of option-

- (a) may be forfeited by the company if the option is not exercised by the employees within the exercise period; or
- (b) the amount may be refunded to the employees if the options are not vested due to non-fulfillment of conditions relating to vesting of option as per the Employees Stock Option Scheme.

(8) (a) The option granted to employees shall not be transferable to any other person.

- (b) The option granted to the employees shall not be pledged, hypothecated, mortgaged or otherwise encumbered or alienated in any other manner.
- (c) Subject to clause (d), no person other than the employees to whom the option is granted shall be entitled to exercise the option.
- (d) In the event of the death of employee while in employment, all the options granted to him till such date shall vest in the legal heirs or nominees of the deceased employee.
- (e) In case the employee suffers a permanent incapacity while in employment, all the options granted to him as on the date of permanent incapacitation, shall vest in him on that day.
- (f) In the event of resignation or termination of employment, all options not vested in the employee as on that day shall expire. However, the employee can exercise the options granted to him which are vested within the period specified in this behalf, subject to the terms and conditions under the scheme granting such options as approved by the Board.

(9) The Board of directors, shall, inter alia, disclose in the Directors' Report for the year, the following details of the Employees Stock Option Scheme:

- (a) options granted;
- (b) options vested;
- (c) options exercised;
- (d) the total number of shares arising as a result of exercise of option;
- (e) options lapsed;
- (f) the exercise price;
- (g) variation of terms of options;
- (h) money realized by exercise of options;
- (i) total number of options in force;
- (j) employee wise details of options granted to;-
- (i) key managerial personnel;
- (ii) any other employee who receives a grant of options in any one year of option amounting to five percent or more of options granted during that year.
- (iii) identified employees who were granted option, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

(10) (a) The company shall maintain a Register of Employee Stock Options in Form No. SH.6 and shall forthwith enter therein the particulars of option granted under clause (b) of sub-section (1) of section 62.

- (b) The Register of Employee Stock Options shall be maintained at the registered office of the company or such other place as the Board may decide.
- (c) The entries in the register shall be authenticated by the company secretary of the company or by any other person authorized by the Board for the purpose.

(11) Where the equity shares of the company are listed on a recognized stock exchange, the Employees Stock Option Scheme shall be issued, in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.

# What does IND AS say about ESOPs?

In India, accounting of share-based payment transactions is done in accordance with SEBI guidelines and Guidance Note on Accounting for Employee Share-Based Payments or on the basis of Ind AS 102 "Share-Based Payment". The corporate entities following Ind AS would not account for share-based payment based on Guidance Note.

The Companies Act, 2013 also discusses about it under section 62

Under Section 62 (1) (b) of the Companies Act 2013, where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares may be offered to employees under a scheme of employees' stock option, subject to a special resolution passed by the company and subject to such conditions as may be prescribed.

Some of the terms used in IND As are as Follows:

Fair Value : The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arms length transaction.

Grant Date: The date at which the entity and another party (including an Employee) agree to a share-based payment arrangement.

Share option : A contract that gives the holder the right, but not an obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period.

Vesting Condition: A Condition that determines 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. A vesting condition is either a service condition or a performance condition.

Vesting Period: The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

**Important Note:**

- **Share based payment will be measured at fair value on initial recognition which will include the effect of the vesting conditions. Equity based Share based payment at fair value on grant date with no subsequent measurement.**

Calculation of Fair Value of Option.

- All the share-based payment plans are recognized referring fair value at grant date and it is crucial to understand how the fair value is arrived and the specific guidance available in the standard.
- To Determine the Fair value, one must use valuation techniques.
- However, there is nothing specific which has been defined by the standard. Black-scholes pricing model and Binomial pricing model are being used widely and are also generally accepted.
- All option pricing models consider, as a minimum, the following factors:

Exercise price of the option;

Life of the option;

Current price of the underlying shares;

Expected volatility of the share price; (Calculate Volatility on Historical Share Price (If share are not traded can adopt comparable company method)

Dividends expected on the shares (if appropriate);

Risk-free interest rate for the life of the option.

*Layman Explanation :This Calculated fair value of option is expense for the entity for the services of the employees, means company is issuing equity share to its employees at the exercise price which employee will pay to the company, but the market price of the share is higher than the exercise price, company is spending from its own pocket the difference amount for the equity shares.*

# Recognition / Accounting Treatment (IND AS 102):

- An Entity shall recognise the services received or acquired under the ESOP Scheme as follows:

The Entity shall recognise the Corresponding increase in Equity if the services were received in an Equity Settled Share Based payment transaction.

The Recognition will depend on vesting conditions, it means if there are certain conditions either service related or performance related which needs to be completed in order to be eligible for such ESOP Scheme, then recognition shall be based on the based estimate of the expected vesting value of such amount.

**For Example :**

**An entity has given 100 stock options to each of its 1,000 employees for those who will remain in service for next 4 years. The grant date was 1st January, 20X1. The condition to remain in service shows that the stock option has been given for the services to be provided in the next 4 years; hence at the end of each year, the entity will estimate the expected number of Employees who will remain in service and accordingly will recognize the cost over 4 years .**

- ✓ **In other words, ESOP Expense is to be booked over the vesting period on SLM Basis (Exercise Period is not Relevant)**
- ✓ **Calculation of Expense to be recognised over each year:**

$$\frac{\text{No. of Employees Expected to Fulfil the Condition at each year end} \times \text{No. of Options per Employee} \times \text{Fair Value of Options on the Grant Date}}{\text{Total Vesting Period}} \times \text{Vesting Period Completed till Date} = ****$$

Less :Expense Already recognised up to previous years. = ****

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Therefore, Expense to be recognised in the current year: = ****

# Requirement for Valuation of ESOPs

Obtaining accurate ESOP (Employee Stock Option Plan) valuations is crucial for several reasons, primarily for accounting and taxation purposes. Let's delve into the reasons why obtaining ESOP valuations is so important:

- **Accounting Purposes:** ESOP valuations are necessary for proper accounting treatment. When a company grants stock options to employees, it incurs a compensation expense that needs to be recognized on its financial statements over the vesting period. The valuation of ESOPs determines the fair value of these options at the time of grant. This valuation directly impacts the company's income statement by affecting its reported earnings and reducing its earnings per share (EPS).
- **Vesting Period Compensation Expense:** As employees' stock options vest over time, the company needs to account for the corresponding compensation expense. This expense is recognized based on the fair value of the options granted. Accurate ESOP valuations help companies accurately record this expense, ensuring compliance with accounting standards and providing transparency in financial reporting.
- **Taxation Purposes:** ESOP valuations are critical for taxation purposes, both for the company and its employees. For the company, the valuation affects the tax deduction it can claim related to the compensation expense associated with the ESOPs. For employees, the difference between the market price of the company's shares at the time of exercise and the exercise price is subject to taxation as a perquisite (a form of non-salary benefit). Accurate valuations ensure that the correct amount of tax is assessed and paid by both the company and its employees.
- **Employee Attraction and Retention:** The perceived value of ESOPs is a significant factor in attracting and retaining talent. Employees are more likely to view ESOPs positively if they believe the options have a reasonable and accurate valuation. Properly valued ESOPs increase employee satisfaction and motivation, which can positively impact company performance.
- **ESOP Design and Planning:** Valuations play a critical role in designing and planning ESOPs. A thorough valuation analysis helps the company set appropriate exercise prices, vesting schedules, and overall ESOP terms. This ensures that the ESOP aligns with the company's goals, maximizes its benefits, and avoids any unintended negative consequences.
- **Regulatory Compliance:** Various accounting standards and tax regulations dictate how ESOPs should be valued. Accurate valuations are essential for regulatory compliance and to avoid potential legal and financial repercussions.
- **Investor Transparency:** For publicly-traded companies, accurate ESOP valuations contribute to transparency and investor confidence. Investors rely on accurate financial reporting to make informed decisions about their investments.

In summary, ESOP valuations serve as the foundation for accurate financial reporting, proper tax assessment, employee engagement, and overall effective ESOP management. Given their wide-ranging implications, companies should engage qualified professionals to conduct thorough and accurate valuations to ensure compliance and to make well-informed decisions about their ESOP programs.

# Approaches and Methodologies for ESOPs Valuation

- **Intrinsic Value Method:** The intrinsic value method calculates the value of ESOPs based on the difference between the current market price of the company's shares and the exercise price of the options. This method is often used when ESOPs are issued at or near the market price, making the intrinsic value significant. It's relatively straightforward but might not accurately capture the full value of the options, especially if they are granted below market price.
- **Income Approach:** This approach estimates the value of ESOPs based on the present value of expected future cash flows generated by the company. Discounted Cash Flow (DCF) analysis is a common method within this approach.
- **Asset Approach:** The asset-based approach calculates the value of ESOPs by determining the company's net asset value, subtracting liabilities. This method might be appropriate for companies with substantial tangible assets.
- **Market Approach:** The market approach involves comparing the company's financial metrics and market prices to those of comparable publicly-traded companies. This approach relies on market multiples such as price-to-earnings (P/E) ratios, price-to-sales (P/S) ratios, and others.
- **Fair Value Method (Option Pricing):** The fair value method involves using option pricing models to determine the value of ESOPs. This method is often preferred because it considers various factors that affect option value and provides a more comprehensive valuation.
- **Black-Scholes Model:** The Black-Scholes model is a widely used option pricing model that takes into account factors such as the current stock price, exercise price, time to expiration, volatility, and risk-free interest rate. It's commonly used for valuing European-style options.
- **Binomial Model:** The binomial model is another option pricing model that considers the discrete nature of time and allows for greater flexibility in modeling early exercise options or other complex scenarios.

**Disclosure Requirements:** As you mentioned, SEBI norms and accounting standards often require transparency in the valuation process. Even if a listed company isn't using the fair value method, it may need to disclose the financial impact of using option pricing methods in its financial statements' notes. This ensures stakeholders have insight into the potential value of ESOPs and their impact on the company's financials.

**Ind-AS 102:** Indian Accounting Standards (Ind-AS) 102 provides guidelines for accounting for share-based payments, including ESOPs. It requires the application of fair value for accounting purposes, aligning with international standards.

In conclusion, the choice of valuation method depends on various factors including the company's circumstances, the complexity of the ESOP structure, regulatory requirements, and the level of accuracy desired. Engaging qualified professionals with expertise in valuation and regulatory compliance is essential to ensure that the valuation is accurate, compliant, and appropriate for the company's specific situation.

# Taxation of ESOPs

Income tax should be paid in two situations

- At the time of giving ESOPs The income is treated as perquisites which form part of the salary of the employee. The employer is required to deduct TDS and the income is calculated as the difference between the fair value of each share and the market value.
- At the time of sale of ESOPs, The gains arising out of ESOPs are capital gains. The capital gain is the difference between the sale price and the price at which it was awarded to the employee.

The tax should be paid in the year of the sale of ESOP.

- Long Term– When the ESOPs were held by the employee for more than 36 months (3 years) from the date of purchase the capital gain tax rate is 20%.
- Short Term– When the ESOPs were held for less than 36 months (3 years) from the date of purchase the capital gain tax is 10%.

Disadvantages of ESOPs The main concern for ESOPs is dilution. With every share granted to the employee the shareholders share gets diluted. Conclusion ESOPs have proved to be very effective tools for both big companies and start-ups. Companies use these to retain their workforce and the talent whereas start-ups use these tools to hire fresh talent and to attract more workforce. These work as a boon for companies which cannot afford to pay high salary. Besides this the sense of ownership acts as a motivation for the employees to work hard and diligently.