10 UNDERSTANDING EMPLOYEE STOCK OPTION PLANS (ESOP'S)

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LEARNING OBJECTIVE

After studying this chapter, you should be able to:

- Understand the concept of Employee stock option plans
- Learn about the various ESOP options in India
- Describe the Valuation of ESOP's
- Discuss the ESOP pool size and photography

KEY TERMS

This chapter features these terms which you should strive to do more research about:

Employee Stock Purchase Plan (ESPP)	Phantom Equity Plan (PEP)	Restricted Stock Units (RSU)
Restricted Stock Award (RSA)	Stock Appreciation Rights (SARs)	ESOP pool size
Terms of grant	Intrinsic value method	Fair value method

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Understanding Employee Stock option plans (ESOPs)

Employee Stock Option Plan (ESOP) is an option given to directors, officers or permanent employees of a company to purchase or subscribe the securities offered by the company at a future date at a concessional price generally.

ESOPs are one of the most important tools to attract, encourage and retain employees. It is the mechanism by which employees are compensated with increasing equity interest over time.

Under Section 62 (1) (b) of the Company 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 special resolution passed by the company and subject to such conditions as may be prescribed.

Why are ESOPs issued by the companies?

- Link personal wealth creation to organizational creation.
- Attract, reward, motivate and retain talent at the start-up/growth stage.
- Deferred compensation strategy.
- Good retirement benefit plan.
- Reduction in cash costs – market pays not the company.
- Can be especially important for start-up companies that are cash starved.
- Promotes employee ownership culture.
- Helpful tool in cash crunch - In case of economic slow-down where companies are low on cash, they can motivate employees by offering ESOPs.

What do companies see while granting ESOPs to employees?

- Loyalty, Performance and Designation
- Present and Potential Contribution.
- Opportunity Cost

Other Provisions related to ESOPs:

- ESOPs can be implemented by direct route or trust route.
- The company granting options to its employees pursuant to ESOPs will have the freedom to determine the exercise price in conformity with the applicable accounting policies.
- There shall be minimum period of one year between the date of grant of option and the date of vesting of the options.
- As per accounting standards AS20, stock options granted pursuant to an employee share-based payment plan should not be included in the shares outstanding till the time employees have exercised their right to obtain shares or stock options.
- ESOPs granted to directors become part of managerial remuneration.
- Under the Company Act 2013, there shall be a minimum period of one year between grant of options and vesting of options, hence the exercise period cannot be less than one year from the date of grant of option.
- There are two methods of accounting for Employee share Based payment, i.e., intrinsic value method or fair value method.
- For accounting purposes, employee share-based payment plans are classified as equity settled, cash settled and plans with cash alternatives.

Procedure of Issue of ESOP by Unlisted Company:

Step 1: Draft the ESOP scheme.

Step 2: Convene the Board Meeting and pass the scheme.

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Step 3: Call the general meeting to approve the scheme by Shareholders. The following disclosure will be made in the explanatory statement annexed to the notice for passing of the resolution:

- The total number of stock options to be granted.
- Identification of classes of employees entitled to participate in the Employees Stock Option Scheme.
- The appraisal process for determining the eligibility of employees to the Employees Stock Option Scheme.
- The requirements of vesting and period of vesting.
- The maximum period within which the options shall be vested.
- The exercise price or the formula for arriving at the same.
- The exercise period and process of exercise.
- The lock-in period.
- The maximum number of options to be granted per employee and in aggregate.
- The method which the company shall use to value its options.
- The conditions under which option vested in employees may lapse e.g. in case of termination of employment for misconduct.
- 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
- A statement to the effect that the company shall comply with the applicable accounting standards.

Step 4: Approve the ESOP Scheme by passing a special resolution. The approval of shareholders by way of separate resolution shall be obtained by the company in case of:

- Grant of option to employees of subsidiary or holding company; or
- 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 or grant of option.

Step 5: File form MGT-14 to submit the special resolution within 30 days of passing the resolution.

Step 6: After approval of ESOP scheme by the shareholders, grant options to the eligible employees.

Step 7: Vesting of options. There shall be a minimum period of one year between the grant of options and vesting options.

Step 8: Exercise of Options by the employees.

Step 9: Allotment of shares. As and when options are exercised file form PAS-3 (Return of Allotment) with ROC.

Step 10: The Company shall maintain a Register of Employee Stock Options in form SH-6 and shall forthwith enter therein the particulars of option granted.

Step 11: The Board of directors, shall, inter alia, disclose in the Directors' Report for the year, the following details of the Employees Stock Option Scheme:

- Options granted.
- Options vested.
- Options exercised.
- The total number of shares arising as a result of exercise of option.
- Option lapsed.
- The exercise price.
- Variation of terms of options.
- Money realized by exercise of options.

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- Total number of options in force.
- Employee wise details of options granted to:
  - Key managerial personnel.
  - Any other employee who receives a grant options in any one year of option amounting to 5% or more of options granted during the year.
  - 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.

Various ESOP Plan Options:

Employee Stock Option Plan or ESOP in India is one of the most common ways to incentivize employees. It is a type of stock option plan in which the company grants an option to purchase its shares to employees. An employee may exercise their option by buying the stocks at a price determined by the terms of the option agreement. ESOPs are generally used to reward valued employees and provide them with an incentive to stay with the company. They can also be used as part of a corporate buyback program or as part of a broader strategy to retain key employees.

In India, ESOPs have become quite popular. However, there are mainly six different types of ESOPs that can be used to incentivize employees in India.

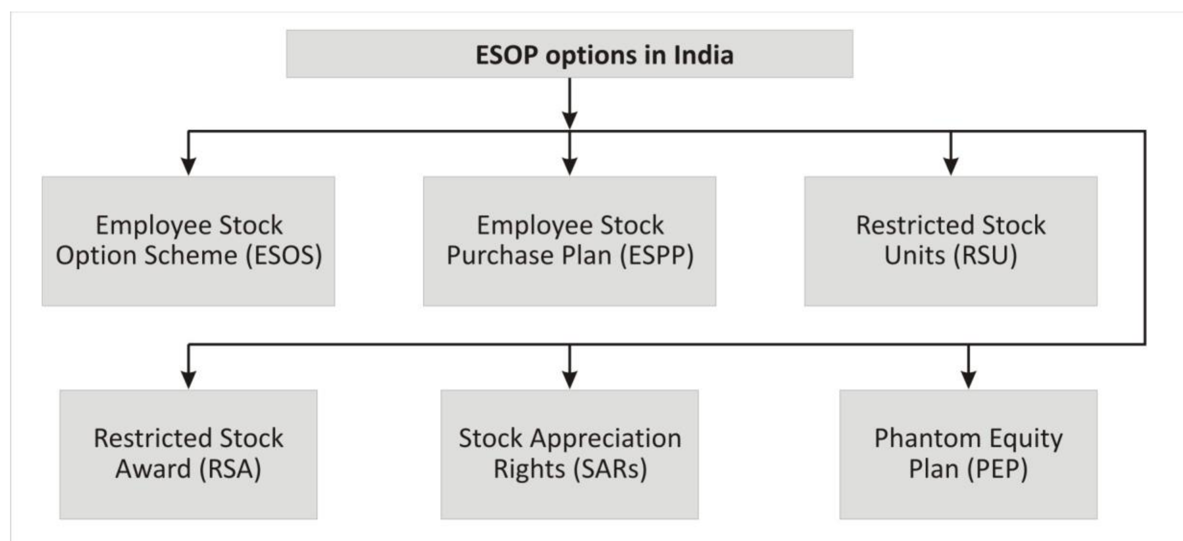

Exhibit 10.1: Various ESOP options in India

Let's have a look at each of them to understand how the different types of ESOPs in India work, how they differ from each other, and what benefits they bring to the company and its employees.

- Employee Stock Option Scheme (ESOS):

  The ESOS is a type of stock option scheme that grants an employee the right (they are in no way obligated, though) to buy shares of the business directly from the company at a predetermined value. This option is subject to specific performance goals over a certain vesting period.

  Employees are allowed to exercise their right to own the offered stocks at a fixed price after the vesting period, which means that there is a chance of acquiring the shares at a much lower value (which is set at the time of issue) than the market price once the vesting period ends. If the employee doesn't want to exercise their right, they can just let it expire and receive nothing.

  Upon exercising, employees enjoy full ownership of their stocks and voting rights in the company and are entitled to receive dividends.

- Employee Stock Purchase Plan (ESPP):

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It is an ESOP that gives employees the ability to purchase shares of the company stock at a discounted or lower than the fair market price. The ESPP allows the employees to make periodic investments into the company's stock, thereby increasing their ownership interest in the business. Each time an employee makes an investment in the stock, they receive a portion of the company's profits, which is known as a dividend.

This plan offers an employee the same opportunity to acquire shares of the company stock as an individual investor would – without the risk. In this model, employees are able to invest a set amount into the company's stock either annually or through payroll deductions. The company can offer employees the option to participate in the ESPP every year.

- Phantom Equity Plan (PEP):

  PEP and SARs are often used interchangeably; however, there is a subtle difference. Like SARs, Phantom Equity Plan also does not involve any real stock and only pays the increased share value benefit to the employee. But at the same time, PEP mimics a bonus (rather than a stock option) that companies award to employees at a predetermined future date (subject to fulfillment of some conditions) and do not allow employees to exercise at their will within a given time.

- Restricted Stock Units (RSU):

  An RSU is an ESOP that grants employees restricted stock units, meaning employees are allowed to exercise them in order to convert RSU into real stocks when some restrictions, which can be either time-based or performance-based, are lifted, hence the name. Usually, employees are granted RSUs in exchange for a particular amount of time spent working with the company or when certain performance milestones are achieved.

  These are specifically designed for executive employees, enabling them to hold a portion of the company's equity without voting rights or dividends until the shares are actually issued after the vesting period is completed. The number of shares awarded to each executive varies based on their position within the company.

  However, since RSUs are not unlocked or cannot be liquidated until the stipulated conditions are met, an employee should not rely on them for financial support in case of an emergency.

- Restricted Stock Award (RSA):

  Even though they might sound similar, Restricted Stock Awards are actually very different from Restricted Stock Units. While RSU is a mere promise of giving stocks once a specified time period is over or achieved a performance goal (or both in some cases), RSA actually issues stocks to the employee immediately, allowing them to own the share with all its associated benefits, including voting rights and dividends from the grant date.

  But why is this option called "restricted" if it grants full ownership benefits? Because it still comes with a vesting period during which the employee is not allowed to sell the shares in the open market. Employers may set some conditions, which, if not met, or the executive leaves the organisation before the vesting period is over, stocks can be forfeited or repurchased by the company.

- Stock Appreciation Rights (SARs)

  If a company wants to give out stock benefits to its employees but does not want the shares to be liquidated, then SARs are the best choice. SARs grant the employee the right to receive an increase in the price of the company's stock once a specified time period has passed before the expiration date.

  Where this plan differs from the regular ESOP is the employee does not pay any exercise price (as no actual shares have been granted); they just receive the value increment of the allotted stocks in the form of cash or shares.

Role of Employee Stock Ownership Plans (ESOPs) in Promoting Employee Retention

1. Impact on Employee Morale

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One of the most significant benefits of ESOPs is the impact it creates on employees' morale. When employees feel like they have a personal stake-holding in the company, they are more likely to feel a sense of pride and ownership. This, in turn, can increase employee motivation and engagement, leading to improved performance and increased job satisfaction.

2. Financial Benefits for Employees

ESOPs also offer a variety of financial benefits for employees. By owning stock in the company, employees can build wealth over time. Additionally, ESOPs can provide a valuable source of retirement income, giving employees peace of mind as they plan for their financial future.

3. Promoting Employee Loyalty

Another critical benefit of ESOPs is their ability to promote employee loyalty. Employees vested in the company's success are less likely to leave for other opportunities. This can lead to increased stability and improved performance over the long term.

4. Encouraging Employee Investment

ESOPs can also encourage employees to invest in the company. By offering a direct link between employee performance and company success, ESOPs can motivate employees to work efficiently and be more productive. This can positively impact the company's bottom line, leading to increased success and growth.

5. Fostering a Collaborative Work Environment

Finally, ESOPs can help to foster a collaborative and supportive work environment. By aligning employee and company interests, ESOPs can encourage employees to work together towards common goals. This can lead to a more positive and productive work environment, with employees feeling more invested in their work and committed to the company's success.

Hence, it can be concluded that ESOPs offer a unique and effective way for companies to incentivise employees and thus promote employee retention. They create a sense of ownership and pride among employees, align employee and company interests, and provide a valuable benefit that can attract and retain top talent. In the end, ESOPs are one tool in a larger strategy for promoting employee retention. Other measures, such as offering competitive salaries and benefits, creating a positive work environment, and promoting career development opportunities, are also important for retaining top talent. By combining these strategies, companies can create a comprehensive approach to promoting employee retention and ensuring long-term success.

How to design an Effective ESOP Scheme.

Design and implementation of Employee Stock Option Plans (ESOPs) is more than just creating a scheme document. It is the process of setting the whole framework on how the ESOP Program of your Company will run. A well thought out framework goes a long way in making ESOPs an effective compensation tool than just a mere tick-box exercise. In fact, Companies with an objective and well set out framework find it easier to explain the value of ESOPs to their employees both at hiring stage as well as part of on-going employee engagement.

However, it has been often noticed that companies focus only on the detailed documentation around creation of such schemes and in the process lose sight of the decisions that are most crucial to the successful design and implementation of the ESOP Scheme.

This segment will highlight the key decisions and considerations involved in designing a successful ESOP Program. Whether a company designs and implements a new ESOP scheme or modifies an existing one or makes further grants under an existing scheme, the considerations listed here would remain relevant, however, considering the changes we are witnessing globally, this list cannot be considered as an exhaustive list

Design Considerations: 5 Key Areas

Designing ESOPs requires consideration of many factors and the need to strike a balance between various conflicting objectives.

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Key considerations / aspects to be considered are listed below:

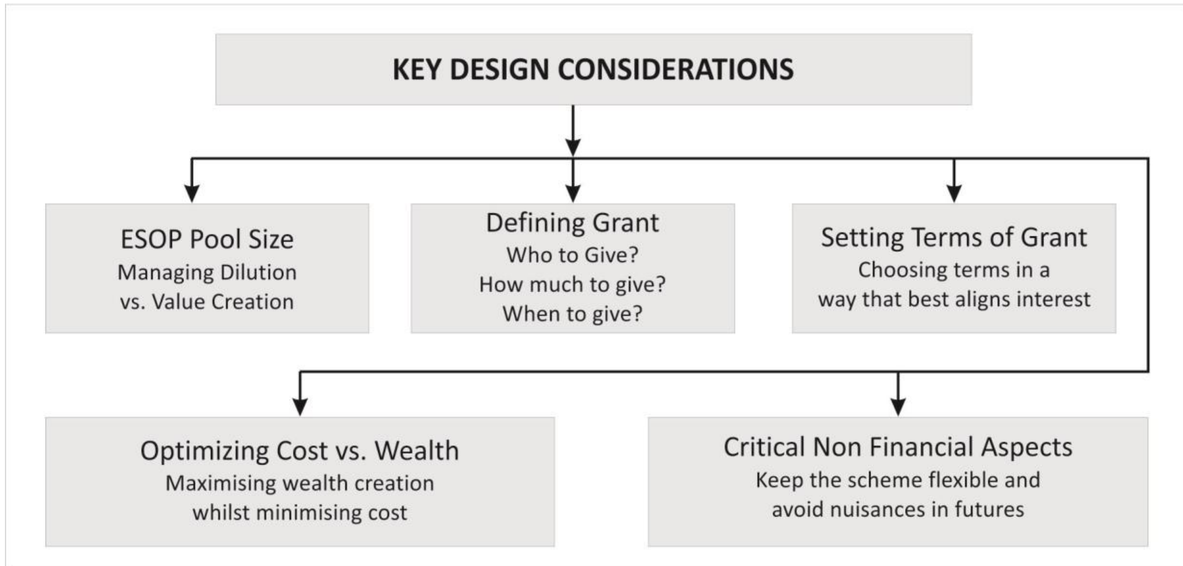

Exhibit 10.2: Key design considerations

Decision on each of these factors in turn requires understanding the financial implications for the company under different scenarios and alternative design choices, incorporating factors and variables unique to each organisation.

ESOP Pool Size and Philosophy:

ESOP Pool represents the portion of equity reserved for employees, directors and where permissible, consultants and advisors of a Company. Creation of ESOP Pool is a strategic decision as it immediately dilutes the percentage holding of the existing shareholders.

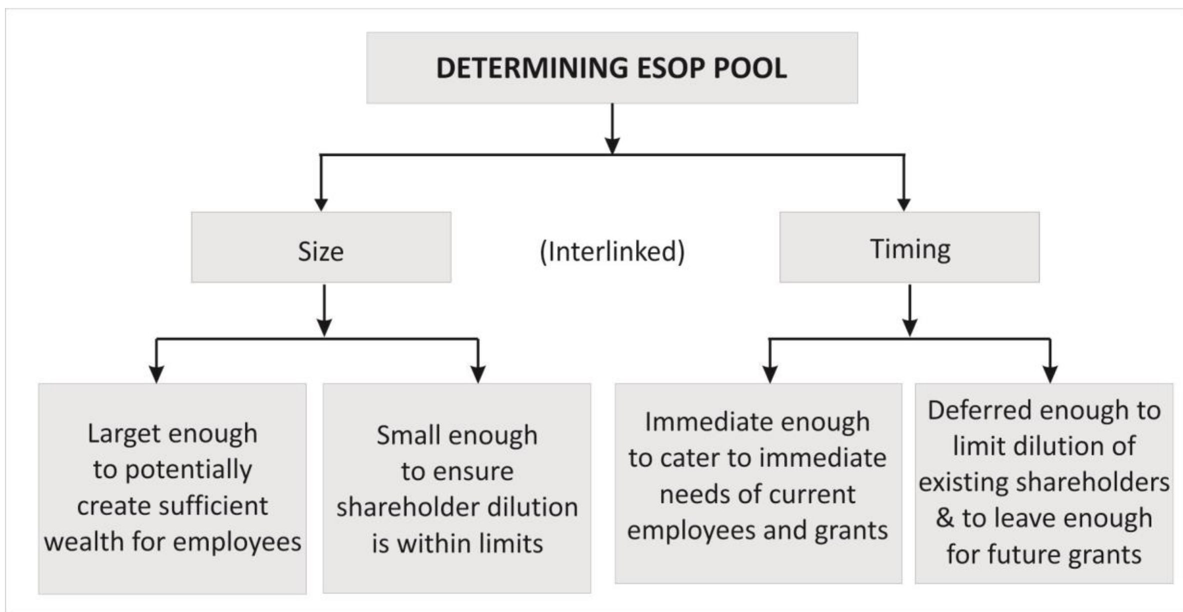

Exhibit 10.3: Determining ESOP pool

Founders or Promoters are generally recommended to avoid using broad benchmarks and instead assess the size of the Pool needed to strike a balance between managing their own dilution overtime and the need to offer competitive equity compensation to retain / attract the right talent.

Following are the key considerations:

Key considerations in siz e and timing related decisions with regards to ESOP Pool:

- Time frame for which the current ESOP Pool should suffice:

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  - Companies should avoid setting a pool with very long-term time horizon. Instead, it should be focusing on the pool needed for next 12-18 months or until your next funding round.
  - Companies can always top-up / expand the pool as it grows and manages dilution impact between all shareholders (including future investors) than just taking the full hit as a Promoter.
- Expected Employee Coverage:
  - Companies should factor the founding team, future hires over the chosen time frame and assess how many people are expected to be covered by the current Pool.
  - It should make an estimation of future hires and their compensation, which should be aligned to business plan of the Company.
- Growth in Value of ESOP Pool over time:
  - Assessment of the growth expected in the value of your ESOP Pool should be made for the next 4 to 5 years. This should be linked to the expected movement in the share price of the Company.
  - Small pool may also suffice if the Company expects significant growth overtime.

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Grant Framework for Employee Level Grants:

Grant Framework sets the ESOP Policy tone for the company by establishing contours for:

- Eligibility criteria – whether it will be broad based or selective.
- Whether it will be restricted to the promoters and founding team only, or it will get extended to the Senior Management.
- Whether Middle management employees will also be considered.
- Whether there will be any past tenure or performance which will be considered as a selection criterion?
- Methodology for grants basis compensation philosophy:
  - CTC Replacement
  - CTC Replacement using future wealth
  - CTC Multiple approach.
- Triggers for future grants.
- Promotions, milestones, etc.
- Criteria for grants to new entrants if needed.

As organizations grow and hire more and more people, it becomes important to standardize the process of granting ESOPs and avoiding last minute surprises. It also helps to embed the ESOP Program as part of the overall compensation.

A well thought out framework helps employees view the ESOP Program as a real long term wealth program wherein they can gain by staying longer with the Company than as a piece of paper offered to them once at the time hiring!

Key considerations in determining grant framework for employee level grants include:

- Setting Participation rules such as minimum service period, grade, performance rating etc.
- Choosing Employee level Grant Method

This can be based on the Company's compensation philosophy and growth stage. Widely used methods include:

- Replacing reduction in CTC (compared to market levels) with same intrinsic value of ESOPs.
- Granting ESOPs with future estimated intrinsic value being a multiple (say 3 to 4 times) of immediate reduction in CTC or of the full immediate CTC.
- Granting ESOPs equivalent to a multiple of full CTC of employees, with multiples varying by grade, tenure etc. and back solved for Company's plan projections.
- Rules for future grants, which could include rules for annual grants or granting only on promotion, outstanding performance or long service with Company.

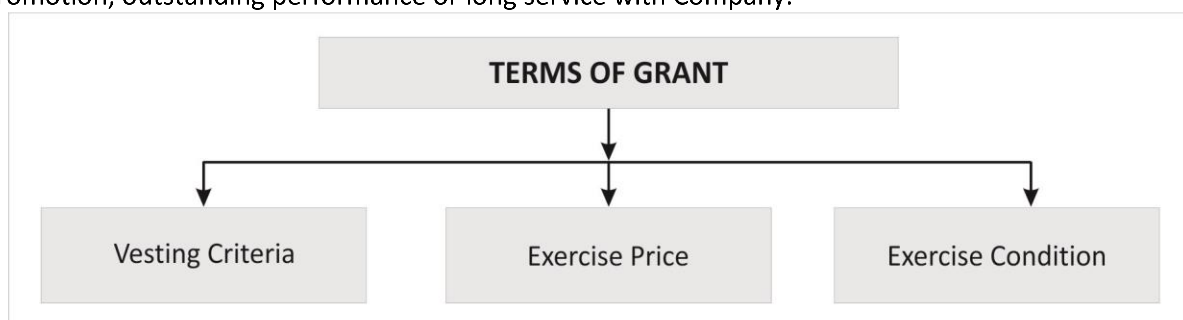

Exhibit 10.4: Terms of grant

Terms of Grant:

The key terms of grant that need to be determined and the options available for each are given below:

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- Performance or service based or both.
- Graded or bullet vesting.
- Uniform, front-ended, back-ended
- Performance criteria recommended for senior employees
- Distinction for different divisions / departments
- Current share price vis-à-vis discount to be offered.
- Impact on cost to company and wealth creation
- Length of exercise period.
- Linkage or not to happening of corporate event.
- Flexibility to Board for buy back (including implications)
- Flexibilities to board to enable early exits / liquidity.

Following are the other key considerations:

Vesting criteria is the set of requirements (service or performance based) that an employee must fulfil to earn the rights attaching with ESOPs. Choosing the right vesting criteria for different category of employees involves deciding on:

- Length of vesting period
- Type of vesting - Graded (front ended or back ended) versus bullet vesting
- Simple service-based vesting or linked to individual / company performance milestones.

Other Key Considerations:

- Balance quantum of equity being granted vis-à-vis the vesting requirements imposed.
- A company should choose criteria which is simple and objective to monitor / administer yet creates incentive for employees to work hard for the Company.
- Avoid criteria which creates complacency amongst employees.
- Set Exercise Price based on growth stage and compensation offered.
  - Issuing at market price: Employees share both upside and downside.
  - Issuing at discount: Employees gain immediate wealth in addition to share in future upside.
  - Issuing at deep discount: Employees immune to any fall in share price.
  - Issuing at premium: Creating incentive to drive share price above a level to earn the upside.
- Exercise price denotes the price the employee will eventually pay when buying ESOPs.
- ESOPs can be issued at current market price, discount to current market price (as low as face value) or at premium to current market price.
- Exercise Price directly influences the level of wealth creation for employees and help define the level of upside / downside risk shared with employees.

Optimizing Cost vs Wealth Creation for Employees

- Designing ESOPs is a balancing act between managing the Cost to the Company and estimated wealth creation for employees. This step brings together all the chosen design terms to assess the impact on P&L vis-à-vis wealth creation for employees.
- ESOPs create a P&L charge, which should be managed Whilst Investors may appreciate that this charge is possibly replacing the cash compensation for employees, it's important that the cost is managed and not unreasonably high as it depresses reported profits and consequently valuations.
- While trying to maximize wealth creation for employees Companies should assess the wealth creation at end of Vesting period under different scenarios of business plan to choose terms which best meet the desired employee outcomes.

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- Each design decision (i.e. exercise price, number of ESOPs granted, vesting criteria etc**.)** impacts either P&L cost or wealth creation or both, thus making the design process iterative. It's important to assess outcomes in advance and make informed decisions.

Other Critical Non-Financial Aspects:

Other than what we have discussed so far, following are some of the critical nonfinancial aspects that companies look into while finalizing an ESOP scheme.

Minimising Cash flow strain for Employees:

- By choosing scheme rules which aims to match cash inflow and outflow for employees.
- By linking the exercise only with Liquidity Events.

Capital Structure overtime:

- View of level of dilution expected over time.
- Consider whether to put individual employees on cap-table as shareholders.

Treatment of vested options of ex-employees:

- Consider what would happen to the vested options of employees once they leave the company.
- Compulsion on exercising options in a short period.
- Allowing employees to continue holding vested options post leaving the company.

Other scheme rules:

- Ensuring flexibility to Board to decide exact terms of Exercise at a later stage depending upon how the Company grows.
- Ensuring flexibility to accelerate vesting of key employees, if needed.
- Not compromising on the tightness of the scheme rules to avoid misinterpretation by employees.

Tax Advantage of an ESOP for Employers:

When it comes to the employers, ESOP brings the following tax advantages for the employers.

1. Deduction of Contributions to the ESOP

One of the most significant tax benefits of an Employee Stock Option Plan is the ability for the employer to deduct contributions made to the plan. Contributions to the Employee Stock Option Plan can be deductible up to 25% of an employee's compensation. This means that an employer can reduce its taxable income by the amount of the contribution made to the Employee Stock Ownership Plan, thereby reducing its tax liability.

For example, say the employer books a pre-tax profit of Rs. 100 Crore and while issuing the ESOPs to its employees as they exercise it, the difference between the exercise price and the market price of share is Rs. 12 Crore which is getting booked as a perquisite income in the hands of employees. Hence, this Rs. 12 Crore is allowed as a deduction in the hand of employer. However, there has always been a general sense of ambiguity in these, and such matters have always been subject to litigation in India. Section 37(1) grants deduction for expenses that are neither personal nor capital expenditure in nature and are not covered under Section 30 to Section 36. But, there have been various judgements ruled in favour of the employers, example, CIT vs Lemon Tree Hotels Limited, August 2015 and M/s Biocon Limited vs Deputy Commissioner of Income Tax, Bengaluru, in 2020.

2. Diversion of Corporate Income Taxes

An Employee Stock Option Plan can also provide tax benefits by diverting corporate income taxes. When an Employee Stock Option Plan buys company stock from the employer, the company can use the proceeds to pay off debt or make new investments rather than paying taxes on the transaction. This results in a lower tax bill for the company and freeing up cash that can be used to grow the business.

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In the example discussed above, the deduction of Rs. 12 Crore is saving a tax of Rs. 3 Crore for the employer, which it can use to pay of its debt obligations and increase the liquidity within the business.

3. Deferral of Capital Gains Taxes

Another benefit of an ESOP is the ability to defer capital gains taxes on the sale of company stock. Suppose an owner of a closely held business sells their stock to an Employee Stock Ownership Plan. In that case, they can defer paying capital gains taxes on the sale until they sell their shares or until the Employee Stock Option Plan is terminated. This allows the owner to delay paying taxes on the sale and potentially defer them for many years.

Tax deferral is allowed under Section 1042 if:

- The selling shareholder elects this treatment upon the sale of company stock to an ESOP that owns at least 30% of the company following the sales.
- The proceed from the sales are reinvested in qualifying replacement securities.

Provided the shareholder acquires the stock other than through an employer's plan providing an option to purchase the stock and hold the stock at least three years prior to sales.

For example, if promoters owns 75% of the corporation's stock since its inception 15 years back at Rs. 100 Crore. Today, the corporation is worth Rs. 5,000 Crore, and the promoter sells stock at approximately Rs. 50 Crore. If the promoters sold their stock in a taxable sale, they would pay capital gains tax on Rs. 48.67 Crore of appreciation, and Rs. 12.2 Crore after adjusting for grandfathering resulting in approximately Rs. 1.22 Crore of tax. If the promoters met all of the requirements and instead elected tax deferral under section 1042 and reinvested the entire Rs. 50 Crore in qualifying replacement securities, they would pay no tax on the sale. Then, if they were to sell those replacement securities five years from now, they would have only a Rs. 100 Crore basis in them. Thus, the gain of Rs. 48.67 Crore that existed at the time of sale to the ESOP would get taxed in five years. Therefore, the value of the tax deferral would approximately equal the value of the earnings on the additional investment that promoter would be able to invest for five years. Of course, promoters would need to compare that value to the earnings they could have made if they had left their investment in the corporation for the five years.

4. Increased Depreciation Deductions

An Employee Stock Option Plan can also provide tax benefits by increasing depreciation deductions. When an Employee Stock Option Plan borrows money to purchase company stock, the company can depreciate the loan, which results in a tax deduction. This means the company can reduce its taxable income and lower its tax bill.

5. Use of ESOPs as a succession planning tool

An ESOP can also provide estate planning benefits for the business owners. By selling their stock to an Employee Stock Option Plan, owners can transfer the ownership of their business to their employees without paying estate taxes. This can result in significant tax savings and ensure that the business continues to be owned and operated by those who are fit for the job and also has a skin in the game.

6. Use of ESOP to reduce debt

Through ESOP a company gets to raise fund through Equity which naturally brings down the Debt to Equity ratio in their capital structure. Raising equity which otherwise would have come from investors, are coming from the employees who are actively involved in the process. Hence, it is more profitable for the organisation as they are in a way getting investment from the people who will also be working towards its success.

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Valuation of ESOP’s

ESOP's allow businesses to sell part of their company’s shares to employees. ESOPs are provided, in the main, to increase the retention rate in a firm. The idea here is to recognize and reward staff for their commitment and contribution to the company while ingraining a sense of ownership. Employee stock options can provide new possibilities for succession and estate planning, offering closely held businesses a vehicle for continued expansion.

For a startup, ESOP valuation is crucial as the valuation of the organization in its entirety. Companies that offer ESOPs are required to provide ESOPs as an expense in their P&L statement. The provision impacts the determination of distributable profits for factors such as EPS calculation, dividend declaration, MAT payment, and profit determination for senior management remuneration. Valuing ESOPs eventually translates into valuing the entire company. ESOPs need to be treated as an expense in the P & L statement.

The valuation is also important for issuing ESOPs over a vesting period (a specified amount of time working with the company) and calculating the required tax that employees must pay. In India, ESOPs are valued using a variety of approaches including income, asset, market, and fair value methods among others.

Valuing ESOPs

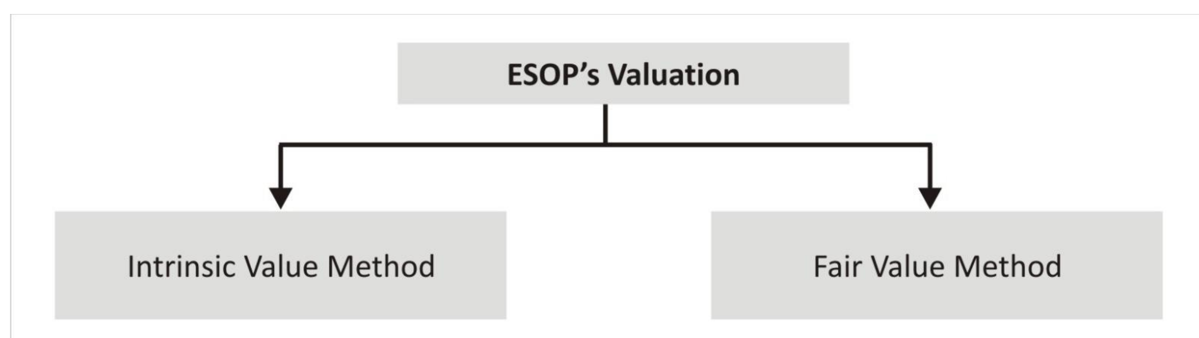

Exhibit 10.5: ESOP’s Valuation

Intrinsic Value Method

Intrinsic Value is the measure of the extent to which the market price of the share exceeds the exercise price of the option. In other words, "intrinsic value" is the profit that accrues to employees on account of the higher market value of the shares.

Fair Value Method

An ESOP's fair value is calculated using option-pricing models such as the Black-Scholes or Binomial model. The Black-Scholes model is commonly used to arrive out at a fair value of ESOPs, taking into account various factors such as Time Value, Interest Rate, Volatility, Dividend Yield, and so on.

The Black Scholes model factors in various external aspects that affect the value of the ESOPs. The following factors must be considered when calculating the value of ESOP options using Black Scholes:

- The expected life of the option
- Exercise price
- The fair value per share
- Expected volatility of share price
- Expected dividend yield
- Risk-free interest rate

Tax Valuation

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To comply with applicable provisions of the Indian Income Tax Act, 1961, and the CBDT notification in this regard, ESOP valuation needs to be carried out for determining the value of perquisites taxable in the hands of employees.

According to "CBDT Notification No. 94/2009 dated 18.12.2009, the fair market value of any specified security or sweat equity share, being an equity share in the company not listed at any recognized stock exchange, shall be the value of the share in the company as determined by a merchant banker on the specified date for the purpose of clause (vi) of sub-section (2) of section 17."

In India, no method is prescribed for unlisted companies. This includes shares of companies listed on foreign stock exchanges, which do not qualify as recognized stock exchanges in India.

Merchant bankers can perform the valuation of an ESOP in accordance with Indian Income Tax law. Companies should seek expertise to arrive at an accurate and conclusive value of the ESOP. The initial value could serve as the foundation for future valuation. There are numerous rules and regulations associated with the ESOP scheme. To ensure that there are no adverse consequences, businesses must comply with the regulations. An independent valuer conducts an annual appraisal of the plan sponsor after an ESOP is established. The market price for shares held by employees is influenced by such appraisal. When employees retire or leave the company, the sponsor buys back their shares at the most recent valuation price.

When a corporation sells its stock to an employee trust via a leveraged ESOP (a leveraged ESOP entails taking out a loan to buy equity in a firm directly from them or their existing shareholders), the trustee needs to appoint an impartial assessor to determine the business's fair market ESOP value (FMV). Using this valuation as a baseline, ESOP trustees and plan sponsor negotiate the final sale price. The plan 9/99sponsor is typically also the participants' employer in most ESOPs. However, the sponsor could alternatively be the employer's parent company.

A contributing ESOP is one in which a company issues new shares to an employee trust and is reimbursed for their fair market ESOP price on the contribution date. An independent valuation is performed to ascertain the corporate income tax gain when new shares are issued.

Communicating ESOP's with employees

Equity based compensation in any form or shape is relatively complicated to understand and also difficult to communicate. However, that precisely is the reason why communication is key to ensure its success. For good reason, globally companies earmark a significant budget for Plan communication.

Communication in every form is crucial for the success of any Plan for several reasons.

Every form of equity compensation is inherently linked to hard core financial elements – Operations, Profitability, Balance sheet, ratios, stock markets, business cycles. These are not subjects easily understood by most of the O/ptions holders. If their reward is going to be linked to these aspects which they do not understand, it often leads to an impression that ESOPs are a lottery.

These are long term instruments, requiring consistent year on year performance from employees. Unless employees know how well the company is doing on an on-going basis, they may be in the dark and make impressions based on grapevine.

Given macro and micro economic fluctuations, it is likely to have a bad year or two in the ESOP vesting period, leading to decline in the business valuation and deferment of value appreciation. Unless these trends are communicated effectively, Option holders may carry an impression that Valuation is a black box calculation which only select few decide.

By giving Equity of the Company you are making the Option holder a partner in business. It is important that he not only knows that he is a partner but also feels like one. There are instances where just on receiving Company's Annual Report, Option holders and their families have felt proud and delighted. Just an experience of a CEO of the Company, talking to you on an Annual basis giving you heads up on how is the Company doing, in itself is a very motivating feeling and brings everyone on par as shareholders.

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Companies can communicate through banners, fliers, townhall meetings, Plan handbooks, FAQs. Send reminders, alerts about vesting, end of exercise period, potential lapsing of Options. Periodical communication on value of the Options held based on latest independent valuation is also essential. A very common, communication need is when the Company is raising Capital rounds and Option holders read about the valuations in the media. This creates expectations that if one were to exercise and sell

Corporate action, especially in the nature of Change in Control, often results into a situation where investors get an exit and realize their appreciation, the Option holders are often expected to continue with their Options by the incoming investors. Open and transparent communication apart from a fair treatment is extremely essential to uphold the spirit with which Options were given to employees Global research shows that almost a third of the Options granted, lapse. Employees leave their jobs keeping lacs of Rupees in value on the table. Lack of education and awareness is one of the prime reasons for this behavior. Effective communication plan can go a long way in reducing this gap and ensuring better impact of the Plan.

Plan administration of ESOP’s

ESOP (employee stock option plan) supports plan administration needs. Well, when we talk about plan administration, it means a person or company responsible for managing a retirement fund or a pension plan on behalf of its participants and beneficiaries. The plan administrator ensures the funds are properly collected and distributed to all qualified participants.

Other tasks which are included in plan administration are:

- Enrolling company employees in their respective pension plans
- Calculating a plan beneficiary's entitlement
- Making the correct scheduled payments to beneficiaries
- Make sure all plan data is accurate and is provided to participants in a timely manner
- Paying pension benefits to ex-spouses of beneficiaries, according to court rulings and regulations
- Fielding questions, concerns, and complaints from beneficiaries

What are the ESOP plan responsibilities?

- Understanding and interpreting plan provisions.
- Hiring, monitoring or replacing plan service providers.
- Assuring accuracy of the TPA’s work.
- Overseeing eligibility and benefit claims and appeals.
- Assuring preparation and veracity of the plan's annual audit.

What does the ESOP administrative committee do?

The ESOP administrative committee is usually appointed by the board of directors and delegates the responsibility to oversee the plan's day-to-day operations.

What does a Third party administrator do?

A third-party administrator is a business that contracts with another business to offer operational services like employee benefits administration and claims processing. Claims handling is frequently contracted out to outside parties by insurance companies and self-insured businesses

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MEASURING INVESTMENT RISK AND RETURNS

UNIT IV