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ESOP: Employee Stock Option

Webinar 30th May 2020

What is ESOP?

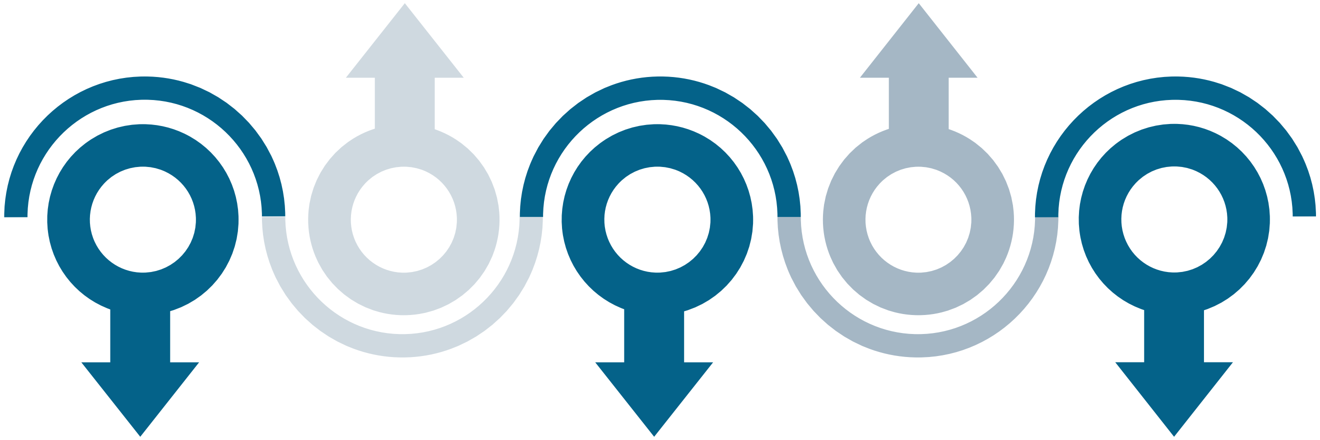
ESOP is defined under section 2(37) of the Companies Act, 2013 as option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price;

- Permanent employee (not contractual);
- There is no obligation on part of employee, its only an option;
- Future sale at pre-determined price;
- To curb attrition among employees;
- Vested options gets transferred to legal heirs on death of an employee, hence a long-term incentive

ESOP at a Glance

How do ESOP Work

ESOP Implementation



Benefits of ESOP

Who is Eligible

Regulatory Compliance

Benefits of ESOP

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For Employer

- To minimize attrition with additional reward
- To attract and retain high-quality employees
- To offer its employees an incentive without monetary compensations
- To connect employees with your company's mission

For Employee

- Stock monetization exceeds the regular remuneration
- Enhance job security and stability
- Direct ownership opportunities by acquiring the shares
- Significant retirement benefits at no monetary cost

ESOP Procedure

Who is Eligible to be an Employee?

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Included in the definition

- Non-Executive and Non-Promoter Directors
- Whole Time Director
- Permanent Employees

Employee of Company, its holding & subsidiaries working in India or outside India

Excluded from the definition

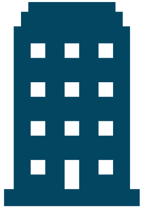
- Contractual Employees and Vendors
- Independent Directors
- Director or his relative holding more than 10% ES*
- Employee belonging to Promoter Group*

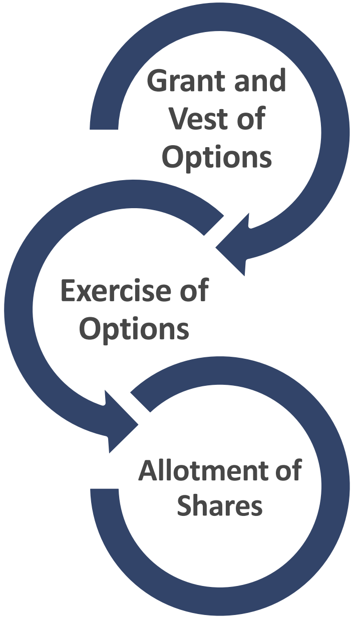
**Exemption for startups*

How to Implement the Scheme?

ESOP Implementation: Direct Route

COMPANY





EMPLOYEE

ESOP Implementation: Trust Route

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Company → Employee Welfare Trust → Employee

Company

- Formation of trust
- Funding the Trust to buy shares of Company
- Acquisition of Shares by Trust
- Grant of options to Employee

Employee

- Exercise of options after vesting period

Trust

- Transfer of Shares to Employee
- Repayment of Loan to the Company

Regulatory Compliance

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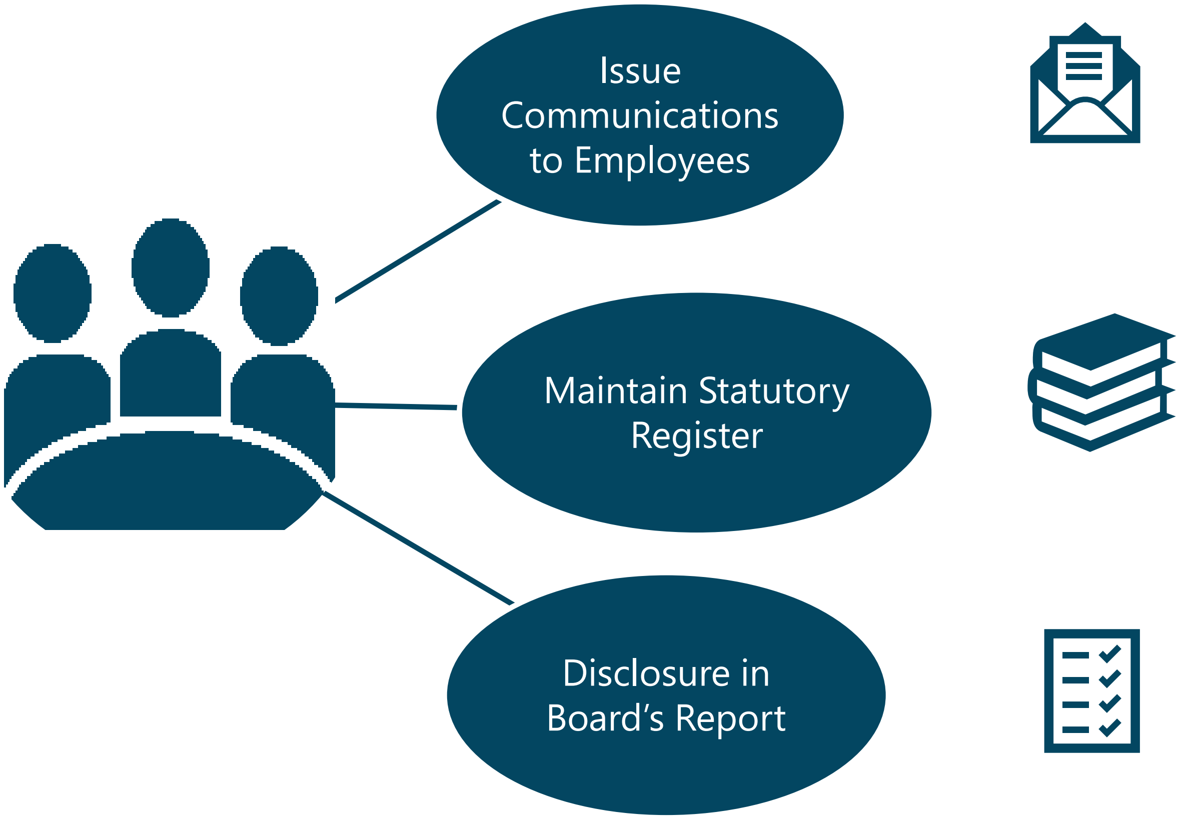
Companies Act, 2013 along with Rules

S. No.	Event	Filing Required
1.	Approval of Scheme	Public Co.
2.	Grant of Option	Not Req
3.	Vesting of Option	Not Req
4.	Exercising of Option	Yes
5.	Sale of Shares	Not Req

Foreign Exchange Management Act, 1999 (including Rules and Regulations enacted there under)

S. No.	Event	Filing Required
1.	Approval of Scheme	Not Req
2.	Grant of Option	Yes
3.	Vesting of Option	Not Req
4.	Exercising of Option	Yes
5.	Sale of Shares	Yes

Other Regulatory Compliances



Alternative Plans

Stock Appreciation Rights (SAR)

- No dilution of shareholding;
- No obligation for upfront payment by employee;
- No taxation on grant or vesting;
- Appreciation is linked to the performance of Company;
- Benefit to employee equivalent to the incremental value of equity;
- Equity settled or cash settled reward to employee;

Phantom Stocks

- When SAR is settled in cash;
- Another form of giving cash bonus;
- Monetary incentive either as appreciation value or full value;
- No Voting or decision-making rights;
- Governed by agreement, no provisions prescribed;
- Incentive to work harder towards company’s performance.

How ESOP is Different from Sweat Equity?

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ESOP

- These are kind of incentive and retention plan
- To purchase shares in future, at a predetermined price
- Cannot be issued to the promoters or promoter group
- No Lock-In period Specified
- There is no cap provided for issuance of ESOP

SWEAT EQUITY

- These are issued as consideration for some value addition
- Shares get issued immediately without monetary considerations
- Can be issued to the promoters of the Company and also ID
- 3 Years compulsory Lock-In Period
- Company can provide certain % of its capital as Sweat Equity.

  (Exemption for Start ups)

Taxation Under ESOP

Taxation of ESOP

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For Employee

On Allotment of shares

- Taxable as perquisite income = FMV on exercise of option- Exercise Price
- For Start Ups, tax may be levied on earliest of below:
  - Sale of shares
  - Exit from company
  - Four years from end of assessment year in which ESOP are allotted

On Transfer of Shares

- Capital Gain = Sale value – FMV on date of exercise

For Employer

- No tax liability in the hands of employer on issuance of shares
- Employer can claim ESOP cost as an ascertained expense
- TDS need to be deducted at the time of allotment of shares

Relevant Valuation Provision

FMV of ESOP (Rule 3 of Income Tax Rules, 1962)

- Case A: Listed Shares
  - Opening Price + Closing Price
    2- Of recognized stock exchange with highest volume
    - On exercise date
- Case B: Unlisted Shares
  - Value determined on specified date* of shares by Category 1 merchant Banker (registered with SEBI)
- Case C: ESOP not being equity shares in the company
  - Value determined on specified date* of specified security by Category 1 merchant Banker (registered with SEBI)

Valuation for ESOP Purposes

Various Stages of ESOP Cycle

Formulation of ESOP Scheme

- Valuation for decision making
- Differential pricing
- Differential vesting
- Differential terms

Grant of ESOP

- Required for Financial Reporting
- Fair value and intrinsic value
- Can be done by RV, CA, MB
- Valuation at each grant date

Vesting of ESOP

- No valuation required
- Expenses are accounted over the vesting schedule

Exercise of ESOP

- Valuation required from merchant banker for Income Tax purposes

Valuation Approaches

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There are various methods to arrive at a fair value of business. The selection of the method depends upon a case-to-case basis and also upon the availability and reliability of data for a particular method. The different methods of valuing a business can be classified under the following approaches

Cost Approach

The approach as the name suggests estimates the fair value of the business / assets basis the cost incurred to build the asset historically or the cost that will be incurred to build the asset currently

The most commonly used methods of valuation under this approach are:

a) Replacement Cost Method
b) Reproduction Cost Method

Market Approach

The approach uses the prices & other relevant information from market transactions of similar assets, liabilities or business to estimate fair value of business

The most commonly used methods of valuation under this approach are:

a) Market Price Method
b) Comparable Company Multiple
c) Comparable Transaction multiple

Income Approach

The approach uses the income/cash flow generating capacity of the asset to determine its fair value by either capitalizing or discounting the cash flow/income generated.

The most commonly used methods of valuation under this approach are

a) Discounted Cashflow Method
b) Income capitalization Method
c) Option Pricing Method

Option Pricing Methods

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Black – Scholes

This method is used for valuation of European options i.e. options which can be exercised at expiration.

Assumptions

- *The returns on the underlying are normally distributed*
- *Stock prices are log normally distributed.*

$$C = S_t N(d_1) - K e^{-rt} N(d_2)$$

where:

$$d_1 = \frac{ln\frac{S_t}{K} + (r + \frac{\sigma_v^2}{2})\,t}{\sigma_s\,\sqrt{t}}$$

and

$$d_2 = d_1 - \sigma_s\,\sqrt{t}$$

where
C=Call option price
S=Stock price
K=Exercise price
T=Remaining life of option (i.e. maximum time that can elapse until exercise)
R=Risk-free rate
σ=Expected volatility

Option Pricing Methods

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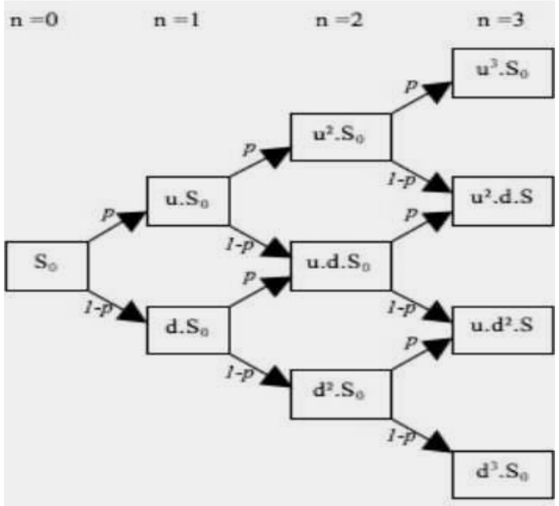
Binomial method

This method is used for valuation of European options & American options i.e. options which can be exercised at any time during the life of option.

The binomial option pricing model values options using an iterative approach utilizing multiple periods to value American options.

With the model, there are two possible outcomes with each iteration—a move up or a move down that follow a binomial tree.



$$p = \frac{e^{rt/n} - d}{u - d}$$

$$u = e^{\sigma\sqrt{t/n}}$$

$$d = e^{-\sigma\sqrt{t/n}}$$

Inputs to Option Model and its Sensitivity

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Underlying Variables	Movement in Variable	Impact on Option Value	Relation
Strike Price	↓	Higher	Inverse
Current Spot Price	↑	Higher	Direct
Volatility	↑	Higher	Direct
Dividend Yield	↑	Lower	Inverse
Risk Free Rate	↑	Higher	Direct
Expected life	↑	Higher	Direct

Accounting for ESOP

Accounting for ESOP’S

- Accounting principles are prescribed by Ind AS 102 (for companies follows Ind AS or Guidance note on ESOP valuation (for companies follows IGAAP)
- ESOP cost is considered as employee cost and accounted as expenses in financial statements
- Under Ind AS we follow **fair value** method for accounting of expenses (based on option valuation methods)
- Under IGAAP we follows **intrinsic** method for accounting of expenses (based on business valuation methods)
- **Intrinsic Value = fair value of full share – exercise price and Fair Value = Intrinsic Value + Time Value**
- Expenses are recorded over proportionately over the vesting period
- In case the Company has formulated trust, the operations of the **ESOP trust should be included in consolidated financial statements** of the Company
- **Regulatory disclosures** (MCA & SEBI) need to be made in the Financial Statements & Annual Reports regarding the ESOP grants made

Global References : AICPA

Valuation of Privately- Held-Company Equity Securities Issued as Compensation

Back solve method or waterfall method for valuing an enterprise within the market approach, derives the implied equity value for the company from a transaction involving the company's own securities. The back solve method requires considering the rights and preferences of each class of equity and solving for the total equity value that is consistent with a recent transaction in the company's own securities, considering the rights and preferences of each class of equity.

It involves estimating different level of equity value or breakpoints. Each consecutive break point represents an incremental claim on the Company's equity value by different classes of shareholders prompted by their respective liquidation preference, and participation rights.

Benefits

- This method uses recent round of fund raise to derive the value of different class of securities.
- This method considers different rights associated to security and basis same value equity shares
- This method captures discount for lack of marketability
- Generally value of equity shares are 20%-45% discount to latest round of fund raise, thus lowering of expenses.

For more information contact

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