

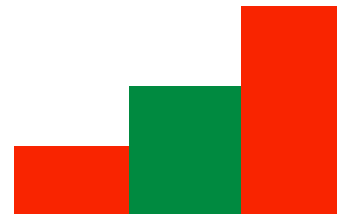
Tuesday Series

Company Law Master Class

Employees' Stock Option Plan

CA Sachin Miniyaar

1st June 2021





What is ESOP?

Indian Perspective

E – Employee

S – Stock

O – Option

P – Plan

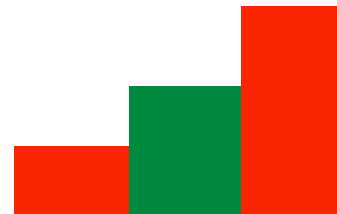
US Perspective

E – Employee

S – Stock

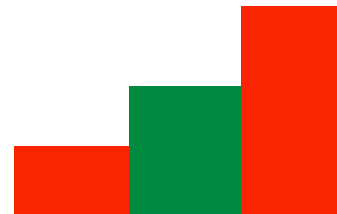
O – Ownership

P – Plan



What is Stock Option?

- Stock Option is a right given to an employee to buy certain number of shares of the company at a fixed pre-determined price over a period of time.
- It has 3 main characteristics:
 - The **number** of shares that can be bought is **pre-determined**.
 - The **price** at which shares can be bought is **pre-determined**.
 - The right is available over a **period of time**.



ESOP Lifecycle

Conceptualizing & Designing

Legal Compliance

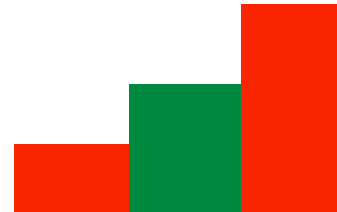
Employee Presentation

Implementation

Administration

ESOP Terminologies

- **Grant Price / Exercise Price** – The price at which shares are offered to the employees.
- **Vesting Period** – The period after which the options can be converted into shares.
- **Exercise** – The action of paying the price and converting the options into shares.
- **Exercise Period** - The period after vesting within which the employee has to take the decision of exercising Options.

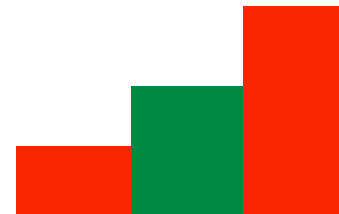


What is Vesting of Options?

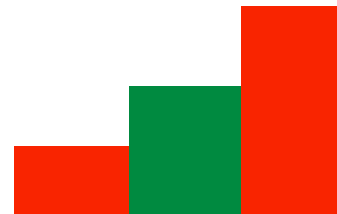
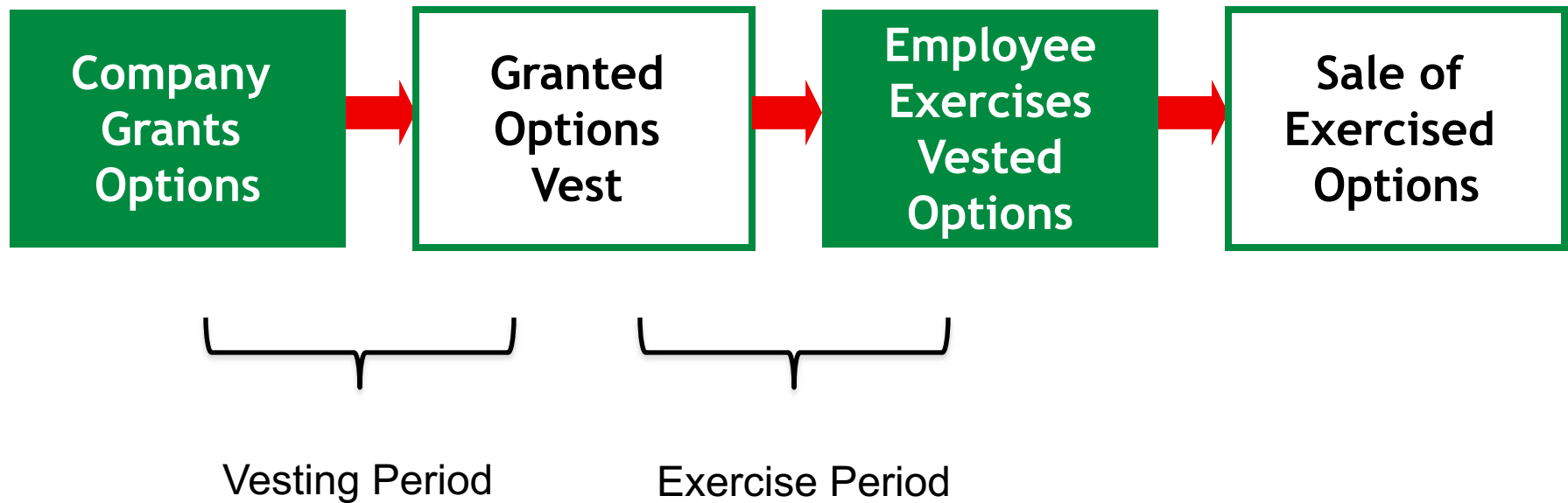
- Example of a vesting schedule:

Years	1	2	3	4
% Vesting	25%	25%	25%	25%

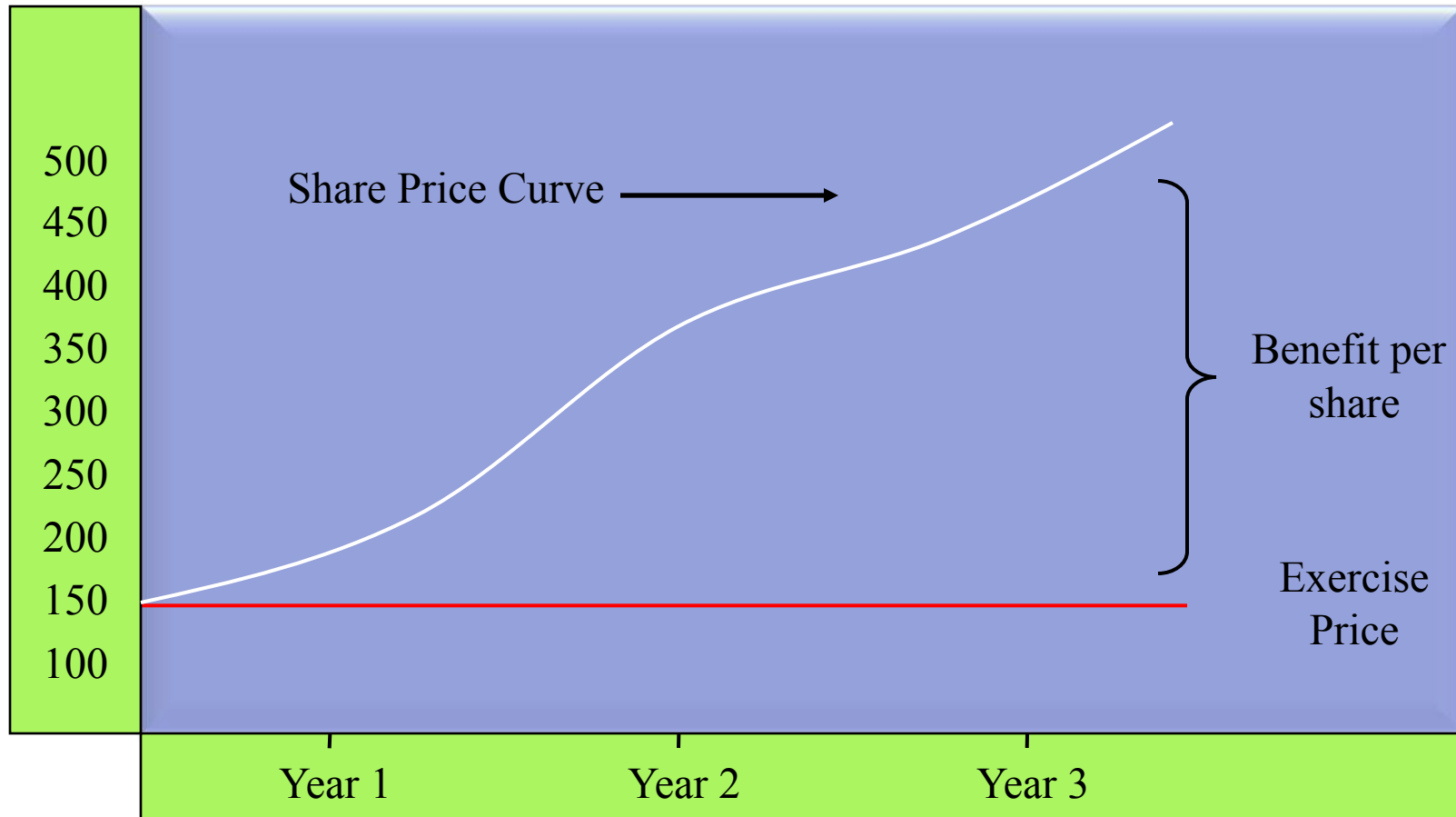
	2021	2022	2023	2024	2025
Options Granted	200				
Vesting of Options		50	50	50	50



ESOP Lifecycle



How does Employee Benefits



Types of ESOPs

ESOP

- Employee Stock Option Plan

ESPP

- Employee Share Purchase Plan

SAR

- Stock Appreciation Rights

Phantom

- Phantom Option

Types of ESOPs



ESOP

- Employee Stock Option Plan

- Options which can be converted into Equity Shares on a future date are granted.
- Conversion of Options in shares happen on completion of the lock in period (vesting period).
- Generally post conversion, there is no lock in period for the equity shares

Types of ESOPs



ESPP

- Employee Share Purchase Plan

- Shares are issued to employees at a certain price.
- These shares have a lock in period during which employee cannot sale the shares.
- Employee need to pay for the price on date of issue i.e. on the day the scheme is implemented.

Types of ESOPs



SAR

- Stock Appreciation Rights

- A stock appreciation right (SAR) is a form of bonus compensation given to employees that is equal to the appreciation of company share price over an established time period.
- These increase in share price is paid to employee in cash.
- Employee is not required to pay exercise price nor can he become shareholder of the company at any point of time in future.

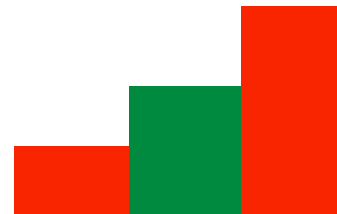
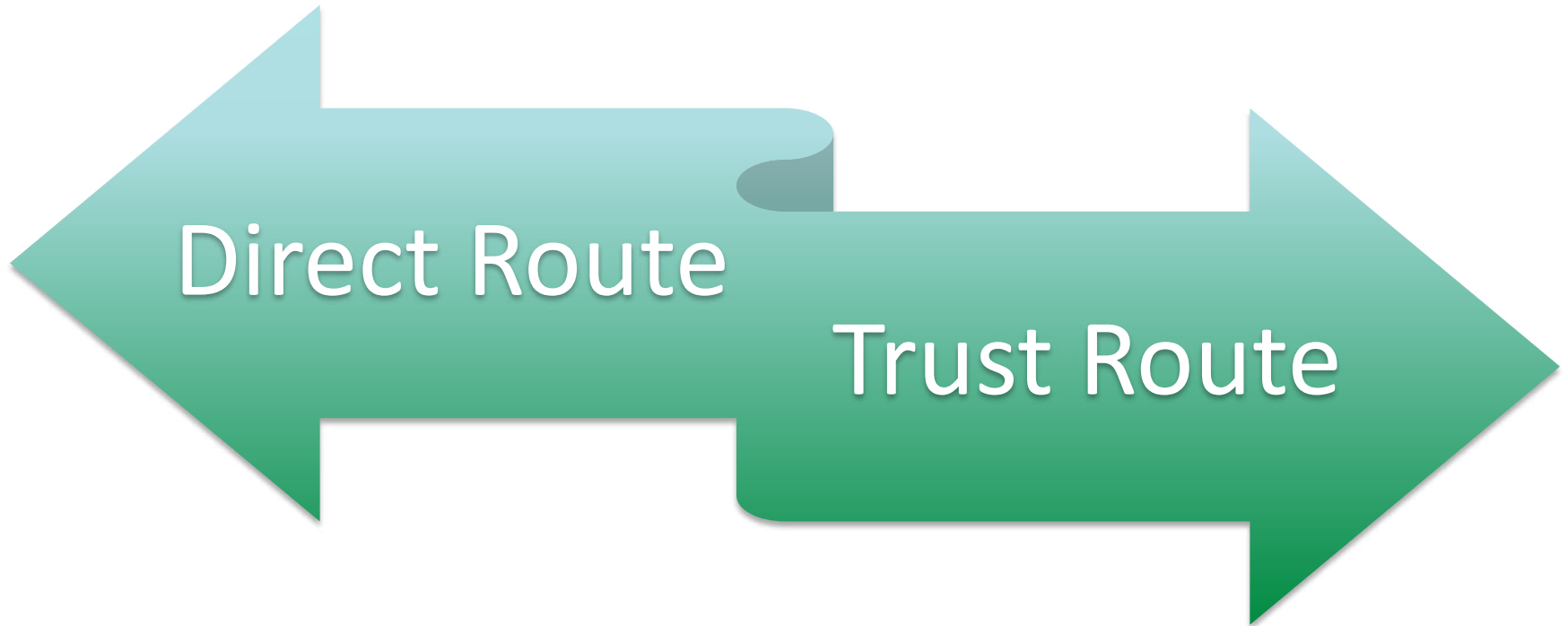
Types of ESOPs

Phantom

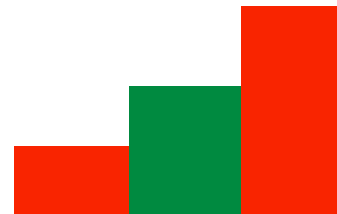
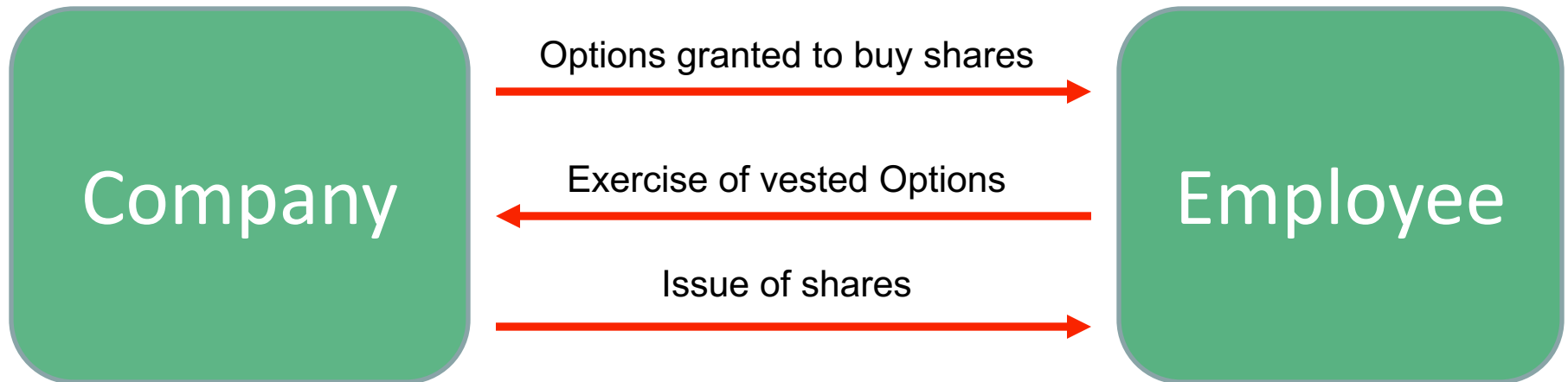
- Phantom Options

- A Phantom Option is a form of SAR where appreciation of company share price over an established time period is paid in form of free shares to the employees.
- Employee is not required to pay exercise price.

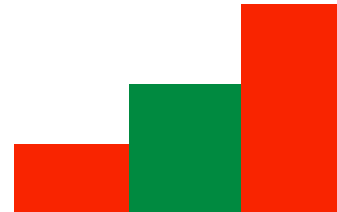
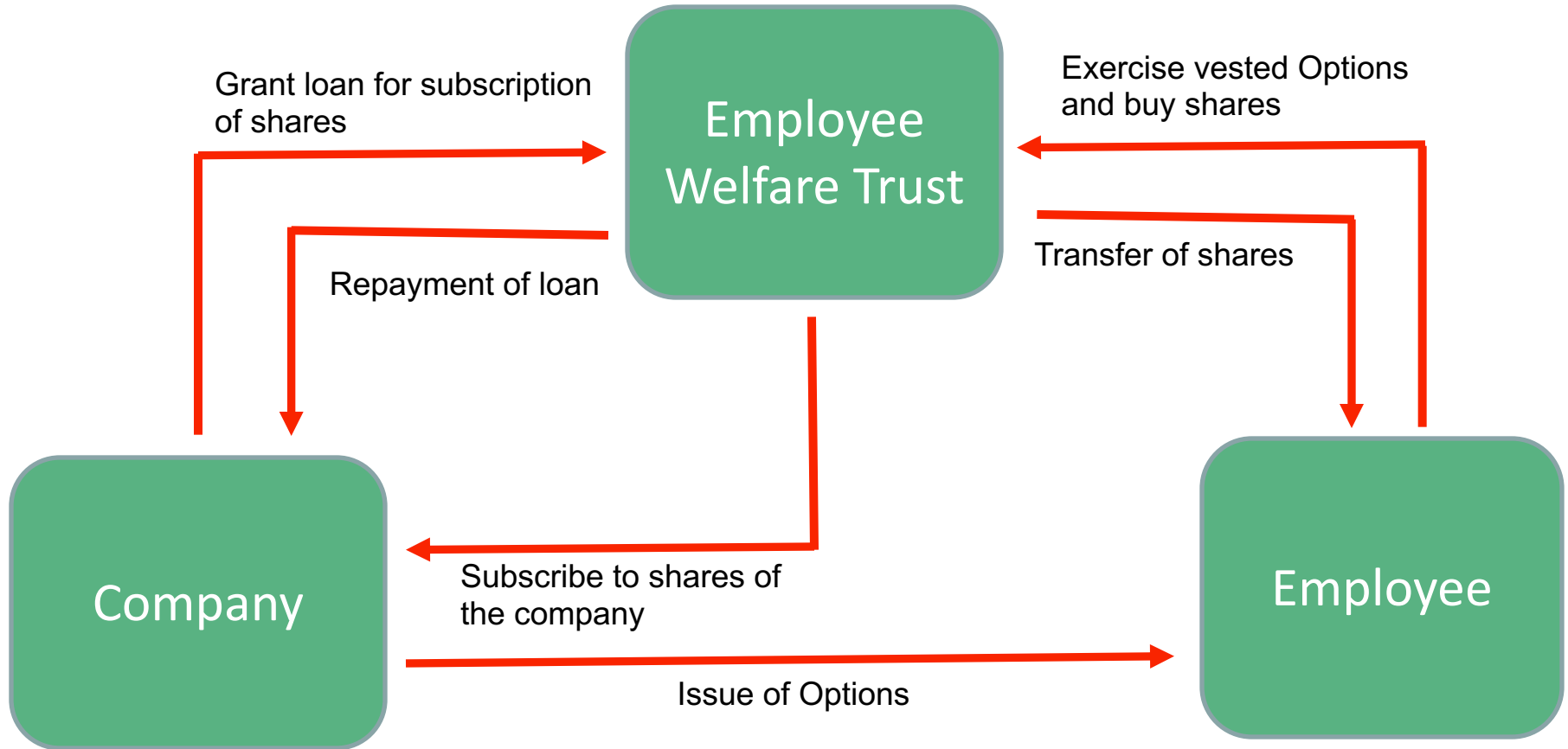
Implementation Modes



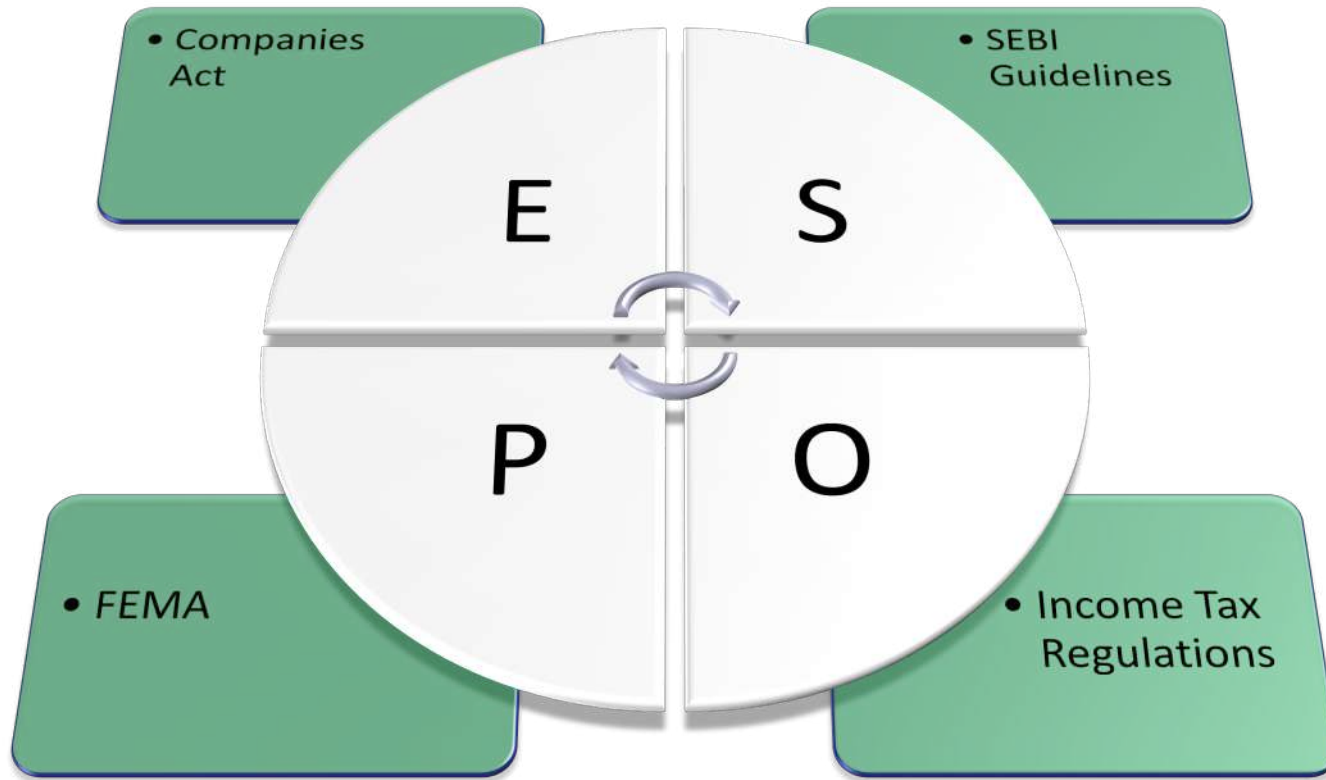
Direct Route



Trust Route

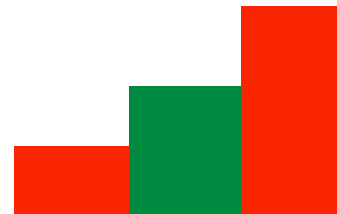


Applicable Rules & Regulations



Companies (Share Capital & Debenture) Rules 2014

- Applicability
- Eligibility
- Shareholders approval
 - Special Resolution
 - Separate resolution for grant to Subsidiary / Holding employees or to identified employees equal to or greater than 1% of issued capital.
- Pricing & Lock in
- Accounting for ESOPs as per AS / ICAI guidance note.
- Annual disclosures in Directors' Report
- Register to be maintained.
- Administration.



SEBI (Share Based Employee Benefits) REGULATIONS 2014

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- Same like Companies Act regulations.
- Following exceptions:
 - Applicable only to listed companies.
 - Administration of the scheme to be done by Compensation Committee (Majority member to be independent director)

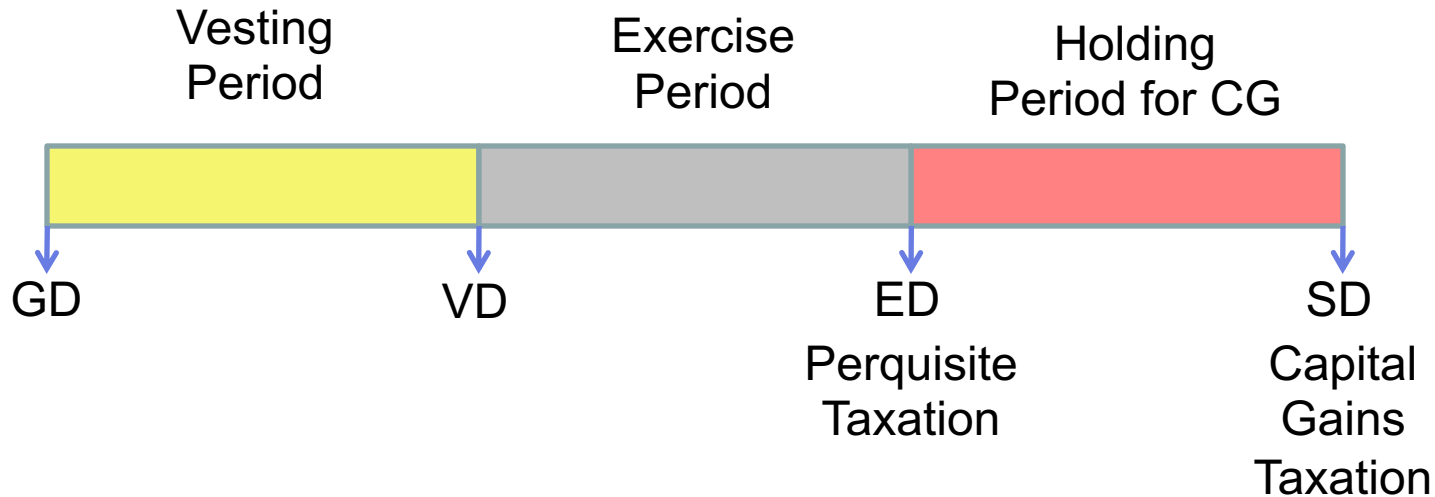
Regulations 2014

- ESOPs through a Trust
 - Implementation through Trust need to be decided upfront while taking shareholders approval.
 - Following cannot be Trustees of the Trust
 - Director, KMP, Promoter.
 - Any relative of above persons.
 - A person who holds more than 10% equity in the company
 - Trustees cannot vote for the shares held in Trust.
 - Shareholding of Trust need to be shown as “non-promoter and non-public” shareholding.

Regulations 2014

- Secondary acquisition of shares by Trust
 - Cannot exceed 2% of the paid up equity capital at the end of the previous financial year.
 - Total shares held by Trust cannot exceed
 - 5% of paid up capital for ESOP / ESPS / SAR
 - 2% of paid up capital for GEBS / RBSIf ESOP / ESPS / SAR exceeds above limits then company need to issue additional shares to the Trust in accordance with guidelines applicable for new issue.
 - Unappropriated inventory, if any, shall be appropriated before the end of the subsequent financial year.
 - Trust will have to give disclosures and give comply with Insider Trading guidelines of the company.

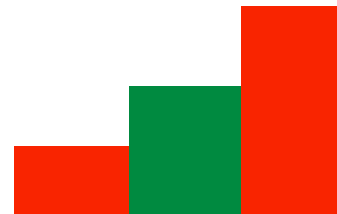
ESOP Taxation



- On Exercise
Difference between the prevailing price and exercise price taxed as perquisite
- On sale of shares
Difference between selling price and price as on date of exercise taxable as Capital Gains

When is FEMA Applicable?

- When a foreign company wishes to grant Options
 - to its employees working in India.
 - to the employees of Indian Subsidiary Company.
- When a Indian company grants Options
 - to its employees working overseas.
 - to employees of overseas holding company / joint venture / wholly owned subsidiary.



ESOPs of Foreign Securities

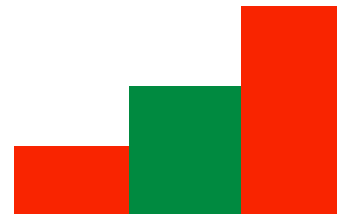
- Resident individuals can acquire foreign securities under stock option scheme of its overseas parent / subsidiary company provided:
 - The Options are issued to the employee under **Cashless** Employee Stock Option Scheme / **does not** involve any remittance from India.
- An Indian company in knowledge based industry may allow its resident employees to purchase foreign securities under the **ADR/GDR linked stock option** scheme provided it is in accordance with applicable guidelines.

ESOPs of Foreign Securities

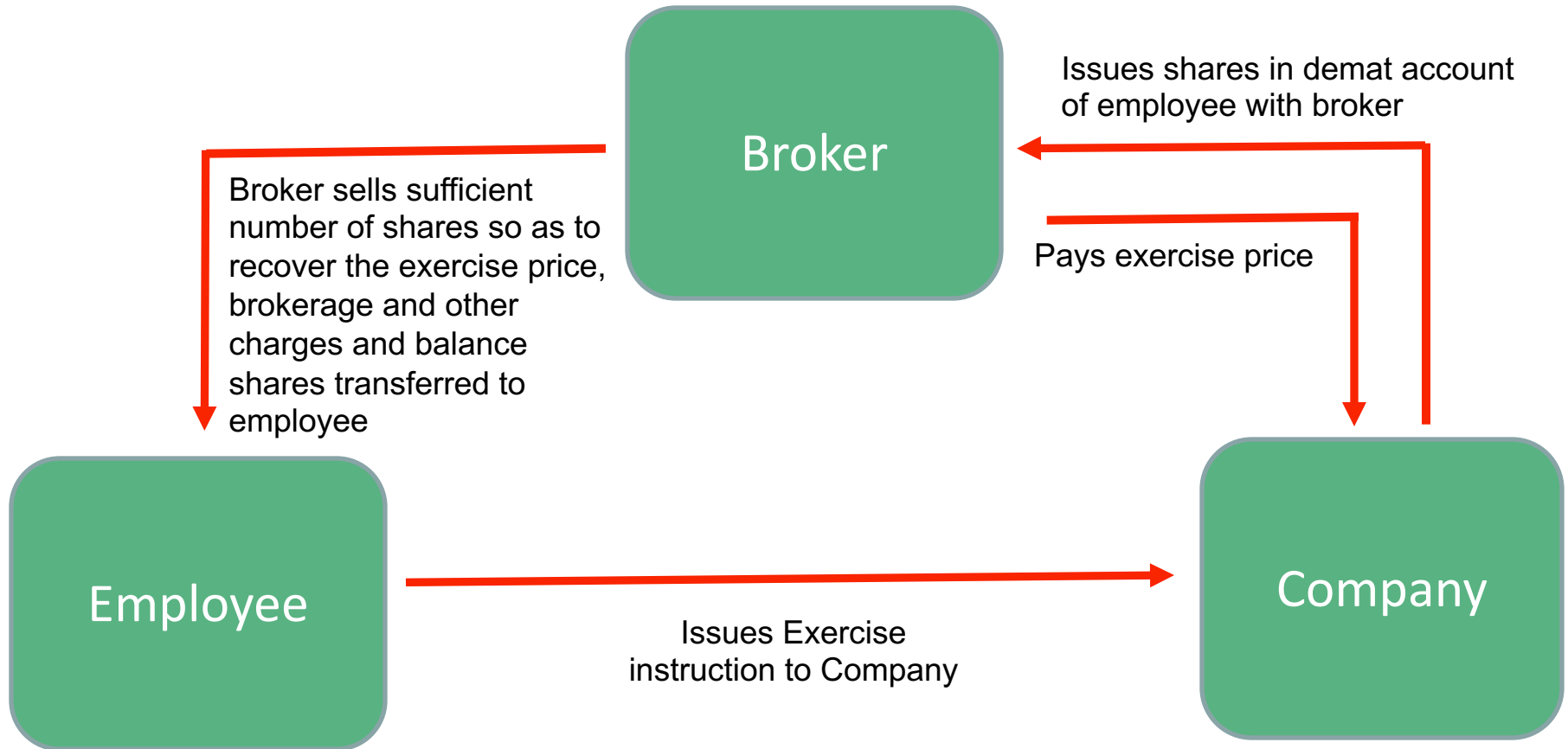
- *Example: 100 Options are granted with an exercise price of \$10 USD. The fair market value as on date of exercise is \$25 USD per share.*

Under Cashless exercise, employee exercises 100 Options and simultaneously sells 40 shares to pay the exercise price. Thus employee gets net 60 shares because of cashless exercise mechanism.

- In case of RSU since exercise price is Nil, by default it is like cashless exercise only.



Cashless Exercise Procedure

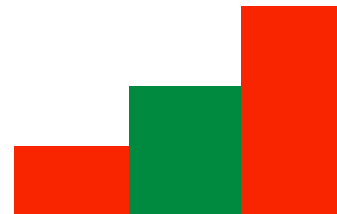


ESOPs to overseas Employees

- An Indian company is permitted to issue ESOPs to non resident employees of its holding company / joint venture / wholly owned overseas subsidiary subject to the following conditions:
 - The ESOP scheme is in accordance with regulations issued under **SEBI Act 1992** / rules notified by Central Government under the **Companies Act 2013**.
 - The ESOP is in compliance with the **sectoral cap applicable** to the said company.
 - Issue of ESOP in a company where investment by non resident is under approval route **requires prior** Government approval.
 - Issue of ESOP to a citizen of **Bangladesh / Pakistan** requires prior Government approval.

RBI Reporting

- If Options are granted to any non resident employee then
 - Company need to submit ESOP form on SMF portal within **30 days of grant** of Options.
 - Company also need to submit ESOP form on SMF portal within **30 days of issue** of shares on exercise of Options.



ESOP Accounting

Accounting Method

GN issued by ICAI

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Intrinsic Value Method or
Fair Value Method

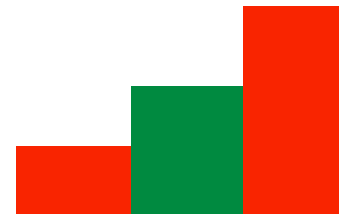
Option Value = Value calculated
using any binomial model eg:
Black Scholes Method

- Aggregate Option Value to be amortised over the vesting period on SLM.

Intrinsic Value Method

- Market price as on the date of grant – Rs.100/-
 - Exercise price per Option – Rs.25/-
 - Number of Options Granted – 1000
 - Vesting period – 100% after 3 years
 - Date of Grant – 1st April 2013
-
- Intrinsic Value = $100 - 25 = 75$ per Option
 - Aggregate ESOP Cost = $1000 \times 75 = 75,000$
 - ESOP cost to be debited to P&L
 - In 2013-14: $(75000 / 1095 \text{ days}) \times 365 \text{ days} = 25000$

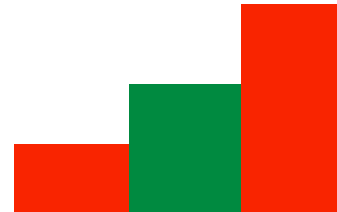
Accounting in case of Graded Vesting



Accounting in case of Graded Vesting

- Vesting period – 25% at the end of every 12 months (i.e. equal vesting over 4 years)
- Details of vesting of Options:
 1. 25 Options vest at the end of 1 year from date of grant.
 2. 25 Options vest at the end of 2 years from date of grant.
 3. 25 Options vest at the end of 3 years from date of grant.
 4. 25 Options vest at the end of 4 years from date of grant.

Treat each vesting as a separate grant and calculate the accounting impact.



Accounting in case of Graded Vesting

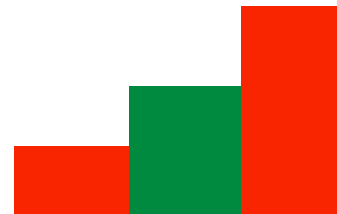
- New Example:

1. 25 Options granted on 1/4/20 which vesting 100% after 1 year.
2. 25 Options granted on 1/4/20 which vesting 100% after 2 years.
3. 25 Options granted on 1/4/20 which vesting 100% after 3 years.
4. 25 Options granted on 1/4/20 which vesting 100% after 4 years.

- Previous Example:

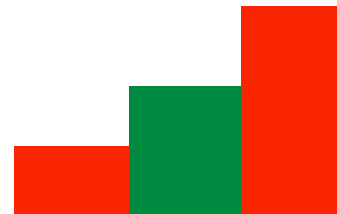
100 Options granted with 25% vesting at end of every 12 months (i.e. equal vesting over 4 years)

Treat each vesting as a separate grant and calculate the accounting impact.



Fair Value of Option

- Fair value of Options to be calculated using any binomial valuation method which takes into consideration the following:
 - Fair market price of share as on the date of grant
 - Exercise price
 - Volatility in share price
 - Expected Life
 - Risk free interest rate
 - Dividend yield
- Generally Black Scholes model is used for arriving at Fair Value of the Option.



Questions



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