B.C.H. Sem II ; CORPORATE ACCOUNTS 21st April,2020

Chapter – Employee Stock Option Plan

An ESOP (Employee stock ownership plan) refers to an employee benefit plan which offers employees an ownership interest in the organization. Employee stock ownership plans are issued as direct stock, profit-sharing plans or bonuses, and the employer has the sole discretion in deciding who could avail of these options.
However, Employee stock ownership plans are just options that could be purchased at a specified price before the exercise date. There are defined rules and regulations laid out in the Companies Rules which employers need to follow for granting of Employee stock ownership plans to their employees.
An organization grants ESOPs to its employees for buying a specified number of shares of the company at a defined price after the option period (a certain number of years). Before an employee could exercise his option, he needs to go through the pre-defined vesting period which implies that the employee has to work for the organization until a part or the entire stock options could be exercised.

Organizations often use Employee stock ownership plans as a tool for attracting and retaining high-quality employees. Organizations usually distribute the stocks in a phased manner. For instance, a company might grant its employees the stocks at the close of the financial year, thereby offering its employees an incentive for remaining with the organization for receiving that grant.

Companies offering ESOPs have long-term objectives. Not only companies wish to retain employees for a long-term, but also intend making them the stakeholders of their company. Most of the IT companies have alarming attrition rates, and ESOPs could help them bring down such heavy attrition Start-ups offer stocks for attracting talent. Often such organizations are cash-strapped and are unable to offer handsome salaries. But by offering a stake in their organization, they make their compensation package competitive.

With ESOPs, an employee gets the benefit of acquiring the shares of the company at the nominal rate, and sell them (after a defined tenure set by his employer) and make a profit. There are several success stories of an employee raking in the riches together with founders of the companies. A very notable example is of Google when it went public. Its founders Sergey Brin and Larry Page became the richest persons in the world, even the stock-holder employees earned millions too.

The issue with ESOPs ESOPs come with complex rules and regulations. Companies that provide it to the employees must have a proper administration system that works towards providing stock ownership to the employees. If a company does not have staff or help to look into the administration of ESOPs then it may invite certain risk issues. Upon establishing ESOPs the company must have proper administration, staff, including third-party administration, legal costs, and trustees. It must be aware of the costs that will be incurred while providing this facility.

Disadvantages of ESOPs

Often, the employees invest a large part of their savings in one investment scheme, which is not advisable. Any person saving more than 10 percent of his/her salary is warned by the investors. It is not logical to save a large amount of savings in company's stocks, in case the company fairs poorly or runs into losses and an employee loses out on a huge amount of savings. Also, there are many unanswered accounting procedures when it comes to ESOPS. Hence the factor of uncertainty is always there.

Accounting Policies In respect of options granted during any Accounting period, the Accounting value of the options shall be treated as another form of employee compensation in the financial statements of the company. The Accounting value of options shall be equal to the maximum of: a) The aggregate over all employee stock options granted during any Accounting period of the excess of the fair value of the option over the specified percentage of the market value of the share on the date of grant of the option; or b) Excess of the aggregate of the option discounts on all employee stock options granted during any Accounting period over 20% of the total employee compensation as reported in the profit and loss account of that period. c) Zero. For this purpose: 1. Fair value means the option discount, or, if the company so chooses, the value of the option using the Black Scholes formula or other similar valuation method.

2. Option discount means the excess of the market price of the share at the time of grant of the option over the exercise price of the option (including up-front payment if any)

3. Specified percentage means 25% in case of options granted within 12 months of the effective date, 20% in case of options granted during the 13 to 24 months after the effective date, and 15% in case of options granted after 24 months of the effective date.

Effective date is the date on which these guidelines come into effect. Where the Accounting value is accounted for as employee compensation in accordance with the above stated , the amount should be amortized on a straight-line basis over the vesting period. When an unvested employee stock option lapses by virtue of the employee not conforming to the vesting conditions after the Accounting value of the option has already been accounted for as employee compensation, this Accounting treatment shall be reversed by a credit to employee compensation expense equal to the amortized portion of the Accounting value of the lapsed options and a credit to deferred employee compensation expense equal to the unamortized portion.

When a vested employee stock option lapses on expiry of the exercise period, after the Accounting value of the option has already been accounted for as employee compensation, this Accounting treatment shall be reversed by a credit to employee compensation expense. The Accounting treatment prescribed above can be illustrated by the following numerical example. Suppose a company grants 500 options on 1/4/1999 at Rs 40 when the market price is Rs 160, the vesting period is two and a half years, the maximum exercise period is one year and the total employee compensation for the year 1999- 2000 is Rs 900,000. Also supposed that 150 unvested options lapse on 1/5/2001, 300 options are exercised on 30/6/2002 and 50 vested options lapse at the end of the exercise period. The Accounting value of the option being the maximum of: a) 500 x [(160-40) - 25% x 160] = 500 x [120 - 40] = 500 x 80 = 40,000 b) 500 x (160-40) - 10% x 900,000 = 60,000 - 90,000 = -30,000 c) Zero would be equal to Rs 40,000. The Accounting entries would be as follows: 1/4/1999 Deferred Employee Compensation

Expense 40,000 Employee Stock Options Outstanding 40,000 (Grant of 500 options at an Accounting value of Rs 80 each) 31/3/2000 Employee Compensation Expense 16,000 Deferred Employee Compensation Expense 16,000 (Amortisation of the deferred compensation over two and a half years on straight-line basis) 31/3/2001 Employee Compensation Expense 16,000 Deferred Employee Compensation Expense 16,000 (Amortisation of the deferred compensation over two and a half years on straight-line basis) 1/5/2001 Employee Stock Options Outstanding 12,000 Employee Compensation Expense 9,600 Deferred Employee Compensation Expense 2,400 (Reversal of compensation Accounting on lapse of 150 unvested options) 31/3/2002 Employee Compensation Expense 5,600 Deferred Employee Compensation Expense 5,600 (Amortisation of the deferred compensation over two and a half years on straight-line basis) 30/6/2002 Cash 12,000 Employee Stock Options Outstanding 24,000 Paid Up Equity Capital 3,000 Share Premium Account 33,000 (Exercise of 300 options at an exercise price of Rs 40 each and an Accounting value of Rs 80 each) 1/10/2002 Employee Stock Options Outstanding 4,000 Employee Compensation Expense 4,000 (Reversal of compensation Accounting on lapse of 50 vested options at end of exercise period) Employee stock option outstanding will appear in the Balance Sheet as part of net worth or share holder¡¦s equity. Deferred employee compensation will appear in the Balance Sheet as a negative item as part of net worth or share holders equity. Disclosure in Directors¡¦ Report The Board of Directors shall disclose either in the Directors Report or in the annexure to the Director¡¦s Report, the following details of the Stock option plan: a) The total number of shares covered by the Employee Stock Option scheme as approved by the shareholders b) The Pricing formula c) Options granted d) Options vested e) Options exercised f) Options forfeited g) Extinguishment or modification of options h) Money realised by exercise of options i) Total number of options in force j) Employee wise details of options granted to i) Senior managerial personnel ii) any other employee who receives a grant in any one year of options amounting to 5% or more of options granted during that year. k) Diluted Earnings Per Share (EPS) calculated in accordance with International Accounting Standard (IAS) In today¡¦s world ESOPs have been increasingly used as a motivating weapon by the management to retain its most efficient employees. Employees of blue chip companies like Infosys, Wipro, ITC and others become millionaires overnight. But the tool meant for rewarding employees commitment is being misused by few senior managers to serve their self-interest by manipulating the market price. Some investors are unhappy with the scheme as it dilutes their level of participation in company¡¦s affairs. Also the very purpose of ESOPs will get defeated if the employees sell their shares in the market. The scheme also has an uncertainty hidden due to the fluctuating stock prices. Despite the disadvantages ESOP¡¦s is still a popular tool to attract and retain the best talent and hence the management must draw a scheme suiting the employees¡¦ expectations and must study the dynamic changes in stock market to ensure its success. Recommended Read Role of nominee directors in the board of joint stock companies Employee Stock option plan - Concept & Procedure

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