

Optimizing Employee Engagement through aligning Appraisals & ESOPs

2/29/2024

Overview of ESOPs (Employee Stock Benefit Schemes)

Employee Stock Benefit Schemes/Equity Incentive Plans (commonly referred to as ESOPs) give the employees an **ownership interest** by participating in the Stock /Shares of the Company.

“**Options/Units**” is a **right** given to an Employee to purchase a given number of Shares of the Company at a future date, at a fixed pre- determined price.

“1 Option/Unit = 1 Equity Shares of the Company”

Type of Incentive Instruments Offered



**EMPLOYEE STOCK
OPTION PLANS
(ESOP)**



**RESTRICTED
STOCK UNITS
PLANS
(RSU)**



**EMPLOYEE STOCK
PURCHASE PLANS
(ESPS)**



**STOCK
APPRECIATION
RIGHTS (EQUITY
SETTLED)
(SAR-EQ)**



**STOCK
APPRECIATION
RIGHTS (CASH
SETTLED)/
PHANTOM STOCK
(SAR-CASH)**

Overview of Incentive Instruments – **ESOP**



Employee Stock Option Plan is a type of Equity ownership plan, where in;

- ✓ Options are issued to employee
- ✓ Creating a right to subscribe shares of the Company
- ✓ At a pre-determined price
- ✓ Over a fixed period of time
- ✓ Upon fulfilment of certain conditions

- It is one of the most traditional mode used **to incentivize** the employees.
- ESOP provides **flexibility** to decide the terms, exercise price, vesting period at the time of grant.

Overview of Incentive Instruments - **RSU**



Restricted Stock Unit Plan is another type of Equity ownership plan, where in

- ✓ Units are issued to employee
 - ✓ Creating a right to subscribe shares of the Company
 - ✓ Over a fixed period of time
 - ✓ Upon achieving certain conditions
-
- **Based on vesting ,types of RSU:**
 - **Loyalty Based RSU**
 - **Performance Based RSU**
 - Generally, RSU can be issued at zero price, but in India it is read with context of ESOP.
 - Unlike ESOP's, the exercise price of RSU's is near **the face value of shares.**

Overview of Incentive Instruments - ESPS

Employee Stock Purchase Plan is a type of Equity ownership plan, where in

- ✓ Shares are issued to employee
- ✓ Creating a right to subscribe shares of the Company
- ✓ At a discounted price
- ✓ Over a fixed period of time.

- In compared to ESOP, Employees get "**Shares**" of the company instead of options.
- It is a reward plan used **to appraise and incentivize** the employees.
- Under ESPS , the shares allotted immediately to the employee, so the benefit received is well ascertained. The shares so allotted are subject to a lock in of minimum 1 year from the date of allotment.



Overview of Incentive Instruments – **SAR Equity Settled/SAR Cash Settled**



A **Stock Appreciation Rights** is a form of incentive or deferred compensation that is linked with the performance of the Company's Share.

- ✓ Units are issued to employee
 - ✓ Employee receives Appreciation Value
 - ✓ Settlement of appreciation is made in either in Equity or in Cash
-
- “**Appreciation**” shall be the difference between the Fair Market Value as on date of Exercise i.e., Exercise date Price and Grant Price or Base Price as on date of Grant.
 - Based on settlement, SAR can be categorized as:.
 - **Settled in Equity Shares; or**
 - **Settled in Cash;**

Overview of Incentive Instruments – **SAR Equity Settled/SAR Cash Settled**

DELHIVERY

Cipla

Based on Settlement of appreciation: The appreciation amount can be settled as:

- **Settled in Cash:** *If the appreciation amount is settled in cash, then the amount shall be credited directly in the bank account of the employee.(The SAR Scheme shall be termed as SAR-Cash Settled, which is not governed by SEBI(SBEB & SE) Regulations).*

Or

- **Settled in Equity Shares:** *If the appreciation amount is settled in Equity Shares, then the no. of Shares shall be calculated as follows:*

*No. of shares = [Appreciation (per SAR Unit) * No. of SAR Units exercised]/ Exercise Date Price(Fair Market Value as on Exercise Date)*

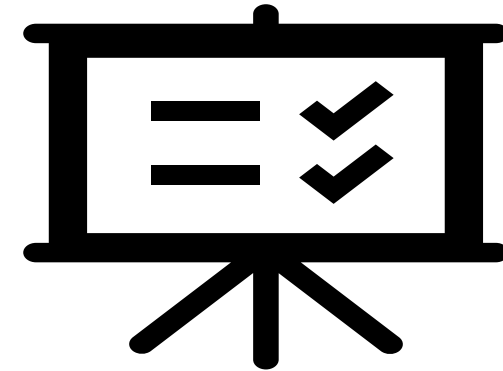
The SAR Scheme shall be termed as SAR-Equity Settled, which is governed by *SEBI(SBEB & SE) Regulations*).

Objective for Implementation of ESOPs

Implementation of ESOPs in various industries can serve several objectives, tailored to the specific needs and dynamics of each sector.

Here are common objectives across different industries:

- Talent Attraction and Retention
- Employee Engagement and Motivation
- Achieve sustained growth
- Creation of shareholder value
- Sense of ownership and participation
- Additional deferred rewards
- Cash saving along with Tax Benefits
- Aligning Interests with Company Performance.



*We can see more strengthening of ESOP in **BFSI Sectors(Private Sector Banks) and Insurance Sectors.***

Objective for Implementation of ESOPs

➤ BFSI Sectors (Private Sector Banks) :

RBI Guidelines: Guidelines on Compensation of Whole Time Directors / Chief Executive Officers / Risk takers and Control function staff, etc.

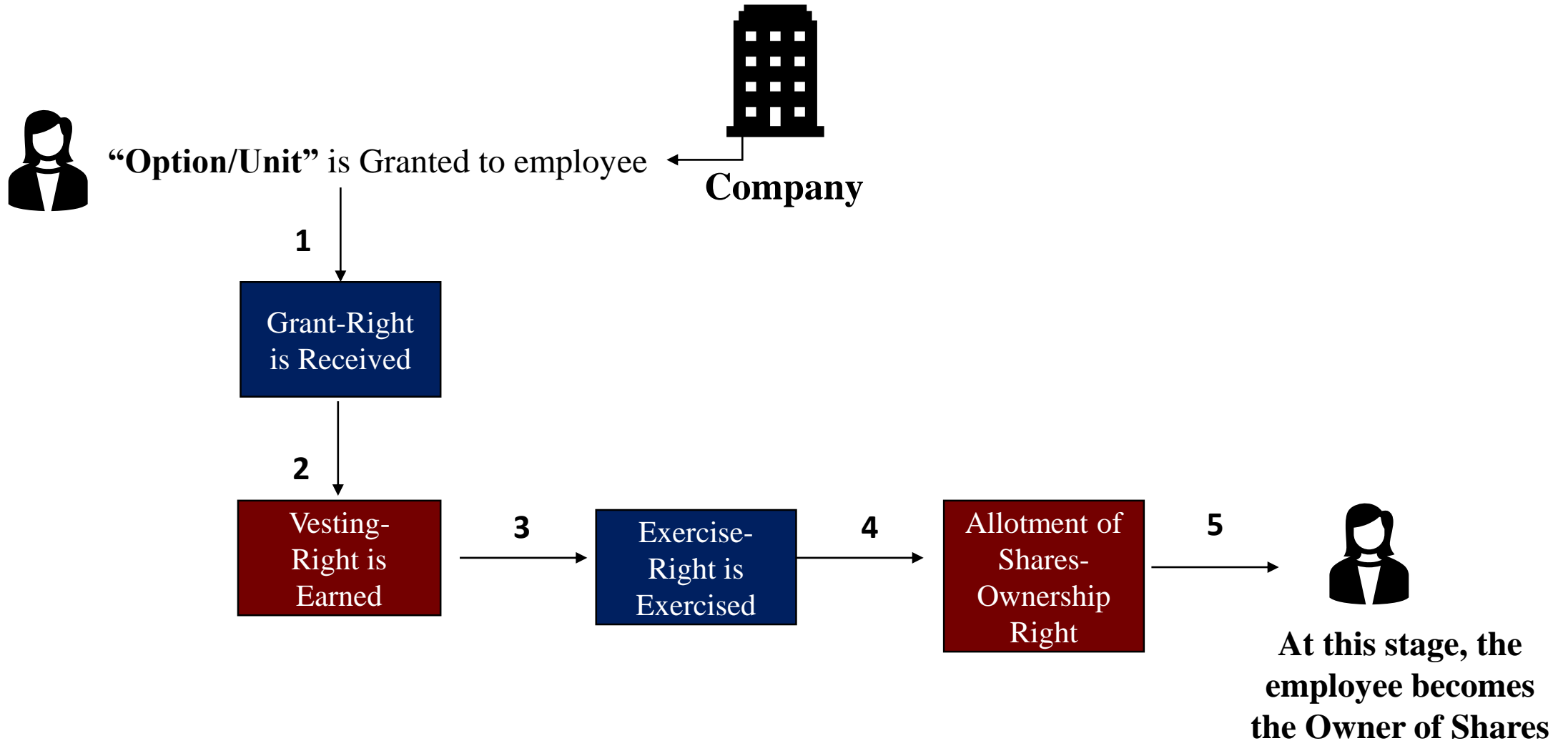
- Banks should formulate and adopt a comprehensive compensation policy covering all their employees.
- The policy should cover all aspects of the compensation structure such as fixed pay, perquisites, bonus, etc.
- The specified % of variable pay must be paid by way of **non-cash linked Instruments**.
- The variable pay must be deferred for minimum 3 years.

➤ Insurance Sectors:

IRDAI Guidelines: IRDAI (Remuneration of KMP of Insures) Guidelines, 2023

- Remuneration policy for KMP's.
- ESOPs have been made a part of variable pay compensation.
- A minimum of 50% of the variable Pay must be paid through **share linked instruments**.
- A min of 50% of total variable pay must be under deferred for minimum 3 years.
- Total number of ESOP granted shall not exceed 1% of capital in a year and not more than 5% at any point of time.

How ESOPs Works at Organisation Level





Lifecycle of ESOPs

Create- ESOP
Policy



An ESOP Policy stating the terms and conditions is formulated by the Company.

Grant-Issue of
Options



“**Grant**” is the process by which the Company issues Options to the Employee.

Vest-Right
Earned



“**Vesting**” is the process by which the employee receives the benefit of a Grant .

Exercise-
Convert into
Shares



“**Exercise**” means the employee makes application for converting his option into Equity Shares.

Allotment:
Issue of
Shares



“**Allotment**” is the process of issuing of Equity Shares by the Company to the Employee.

Process of issuance of ESOPs

❑ Applicable Laws:- Unlisted Company

**Companies Act, 2013 along
with Rules**

**Income Tax Act, 1961
(including Rules and
Circulars issued there under);**

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

**Applicable Accounting
Standards- Ind AS 102/
Guidance Note - 18**

Process of issuance of ESOPs

❑ Applicable Laws:- Listed Company

**Companies Act, 2013
along with Rules**

**SEBI (Share Based
Employee Benefits and
Sweat Equity)
Regulations, 2021**

**SEBI (Listing
Obligations &
Disclosure
Requirements)
Regulations, 2015**

**SEBI (Prohibition of
Insider Trading)
Regulations, 2015**

**Income Tax Act, 1961
(including Rules and
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**Foreign Exchange
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Process of issuance of ESOPs

❑ Coverage of Employees:

Employees Covered

- ✓ Employees designated by company.
- ✓ Directors of the Company.
- ✓ Employees of Subsidiary Company
- ✓ Employees of Holding Company
- ✓ Employees of Associate Company.
- ✓ Employees of Group Company.
- ✓ Foreign Employees.

Employees not Covered

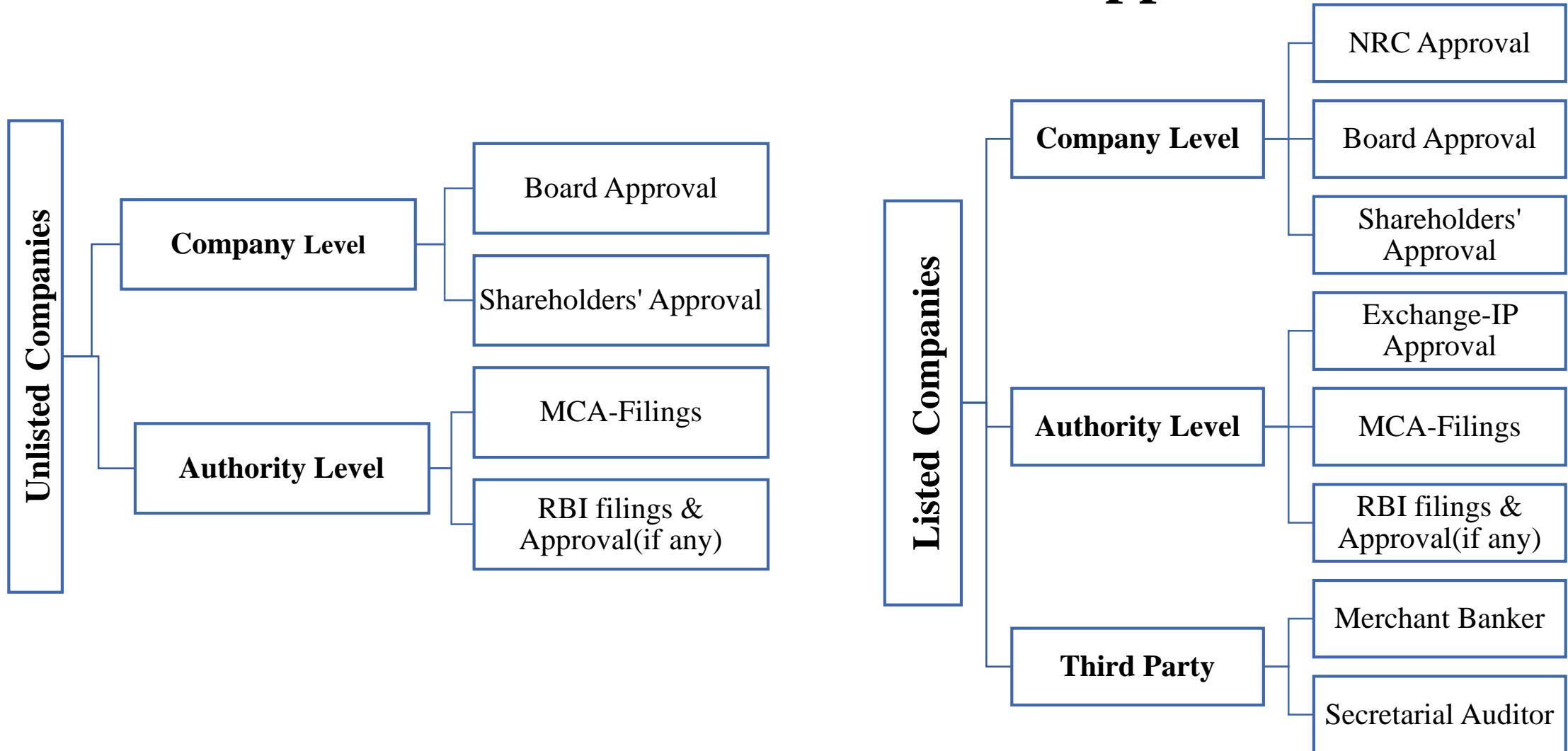
- ❖ Employees who is a promoter or belonging to promoter group.
- ❖ Director holding directly or indirectly more than 10 % of outstanding equity shares of the Company.
- ❖ Independent Directors.
- ❖ Consultants, Like Doctors, Gig workers Contractual Employees(Not yet covered under definition of Employee, but clarity on their coverage is still under discussion).

Process of issuance of ESOPs

❑ Minimum Requirements of Law :

- ✓ **Route of the scheme:** The Company are **free to decide** the Route the Scheme i.e. Direct Route or Trust Route.
- ✓ **ESOP Pool:** Companies are **free to decide** the number of shares to be reserved for ESOP Pool.
- ✓ **First Vesting:** Minimum gap of **1 year** is required between the date of grant and Date of first vesting.
- ✓ **Exercise Price:** Companies are **free to decide** the Exercise price; Price shall not go below the Par Value of Shares.

Process of issuance of ESOPs-Approval





Understanding ESOP Valuation

What is ESOP Valuation?

At the time
of Grant

Fair value of Shares is determined by a registered valuer.

At the time
of Exercise of
options

To determine the Fair value of shares at the time of exercise of options.

This two-step process ensures that the **fair value of the shares** is properly assessed both when the options are initially granted and when they are exercised, helping to determine the value of the shares at those points in time.



Valuation for different Entities



Listed Entity

At the time of Grant



Unlisted Entity

At the time of Grant

At the time of Exercise

When is ESOP Valuation required?

1

At the time of Grant

- As per Ind AS
- However, at every reporting date valuation of options is required in case of cash-based settlement

2

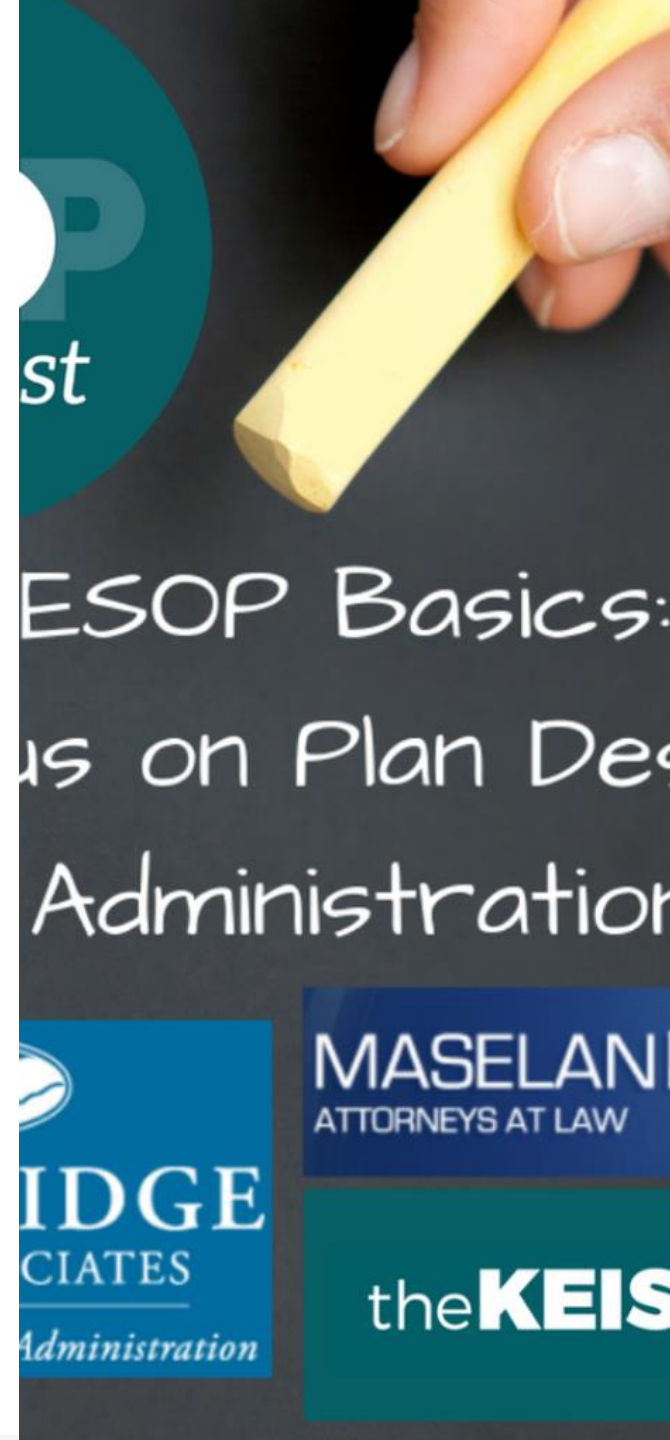
At the time of Exercise

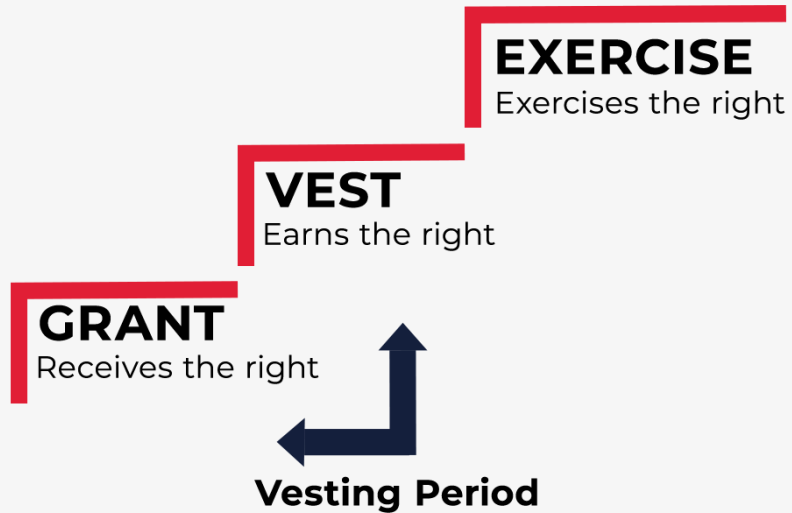
- The Income-tax Act, 1961 imposes taxation on Employee Stock Options (ESOPs) as a perquisite during exercise.

Valuation of ESOP in case of Listed Companies:

1 Listed Company needs valuation only for accounting purpose at the time of grant of the options.

2 The price of shares of a Listed Company is known from the price quoted on the Stock Exchange, so the valuation of shares for taxation purpose is not required by it.





Valuation of ESOP in case of Unlisted Companies:

- An Unlisted Company must get valuation both at the time of **grant of the options** and the **exercise of the options**.
- The Income-tax Act, 1961 provides for taxation of ESOPs as a perquisite at the time of exercise, subject to the valuation of the perquisite as prescribed in the Income-tax Rules, 1962, by a **merchant banker** on a **specific date**.
- The term "**Specified Date**" refers to either the date of exercising the option or any date preceding the exercise date, provided that it is not more than 180 days prior to the exercise date



**Corporate
Professionals**



LEGAL PROVISIONS REGARDING ESOP VALUATION

I :Valuation Requirement under Ind AS 102- Share Based Payments:

Ind AS 102 - Share-based Payment specifies the financial reporting by an entity when it undertakes a share-based payment transaction.

In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions.

This applies to both equity-settled share-based payment transactions as well as cash-settled share-based payment transactions

Point of Calculation is **Grant** and Period of Booking is **Over vesting period**

Standard specifies the following minimum inputs to be used while calculating the fair value.

- (a) Exercise price of the option;
- (b) Life of the option;
- (c) Current price of the underlying shares;
- (d) Expected volatility of the share price;
- (e) Dividend expected on the shares (if appropriate); etc

II :Mandatory Valuation Exercise:

- The Income-tax Act, 1961 imposes taxation on Employee Stock Options (ESOPs) as a perquisite during exercise, with the taxable value determined by the Fair Market Value (FMV) of the shares on the date of allotment/transfer minus the Exercise Price paid by the employee.
- Unlisted companies are required to obtain a valuation certificate from a **Category 1 Merchant Banker registered with SEBI**, dated **not earlier than 180 days** before the exercise date.
- Valuation of unlisted equity shares involves considering Fair Value of Underlying, employing methods such as market multiples and DCF, and adjusting for Discount for Lack of Control (DLOC) to reflect minority-level value.
- In terms of Financial Reporting, listed companies do not have specific specifications beyond the valuation methodology. However, auditors prefer valuations conducted by reputable and proficient valuers with a credible track record, given the impact on financial statements.

Amendments introduced vide Budget 2020 for Startups

Finding buyers for startup shares can be challenging due to the absence of an active ESOP market. However, the Income Tax Act provides certain tax benefits for "eligible startups." Beginning from the fiscal year 2020-21, no tax is payable when employees exercise their ESOP options. The Tax Deducted at Source (TDS) on the "perquisite" of ESOPs is deferred until one of the following events occurs:

- **5 years from the ESOP allotment date.**
- **The date when the employee sells their ESOP shares.**
- **The date of employment termination.**

When employees sell ESOP-acquired shares, they are subject to a second tax, similar to capital gains tax, with the tax rate determined by the holding period (short-term or long-term). The cost of the ESOP is considered to be the fair value at the date of exercise, as tax was already paid when the options were exercised.

Points to Remember



For a **Listed Company**, the base price is Market price, one day before the date of Grant-**For Underlying Price**



For an **Unlisted Company**, a price calculated on the basis of valuation done upon Grant-**For Underlying Price**



Companies are free to decide the Exercise price, discount / premium over it however, the Exercise price shall never go below the Par Value of Shares



The minimum vesting period of ESOPs granted under a scheme is minimum of one **(1) year**, whether Listed or Unlisted Company

Appraisal Process viz-a-viz ESOP Grants



Appraisal Process viz-a-viz ESOP Grants

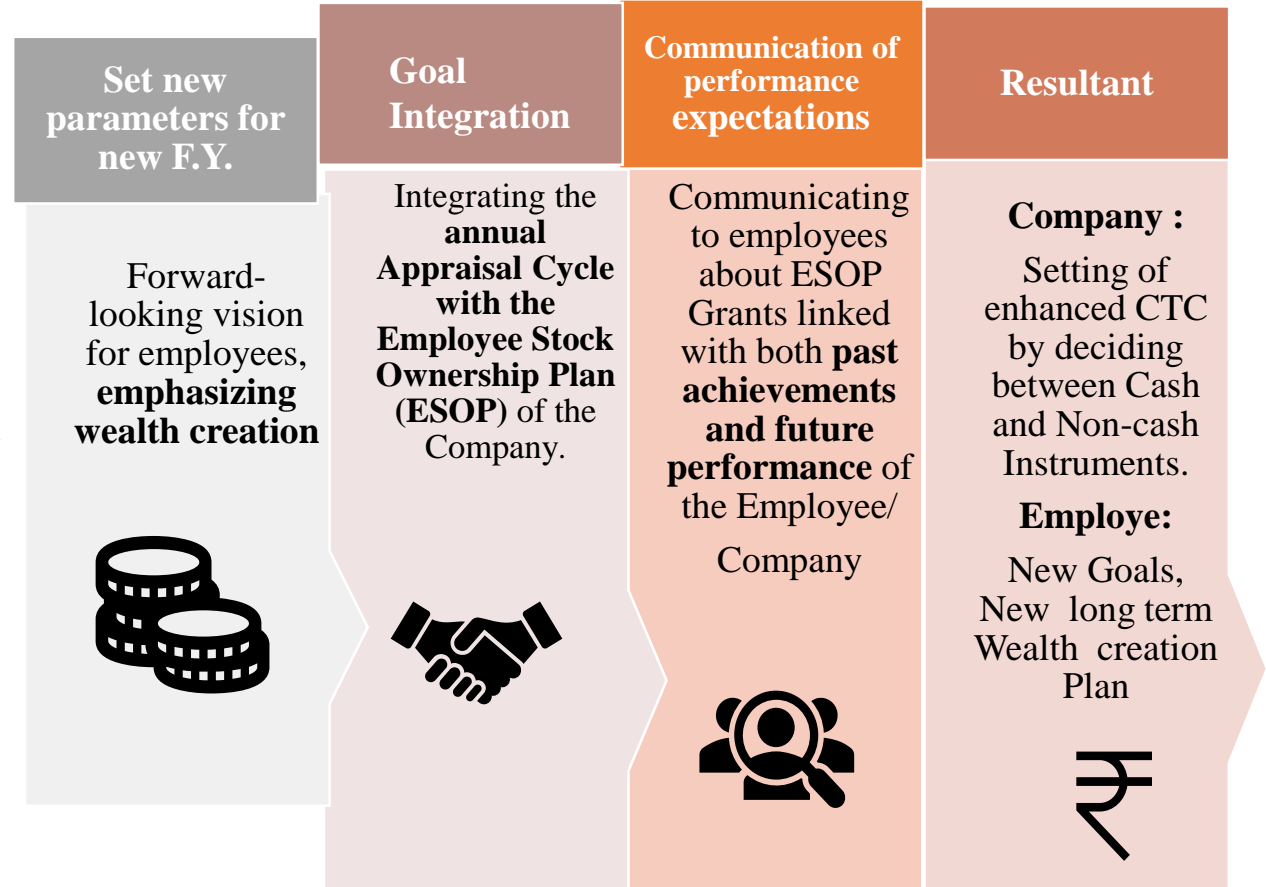
❑ Overview:

- Annual Appraisal and giving of **enhanced CTC and Rewards** is an important activity in an organisation once the **new financial year** begins. **Appraisal process** aims to motivate the employees and inform them about rewards earned on the basis of their performance & increased CTC for the new financial year, setting of new parameters for the new financial year.
- **ESOPs** provide employees with the opportunity to participate in the company's success and align their interests with the Organisation goals and give the employees an ownership interest by participating in the Stock /Shares of the Company. Thus, we can say that **ESOP is the new Compensation Tool.**

Appraisal Process viz-a-viz ESOP Grants



**Near to annual
Appraisal Cycle ?**



Appraisal Process viz-a-viz ESOP Grants

- **Impact of alignment on Employee engagement:**

- **Enhanced Employee Motivation:**

Employees are more motivated when they see a direct link between their performance evaluations and the potential for financial rewards through ESOP grants.

- **Improved Employee Engagement:**

The alignment fosters a sense of ownership and commitment among employees.

- **Performance Driven Culture:**

The alignment contributes to the establishment of a performance-driven culture where employees are recognized and rewarded for their contributions, creating a positive work environment.

Appraisal Process viz-a-viz ESOP Grants

- **Impact of alignment on Employee engagement:**

- **Increase in Performance Levels of Employee:**

Employees tend to perform at higher levels when they know their efforts are directly tied to the potential for earning additional equity in the company.

- **Improved Talent Attraction:**

The prospect of ESOP grants tied to performance can make the organization more attractive to potential hires, aiding in the recruitment of top talent.

- **Sense of Ownership and Accountability:**

Employees develop a sense of ownership and accountability for their work, knowing that their performance directly influences their equity ownership in the company.

Appraisal Process viz-a-viz ESOP Grants

- **Impact of alignment on Employee engagement:**

- **Strategic Goal Achievement:**

The alignment ensures that the achievement of individual performance goals directly contributes to the accomplishment of the company's strategic objectives.

- **Long term financial benefit for employee:**

Employees have the potential to accumulate wealth over time as the value of the company increases.



Appraisal Process vis-a-vis ESOP Grants

What is Missing out, if not aligned?

- **Reduction in Employee Motivation:** The employee may not relate to his performance and ESOP Grant, leading to reduction in motivation and engagement.
- **Challenge in Retention of Employee:** Employee may not feel connected with the Company goal and his performance, when linked with the long-term financial growth.
- **Ineffective Top Talent Management:** Failure, to align the appraisal cycle with ESOP grants, may impact retention of top talents in management.
- **Impact on Organizational Culture:** The absence of alignment with ESOP grants, eliminates the performance driven organisational culture.
- **Missing on Competitive Advantage:** In today's competitive era, ESOP is the new compensation Tool, missing on the same , will result in loss of talent acquisition in organisation.



ESOP Taxation & Accounting Treatment

ESOP Taxation Aspects

- Double point of taxation at the time of Exercise on employees:
 - At the time of Exercise of Options
 - At the time of sale of options

- ▶ **Point 1: At the time of Exercise**, the difference between the Market Price of the Shares as on date of Exercise and the Exercise Price will be added as a perquisite under salary in the month of Exercise. The Grantee will be liable to pay the taxes at the individual slab rate in which he falls.

E.g.: Exercise Price (after providing 30% of maximum discount) = Rs. 25 per Option / Market Price of Share on Exercise = Rs. 100 per Share / Perquisite = Rs.100 – Rs.25 = Rs.75/- per Share.

Suppose Employee falls in 30% slab, his perquisite tax will be Rs.23/-

ESOP Taxation Aspects

- Double point of taxation at the time of Exercise on employees:
 - At the time of Exercise of Options
 - At the time of sale of options

- ▶ **Point 2: At the time of sale of the Shares** of the Company by the Grantee. On selling of the Shares, the concerned Employee would be liable to income tax as per the applicable provisions of the laws at the time of sale of the Shares.

Accounting Treatment

Cost Determination: At the time of Grant

Value= MV on the date of Grant – Exercise Price

Method: Black Scholes

Period of Booking: Over the Vesting Period

Example :

Current Value Rs.100/-

Offer price is Rs.10/-

Then Price Discount/Employee

Compensation Expense to be booked

is Rs.90/-.

REGULATORY FRAMEWORK

Ind-As 102 / ICAI Guidance Note 18

- Employee Compensation Expense (equivalent to Price Discount)= Market Value- Price at which Shares are offered

Allowable Expense during the relevant Accounting Period in which the Shares are issued.

Direct Impact on Profit & Loss Account



Polling Analysis

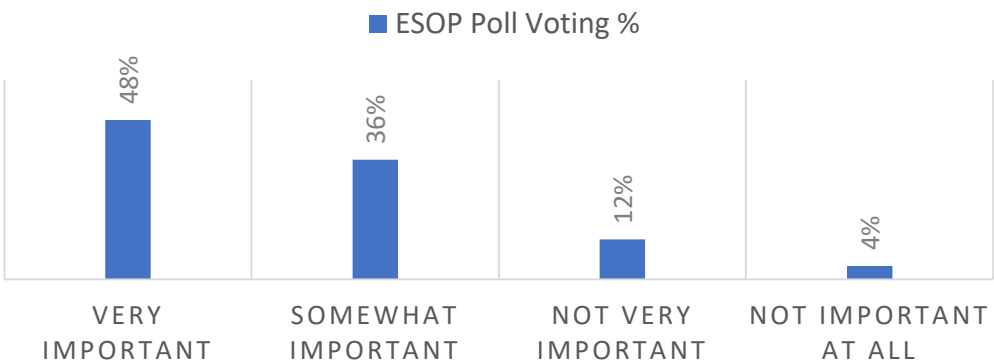
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Polling Analysis:

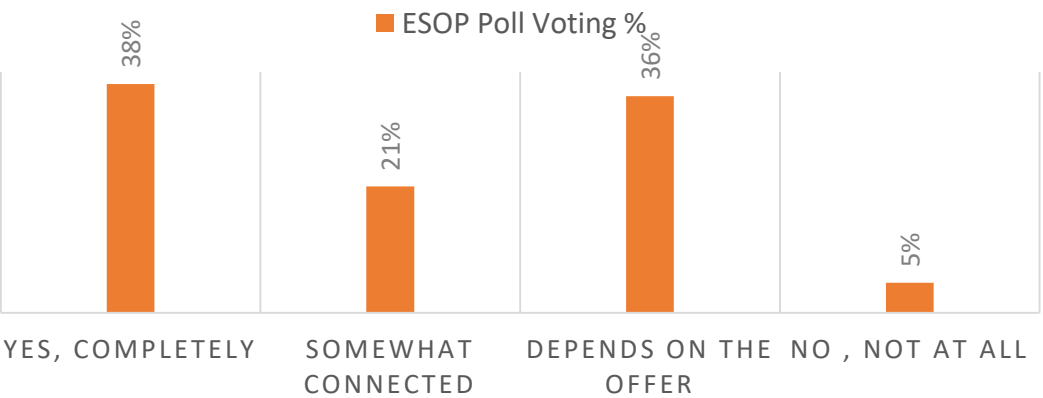
A : Importance of ESOP for an Employee while deciding to join or stay with a Company?

Analysis: Over 48%-36%, consider ESOPs to be a crucial component of their compensation.

A ESOP POLL VOTING %



B ESOP POLL VOTING %



B :Does Accepting ESOP make the employee feel a part of the Company?

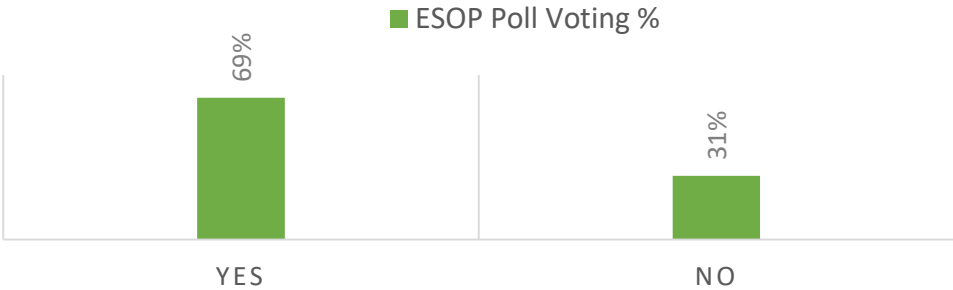
Analysis: Almost 38%-36%, consider that acceptance of ESOPs depends upon the offer given to employees, and it is completely important.

Polling Analysis:

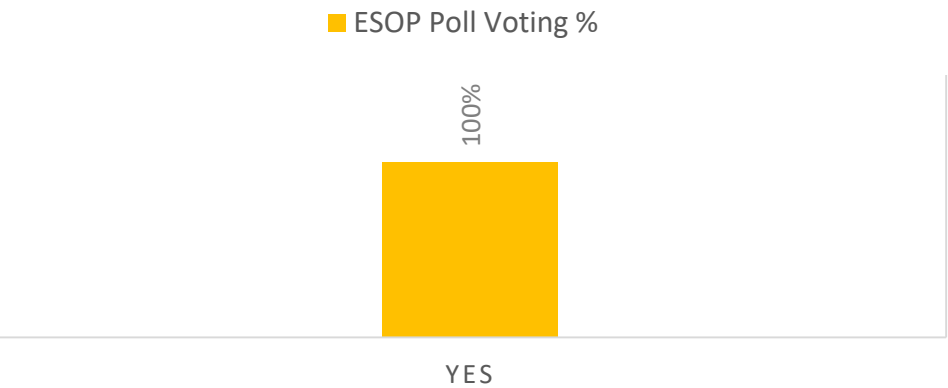
C : Is grant of ESOP usually aligned with the annual performance evaluation cycle?

Analysis: Over 69%, consider yes, that ESOP grants are aligned with annual appraisal cycle.

C ESOP POLL VOTING %



D ESOP POLL VOTING %



D :Does ESOP is considered as a part of hiring strategy?

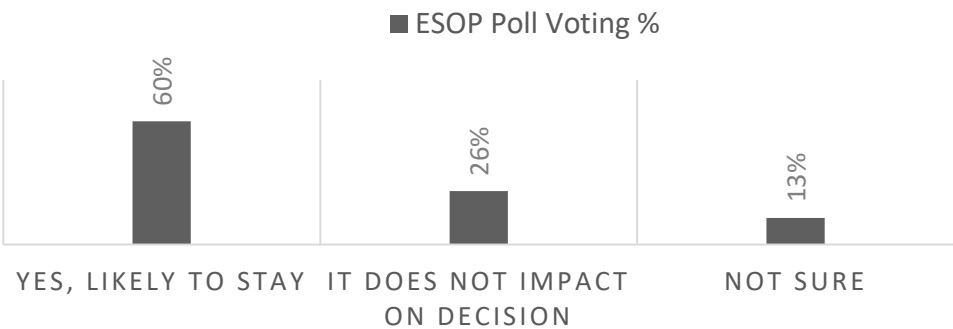
Analysis: Almost 100%, consider ESOP as a part of hiring strategy of company.

Polling Analysis:

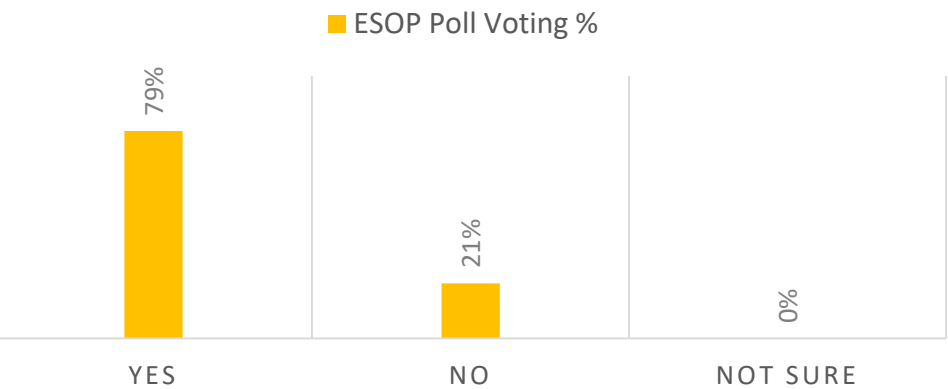
E : Is an Employee likely to continue with a company that provides an ESOP than one doesn't?

Analysis: Over 60%, consider yes, the employees are more likely to stay in a company that offer ESOPs as a part of their compensation.

E ESOP POLL VOTING %



F ESOP POLL VOTING %



F :Does ESOP fosters ownership and long-term commitment among employees?

Analysis: Almost 79%, consider that yes ESOPs provides employees a sensation of long-term commitment and ownership.

Thank You!

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