An Analytical Study of Employee Stock Option Scheme of Leading Indian Companies

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Abstract

An Employee Stock Option Plan (ESOP) is a benefit plan for employees which make them owners of stocks in the company. ESOPs have several features which make them unique compared to other employee benefit plans. Most companies, both at home and abroad are utilizing this scheme as an essential tool to reward and retain their employees. Currently, this form of restructuring is most prevalent in IT companies where manpower is the main asset.

ESOP is used largely to motivate employees to put in their best and in turn, help the company enjoy lower employee turnover and retain its talent pool. These two uses probably account for over two-thirds of all ESOPs now in existence, and their numbers are expected to increase with time. This is a new financing technique which is experiencing phenomenal growth in the USA and popular in the emerging markets like India. ESOPs provide a market for the shares of closely held businesses; motivate greater employee productivity, provide tax advantages in the financing of acquisitions, capital improvements, charitable giving and stock purchases from retiring owners. ESOPs are widely adopted by companies from IT/Software, Banking /Financial Services, Cement, Drugs & Pharmaceuticals, Synthetic Fibers, FMCG and recently E –Business in India.Most companies often use ESOP either to retain talent or plug an employee from its competitors. But ESOP has far more potential than these strategies. ESOPs are relevant where an employee plays an important role in the on-going progressive growth of a company. (ICICI Bank, Infosys are leading examples recently.)

The main aim of giving such a plan to its employees is to give shares of the company to its employees at a discounted price to the market price at the time of exercise. Many companies (especially in the startup phase) have now started giving Employee Stock Options as this is beneficial to both the employer as well as the employee. The paper highlights the status of ESOP in leading companies of India and what polices they have followed to use it as a tool to attract and retain their employees. It also studies the legal framework governing the ESOPs and various tax issues related to it.

Keywords: **ESOP, Employee, Stock, Company, SEBI, Income Tax**

Introduction to Esop

ESOP is a generic term for a basket of instruments and incentive schemes that find favour with the new upward mobile salaried class and which are used to motivate, reward, remunerate and hold on to achievers.

The concept was developed in the 1950s by a lawyer and investment banker Louis Kelso, who argued that the capitalist system would be stronger if all workers, not just a few stock holders, could share in owning capital –producing assets. He believed that the capitalist system would function more efficiently if all workers shared in owning capital –producing assets. The concept in USA developed on certain tax benefits given to the employer for the contribution the employer makes. In UK, it was seen that the shareholders had a direct interest in improved company performance. But only few employees had such direct incentives. So an ESOP scheme encouraged the employees to participate in the share ownership of the company.

India has accepted and adopted ESOP in a manner and to an extent which was unimaginable just 5 years ago. Beginning with the info-tech sector, ESOP has spread across the services and manufacturing sector. Regulatory development had kept pace with the speed of ESOP in India. The legislations related to ESOP are now part of Income Tax and Corporate Laws. SEBI has issued revised guidelines on the issue of ESOP in the light of continuous evolution in India and abroad.

Therefore, taking into consideration about all the three important countries, it can be clearly understood that how the importance of ESOP was felt and what the rules and regulations formed for it.

DEFINITION:

An Employee Stock Option Plan (ESOP) is a benefit plan for employees which make them owners of stocks in the companies.

OBJECTIVE OF ESOP

- To analyze the ESOP policies of leading companies of India.
- To study the legal framework, of ESOP in India.
- To study the tax implication of ESOP in India.

RESEARCH METHODOLOGY

1. Theoretical and exploratory research is used in this study in order to obtain proper knowledge regarding how ESOP practices are implemented by various companies, main focus is on four selected companies.
2. Data collected is mainly secondary in nature. The source of data includes research papers and books dealing with current scenario of esop in India.

LIMITATIONS OF PRESENT STUDY

The study is undertaken by the use of secondary data collected from various sources which may have some deficiencies.

REVIEW OF LITERATURE

SEAN M. ANDERSON AND ANDREW STUMPFF MORRISON[2018] in his ***"Proposal For A Non-Subsidized, Non-Retirement-Plan, Employee-Owned Investment Vehicle To Replace The Esop",*** *observed that* The rationale for permitting employee ownership vehicles is particularly strong in the case of smaller companies where the founding or sole owner is withdrawing or has died, and our proposal would actually expand the incentives for employee ownership in that context. One advantage of the proposal is that it seems potentially (slightly) more politically viable than simple repeal of ESOPs with no replacement.

FITRI ISMIYANTI, PUTU ANOM MAHADWARTHA, FITRI ISMIYANTI,PUTU ANOM MAHADWARTHA [2018] ***"Does Employee Stock Ownership Plan Matter? An Empirical Note"*** observed that the company's performance is measured by using return on assets, return on equity and Tobin's Q, while productivity is measured by using sales per employee, cash flow per employee, and total assets turnover. Based on the results, it can be concluded that Employee Stock Ownership Program (ESOP) has a positive and significant impact on productivity.

SHENGXIONG WU AND JOHN HARRIS THORNTON [2018] in his study, "***ESOPs and Firm Risk"*** observed that the relation between the percentage of firm shares controlled by Employee Stock Ownership Plans (ESOPs) and firm risk as measured by stock return volatility. We find a negative relation between percentage ownership and firm risk. This relation is statistically and economically much stronger in smaller firms. The negative relation between ESOP ownership and risk in smaller firms holds for both systematic and unsystematic risk as well as total risk. These findings are consistent with the view that risk-averse employees with a substantial portion of their wealth in their ESOP discourage firm risk taking.1

ISAIAH AGUILAR [2016] in his study *"ESOP Sustainability and Stock Price the Value of Being Proactive"* observed that an ESOP's long-term sustainability depends on a proactive management team that understands the value of strategic planning. By performing interactive repurchase obligation studies, a company and its advisors can formulate an appropriate strategy to satisfy and fund future stock repurchases. It is important that companies recognize that the relationship between a company's stock price and the ESOP's sustainability should not be about limiting repurchase obligations. Companies should understand how their stock price can maximize the period during which the ESOP provides a fair and meaningful benefit to employees.

PAVAK VYASI[2][2016] **in his study "*Evaluation Of Various Methods Of Accounting For Employee Stock Options*"** observed that an the Evolution of Employee Stock Options, various ways of accounting of stock options granted to employees as remuneration and evaluation of such methods of valuation of such stock options, global perspective thereon and the Indian practice. Employee Stock Options it can be concluded that the fair valuation method offers better accounting treatment thought there exist a scope of development of more accepted method of valuation of models ESOPs, also reporting requirement can be clarified further so as to bring more transparency in financial statements.

TYPES OF ESOP

Employee Stock Option Scheme (ESOS)	Under this scheme, the company grants an option to its employees to acquire shares at a future date at a pre-determined price. Eligible employees are free to acquire shares on vesting within the exercise period. Employees are free to dispose of the shares subject to lock-in-period if any. Generally exercise price is lower than the prevalent market price.
Employee Stock Purchase Plan (ESPP)	This is generally used in listed companies, wherein the employees are given the right to acquire shares of the company immediately, not at a future date as in ESOS, at a price lower than the prevailing market price. Shares issued by listed companies under ESPP will be subject to lock-in-period, as a result, the employee cannot sell the shares and/or the employee has to continue with the employer for a certain number of years.
Share Appreciation Rights (SAR)/ Phantom Shares	Under this scheme, no shares are offered or allotted to the employee. The employee is given the appreciation in the value of shares between two specified dates as an incentive or performance bonus, that is linked to the performance of the company as a whole, as reflected in its share value.

USES OF ESOP

- TOP MANAGEMENT COMMITMENT
- EMPLOYEE RETENTION
- COMPENSATION

NEED OF ESOP

- To buy the shares of a departing owner.
- To borrow money at a lower after-tax cost.
- To create an additional employee benefit.
- Capital appreciation.
- Incentive based retirement.
- Tax advantage.
- Company reduces its tax liability.

PURPOSE OF ESOP

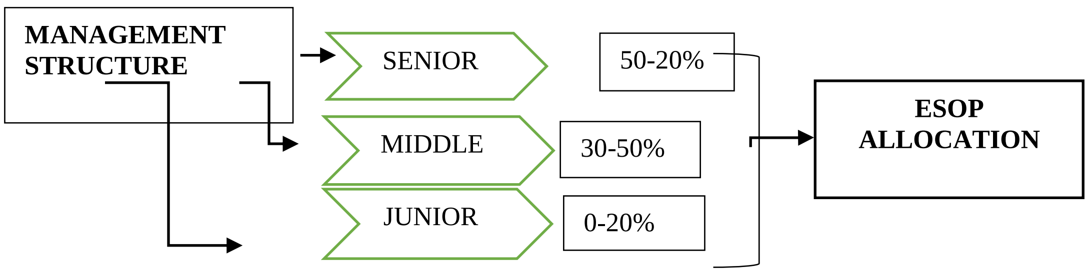
- To attract, reward, motivate and retain employees.
- To enable employees to acquire beneficial ownership in their company without having to invest.
- To improve the overall performance of the company.
- To enhance job satisfaction of the employee due to ownership incentive.

- To help in wealth creation for employees.

CRITERIA TO ISSUE ESOP

- Generally the following criterion are taken into consideration:
- Performance
- Length of Service

WHOM TO GIVE



REGULATORY FRAMEWORK IN INDIA

1. Companies Act, 2013 section 2(37)
2. Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014
3. Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014.
4. Income Tax Act, 1961 •clause (iii) of sub-section (2) of section 17 •Section 49(2B)

Scenario under erstwhile Companies Act, 1956. Provisions related to ESOPs were not documented.) Allotment to the Employees was considered under the ambit of Section 81(1A) related to issuance of shares. There was no other Regulatory framework for unlisted companies. However, Listed Companies were been regulated by SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999

ESOPs- Now covered under the ambit of Companies Act, 2013 Unlisted Companies, Listed Companies Regulated by Section 62(1)(b) of the Act read with SEBI (ESOS and ESPS) Guidelines, 1999 Regulated by Section 62(1)(b) of the Act read with Rule 12 of Companies (Share Capital and Debentures) Rules, 2014.
Scenario under New Companies Act, 2013. Highlights of Rule 12 of the Companies (Share Capital and Debentures) Rules 2014. Approval from Shareholders via Special Resolution Permanent Employees of Company, Holding Company, Subsidiary Company and Associate Company can be covered. All Directors excluding Promoter Directors and Independent Directors can be covered under the ESOP Plan. Freedom to determine Exercise Price. Freedom to determine lock-in period. Separate resolution to be passed in case of grant to employees of holding/subsidiary company. Explanatory statement shall disclose material details as prescribed.
Mandatory Annual disclosures in Directors Report. Minimum period of one year between grant and vesting of options. Options granted cannot be pledged, hypothecated or otherwise transferred. In case of death, all options granted shall vest in the legal heirs. In case of resignation, all unvested options shall lapse. Register to be maintained as per format prescribed by ROC.

TAX TREATMENT FOR EMPLOYEES:¬

According to the Finance Bill 2009 - FBT on ESOPs has been abolished. ESOPs have been included in the purview of Perquisites under Section 17 (2). -Where the capital gain arises from the transfer of such shares referred to in sub-clause (vi) of clause (2) of section 17, the cost of acquisition of such security or shares shall be the fair market value which has been taken into account for the purposes of the said sub-clause".

TAX TREATMENT FOR THE COMPANY:¬As per SEBI guidelines listed companies have to account for ESOP by treating the same as an expense. As yet there is no clarity whether this expense will be allowed as deductible expense by the Income Tax authorities.
SEBI Guidelines Promoters and the part- time directors will not be entitled to receive the securities under the ESOPs even if the promoter(s) is/are employee(s) of the company. The issue of shares/convertible instruments under an ESOP shall not exceed 5% of the paid-up capital of the company in any one year. Clause 4 of the guidelines on preferential issues providing for pricing shall be also applicable to the ESOPs. A company introducing ESOPs shall submit a certificate to the concerned stock exchange at the time of the listing of the securities .If the exercise-price is at a discount to the market price, the discount will be treated as a cost .A minimum lock-in period of 1 year from the date of issue.

CASE STUDIES OF ESOP

1. **RELIANCE JIO**

   COMPANY PROFILE:

   Reliance Industries Limited (**RIL**) is an Indian conglomerate holding company headquartered in Mumbai, Maharashtra, India. Reliance owns businesses across India engaged in energy, petrochemicals, textiles, natural resources, retail, and telecommunications. Reliance is the most profitable company in India, the largest publicly traded company in India by market capitalization, and the second largest company in India as measured by revenue after the government-controlled Indian Oil Corporation. The company is ranked 203th on the *Fortune Global 500* list of the world's biggest corporations as of 2017. It is ranked 8th among the Top 250 Global Energy Companies by Platt's as of 2016.

   ESOP POLICY

   According to 10th August, 2017 Mukesh Ambani owned Reliance Jio Infocomm had planned to roll out stock options for its employees, which could be a reward for the pace at which subscribers are being added as well as a talent retention and attraction strategy.
   All leading Telco's such as Bharti Airtel, Idea Cellular and Vodafone India have employee stock option plans (ESOPs). Mukesh Ambani-owned Reliance Jio Infocomm was planning to roll out stock options for its employees, which could be a reward for the pace at which subscribers are being added as well as a talent retention and attraction strategy.

The biggest challenge for Reliance Jio would be to ensure that subscribers who have signed up do not migrate to rival Telco's, once the free offer ends. And this is where ESOPs will come in handy, especially, in retaining key people tasked with customer retention.

In India, and indeed globally, telecom majors offered ESOPs to senior ranks. That move would help Jio retain employees for a longer period.
In October, Jio had handed out 7-15% increments to junior and middle-level employees and 5-10% to seniors — slightly better than industry averageof7-12.

2. **INFOSYS**

COMPANY PROFILE:

Infosys is the second-largest Indian IT company of 2017 by revenues and 596th largest public company in world in terms of revenue. On June 30, 2017, its market capitalization was $34.33 billion. The credit rating of the company is A (rating by Standard &

Poor's). IT industry like Infosys was the first to use this ESOP feature in India. In 1993 – Infosys Introduced Employee Stock Options (ESOP) program. Infosys- pioneered the concept of ESOP in India in 1994.

ESOP POLICY

According to July 15, 2016 Infosys has relaunched its employee stock option plan (ESOP) for junior to middle-level management staff as it looks to rein in rising attrition that stood at 21% in the April-June 2016 quarter . They have rewarded about 7,500 of their employees from junior to middle level management with restricted stock options and they extend it to middle management to senior leaders and title holders subsequently .The company continues to focus on reskilling employees and has also revamped its leadership development programs.

ESOPs allow employees to own equity in the company, which was seen as a morale booster for company.

Infosys added 13,268 (gross) and 3,006 (net) people in the said quarter, taking its headcount to 1,97,050 at the end of June 2016.

That year, Infosys has given wage hikes of 6-12% to its employees in India and about 2% to onsite workers, apart from offering equity to incentivize top performers.

Infosys has rewarded - plumbers, peons, electricians drivers with Infosys stock. Narayana Murthy's Chauffeur Kannan is a millionaire -His portfolio is worth 20 million rupees. Sixty-seven others drivers are among 2000 Infosys millionaires.

3. BHARTI

COMPANY PROFILE:

Bharti Airtel Limited is an Indian global telecommunications services company based in New Delhi, India. It operates in 16 countries across South Asia and Africa. Airtel provides GSM, 3G, 4G LTE and VoLTE mobile services, fixed line broadband and voice services depending upon the country of operation. Airtel had also rolled out its VoLTE technology across seven telecom circles namely Mumbai, Maharashtra and Goa, Madhya Pradesh, Chhattisgarh, Gujarat, Andhra Pradesh & Telangana, Karnataka, Tamilnadu and Kolkata in India and should roll out the technology in rest circles by end of March 2018. It is the largest mobile network operator in India and the third largest in the world with over 386 million subscribers. Airtel was named India's second most valuable brand in the first ever Brandz ranking by Millward Brown and WPP plc

ESOP POLICY

According to August 10, 2017 Gopal Vittal, MD & CEO, Airtel was selling a part of his ESOPs and BTL offered to buy the same, a Bharti Airtel spokesperson said. Shares of the telecom major ended the day 0.08 per cent up at Rs. 416.40 on the NSE. With a number of start-ups collapsing mid-way, many employees are now preferring bonuses instead of Employee Stock Option Plans (ESOPs) as part of their compensation package, industry experts said they had seen a change where the ESOP component in compensation packages has dropped in start-up companies. This is because they never reach the valuations they initially project and in the past year, a lot of start-ups also had to close businesses. "Since around the end of 2016, they had been witnessing a change from ESOPs to variable bonuses in terms of compensation in these companies," Mohit Bharti, Director of professional recruitment consultancy Michael Page India, told PTI here.

This trend is seen across the start-up industry, including e-commerce, food, technology, logistics and financial services, Bharti added. Echoing a similar view, GlobalHunt Managing Director Sunil Goel said, with many start-ups collapsing gradually, employees started relying on cash component.

"Bonuses are generally short-term component, paid either yearly or quarterly, and is becoming an attractive option even if it is one-third or one-fourth of the value as compared to the ESOPs," they pointed out. Start-ups are now at a consolidation phase with lot of buyouts, mergers and acquisitions, so ESOPs might be more beneficial in the long run. This has been the trend in the last 1-2 years with declining valuations of e-commerce and tech start-up performance.

ESOPs will form a lower component in the compensation of top talent going forward, as earlier top talent would agree to a 30-50 per cent salary cut and opt for ESOPs, but not these days.

DDI India Member, Key Leadership Team, Amogh Deshmukh, said industries like pharmaceuticals, banking and IT companies are the few who offered ESOPs to employees.

Telecom major Bharti group began its ESOP journey in 2001. In 2005 - Everybody was covered and ESOPs were linked to the employee's loyalty and performance. In 2006, it offered performance share plan to senior executives. But by 2008 – They realized 2005 wide-base ESOP strategy wasn't working as the younger staff preferred deferred bonus plan or cash. Now the company has restricted the plan to the middle management and above.

4. AXIS BANK

Company Profile

Axis Bank Ltd is the third largest of the private-sector banks in India offering a comprehensive suite of financial products. The bank has its head office in Mumbai and Registered office in Ahmedabad. It has 3304 branches, 14,003 ATMs, and nine international offices. The bank employs over 55,000 people and had a market capitalization of ₹1.28 trillion (US$20 billion) (as on March 31, 2017).It offers the entire spectrum of financial services large and mid-size corporates, SME, and retail businesses.

ESOP POLICY

Axis Bank UTI Bank, which changed its name to Axis Bank in 2007, was one of the earliest in the banking sector to experiment with employee stock options. It launched a scheme as early as 2001, starting with the unreserved objective of covering all employees, based on performance. Over the years, the scheme has undergone changes, teaching the bank an important lesson: Not everybody in the organization wants ESOPs and even for those who do, the current market price is an important consideration. When Axis Bank first designed the ESOP scheme, there was much debate about how broad-based it should be. The bank chose to include all employees except the poorest performers. In surveys, they were below their competitors on cash performance bonuses. Also, they did not have an aggressive variable pay plan. So, they decided ESOPs would be a good way to compensate employees, even at lower levels. At first, employees didn't take well to the new plan. Only when the stock price started climbing, they saw the point and embraced the scheme. The first major change came in 2004. Axis Bank had been accounting the difference between the price at which options were granted and the prevailing market price as an expenditure on the books. They noticed they were taking a hit. So, the company changed the formula for pricing the options. It switched from the 52-week average to the previous day's close as the basis for the grant price. This helped the company eliminate its accounting expenditure, and also wiped out the arbitrage the employees enjoyed between the two prices. The next year dealt a bigger blow to ESOPs. The government brought them under the ambit of fringe benefit tax (FBT). Any difference between the fair market value and the vesting price came to be taxed at 33.99 percent. The industry was enraged at what it saw as an unfair levy, but the government did not budge. At Axis Bank, the management decided to pass on the FBT burden to employees, taking advantage of a clause in the tax laws. This and the

new pricing formula had a telling impact on the popularity of ESOPs.
Employees have exercised far fewer options from 2005 to the present than they did in the first four years of the plan. In April 2004, more than three million options were exercised, up from one million at the start in April 2001. However, in April 2007, that number had dropped to less than 3 lakhs. The amount of wealth created had exceeded Rs. 100 core in April 2004, but had dropped to just Rs. 10 core in the same month three years later. The year 2008 saw a big shift in Axis Banks ESOP strategy. In April, the company decided to narrow the scope of the plan to only employees in the middle management and above. Staff in the lower rungs was excluded. There were two reasons for this. Previously, the company was growing at an exponential rate, but growth slowed down and they could not give options to everyone anymore. Axis is now toying with ideas such as phantom stocks and restricted stock units. These options may result in cash outflow. They want wealth creation without impacting the bank. But in these conditions, they may be forced to explore options for better compensation of employees.

CONCLUSION

The wealth creation potential of ESOPs has not been fully explored in India .ESOPs are not considered part of compensation in many Indian organizations. In some cases we saw that Companies are offering a bonus in lieu of ESOPs. But bonus option cannot replace ESOPs as they bring in an element of ownership, which cannot be created by bonuses .However, in the current scenario, instead of ESOPs, many organizations are looking at multiple avenues to develop and retain their leaders. Some of them include business school degrees, certifications, providing a career path and purposeful development. It was also noticed that bonuses are restricted to top and middle management employees and lower level employees preferred cash bonus more than Esop .The organization looks at the ESOP as a wealth creation exercise but the employees don’t.
However it is an advantage for both employee and company. It is used by the companies to reward, retain, attract talent, create a sense of ownership in the company and a retirement benefit scheme. Hence, it improves the corporate performance as a whole.

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