ESOP Schemes – An Insight

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Employee Stock Options Plans (ESOP) have been in vogue for over a decade in India and they still create excitement and hope among employees to become millionaires overnight like Infosys and Wipro employees. Human Resource professionals and Finance directors, especially in ICE Sector (Information Technology, Communication and Entertainment), pharmaceutical and tech driven companies use ESOP as a tool to reward and motivate employees. ESOPs are also used to attract and retain the best talent and to ensure employee commitment.

Before we start our discussion on ESOP, let us briefly understand Options, which are of 2 types - Call Option and Put Option. Call Options are right to buy given number of shares or other security (hereafter referred as shares) at a pre-determined price in consideration of premium to be paid by one party to another. Thus, there are two parties in any Option contract, option writer (Seller) and Option Buyer. In a Call Option, the Option buyer or the grantee of the option has a right but not the obligation to purchase shares at the agreed price. The Option buyer may forgo the option, if the exercise price of the option is not favorable to him. On the other hand, the option writer has an obligation to sell the same, if the Buyer of Call Option exercises his right. A put option is antithesis to Call Option where, the Option buyer or the grantee of the option has a right but not an obligation to sell the shares to the option writer at the predefined price. The option buyer may not sell the Shares to the Buyer, if the market price increases. On the other hand, the writer of a Put Option has an obligation to buy the shares from the Option buyer if the option is exercised. The consideration paid by Option buyer to the option seller is referred as premium.

In case of ESOP, the option writer, that is, the company receives no premium for writing the option and the consideration is future services to be rendered by the employees during the vesting period and lock in period, if any. Most of the ESOPs are Call Option granted by a Company to its employees. The employee has a right but not the obligation to buy specified number of shares from the Company. On the other hand, the employer is obliged to sell the specified number of shares in case the employee exercises the option. The employee will not exercise his option so long as exercise price exceeds the market price and hence the option may ultimately lapse or be forfeited.

These types of options whose exercise price are higher than market price are also referred as underwater option. During the dot com bubble, many software professionals who vied for ESOP in sacrifice for cash component of salary had their dreams shattered when they were left with underwater options arising out of poor valuations. Even options issued by some leading blue chip Companies have been rendered underwater due to adverse market conditions. Indian Clause 7 of SEBI guidelines authorises companies to vary the terms and conditions, including repricing of options, if they become underwater.

Options are also classified as American and European depending on their exercise period. An American Option can be exercised anytime during its pendency while a European Option can be exercised only on a fixed date. ESOPs are in the nature of European Options till they vest, since they cannot be exercised before the vesting period. On vesting, ESOP becomes an American Option and can be exercised anytime during the exercise period.

Stock and Exchange Board of India (SEBI) guidelines de-

fine employee stock option as *"option given to the whole-time Directors, officers or employees of a company which gives such Directors, Officers or employees, the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a predetermined price."* This definition has been incorporated based on similar definition contained in section 2(15A) of Companies Act, 1956.

SEBI Guidelines

The statutory guidelines on ESOP, including accounting treatment of compensation cost, are pronounced by Securities and Exchange Board of India (SEBI) called *Securities And Exchange Board Of India (Employee Stock Option Scheme And Employee Stock Purchase Scheme) Guidelines, 1999*. These guidelines apply only to listed Companies in respect of ESOP issued on or after June 19, 1999. Hence ESOP schemes of unlisted companies or foreign subsidiaries of listed Companies are outside the purview of SEBI guidelines. Further, SEBI guidelines are only applicable to shares or other securities convertible in shares. Hence, Companies can consider issuing Zero Coupon Bond (ZCB) or Bonus Debentures or other such exotic instruments without attracting the disclosure requirement of SEBI guidelines on ESOP. The SEBI guidelines have 23 clauses and VI schedules attached to it.

The salient features of SEBI Guidelines are as follows:

- ESOP schemes of listed companies must be issued and administrated strictly in accordance with SEBI guidelines.
- The Company (referred as Offeror) should issue a detailed offer document containing the terms and conditions of ESOP offer.
- The Offering Company should constitute a Compensation Committee (a committee of Board of Directors, which should have majority of Independent Directors) for administration and superintendence of the ESOP.
- Options can be granted only to eligible permanent employees of the Company but excluding (i) employees belonging to promoter group and (ii) Directors holding 10% or more of capital base either directly or with relatives.
- ESOP Scheme can also be issued for ADR or GDR or other Depository receipts or for securities convertible into equity shares.
- ESOP Scheme must be approved by shareholders at a general meeting by a special resolution. The explanatory statement to the Notice convening the General Meeting must contain disclosures as mandated in para 6.2(a) to (k) of the SEBI guidelines.
- The terms and conditions of ESOP scheme can be amended by special resolution at Shareholders meeting. The Companies can also reprice unexercised options unless the same are prejudicial to the interests of options grantees. (Clause 7)
- In case the ESOP scheme is offered to employee of Holding or Subsidiary Company or to some identified employees, then a separate resolution must be passed at the shareholders meeting.
- A company may reprice the options, which are not exercised, whether or not they have been vested, if ESOPs are rendered unattractive due to fall in the price of the shares in the market.
- There should be a minimum vesting period of 1 year for grant of option.

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- The duration of lock in period after allotment under ESOP is left at the discretion of Companies (Clause 9). This flexibility can be used by the Offering Companies to make the offer attractive as well as to serve the end purpose of employee retention.
- Options right cannot be transferred/pledged/hypothecated/mortgaged or otherwise alienated in any manner (Clause 11). This is a personal right only to the offeree.
- The Directors' Report should contain disclosure as stated in clause 12 of SEBI guidelines (a) about the various options in force, options exercised and lapsed and also list of Senior Management

employees to whom Options were issued. b) Details of Management employees or whole-time directors who have received Options exceeding 5% of the value of Options issued during the year (c) Details of employees who have been issued Options during the year equal to or exceeding 1% of the issued capital (d) Difference in accounting value of Options vis-a-vis Fair Value if intrinsic value accounting is adopted by the Company.

- SEBI Guidelines also provide Accounting Treatment for compensation cost as stated hereunder.

Offering ESOP linked to market price is generally not effective, as the option may turn out to be worthless in case of downtrend in stock markets. The opponents of ESOP scheme thus feel that outright allotment of shares (under ESPS) is a superior tool vis-a-vis ESOP.

- The shares issued and allotted under ESOP scheme should be listed immediately upon allotment in any recognized stock exchange where the securities of the company are listed provided that (a) The ESOP is in accordance with these Guidelines. (b) The Company has to file with the concerned stock exchange(s), before the exercise of Option, a statement as per Schedule V and should obtain in-principle approval from such Stock Exchanges. (c) As and when ESOPs are exercised, the company should notify the Stock Exchanges concerned in Schedule VI.

Interestingly, SEBI guidelines are silent on certain eventualities like transfer of employee to a Group Company, or death or incapacity of the employee. Corporate India is seen taking pro-employee stand in their ESOP offer document in most such cases on humanitarian grounds. A study of ESOP offer document reveals that in such cases, Companies are seen giving option rights to the dependents of the deceased employee.

There is also a debate in some quarters that ESOP entitlements should be treated at par with rights entitlement and should be freely transferable. However, such a view is not tenable, since rights entitlement is tool to reward shareholders for loyalty already shown and for fund raising. Whereas an ESOP scheme is basically to motivate employee for serving for a longer period and then reward him.

The Trust Route

The trust route is often adopted for implementation of ESOP scheme. It works like this: The employer company creates a trust for the employees, also referred to as the "ESOP Trust." The ESOP Trust receives stock either from company by way of fresh allotment or by purchasing from existing shareholders in open market or the owner of the company may sell shares of his holding to the ESOP Trust. The ESOP trust usually obtains its funds through a loan either from a financial institution or from the seller or a combination of institutional and seller. The ESOP Trust then allots shares to employees on exercise of their right in exchange of cash and repays its loans.

Many Indian Companies, including Infosys Limited and Nicholas Piramal, have used trust route to implement ESOP scheme.

SEBI guidelines do not mention ESOP Trust and thus creation of trust to administer the ESOP scheme is optional. SEBI guidelines also do not specify any accounting principles to be followed in case of grant of options through a trust. A committee appointed by SEBI had recommended that since this is a consolidation issue rather than an ESOP issue, the ESOP trust should be consolidated with the company under AS 21 and the existing ESOP guidelines should be applied by the consolidated entity.

Under US GAAP, ESOP trusts are considered as Variable Interest Entity under FIN 46 read with FAS 94. Hence the interest of company in such ESOP trusts is considered as Variable interest and liable for consolidation under US GAAP while there is no such provision under Indian GAAP. Nicholas Piramal's ESOP Trust was also consolidated under FIN 46 under US GAAP, but not under Indian GAAP.

Accounting Treatment & Option Valuation

SEBI Guidelines permit accounting for ESOP Option by intrinsic value method or by Fair Value Method as opted by the Company. The guidelines provide that *the accounting value of options shall be equal to the aggregate overall employee stock options granted during the accounting period, of the intrinsic value of the option or, if the company so chooses, the fair value of the option.* The guidelines further

provide that the employee compensation cost shall be amortised on a straight-line basis over the vesting period. However, if compensation cost is computed using the intrinsic value of stock options, the impact of difference between Intrinsic Value method and Fair Value method as regards compensation cost, profitability and EPS of the Company should be disclosed in the Directors' Report.

Lets us analyse both the valuation methods:

Intrinsic Value Method: SEBI Guidelines define "intrinsic value" as the excess of the market price of the share under ESOP over the exercise price of the Option (including upfront payment, if any). Suppose a Company grants ESOP to its employees at an Option price is Rs 100/- per share (Face value Rs 10), whereas the current market price (CMP) of the share is Rs 150/- .The option is exercisable after 2 years. In such a case, the intrinsic value of options shall be Rs 50/- (Rs 150 minus Rs 100) and will be deemed as accounting value of ESOP; and amortised over the vesting period of 2 years. However, if the offer price is Rs 150/- exercisable after 2 years, while the CMP is Rs 100/-, there is be no intrinsic value and hence no amount shall be charged as Compensation Expense. The Intrinsic value method is so called, because it considers only factors internal to the Option offered and does not consider various external factors, which are considered while determining fair value as stated hereunder. Under Intrinsic value method, compensation expense is recorded on the date of grant only if the exercise price is less than CMP. If the exercise price is higher than CMP, then there is no accounting worth of option and no compensation expense is recorded. The market price to be taken for this purpose shall be latest available closing price, prior to the date of the meeting of the Board of Directors in which Options are granted. (Prior to 22nd July 2004 "*market price*" was defined *as the average of the two weeks high and low price of the share preceding the date of grant of option on the stock exchange on which the shares of the company are listed.*)

Fair Value Method: The fair value of Stock Options is defined as the price in an arm's length transaction between a willing buyer and a willing seller. As per SEBI guidelines, clause 2.1, schedule III, the fair value shall be estimated using an option-pricing model (for example, the Black-Scholes or a binomial model) which takes into account multiple external factors, including the exercise price and expected life of the option, the current price in the market of the underlying stock and its expected volatility, expected dividends on the stock, and the risk-free interest rate for the expected term of the option.

The Black & Scholes model was published in 1973 by Fisher Black and Myron Scholes. It is one of the most popular options pricing models and is frequently used for its relative simplicity. The Black-Scholes model is used to calculate a theoretical call price (ignoring dividends paid during the life of the option) using the five key determinants of an option's price: stock price, strike price, volatility, time to expiration and short-term (risk free) interest rate.

The fair value of an option estimated at the grant date shall not be subsequently adjusted for changes in the price of the underlying stock or its volatility, the life of the option, dividends on the stock, or the risk-free interest rate. Where the exercise price is fixed in Indian Rupees, the risk-free interest rate used shall be the interest rate applicable for a maturity equal to the expected life of the options based on the zero-coupon yield curve for Government Securities.

Accounting Pronouncements

The Institute of Chartered Accountants of India (ICAI) has issued 'Guidance Note on Accounting for Employee Share-based Payments' on 4th February 2005. The Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., employee stock option plans, employee stock purchase plans and stock appreciation rights, various significant aspects of such plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, cash-settled employee share-based payment plans, employee share-based payment plans with cash alternatives, graded vesting, earnings-per-share implications, accounting for employee share-

There are scores of examples where unscrupulous managers engaged in artificially jacking up the prices of company stock to increase the valuation of their stock holding acquired under ESOP, arranged buy back programmes and offloaded their holding at an opportune time.

based payments administered through a trust, etc.

ICAI guidance note recommends computation of stock compensation expense based on Fair Value method and recommends that fair value of the instruments granted may be determined by using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The note further recommends that valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price

The international Financial Reporting Standards (IFRS) on ESOP are contained in IFRS 2, which was issued in February 2004 and applies to annual periods beginning on or after 1 January 2005. IFRS 2 applies to grants of shares, share options or other equity instruments made after 7th November 2002 which had not yet vested at the effective date of the IFRS and also applies retrospectively to liabilities arising from share-based payment transactions existing at the effective date. IFRS 2 also prefers Fair Value method of accounting.

US GAAP Pronouncements on ESOP are contained in APB Opinion 25, FAS 123 (now FAS 123R) and FAS 148. Till recently, US GAAP permitted intrinsic value method of Accounting for Stock based Compensation as per Accounting Principles Board Opinion no 25 read with FAS 123. FASB 123 established Accounting and Disclosure requirement using Fair value method of accounting and permitted companies to use Intrinsic value method, if adopted earlier. However, in December 2004, FASB has issued revised FAS 123R-requiring companies to change their accounting policies to record the fair value of Stock Option as expense. SEC has also issued release no 99-8568 mandating adoption of FAS 123R from 1.4.2006. The adoption of Fair value method is likely to further dent the profitability of Companies, which have adopted intrinsic value method.

Tax Planning

It is a cardinal principle of taxation that only real income can be taxed and not the hypothetical, notional or imaginary income. In case of ESOP option, an employee only gets an option to subscribe to certain number of shares of the Company. This right is subject to a number of conditionalities and obligations. The shares are allotted to employee after the initial vesting period and the real benefit flows only upon sale of such shares after the lock in period, if any, is over. Hence the employee is not liable to pay any income tax at the time of grant or vesting of rights or upon allotment of such rights if the ESOP is in accordance with guidelines issued by CBDT.

The Income Tax Act provides that every Company issuing shares directly or through its parent under an Employees Stock Option plan or Scheme to its employees should furnish a copy of the document describing particulars with the Chief Commissioner of Income-tax having jurisdiction over it within a period of 6 months. If the plan or Scheme is incorporated in any language other than English, an English translation of the same should also be enclosed.

Upon sale of such ESOP shares, the employee may have to pay capital gains tax as per prevalent rules. Presently, long-term capital gains (LTCG) are exempt from tax, if the shares are held for more than 1 year and Securities Transaction Tax (STT) is paid on sale of such shares. Hence if the shares allotted in ESOP are held by employee for 12 months after allotment and these ESOP shares are sold through stock exchange and STT is paid, then no LTCG is payable.

As regards the employer company, compensation expense charged to Income statement is not tax deductible, since ESOP expense is charged to Income statement on notional basis based on either intrinsic value or fair value, which are both without any actual cash outflow. The existence of ESOP expense also gives rise to timing difference, which is a permanent difference and hence no deferred tax liability is created.

The provisions relating to determining perquisites in case of employee stock options (ESOPs) and the effectiveness of Board circulars came up before the Bangalore Bench of the Income-Tax Appellate Tribunal (ITAT) in the *Infosys Technologies Ltd (ITL) vs. Deputy Commissioner of Income Tax (2003 130 Taxman 129*) case.

The facts of the case were that ITL had formulated an ESOP scheme for its employees. A trust was set up by ITL which was allotted 7,50,000 warrants of Re 1 each, entitling the holder to apply for and be allotted one equity share of the face value of

Rs 10. For this, the employee had to pay Rs 100 per option.

The trust was to hold the securities and to transfer them to the employees as per the terms and conditions of the ESOP. ITL had deducted tax at source on the payments to the employees but did not deduct tax treating the ESOPs as a perquisite. The assessing officer (AO) passed an order under Section 201 holding the assessee as in default, which was also concurred by Commissioner (Appeals). The ITAT in a well-reasoned judgement, rejected the stance of both the AO and the Commissioner (Appeals).

FEMA Guidelines

In recent years, FEMA regulations have substantially relaxed to enable Indians to apply under ESOP schemes of their foreign employers and vice versa.

The regulations for outwards remittance of foreign exchange under ESOP scheme are contained in sub regulation 3 of Regulation 24 of Foreign Exchange Management (Transfer or Issue of any Foreign Security) (Amendment) Regulations, 2005 (effective from 1st Oct, 2004). Regulation 3 provides that *an Indian company in the knowledge based sector may allow its resident employees (including working directors) to purchase' foreign securities under the ADR/GDR linked stock option scheme, provided that the issue of employees stock option by a listed company shall be governed by SEBI (Employees Stock Option and Stock Purchase Scheme) Guidelines, 1999 and the issue of employees stock option by an unlisted company shall be governed by the guidelines issued by the Government of India for issue of ADR/GDR linked stock options.*

The guidelines further provide that (a) the consideration for the purchase should not exceed the ceiling as stipulated by the Reserve Bank from time to time, which is presently capped at US$ 25,000 per calendar year. Further the shares so acquired can be sold without Reserve Bank's permission provided the *proceeds thereof are repatriated to India. 'knowledge based sector' are defined to mea such sectors as have been notified by the Government of India from time to time. Previously there was a condition that the shares of such foreign companies had to be issued at a "concessional"* price, which has been done away with. Thus, it is now easier for foreign companies to incentivise and reward their Indian employees under their ESOP/ ESPP schemes.

The regulations for **inwards remittance** of foreign exchange under ESOP scheme of Indian Companies are contained in Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 which provides that "*An Indian company may issue shares under the Employees' Stock Options Scheme, by whatever name called, to its employees or employees of its joint venture or wholly owned subsidiary abroad who are resident outside India, directly or through a Trust Provided that the scheme has been drawn in terms of regulations issued under the Securities Exchange Board of India Act, 1992; and face value of the shares to be allotted under the scheme to the non-resident employees does not exceed 5% of the paid-up capital of the issuing company.*"

The responsibility of adhering to 5% limit has been cast on the Trust and the issuing company as the case may be.

Pitfalls

While ESOP scheme are generally supposed to shower employee benefit and help retention, these are also deployed by unscrupulous managers to enrich their own kitty. The senior management may devise ESOP scheme to serve their self-interest. They manipulate the market price offload their ESOP shares at hefty prices. Sometimes minority shareholders look at ESOP with suspicion and jealousy. These investors cry foul that why employees should be given a stake in the company at less than fair market value which dilutes their value of net worth. ESOP schemes are also blamed to breed a class of employee whose only aim is to sell their allotted quota of shares for a profit thus defeating the very purpose of employee participation in ownership and management.

Just over one year ago, the Wall Street Journal featured this story on its cover page: a Delaware court invalidated $558 million of stock option compensation that Computer Associates (CA) International had awarded to three of its senior officers. The forfeiture did not occur because the compensation was excessive, but because of a mistake in the plan document. It omitted a standard provision that adjusts the number of shares available for awards to reflect stock dividends and stock splits.

The American experience is a classical example of how greedy managers and employees in so-called professionally managed companies can misutilise this excellent HR tool to dupe capital market and investors. There are scores of examples where unscrupulous managers engaged in artificially jacking up the prices of company stock to increase the valuation of their stock holding acquired under ESOP, arranged buy back programmes and offloaded their holding at an opportune time.

Case Studies

An analysis of annual reports of leading Indian corporate gives insight into nuances of management of ESOP schemes, their popularity and effectiveness.

HLL Limited has issued 4 stock Options till date. The exercise price of Options in all cases was linked to market price on /near the date of Grant. The options issued in 2001 and 2002 were rendered unattractive as the Stock price of HLL, fell significantly from the Market price relevant then. Till date, no options have been exercised by the employees, despite the fact that over Option for over 1.63 crore shares have vested. Surprisingly, the terms of scheme were also not varied, while the SEBI Guidelines provide for same. HLL Limited has provided a vesting period of 3 years, as against minimum 1year period stipulated by SEBI. The key assumption for Fair value computation under Black Scholes option Pricing Model was as Follows: Risk free Interest rate (6.75%), Expected Life (7 years), Expected Volatility (28.56%), Expected Dividend Yield (Rs 5 per share).

ITC Limited has till date issued 4 ESOP schemes and the options outstanding as on 31.3.2005 was 28,22,512 shares. The options have been priced mostly based on the Closing Market price as per NSE.

Infosys Limited has till date issued 3 plans i.e. 1994 Plan, 1998 Plan (Plan I and II) and 1999 Plan. Infosys has temporarily suspended grant of options under 1998 and 1999 plan for seeking regulatory and accounting clarity, while 1994 lapsed in 2000. The pricing under 1998 and 1999 plan was based on fair market value as on date of grant of Option. The 1994 ESOPs plan was administered through a trust. If the employees leave the employment before the lock in period, the shares are to be sold back to trust. The 1998 plan clearly has liberal moorings and provides that a) in case of death of employee or his disability, the option will fully vest and can be exercised within 12 months of such event b) in the event of merger or other form of corporate restructuring, the successor corporation shall fully assume such options or such options shall fully vest and become exercisable. In case of 1998 as well as 1999 plan, an optionee is permitted to exercise the option, even after termination of his service but within 3 months of such termination. Infosys also adopted intrinsic value method. The key assumption for Fair value computation under Black Scholes option Pricing Model was as Follows: Risk free Interest rate (6%), Expected Life (1-5 years), Expected Volatility (60%-70%), Expected Dividend Yield (0.2%).

ITC Limited has till date issued 4 ESOP schemes and the options outstanding as on 31.3.2005 was 28,22,512 shares. The options have been priced mostly based on the Closing Market price as per NSE. ITC has adopted intrinsic value method of Accounting for ESOP and hence no compensation cost was recorded. The cost under fair value method would have been Rs 8.91 crore and had the Company adopted Fair value method, its net profit would have reduced to Rs 2182.49 crore as compared to Rs 2191.40 crore. The key assumption for Fair value computation under Black Scholes option Pricing Model was as Follows: Risk free Interest rate (4.89%), Expected Life (2.63 years), Expected Volatility (31.17%), Expected Dividend Yield (2.16%). None of the employees who were granted ESOP breached 5% and 1% limit as specified under disclosure rules.

Polaris Limited has 3 ESOP schemes pending as on 31.3.2005. The option pricing under the latest scheme i.e. ASOP 2003 was based on Market price. The key assumption for Fair value computation under Black Scholes option Pricing Model was as Follows: Risk free Interest rate (5.5%), Expected Life (3 years), Expected Volatility (0.33) Expected Dividend Yield (Nil/Ignored), employee Attrition rate 15.5%. The difference in Compensation cost between intrinsic value and Fair value was Rs 3.56 crore.

Rolta Limited had 2 ESOP schemes pending as on 31.3.2004. ESOP 2000 carried exercise price of Rs 198.60 while ESOP 2003 had fixed the exercise price at Rs 111.35. Over 214600 options lapsed either due to non-exercise or by cessation of employment. Rolta had amended the ESOP scheme by making the equity shares to be issued under the scheme as ranking pari passu in all respects with the existing shares of the company.

Glenmark Pharmaceuticals Limited had 2 ESOP schemes pending as on 31.3.2005. Of the 875000 Options granted in 1999 scheme, 650,000 vested and exercised by the employees, 215,000 were cancelled and only 10,000 were in force. regarding its 2003 scheme, out of 12,17,225 options granted, no options were vested as on 31.3.2005. Glenmark used Intrinsic value for cal-

culation of Employee compensation cost. The key assumption for Fair value computation under Black Scholes option Pricing Model was as Follows: Risk free Interest rate (6%), Expected Life (6 years), Expected Volatility (25%), Expected Dividend Yield (1.24%), the difference in Compensation cost between intrinsic value and Fair value was Nil.

Aurobindo Pharma Limited had only 1 ESOP scheme pending as on 31.3.2005. Of the 507,700 Options granted in 2004 scheme no option had vested. It used Intrinsic value for calculation of Employee compensation cost and since the grant price was market price prevailing on grant date, hence no compensation cost was recorded under intrinsic value. Interestingly the fair value calculated under Black Scholes model was Rs 288.25 being less than Grant price, no proforma disclosure was either required. The key assumption for Fair value computation under Black Scholes option Pricing Model was as Follows: Risk free Interest rate (7%), Expected Life (4 years), Expected Volatility (-4.11%), Expected Dividend Yield (2.25%).

Matrix Limited had only 1 ESOP scheme pending as on 31.3.2005. Of the 30,00,000 Options granted in 2004 scheme @ Rs 143.136 which was at 20% discount to market price (Rs 170.70), no options have been vested till date. It used Intrinsic value for calculation of Employee compensation cost amounting to Rs 6.48 million. Had the company adopted the compensation cost under fair value method, the cost would have been Rs 22.99 Million. The key assumption for Fair value computation under Black Scholes option Pricing Model was as Follows: Risk free Interest rate (6.43%), Expected Life (4.5 years), Expected Volatility (52%), Expected Dividend Yield (0.79%).

Nicholas Piramal (NPIL) has implemented its ESOP schemes under the Trust route. The ESOP Trust is managed by the trustee, being the chairman of the NPIL. The ESOP trust has acquired shares from existing shareholders and not fresh shares will be issued by the company, thus there will be no increase in the floating stock, or increase in capital, nor there any impact on EPS or other ratio relating to Share Capital. All stock options have been granted to senior managerial personnel. In fact, 3 employees received, more than 5% and more of stock options granted during FY 2005. As on 24.06.2005 NPIL ESOP Trust was holding 59,19,000 Equity shares under ESOP trust which was 3.1% of pre-issue capital.

Mphasis BFL has also implemented its ESOP schemes under the Trust route. The company has granted interest free Loans of Rs. 8.06 Million as on 30.06.05 (Rs. 33.08 Million as on 30.6.04) to ESOP Trusts which have been included under Loans and advances. All the ESOPs are in respect of parent company's shares. It has 5 ESOP scheme pending as on 31.3.2005 and the total no of options outstanding as on that date were 827, 85,000. The vesting period of options range from 6 months to 48 months and exercisable at any time after vesting, whereas in 1998-II scheme the options granted to Managing. The company has adopted Intrinsic value for calculation of Employee compensation cost. Had the company adopted the compensation cost under fair value method, the profits would have been lower by Rs. 5.05 million. The key assumption for Fair value computation under Black Scholes option Pricing Model was as Follows: Risk free Interest rate (5.78%-6.55%), Expected Life (1-4 years), Expected Volatility (70.75%), Expected Dividend Yield (2.02%).

Conclusion

ESOP schemes are currently offered to select group of employee as decided by management. Some of the corporates also prefer to offer ESPS scheme, which provide immediate gratification to employees vis-a-vis ESOP which has longer vesting period. ESOP schemes have an inbuilt uncertainty due to fluctuating Stock Market prices. It is also observed that offering ESOP linked to market price is generally not effective, as the option may turn out to be worthless in case of downtrend in stock markets. The opponents of ESOP scheme thus feel that outright allotment of shares (under ESPS) is a superior tool vis-a-vis ESOP.

The success of any share benefit scheme (ESOP or ESPS) depends upon management objective, leveraging employee expectation and above all stock market dynamics, which are unpredictable and uncontrollable. ❐

ESOP schemes have an inbuilt uncertainty due to fluctuating Stock Market prices. It is also observed that offering ESOP linked to market price is generally not effective, as the option may turn out to be worthless in case of downtrend in stock markets.