A Study on ESOPs as an Employee Incentive

Dr.RAMACHANDRA C G, Professor, DBM, Maturi Ventaka Subba Rao (MVSR) Engineering college,Sravanthi_mba@mvsrec.edu.in

Dr.NATHALIE JOHN,Asst.Prof, DBM, Maturi Ventaka Subba Rao (MVSR) Engineering college, sridivya_mba@mvsrec.edu.in

I. Abstract

Employee compensation has gone beyond the basic pay package that employers offer. Nowadays, employees are offered much more than just their salary slips; one such benefit is the Employee Stock Option Plan (ESOP) it is the employee benefit plan that gives the employees an ownership stake in the company which encourage employees to give their all as the company's success translates into financial rewards. ESOPs help staff to feel more appreciated and better compensated for the work they do. ***The present research paper aims at studying the concept of ESOPs, to understand the working mechanism of it and how ESOPs are considered as an Employee incentive plan.***

Key words: Employee Stock Option Plan, Employee incentive Plan, working mechanism, performance

II. Introduction

An Employee Stock Option Plan (ESOP) is an employee benefit plan that gives workers ownership interest in the company in the form of shares of stock. ESOPs give the sponsoring company the selling shareholder and participants various tax benefits, and are often used by employers as a corporate finance strategy to align the interests of their employees with those of their shareholders. Thus, ESOPs provide a great deal of flexibility for shareholder liquidity, ownership succession, and also act as an employee incentive.

III. Objectives

- To know the concept of Employee Stock Option plan
- To understand the working mechanism of Employee Stock Option plan
- To study the of Employee Stock Option Plan as an Employee incentive tool

IV. Research Methodology

The present research study is based on secondary source of data collection and is collected from books, journals and published research articles, newspapers, magazines etc.,

V. Review of Literature

MahmoodAthar (2020) in his study on “Employee Stock Option Plans: A Meta-Analysis has observed the impact of ESOPs on several organizational Parameters and several job attitudes of employees towards their organization. This study has covered all the available literature on ESOPs for over 30 year period. It is also observed that ESOPs are used as a tool in the domain of Human Resource Management and is an accepted technique to create psychological ownership for employees to gain a competitive advantage in the market.

Mrs.ShefaliRai and Ms.ManjiriMalwe (2019) have presented their study on “An Analytical Study of ESOPs of Leading Indian Companies”. This Study is conducted on Leading Indian Companies about ESOP scheme as a benefit plan for the employees that make them the owners of the stocks of the company. The Scheme acts as an important tool to reward and to retain the talent in the organization.

Sonali B. Ramchandani and Dr.HemalB.Pandya (2019) in their research article “Evaluating the Effect of ESOPs on the Financial Performance of Indian Construction & Infrastructure Companies” have mentioned that ESOPs are utilized by many competent companies all over the world to respond to the competitive pressure to increase the Company’s and employees productivity and performance by retaining the employees.

Dr.Atul Kumar, Dr.S.G.Walke, Dr.MahavirM.Shetiya (2018) conducted research on “Evaluation of ESOPs as a Reward management practice in the Indian IT Industry”. This study has revealed the popularity of ESOPs and how it is helpful especially for IT industry to recruit and retain the best employees.

Ms.RekhaRathore&Rakesh K Shukla (2015) have observed in their study on “Do ESOP Enhance Productivity Performance in Pharmaceutical Sector?: A Study of Selected Pharmaceutical Companies” that Stock option plans are useful to create a sense of ownership among the employees, to create long term wealth for the employees, to give performance linked rewards, to share the growth of the company with the employees.

VI. About ESOPs

Employers offer their employees the stock of the company at a low or no additional cost that they can encash after a specified period at a specific price. ESOP is an employee benefit plan that is uniquely positioned to use the shares of employer corporation stock to fund tax-preferred employee retirement benefits and serve as a corporate financing tool.

According to Securities Exchange Board of India ESOP/ESPS Guidelines (1999) ESOPs means the option given to the wholetime Directors, Officers or employees of a company which gives the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a predetermined price.

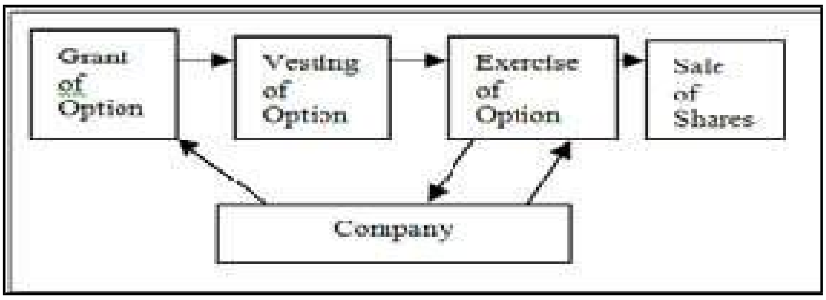
a. ESOPs Working Mechanism

Employers decide the number of shares to be offered under ESOPs, their price, and the beneficiary employees. ESOPs are then allotted to employees and a grant date is provided.

Once ESOPs are offered, they remain in a trust fund for a specific period, called the vesting period. Employees should stay with the organization for the vesting period to avail the ownership of stock by exercising the ESOP.

Once the vesting period expires, employees get the right to exercise their ESOPs. Employees can exercise their ESOPs and buy the company shares at allotted prices, which are lower than the market value. Employees can also sell the shares that they have bought through ESOPs and make a gain on their holdings.

Thus, The option can be converted to shares if the holder of the option fulfills certain conditions. These conditions are the “vesting criteria” and it is based on number of years of continued service after receiving the option, or satisfaction of some performance goals by the employee. When the vesting criteria are satisfied, the options are said to be “vested”, only then the option holder has the right to exercise the allotted shares of the company at an exercise price. The exercise price is normally determined at the time the option is granted to the employee. The option holder is not entitled to either dividend or voting rights until he exercises his option and is allotted shares.



b. Types of ESOPs

(i) Employee Stock Option Scheme:
An ESOP Scheme is a plan under which a right is given to employees covered by the plan to buy shares at a pre-determined price. The options granted under such a plan confer a right, but not an obligation, on the employee to exercise the options. Stock options are subject to vesting conditions that normally require continuous employment over a specified period. Upon vesting of options, employees can exercise the options to get shares in the company, by paying the pre-determined exercise price.

(ii) Employee Stock Purchase Plan:
An employee stock purchase plan allows employees to purchase shares directly from the company. The purchase is normally at a price which is at a discount to the fair market value at the time of the grant or exercise. Such plans set out the conditions, date and price at which the employee is entitled to purchase the shares.

(iii) Restricted Stock Award:
In a restricted stock award plan, an employee receives an award of a certain number of shares, subject to certain conditions with respect to the award. Normally, in such plans, the employee is considered the owner of the shares from the date of the award, with an entitlement to receive dividends and voting rights. The conditions for such awards normally include continued employment over a period of time, and may also be subject to performance parameters.

(iv) Phantom Equity Plan / Stock Appreciation Rights:
In a plan that is modeled as a phantom equity plan or a stock appreciation rights plan, employees are allotted notional units or shares at a pre-determined price. The strike price is not actually paid but is recorded as the strike price on the date of the grant. Upon the completion of vesting conditions, the employee is paid the cash equivalent of the net gain, if any, *i.e.*, appreciation in the price of the underlying shares without any cash investment.

c. Advantages of ESOPs

i. Benefits of ESOPs for Employees

ESOPs are beneficial for employees in the following ways:

- Stock Ownership : Employees can enjoy ownership in the company that they work for, as ESOPs give them the right to own a part of the company's share capital.
- Dividend Income : A part of the profit earned by the company is distributed among the shareholders in the form of dividends. Employees can therefore, earn additional dividend income and also get the direct benefit from the efforts that they put towards the company's profitability.
- Buy Shares at a Discounted Rate: At the time of exercising the ESOPs, employees usually pay a nominal amount to buy the shares allotted to them. This, therefore, allows them to invest in the company at a preferential rate.
- A Strategy for Attracting New Talent: ESOPs are supplemental to compensation plans that help businesses to find and keep outstanding employees. In fact, ESOPs in India help start-ups recruit top talent in the early stages of their establishment when offering greater salary packages may not be a particularly practical alternative for them.

ii. Benefits of ESOPs for Employers

ESOPs are favorable for employers too.

Employee Retention : ESOPs give employees a stake in the business, which may encourage them to work there, longer to maximise earnings. Retention of Employees is one of the purpose for which ESOPs are issued.

Better Productivity: Since employees themselves stand to gain from the profits earned by the company, ESOPs can boost employee productivity and make the company more profitable.

A Tool for Attracting Talent: ESOPs are additional compensation plans that help employers attract and retain talented employees. In fact, for start-ups, ESOPs help lure in good talent in the initial days when high pay packages are not feasible.

d. Tax Implication of ESOPs

There are dual tax implications of ESOPs:

i. When the employee exercises the right and buys the shares of the company

Employees can buy the shares after the vesting date at a rate lower than the Fair Market Value (FMV) of the share as of that date. As such, the difference between the FMV and the exercise price of the share is treated as a prerequisite in the hands of the employee and taxed at his income tax slab rate. However, in the case of start-ups, the government has relaxed the tax implications on ESOPs

ii. .When the employee sells the shares after buying them

If the employee sells the shares, the difference between the selling price of the share and the Fair Market Value on the date when the share was exercised, would be subject to capital gains tax.

Taxability from the point of view of the Employer, there has always been a general sense of ambiguity regarding the deductibility of ESOP as an expense in India. In the case of the employer, since the discount provided under ESOP is a general expense, herein the expense incurred by the employer is to be treated as allowable.

VII. ESOPs as an Incentive:

Once unheard of ESOPs in India, now they are gaining popularity rapidly, especially during the past few years. Faced with the problem of loosing and brain drain, the software industry especially has realized the importance of ESOPs to recruit and retain the best talents. Azim Premji led Wipro first brought the concept to India in the late 1980s. Infosys, the country's second largest IT services firm, was the first to offer stock options to employees when it went public in 1993.
ESOPS have become an integral part of compensation. It is the generic term for a basket of instruments and incentive schemes provided to the employees of the company to motivate, reward, remunerate and to retain the employees. Thus, the unique features of ESOPs make them distinctive compared to other employee benefit plans. Provides a cost-effective plan to motivate employees.

Most of the companies, both in India and abroad, are utilizing this scheme as an essential tool to reward and retain their employees.

Companies see this as a useful method to reward key employees to stay in the company, without monetary compensation, by granting them equity interest to share in any future growth in profits that they receive rights to when they buy stock. ESOP, to some, is an alternative method to incentivize and motivate key performers and talent. In simpler terms, private companies choose to make employees share owners through employee stock options rather than provide employees with higher salaries or other forms of monetary remuneration and capital gains.

Becoming stock owners can be more attractive than a cash reward to some workers, especially in start ups. it provides an incentive to remain in the company, upon retaining the talented workforce, the company will prosper and underlying shares will yield a good return

VIII. Conclusion

Attracting and retaining competent professionals are challenging tasks faced by many organizations. Besides cash rewards, it is important for organizations to make their employees believe that their personal growth is linked to the growth of the company. ESOPs are one of the important tools to achieve this objective. The feeling of ownership has been generally observed to have a positive impact on the employee engagement scale, especially in case of employees who are thinking of a long-term career with the organization.

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