

ESOP AND SWEAT EQUITY – CONCEPT, REGULATORY FRAMEWORK, ACCOUNTING AND TAXATION

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1.0 Introduction

1.1 Concept of ESOP and Sweat Equity

Over the years, various researches has been conducted and reported on employee ownership and its effect on the performance of the organisation for which they work. The research comes to a very definite conclusion: the combination of ownership and participative work force is a powerful competitive tool. Neither ownership nor participation alone, however, accomplishes very much. It can be said with certainty that when ownership and participative employment are combined, substantial gains result. Ownership alone and participation alone, however, have, at best, spotty or short-lived results. The best way to achieve this is granting of ESOPs.

ESOPs, “Employees Stock Ownership Plans” or "Employees Stock Options Plans" 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. These are rather modern way of motivating employees as against the age old method of compensating the employees with salaries alone. It is now an accepted practice for large entities to remunerate their employees, apart from salary, by the way of granting options to the employees to acquire the shares, hence a portion of the ownership, of the company for which they work. This is believed to motivate employees as they can closely relate their success with the success of the entity for which they work.

Over the years, the ESOP has taken various forms. ESOP when spelled as ‘Employees Stock Ownership Plans’, relates to the broad and generic meaning which covers most types of share based payments made to employees. However, ESOP as ‘Employees Stock Options Plans’ is one of the mode of share based payment and hence a classification under the generic term. In this

book we will discuss ESOP as Employees Stock Options Plans as this is most common and popular form of share based payments to employees.

1.2 History of ESOP

The employee stock option scheme (ESOS) concept was developed in the 1950s by lawyer and investment banker Louis Kelso, who argued that the capitalist system would be stronger if all workers, not just a few stockholders, could share in owning capital-producing assets. In today's world, the human capital is unarguably one of the most important resources to run any enterprise. Companies use untraditional methods of remunerating employees to retain their employees and attract new employees to their organization. Therefore, scheme like ESOS, ESPS and sweat equity has gained popularity in recent times.

1.3 Advantages and Disadvantages of ESOP

The advantage of ESOPs are many fold – it contributes to the motivation of employee, helps in retaining workforce, provides tax benefits and easier financing. ESOPs provides an incentive for the employee to remain in the company as he knows that if he does well, the company will prosper and eventually the shares will yield a higher return which will in turn benefit him. This is a multiplier effect acting in a loop as with highly motivated employees; the chances of the company doing well are extremely high which in turn motivates them more. All these lead to improved efficiency, productivity & profits. It is a win-win situation for all.

ESOPs are very useful for companies at the growing stage to attract good employees. As the high growth employers are utilizing most of the funds for sustaining the growth, they don't have many resources to distribute to the employees and hence may be considered as with low paying ability. They can then use ESOPs to retain good employees as there is no cash outlay involved for the company. Also studies shows that there is a correlation between employee ownership and stock performance. As research shows that companies which make financially significant contributions to the ESOP (at least 5% of pay per year), share corporate performance information, and get employees involved in decisions at the work level.

But ESOPs also have some demerits to handle such as the equity of the company is being diluted because of the issue of further equity shares of the company which ultimately leads to a negative effect on the Earning per Share. Also as ESOPs are a form of profit sharing plan so when these shares are provided, they are generally issued such that there is a difference between the market price and price offered. This difference is a cost to the employer which has to be adjusted. Also employees become more interested in the stocks. Another downside occurs when options of an employee becomes of considerable worth, they don't have to work anymore. There are also some employees who job hop from one start-up to another only because they are in the look out for the best deal in stock options.

1.4 Usage of ESOPs

The ESOPs at present are mostly used to buyback the share of a retiring employee and as an incentive scheme for employees. ESOPs can also be used for financing in various areas such as financing expansion, when going for acquisition, creating a new division.

The basic purpose of ESOPs for many companies is to provide employee benefits or incentives. As they believe that by increased employee participation, with them perceiving themselves as owners and more involved with the company it will lead to a positive increase in their dedication to the company, improve work effort, reduce turnover and generally bring a more harmonious atmosphere to the company. All these in turn lead to improved profitability and a win - win situation for all concerned.

In case of a retiring owner, in order to convert his paper money into actual money he has to sell the shares to someone. If he sells to some other company, the income will be taxed as ordinary income or in some special cases as capital gains. But it's difficult to buy a buyer if it's a closely held company. Also there comes an issue of loyalty as the employees don't want to sell to any outsider if it may harm their company. Here ESOP provides a market for the equity of a retiring owner—or any interested major shareholder and provide a benefit and job security for employees in the process. Retiring owners of closely held companies incur no taxable gain on a sale of stock to an ESOP, provided that the ESOP owns at least 30% of the company immediately after the sale, and that the sale's proceeds are reinvested in qualified securities within a fifteen month

period beginning 3 months before the date of the sale. This tax-deferred rollover is a most tax favored way for an owner of a closely held company to sell his or her stock.

Another use of ESOPs is for financing in the form of leveraged ESOP, where the ESOP or the company can borrow from banking or other lending institutions. In return of this loan the company guarantees to make contributions in the ESOP trust hence enabling the trust to amortize the loan. The company can also borrow directly and make a payment to trust. If the leveraging is meant to provide new capital for expansion or capital improvements, the company will use the cash to buy new shares of stock in the company. If the leveraging is being used to buy out the stock of a retiring owner, the ESOP will acquire those existing shares. If the leveraging is being used to divest a division the ESOP will buy the shares of a newly created shell company, which will in turn purchase the division and its assets. ESOP financing can also be used to make acquisitions, buy back publicly-traded stock, or for any other corporate purpose. The companies go for financing through ESOP as it provides two way tax benefits. Firstly as the ESOP contributions are tax deductible, thus the company would get the benefit of deducting interest as well as principal from taxes which in turn leads to reduced cost of financing. Another benefit is that the dividends paid on ESOP stock passed through to employees or used to repay the ESOP loan are tax deductible. ESOPs entitled to an employee can also be gifted by him to another person. But here the donor would have to pay income tax on the notional gains received. These notional gains can be calculated keeping in mind the difference between the option price and the market price when it was issued. This change was added as gifting of ESOPs was done to evade the tax on transaction, but now it has to be paid. Now even if the individual to whom the ESOPs were gifted sells the shares he would then have to pay the capital gains tax.

Importantly the company should invest in ESOPs as the employees are the intellectual capital of the company. Nowadays more and more employees want share of stock in the company. As the employees are the ones who are going to come up with the ideas leading to new innovations in terms of both product and service leading to improved productivity of the company. Also employees have the industry - specific knowledge a company needs to keep changing and growing and creating value. So it's a good practice to compensate people for their intellectual inputs to the company, just as the company would compensate people for contributing financial

capital. At present ESOPs are mostly being offered as an addendum to the salary package. So because of its advantages many employees are opting for it but if it constitutes a significant portion of their salary as is the trend in US then they need to properly evaluate its pros and cons.

1.5 Different Kinds of ESOP

ESOP can be a one-time plan or an ongoing scheme depending upon the objectives that the company wants to achieve. ESOPs can be in the form of ESOS (Employee Stock Option Schemes), ESPP (Employee Stock Purchase Plans), Compensation Plans, Incentive Plans, SAR/Phantom ESOPs etc.

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.

1.6 Sweat Equity

Sweat Equity Shares mean equity shares issued by the company to its directors and / or employees at a discount or for consideration other than cash for providing know how or making

available the rights in the nature of intellectual property rights or value additions. In other words, it refers to equity shares given to the company's employees on favourable terms, in recognition of their work. The issue of sweat equity allows the company to retain the employees by rewarding them for their services. Sweat equity rewards the beneficiaries by giving them incentives in lieu of their contribution towards the development of the company. Further, it enables greater employee stake and interest in the growth of an organization as it encourages the employees to contribute more towards the company in which they feel they have a stake.

1.7 ESOP vs. Sweat Equity

Some of the significant differences between the two are:

- Sweat Equity is grant of shares at discount or without monetary considerations whereas ESOP/ESOS is grant of option to purchase share at predetermined price given to employees.
- Sweat Equity can be issued to the promoters of the Company whereas ESOS/ESOP cannot be issued to the promoters or promoter group
- Minimum lock in period of 3 years for Sweat Equity whereas no such lock in period for ESOP and lock in period of 1 year for ESOS.

2.0 Regulatory Framework in India

Government has time and again come with certain laws, rules and clarifications to govern the use of such schemes

2.1 Regulatory Framework in India:

(a) Companies Act, 1956:

As per section 2(15A) of Companies Act, 1956, 'employees stock option' means option given to the whole time directors, officers or employees of a company, which give them the benefit or right to purchase or subscribe at future date, the securities offered by the company at predetermined price.

Further, as per section 79A, a company may issue sweat equity shares of a class of shares already issued, if following conditions are fulfilled:

- the issue of sweat equity shares is authorized by a special resolution passed by company in general meeting
- the resolution specifies the number of shares, current market price, consideration, if any, and the classes of directors or employees to whom such shares are issued
- on date of issue at least one year elapsed since the date on which company was entitled to commence the business
- for companies whose shares are listed in recognized stock exchange, it should be in accordance with regulation made by SEBI
- for other companies, in accordance with prescribed guidelines

- (b) Securities and Exchange Board of India (employee Stock Option Scheme and Employee Stock Purchase Scheme) guidelines, 1999:

The companies whose shares are listed in any recognized stock exchange in India may issue equity shares under the scheme of ESOS or ESPS in accordance with these guidelines. This guideline has been amended in 2004, 2008 and 2009. These guidelines are dealt with at length in subsequent chapters.

- (c) Securities and Exchange Board of India (Issue of Sweat Equity) Regulation, 2002:

The companies whose shares are listed in any recognized stock exchange in India shall follow this regulation for issue of sweat equity shares.

- (d) Employee Stock Option Scheme and Employee Stock Purchase Scheme Rules, 2002

These rules have been notified by Central Government. These Rules shall apply to any company which grants employees stock options either under a scheme or otherwise.

- (e) Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003:

These Rules shall be applicable to issue of sweat equity shares by all unlisted companies.

- (f) Guidance Note (A) 18 (issued 2005)

This is a guidance note on Accounting for Employee Share Based Payments. It establishes financial accounting and reporting principles for employees share based payments plan like ESOS, ESPS and stock appreciation rights.

(g) IFRS 2 and SFAS 123

Internationally, the accounting aspects are covered by these statements issued by International Accounting Standard Board and Financial Accounting Standard Board respectively. These standards deals with all types of share based payments including payments made to employees.

(h) Income Tax Act, 1961

Income Tax Act deals with the taxation aspects. Prior to amendments made by Finance Act 2009, ESOP was under the ambit of FBT. However, now it has been made taxable in the hands of employees as perquisites. The details have been dealt in the chapter pertaining to Taxation of ESOP.

2.2 An understanding of the Terminology used

- *Asset* means a resource controlled by the company and from which future economic benefits are expected to flow to the company.
- *Associate* includes a person,
 - who directly or indirectly by himself or in combination with relatives, exercise control over the company; or,
 - whose employee, officer or director is also a director, officer or employee of the company;
- *Control* shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders or voting agreements or in any other manner.
- *Company* means a company as defined in Companies Act, 1956.

- *Director* means, a director as defined in sub-section (13) of section 2 of the Companies Act, 1956.
- *Employee* means
 - a permanent employee of the company working in India or out of India; or
 - a director of the company, whether a whole time director or not; or
- An employee as defined in sub-clauses (a) or (b) of a subsidiary, in India or out of India, or of a holding company of the company.
- *Employee compensation* means the total cost incurred by the company towards employee compensation including basic salary, dearness allowance, other allowances, bonus and commissions including the value of all perquisites provided, but does not include:
 - the fair value of the option granted under an Employee Stock Option Scheme; and
 - The discount at which shares are issued under an Employee Stock Purchase Scheme.
- *Employee Stock Option* is a contract that gives the employees of the enterprise the right, but not the obligation, for a specified period of time to purchase or subscribe to the shares of the enterprise at a fixed or determinable price. [as per ICAI GN A (18)]
- *Employee stock option* means the 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. [as per SEBI (ESOS and ESPS) Guidelines, 1999]
- *Employee Stock Option Plan/ Scheme* are a plan/scheme under which the enterprise grants Employee Stock Options.
- *Employee Stock Purchase Plan/ Scheme* is a plan/scheme under which the enterprise offers shares to its employees as part of a public issue or otherwise.
- *ESOS shares* means shares arising out of exercise of options granted under ESOS.
- *ESPS shares* means shares arising out of grant of shares under ESPS.
- *Equity* is the residual interest in the assets of an enterprise after deducting all its liabilities.
- *Exercise* means making of an application by the employee to the enterprise for issue of shares against the option vested in him in pursuance of the Employee Stock Option Plan.

- *Exercise Period* is the time period after vesting within which the employee should exercise his right to apply for shares against the option vested in him in pursuance of the Employee Stock Option Plan.
- *Expected Life of an Option* is the period of time from grant date to the date on which an option is expected to be exercised.
- *Exercise Price* is the price payable by the employee for exercising the option granted to him in pursuance of the Employee Stock Option Plan.
- *Fair Value* is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm's length transaction.
- *Grant* means issue of option to employees under ESOS
- *Grant Date* is the date at which the enterprise and its employees agree to the terms of an employee share-based payment plan. At grant date, the enterprise confers on the employees the right to cash or shares of the enterprise, provided the specified vesting conditions, if any, is met. If that agreement is subject to an approval process, (for example, by shareholders), grant date is the date when that approval is obtained.
- *Independent director* means a director of the company, not being a whole time director and who is neither a promoter nor belongs to the promoter group
- *Insider* means an insider as defined in clause (e) of regulation 2 of Securities and Exchange Board of India (Insider Trading) Regulations, 1992
- *Intangible Asset* means an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes
- *Intrinsic Value* is the amount by which the quoted market price of the underlying share in case of a listed enterprise or the value of the underlying share determined by an independent valuer in case of an unlisted enterprise exceeds the exercise price of an option.
- *Market Condition* is a condition upon which the exercise price, vesting or exercisability of a share or a stock option depends that is related to the market price of the shares of the enterprise, such as attaining a specified share price or a specified amount of intrinsic

value of a stock option, or achieving a specified target that is based on the market price of the shares of the enterprise relative to an index of market prices of shares of other enterprises.

- *Market Price* means the latest available closing price, prior to the date of the meeting of the Board of Directors in which options are granted/ shares are issued, on the stock exchange on which the shares of the company are listed. If the shares are listed on more than one stock exchange, then the stock exchange where there is highest trading volume on the said date shall be considered.
- *Merchant Banker* means a merchant banker registered under Section 12 of the Act;
- *Option Grantee* means an employee having right but not an obligation to exercise in pursuance of the ESOS
- *Promoter* means;
 - the person or persons who are in over-all control of the company;
 - the person or persons who are instrumental in the formation of the company or programme pursuant to which the shares were offered to the public;
 - the persons or persons named in the offer document as promoter(s). Provided that a director or officer of the company if they are acting as such only in their professional capacity will not be deemed to be a promoter.

Explanation: Where a promoter of a company is a body corporate, the promoters of that body corporate shall also be deemed to be promoters of the company.

- *Promoter Group* means
 - an immediate relative of the promoter (i.e. spouse of that person, or any parent, brother, sister or child of the person or of the spouse);
 - Persons whose shareholding is aggregated for the purpose of disclosing in the offer document "shareholding of the promoter group".
- *Recognised Stock Exchange* means a stock exchange which has been granted recognition under Section 4 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956)
- *Reload Feature* is a feature that provides for an automatic grant of additional stock options whenever the option holder exercises previously granted options using the shares of the enterprise, rather than cash, to satisfy the exercise price.

- *Reload Option* is a new stock option granted when a share of the enterprise is used to satisfy the exercise price of a previous stock option.
- *Repricing* of an employee stock option means changing the existing exercise price of the option to a different price.
- *Share* means equity shares and securities convertible into equity shares and shall include American Depository Receipts (ADRs), Global Depository Receipts (GDRs) or other depository receipts representing underlying equity shares or securities convertible into equity shares
- *Stock Appreciation Rights* are the rights that entitle the employees to receive cash or shares for an amount equivalent to any excess of the market value of a stated number of enterprise's shares over a stated price. The form of payment may be specified when the rights are granted or may be determined when they are exercised; in some plans, the employee may choose the form of payment.
- *Share price* means price of a share on a given date arrived on the net worth basis.
- *Value addition* means anticipated economic benefits derived by the enterprise from expert and/or professional for providing know-how or making available rights in the nature of intellectual property rights, by such person to whom sweat equity is issued for which the consideration is not paid or included in -
 - the normal remuneration payable under the contract of employment, in the case of an employee and/or
 - monetary consideration payable under any other contract, in the case of non-employee
- *Vest* is to become entitled to receive cash or shares on satisfaction of any specified vesting conditions under an employee share-based payment plan.
- *Vesting* means the process by which the employee is given the right to apply for shares of the company against the option granted to him in pursuance of ESOS.
- *Vesting Period* is the period between the grant date and the date on which all the specified vesting conditions of an employee share-based payment plan are to be satisfied.
- *Vesting Conditions* are the conditions that must be satisfied for the employee to become entitled to receive cash, or shares of the enterprise, pursuant to an employee share-based payment plan. Vesting conditions include service conditions, which require the employee

to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the enterprise's share price over a specified period of time).

- *Volatility* is a measure of the amount by which a price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period.
- *Valuer* means a Chartered Accountant or a merchant banker appointed to determine the value of the intellectual property rights or other value addition

2.3 SEBI Guidelines on ESOP

1. Introduction

Security and Exchange Board of India issued Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme), Guidelines, 1999 under section 11 of the Securities and Exchange Board of India Act, 1992 to provide guidance as to granting options or shares to employees under ESOS or ESPS by listed companies.

These guidelines are contained in two parts. Part one deals with Employee Stock Option Scheme [ESOS] which is other name for Employee Stock Option Plan. Part two deals with Employee Stock Purchase Scheme [ESPS].

2. Applicability

As per the clause 3 of the guidelines, these guidelines apply to any company whose shares are listed in a recognised stock exchange. An unlisted company in process of listing may also grant options or shares after the unlisted company makes initial public offering and after its shares are listed subject to fulfilment of certain requirements stated in clause 22 of the guidelines.

3. Non Applicability

The SEBI Guidelines are not applicable to the following ESOP Schemes: -

- ESOP structured by unlisted Companies.
- Share issued by the company to the Trust under ESOP by listed companies prior to 19th June 1999.
- ESOP structured by companies not listed in India.

4. Eligibility

As per the clause 4 of the guidelines an employee is eligible to participate in the ESOS. As per clause 2.1.1 of the guidelines the following persons are covered in the definition of employee

- Permanent Employees in India or abroad
- Whole-time Director
- Other Director
- All of above of subsidiary or holding company in India or abroad.

However, in case an employee is a director nominated by an institution, certain conditions has been added vide circular no. SEBI/CFD/DIL/ESOP/4/2008/04/08 dated August 4, 2008, w. e. f. August 4, 2008 as an explanation to clause 4. This explanation states that where such employee is a director nominated by an institution as its representative on the Board of Directors of the company –

- (i) the contract/ agreement entered into between the institution nominating its employee as the director of a company and the director so appointed shall, inter-alia, specify the following:
 - (a) whether options granted by the company under its ESOS can be accepted by the said employee in his capacity as director of the company;
 - (b) that options, if granted to the director, shall not be renounced in favour of the nominating institution; and
 - (c) The conditions subject to which fees, commissions, ESOSs, other incentives, etc. can be accepted by the director from the company.
- (ii) The institution nominating its employee as a director of a company shall file a copy of the contract/ agreement with the said company, which shall, in turn, file the copy with all the stock exchanges on which its shares are listed.
- (iii) the director so appointed shall furnish a copy of the contract/ agreement at the first Board meeting of the company attended by him after his nomination

5. Non Eligibility

As per clause 4.2 and 4.3 the following persons are not eligible to participate in the scheme of ESOS

- Promoter

- An employee who is a promoter or belongs to promoter group
- A director who either by himself or through his relative or through any body corporate, directly or indirectly holds more than 10% of the outstanding equity shares of the company

The term promoter has been defined in the clause 2.1.12 to mean:

- the person or persons who are in over-all control of the company;
- the person or persons who are instrumental in the formation of the company or programme pursuant to which the shares were offered to the public;
- The persons or persons named in the offer document as promoter(s). Provided that a director or officer of the company if they are acting as such only in their professional capacity will not be deemed to be a promoter.

Moreover, where a promoter of a company is a body corporate, the promoters of that body corporate shall also be deemed to be promoters of the company.

The term promoter group has also been defined in clause 2.1.13. Accordingly,

"Promoter group" means

- an immediate relative of the promoter (i.e. spouse of that person, or any parent, brother, sister or child of the person or of the spouse);
- Persons whose shareholding is aggregated for the purpose of disclosing in the offer document "shareholding of the promoter group".

6. **Meaning of Employee Stock Option Scheme**

As per the clause 2.1.3, "employee stock option scheme (ESOS)" means a scheme under which a company grants employee stock option. At the same time as per clause 2.1. 2A "employee stock option" means the 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

The term securities have not been defined in the guidelines. However as per clause 2.1.14 "share" means equity shares and securities convertible into equity shares and shall include

American Depositary Receipts (ADRs), Global Depositary Receipts (GDRs) or other depository receipts representing underlying equity shares or securities convertible into equity shares.

7. Constitution of Compensation Committee

The first point of introduction of ESOS is constitution of Compensation Committee as clause 5 of the guidelines specifically requires that no ESOS can be offered unless the disclosures, as specified in Schedule IV {herein after referred to as disclosure document}, are made by the company to the prospective option grantees and the company constitutes a Compensation Committee for administration and superintendence of the ESOS. For this a meeting of Board of Directors is required to be convened in which a committee of Directors majority of whom are independent directors is constituted. The term independent director has been defined in the clause 2.9 as a director of the company, not being a whole time director and who is neither a promoter nor belongs to the promoter group.

Key Responsibilities of the Compensation Committee

The key responsibilities of the ESOP Compensation Committee include the following:

- To formulate ESOP plans and decide on future grants: The Compensation Committee will decide the overall plan of ESOP. This has to be done with due care and has to be such that it is acceptable to employees, management and shareholders.
- To identify the employees eligible to participate in the scheme of ESOS: The CC will have to identify the employees to whom the options would be granted. These employees however, need to eligible employees as per the guidelines. Therefore, care should be taken to ensure that no grants are made to temporary employees, promoters or person belonging to promoter group, or a director who either by himself or through his relative or through any body corporate, directly or indirectly holds more than 10% of the outstanding equity shares of the company. Moreover, they will also decide if the grants should also be made to the employees of holding or subsidiary company.
- To decide the quantum of option to be granted under ESOP Scheme(s) per employee and in aggregate. SEBI guidelines do not prescribe any restriction on quantum of shares that can be allotted to each employee or on aggregate basis. However, grant of option to identified

employees, during any one year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option requires approval of shareholders by way of separate resolution in the general meeting as per clause 6.3. Moreover, as per the Rules notified by central government the cumulative grant of options to employees by a company shall not exceed 15% of the issued capital of the company or 5 crores of rupees whichever is higher at any point of time except with the prior approval of the Central Government.

- To formulate terms and conditions on followings under Employee Stock Option Schemes of the Company
 - i. the conditions under which option vested in employees may lapse in case of termination of employment for misconduct;
 - ii. the exercise period within which the employee should exercise the option and that option would lapse on failure to exercise the option within the exercise period;
 - iii. the specified time period within which the employee shall exercise the vested options in the event of termination or resignation of an employee;
 - iv. the right of an employee to exercise all the options vested in him at one time or at various points of time within the exercise period;
 - v. the procedure for making a fair and reasonable adjustment to the number of options and to the exercise price in case of rights issues, bonus issues and other corporate actions;
 - vi. the grant, vest and exercise of option in case of employees who are on long leave; and
 - vii. The procedure for cashless exercise of options.
 - viii. Any other matter, which may be relevant for administration of ESOP Schemes from time to time
- To frame suitable policies and systems to ensure that there is no violation of Securities and Exchange Board of India (Insider Trading) Regulations, 1992 and Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 1995, Companies Act, 1956.
- Other key issues as may be referred by the board.

8. **Approval of the Shareholders**

No public company shall offer ESOS to its employees unless the shareholders of the company approve ESOS by passing a special resolution in the general meeting.

In fact before an ESOP is implemented, three approvals are at least required and those are from Board of Directors, Compensation committee and Share holders. Moreover, the approval of shareholders are also required in any variation is sought to be made in already approved scheme and where any employee of holding or subsidiary company is granted the options under the scheme or where the grant of option to identified employees, during any one year, equal to or exceeding 1% of the issued capital of the company.

The explanatory statement to the notice for approval of an ESOS under section 173 of the Companies Act, 1956 must contain the detailed information regarding:

- (i) The total number of options to be granted;
- (ii) Identification of classes of employees entitled to participate in the ESOS;
- (iii) Requirements of vesting and period of vesting;
- (iv) Maximum period within which the options shall be exercised;
- (v) Exercise price or pricing formula;
- (vi) The appraisal process for determining the eligibility of employees to the ESOS;
- (vii) Maximum number of options to be issued per employee, etc.
- (viii) a statement to the effect that the company shall conform to the accounting policies specified in clause 13.1;
- (ix) the method which the company shall use to value its options whether fair value or intrinsic value;
- (x) the following statement:
- (xi) 'In case the company calculates the employee compensation cost using the intrinsic value of the stock options, the difference between the employee compensation cost so computed and the employee compensation cost that shall have been recognized if it had used the fair value of the options, shall be disclosed in the Directors report and also

the impact of this difference on profits and on EPS of the company shall also be disclosed in the Directors' report.

The notices for this meeting are generally given only after the compensation committee has prepared a draft scheme for approval of shareholders. This special resolution is also necessary to comply with the provisions of the section 81(1A) of the Companies Act, 1956.

Besides, the above approval, clause 6.3 of the guidelines also require a separate approval of shareholders in case the options are granted to employees of subsidiary or holding company and, where the grant of option to identified employees, during any one year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option.

9. **Pricing ESOS**

Before getting into the details of regulations regarding the pricing of ESOP let us first understand a few terms associated with ESOS pricing as defined in the clause 2 of the guidelines.

- **Exercise Price:** "Exercise price" means the price payable by the employee for exercising the option granted to him in pursuance of ESOS.
- **Market Price:** "market price" means the latest available closing price, prior to the date of the meeting of the Board of Directors in which options are granted/ shares are issued, on the stock exchange on which the shares of the company are listed. If the shares are listed on more than one stock exchange, then the stock exchange where there is highest trading volume on the said date shall be considered
- **Fair Value:** "fair value" of an option means the fair value calculated in accordance with Schedule III. [it is dealt in details later]
- **Intrinsic Value:** "intrinsic value" means the excess of the market price of the share under ESOS over the exercise price of the option (including up-front payment, if any).

Companies are free to determine the exercise price payable by an employee to whom options are granted under the ESOS. However companies should adhere to the accounting policies as stated in the clause 13.1 and Schedule I. As per this schedule in respect of options granted during any accounting period, the accounting value of the options shall be treated as another form of employee compensation in the financial statements of the company. The schedule also provides two options of calculating the accounting value viz. intrinsic value and Fair Value.

10. Vesting and Vesting Conditions

Under ESOS, generally, employees are given option to purchase stocks of company at reduced price, the act of giving option is called grant of option. However, these options may not be available immediately. Often the rights under the scheme of ESOS are conditional. Fulfilment of such condition is called vesting. As per clause 2.1 (15) "vesting" means the process by which the employee is given the right to apply for shares of the company against the option granted to him in pursuance of ESOS.

Vesting conditions need to be satisfied by the employee in order to be entitled to receive the shares or cash as the case may be depending on the type of plan. Vesting conditions can be classified into:

- a) Service Conditions – these require the employee to complete a specified period of service for the options to vest.
- b) Performance conditions – these require the fulfillment of certain performance parameters individual or company specific, for the options to vest.

11. Allotment and lock in Period

The whole process of making the shares of the company available to the eligible employees of the company under the scheme of ESOS can virtually be divided into 5 phases viz.

- Grant period
- Vesting Period
- Exercise Period

- Allotment Date
- Lock in Period

Expected Life of an Option is the period of time from grant date to the date on which an option is expected to be exercised. In other words it is time between the grant date and allotment date.

Grant is the issue of option to employees under ESOS. *Grant Date* is the date at which the enterprise and its employees agree to the terms of an employee share-based payment plan. At grant date, the enterprise confers on the employees the right to cash or shares of the enterprise, provided the specified vesting conditions, if any, is met. If that agreement is subject to an approval process, (for example, by shareholders), grant date is the date when that approval is obtained. Some nominal amount of the value of the shares may be collected from the employees at the time of grant as up-front payment.

Vesting Period is the period between the grant date and the date on which all the specified vesting conditions of an employee share-based payment plan are to be satisfied. Clause 9.1 Of the SEBI guidelines prescribe a minimum period of one year between the grant of options and vesting of option. However, it is also provided that in a case where options are granted by a company under an ESOS in lieu of options held by the same person under an ESOS in another company which has merged or amalgamated with the first mentioned company, the period during which the options granted by the transferor company were held by him shall be adjusted against the minimum vesting period of one year as required by the guidelines.

Exercise Period is the time period after vesting within which the employee should exercise his right to apply for shares against the option vested in him in pursuance of the Employee Stock Option Scheme. If the employees does not exercise his rights during this period the option lapses. Amount, if any paid by the employee at the time of grant of option is either forfeited by the company if the option is not exercised by the employee within the exercise period or refunded to the employee if the option is not vested due to non-fulfilment of condition relating to vesting of option as per the ESOS.

Allotment Date is the date after the exercise of option by the employee when company finally allots the share to the employees of the company at a predetermined price. At this date the employee pays the balance amount payable by him. The employee does not have right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to him, till shares are issued on exercise of option on the allotment date.

Lock in Period is the period during which the employees of the cannot sell or transfer the rights in the shares which have been allotted to him under the ESOS. The guidelines do not prescribe any lock in period. Therefore, the companies' has their own freedom to fix their own restriction to transfer of the shares by the employees after the shares have been allotted to them under ESOS. However, prior to omission of the clause 22.5 vide circular no. SEBI/CFD/DIL/ESOP/5/2009/03/09 dated September 3, 2009, *the ESOS / ESPS shares held by the promoters prior to Initial Public offering was subjected to lock-in as per the provisions of SEBI (Disclosure and Investor Protection) Guidelines, 2000* .

12. Role of Board of Directors

The Board of Directors (BOD) of the company granting shares to its employees under ESOS plays a very important role in successful formation, implementation and conclusion of the scheme. They perform following essential functions

- They convene a meeting and constitute a compensation committee, majority of who are independent directors, for successful implementation of the scheme.
- Before grant of option under ESOS, the BOD shall have to ensure that the employees are informed about the following through ESOS document or separate document:
 - Business of the company which includes history, main business and present business.
 - Abridged financial information for five years preceding the date of finalisation of ESOS.

- Last audited account of the company
- Management perception of the risk factor
- The BOD of company introducing the scheme for the first time must appoint a registered merchant banker for implementation of ESOS/ESPS as per the SEBI guidelines.
- Allotment of the shares in consultation of merchant banker to employees who have properly exercised the options.
- BOD should file return of allotment with the registrar of the Company
- The BOD have to ensure that disclosures regarding ESOS as stipulated in the SEBI guidelines are mentioned in the directors report for the Annual Report to be sent to shareholders.
- They should place before shareholders at each AGM a certificate from Auditors of the company certifying that the scheme has been implemented as per the SEBI guidelines and as per the resolution of the company as passed in general meeting
- BOD will have to ensure that the copies of notices, explanatory statements, circulars, annual Director's Report, annual accounts, etc. That are sent to members are also sent to the grantees under the ESOS as a measure of continuous disclosures.
- BOD should ensure that the company should file the ESOS/ESPS through Electronic Data Information Filing and Retrieval System (EDIFAR)
- BOD should ensure that until all options granted in the three years prior to the IPO have been exercised or have lapsed, disclosures is made either in the Directors' Report or in an Annexure thereto of the information specified in SEBI guidelines in respect of such options also.
- BOD should also ensure that until all options granted in the three years prior to the IPO have been exercised or have lapsed, disclosure is to be made either in the

Directors' Report or in an Annexure thereto of the impact on the profits and on the EPS of the company if the company had followed the accounting policies specified in SEBI guidelines.

- BOS will have to ensure that the company follows the accounting policies as specified in the guidelines

13. Modification of terms

We come across several companies who are actively thinking on re-pricing or modifying the terms of their underwater options. As per clause 5 of regulation 7 a company may reprice the options which are not exercised, whether or not they have been vested if ESOSs were rendered unattractive due to fall in the price of the shares in the market. However, the company must ensure that

- such repricing should not be detrimental to the interest of employees and
- Approval of shareholders in General Meeting has been obtained for such re-pricing.

14. Non Transferability of Options

Option granted to an employee shall not be transferable to any person as they are in nature of personal benefits and no person other than the employee to whom the option is granted shall be entitled to exercise the option. Under the cashless system of exercise, the company may itself fund or permit the empanelled stock brokers to fund the payment of exercise price which shall be adjusted against the sale proceeds of some or all the shares, subject to the provision of the Companies Act.

The option granted to the employee shall not be pledged, hypothecated, mortgaged or otherwise alienated in any other manner. In the event of the death of employee while in employment, all the option granted to him till such date shall vest in the legal heirs or nominees of the deceased employee. In case the employee suffers a permanent incapacity while in employment, all the option granted to him as on the date of permanent incapacitation, shall vest in him on that day. In the event of resignation or termination of the employee, all options not vested as on that day shall expire. However, the employee shall, be entitled to retain all the vested options.

The options granted to a director, who is an employee of an institution and has been nominated by the said institution, shall not be renounced in favour of the institution nominating him

2.4 SEBI Guidelines on Employees Stock Purchase Scheme

Employee Stock Purchase Plan (ESPP) means a plan under which the company offers shares to employees as part of a public issue or otherwise. In India ESPS are not as popular as ESOP. The Security and Exchange Board of India (Employees Share Option Scheme and Employees Share Purchase Scheme) Guidelines, 1999 regulates the grant of ESPS by the listed companies to its Employees under the scheme.

Under the scheme of ESPS, employees are outright given stocks of the entity at discounted price. Unlike ESOS, there is no option in this case. As in case of ESOS, all permanent employees, whole time or executive directors and employees of holding or subsidiary company of the entity are eligible to participate in the scheme ESPS. Only promoters, person belonging to promoter group and a director who either by himself or through his relative or through a body corporate, directly or indirectly holds more than 10% of voting rights in the company shall not be eligible to participate in the ESPS. ESPS can be offered to employees only after the approval of shareholders of the company by passing special resolution in the meeting of the general body of the shareholders. The explanatory statement to the notice specify the price of the shares and the number of shares to be offered to each employee and the appraisal process for determining the eligibility of employee for ESPS. The number of shares offered may be different for different categories of employees. Company can fix the price and lock in period. But listed companies would be required to have minimum lock in period of 1 year. Moreover, as per central government rules, the company shall ensure that in the case of Directors, CEO, CFO and any employee to whom a cumulative ESPS issue of 1% or more of the issued capital has been made, a minimum period of two years should elapse between the date of issue of shares under ESPS and the date of sale of these shares. Detailed disclosures are required in the director's report.

2.5 Sweat equity and Companies Act, 1956

Issue of sweat equity shares is governed by the provisions of S. 79A of the Companies Act. Explanation II to the said Section defines the expression 'sweat equity shares' to mean equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing the know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called. It is, therefore, necessary for the issue of sweat equity shares that the concerned employee either provides the know-how, intellectual property rights or other value additions to the company.

In terms of the said Section, a company may issue sweat equity shares of a class of shares already issued, if the following conditions are satisfied:

- (a) Such issue is authorised by a special resolution of the company in the general meeting;
- (b) such resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of the directors or employees to whom such shares are to be issued;
- (c) Such issue is after expiry of one year from the date on which the company was entitled to commence business; and
- (d) In the case of an unlisted company, such shares are issued in accordance with the prescribed guidelines.

2.6 Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003

The guidelines referred to in S. 79A are the Rules issued by the Central Government, which need to be followed by unlisted companies. The Rules *inter alia* provide the procedure to be followed by a company issuing sweat equity shares for consideration other than cash.

Rule 9 of the Rules provides that where a company proposes to issue sweat equity shares for consideration other than cash, it shall comply with the following:

- (a) The valuation of the intellectual property or of the know-how provided or other value addition to consideration at which sweat equity capital is issued, shall be carried out by a valuer;
- (b) The valuer shall consult such experts, as he may deem fit, having regard to the nature of the industry and the nature of the property or the value addition;
- (c) The valuer shall submit a valuation report to the company giving justification for the valuation;
- (d) A copy of the valuation report of the valuer must be sent to the shareholders with the notice of the general meeting;
- (e) the company shall give justification for issue of sweat equity shares for consideration other than cash, which shall form part of the notice sent for the general meeting; and
- (f) The amount of sweat equity shares issued shall be treated as part of managerial remuneration for the purposes of S. 198, S. 309, S. 310, S. 311 and S. 387 of the Act, if the following conditions are fulfilled:
 - (i) the sweat equity shares are issued to any director or manager;
 - (ii) They are issued for non-cash consideration, which does not take the form of an asset which can be carried to the balance sheet of the company, in accordance with the relevant accounting standards.

Rule 8 of the Rules prescribes that the issue of sweat equity shares to employees and directors shall be at a fair price calculated by an independent valuer.

Rule 2(v) of the Rules defines the expression 'value addition'. The said Rule reads as under:

"(v) 'value addition' means anticipated economic benefits derived by the enterprise from an expert and/or professional for providing the know-how or making available rights in the nature of intellectual property rights, by such person to whom sweat equity is issued for which the consideration is not paid or included in :

(a) The normal remuneration payable under the contract of employment, in the case of an employee, and/or

(b) Monetary consideration payable under any other contract, in the case of non-employee"

The term 'know-how' is not restricted to technical know-how but can extend to practical knowledge, skill and expertise. Hence, imparting practical knowledge to the company would be considered as value addition.

Quantum of Sweat Equity

Rule 6 of the Rules restricts the issue of sweat equity shares in a year to 15% of the total paid-up equity share capital or shares of a value up to Rs.5,00,00,000/- (Rupees five crores only), whichever is higher. If this limit is to be exceeded, the same is required to be done with the prior approval of the Central Government.

Procedure for issue of Sweat Equity

For issue of sweat equity shares, the following broad procedure needs to be followed :

(i) Convene and hold a board meeting to consider the proposal of issue of sweat equity shares and to fix up the date, time, place and agenda for general meeting and to pass a special resolution for the same. As per clause 4(2) approval of shareholders by way of separate resolution in the general meeting should also be obtained by the company in case of grant of shares to identified employees and promoters, during any one year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversion) of the company at the time of grant of the sweat equity shares

(ii) Issue notices in writing for general meeting with suitable explanatory statement containing the particulars required as per Rule 4 of the Rules. The explanatory statement to be annexed to the notice for the general meeting pursuant to section 173 of the said Act must contain particulars as specified below.

- the date of the meeting at which the proposal for issue of sweat equity shares was approved by the Board of Directors of the company;
- the reasons/justification for the issue;
- the number of shares, consideration for such shares and the class or classes of persons to whom such equity shares are to be issued;
- the value of the sweat equity shares alongwith valuation report/ basis of valuation and the price at the which the sweat equity shares will be issued;
- the names of persons to whom the equity will be issued and the person's relationship with the company;
- ceiling on managerial remuneration, if any, which will be affected by issuance of such equity;
- a statement to the effect that the company shall conform to the accounting policies specified by the Central Government; and
- diluted earning per share pursuant to the issue of securities to be calculated in accordance with the Accounting Standards specified by the Institute of Chartered Accountants of India.

(iii) Pass a special resolution; and

(iv) Allot sweat equity shares.

Disclosures

Disclosure in the Directors' Report-

The Board of Directors should disclose either in the Directors' Report or in the annexure to the Director's Report, the following details of issue of sweat equity shares:-

- (a) Number of shares to be issued to the employees or the directors;
- (b) conditions for issue of sweat equity shares;
- (c) the pricing formula;
- (d) the total number of shares arising as a result of issue of sweat equity shares;

- (e) money realised or benefit accrued to the company from the issue of sweat equity shares;
- (f) diluted Earnings Per Share (EPS) pursuant to issuance of sweat equity shares.

Other requirements

- Sweat equity shares issued to employees or directors shall be locked in for a period of three years from the date of allotment.
- In the case of every company that has allotted shares under these Rules, the Board of Directors should at each annual general meeting place before the shareholders a certificate from the auditors of the company/ practising company secretary that sweat equity shares have been allotted in accordance with the resolution of the company in the general meeting and these Rules

2.7 SEBI (Issue of Sweat Equity) Regulations, 2002

The Companies whose shares are listed in any of the recognised stock exchanges in India must follow the Security and Exchange Board of India (issue of Sweat equity) Regulations, 2002 over and above the requirements of Companies Act, 1956. The important provisions of the said regulation are discussed below.

Procedure for issuance of sweat equity

The Act specifies a limitation for the issue of sweat equity. A listed company which is a public company can commence business only after the Registrar of Companies issues a certificate to commence business and sweat equity can be issued only after one year from the date of commencement of business.

Eligible Employees

Sweat equity can be issued to either an employee or a director of the company. Employee means a permanent employee of the company working in India or abroad or a director of the company whether a whole-time director or not. Therefore, the definition of the employee does not change even if he relocates to a foreign country. Further, director means any person holding the post of director, by whatever name called.

Issue of Sweat Equity at Discount

If the issue is at a discounted price, there is no need to seek recourse to the other provisions of the Act. This saves the company from taking approvals from the Central Government and the company can initiate the process on its own. The company can give discount of any amount as it deems fit.

Shareholders' Approval

The sweat equity can be issued pursuant to a special resolution passed by the company in a shareholders meeting, either an Annual General meeting (AGM) or an Extraordinary General Meeting (“EGM”). Before the shareholders meeting the board of directors should approve the proposal for the issuance of sweat equity. The board should send a notice to the shareholders in regard to conducting the AGM/EGM. An explanatory statement must be annexed to the notice which should clearly specify all the material facts concerning items, in respect of which the AGM/ EGM has been called. The special resolution passed in the AGM/EGM should specify the following:

- i. the number of the equity shares to be issued,
- ii. current market price,
- iii. consideration, if any; payable by the allottee and
- iv. the class of the employees or directors or employees to whom the shares are proposed to be issued.

After the special resolution is passed the company can proceed with the process of issuing the sweat equity.

Issue of Sweat Equity to Promoters

The Regulations prescribe different procedures for the issue of the sweat equity in case of promoters may be because the promoters with their relatives, associates hold majority of shares. If the issue is in favor of the promoters then an ordinary resolution of the shareholders in the AGM/EGM is sufficient. In order to pass the resolution, voting by postal ballot is required which is governed by the (Passing of the resolution by Postal Ballot) Rules, 2001 (“the Postal Rules”).

The postal ballot includes voting by postal or electronic mode instead of voting personally. The notice for postal ballot can be by:

- a registered post acknowledgement due; or
- certificate of posting and with an advertisement stating that the ballot papers are dispatched,
- Published in a leading English newspaper and in one vernacular newspaper circulated in the state in which the registered office of the company is situated.

The procedure for the passing of resolution by postal ballot for the issue of sweat equity involves the following:

- The company should make a note below the notice of general meeting of the shareholders for the understanding of the members that the transaction requires the consent of the shareholders through postal ballot.
 - The board of directors should appoint a scrutinizer who, in the opinion of the board, could conduct the postal ballot process in a fair and transparent manner.
 - The scrutinizer is required to submit its report after the last date of the receipt of the postal ballot.
 - The scrutinizer should be willing to be appointed and should be available at the registered office of the company for the purpose of ascertaining the requisite majority.
 - The scrutinizer is duty-bound to maintain a register to record the consent of the shareholders.
 - The postal ballot and all other papers should be under its safe custody till the chairman of the company considers, approves and signs the minutes of the meeting. Thereafter, the scrutinizer shall return the ballot papers and other related registers to the company so as to preserve such papers till the resolution is given effect.
 - If the shareholders do not vote within 30 days of the issue of notice, the law considers that the shareholder has acquiesced.
 - The promoter is not allowed to vote in the resolution for the issue of sweat equity to him.
- Besides regulation 6 requires that:
- Each transaction of issue of Sweat Equity shall be voted by a separate resolution.

- The resolution for issue of Sweat Equity shall be valid for a period of not more than twelve months from the date of passing of the resolution.
- For the purposes of passing the resolution, the explanatory statement shall contain the disclosures as specified in the Schedule.

Pricing

The price of the sweat equity offered to the employee or the manager should not be less than average of the weekly high and low of the closing prices of the related equity shares during the last six months preceding the relevant date or higher than the average of weekly high and low of the equity shares during the two weeks preceding the relevant date.

Lock in Period

The Sweat Equity shares shall be locked in for a period of three years from the date of allotment.

Post issue compliances

After the allotment of the sweat equity shares, the Board of Directors are obliged to place in the annual general meeting the auditor's certificate stating that the issue of the sweat equity has been made in accordance with the Regulations and the shareholders resolution. The company is required to send a statement to the stock exchange disclosing the following:

- the number and price of issued sweat equity shares;
- the total amount invested in sweat equity;
- details of the person to whom the sweat equity is issued;
- the consequent change in the capital structure and the shareholding pattern after and before the issue of the sweat equity.

Non-cash consideration

The condition precedent to issue sweat equity for non-cash consideration is that an employee must provide know-how or make available intellectual property rights.

In case of allotment for non-cash consideration, the important issue which arises is the valuation of the consideration. The Regulations prescribe that the value of the intellectual property rights or of know-how is to be carried out by the merchant banker who must consult experts and valuers who the merchant banker consider fit for the purpose. The merchant banker is under an

obligation to provide a certificate from an independent chartered accountant confirming that the valuation is in accordance with the relevant accounting standards. After the valuation is complete, attention must be paid to the accounting treatment of the non-cash consideration. If the non-cash consideration takes the form of a depreciable asset it is carried to the balance sheet of the company. However, if it does not take the form of depreciable asset then it must be expensed as provided by the relevant accounting standards. If non-cash consideration takes the form of an asset, which cannot be transferred to the balance sheet then it is treated as managerial remuneration. However, for this purpose the issue of sweat equity must be made in favor of the director or manager.

Penalties

The Securities and Exchange Board of India (“SEBI”) has the authority to conduct an investigation or to inspect the books or accounts of the company in respect of any contravention of the provisions of the Regulations. SEBI is also authorized to initiate criminal prosecution by filing a complaint in writing in a court. If it is found that the company has contravened the provisions in regard to the issuance of sweat equity, it can be restrained from issuing further sweat equity. SEBI also has the authority to ask the person to whom the sweat equity is issued to be divested of it.

3.0 Types of Documentation in a typical ESOP/ESPS

The types of documentation in a typical ESOP/ESPS plan include:

1. ESOP/ESPS Plan – this is the main part of any ESOP initiative. The ESOP Plan will set out the details of following:

- The quantum of option to be granted under an ESOS per employee and in aggregate.
- the conditions under which option vested in employees may lapse in case of termination of employment for misconduct;
- the exercise period within which the employee should exercise the option and that option would lapse on failure to exercise the option within the exercise period;

- The specified time period within which the employee shall exercise the vested options in the event of termination or resignation of an employee.
- the right of an employee to exercise all the options vested in him at one time or at various points of time within the exercise period;
- The procedure for making a fair and reasonable adjustment to the number of options and to the exercise price in case of corporate actions such as rights issues, bonus issues ,merger, sale of division and others. In this regard following shall be taken into consideration by the compensation committee:
 - the number and the price of ESOS shall be adjusted in a manner such that total value of the ESOS remains the same after the corporate action
 - For this purpose global best practice in this area including the procedures followed by the derivative markets in India and abroad shall be considered.
 - The vesting period and the life of the options shall be left unaltered as far as possible to protect the rights of the option holders.]
 - the grant, vest and exercise of option in case of employees who are on long leave; and
 - The procedure for cashless exercise of options.

2. **ESOP Grant Letter** – this is the letter agreement between the company and the employee under which the company allots the share options and the employee agrees to accept the options subject to the rules in the ESOP plan.

3. **Options exercise letter** – this is the letter using which the employee exercises his options.

3. **ESOP Trust Deed** – this is needed when you constitute an Employee Welfare Fund for running the ESOP scheme. The trust deed appoints a trustee for the EWF.

4. **Resolutions** – you will usually need shareholders and board of directors resolutions for approving ESOP and setting up the Trust, constituting the Compensation Committee and for increasing the authorised capital (if needed).

5. **Valuation reports** – this report usually forms the basis of the fixing of the exercise price, as well as the buyback of the shares by the company (in case other liquidity events do not happen).

Disclosure requirement as per SEBI Guidelines

A. Disclosure Document: pursuant to clause 5(1) of the SEBI Guidelines no ESOS can be granted if the company does not make the following disclosures to option grantees

Disclosure Document

(Clause 5.1)

Part A: Statement of Risks

All investments in shares or options on shares are subject to risk as the value of shares may go down or go up. In addition, employee stock options are subject to the following additional risks:

1. Concentration: The risk arising out of any fall in value of shares is aggravated if the employee's holding is concentrated in the shares of a single company.
2. Leverage: Any change in the value of the share can lead to a significantly larger change in the value of the option as an option amounts to a levered position in the share.
3. Illiquidity: The options cannot be transferred to anybody, and therefore the employees cannot mitigate their risks by selling the whole or part of their options before they are exercised.
4. Vesting: The options will lapse if the employment is terminated prior to vesting. Even after the options are vested, the unexercised options may be forfeited if the employee is terminated for gross misconduct.

Part B: Information about the company

1. Business of the company: A description of the business of the company on the lines of item V (a) of Part I of Schedule II of the Companies Act.
2. Abridged financial information: Abridged financial information for the last five years for which audited financial information is available in a format similar to that required under item B(1) of Part II of Schedule II of the Companies Act. The last audited accounts of the company should also be provided unless this has already been provided to the employee in connection with a previous option grant or otherwise.

3. Risk Factors: Management perception of the risk factors of the company in accordance with item VIII of Part I of Schedule II of the Companies Act.

4. Continuing disclosure requirement: The option grantee should receive copies of all documents that are sent to the members of the company. This shall include the annual accounts of the company as well as notices of meetings and the accompanying explanatory statements.

Part C: Salient Features of the Employee Stock Option Scheme

This Part shall contain the salient features of the employee stock option scheme of the company including the conditions regarding vesting, exercise, adjustment for corporate actions, and forfeiture of vested options. It shall not be necessary to include this Part if it has already been provided to the employee in connection with a previous option grant, and no changes have taken place in the scheme since then. If the option administrator (whether the company itself or an outside securities firm appointed for this purpose) provides advisory services to the option grantees in connection with the exercise of options or sale of resulting shares, such advice must be accompanied by an appropriate disclosure of concentration and other risks. The option administrator should conform to the code of conduct appropriate for such fiduciary relationships.

B. INFORMATION REQUIRED IN THE STATEMENT TO BE FILED WITH STOCK EXCHANGE

In case of an ESOS the company has also filed with the concerned stock exchanges, before the exercise of option, a statement as per Schedule V and has obtained in-principle approval from such Stock Exchanges [clause 22.1]

Description of Stock Option Scheme

1. Authorized Share Capital of the Company.
2. Issued Share Capital of the Company as on date of Institution of the Scheme/ amending of the Scheme.
3. Date of Institution of the Scheme/ amending of the Scheme.
4. Validity period of the Scheme.

5. Date of notice of AGM/EGM for approving the Scheme/for amending the Scheme/for approving grants under Clause 6.3 (a) or (b) of the SEBI (ESOS & ESPS) Guidelines.
6. Date of AGM/EGM approving the Scheme/amending the Scheme/approving grants under Clause 6.3 (a) or (b) of the SEBI (ESOS & ESPS) Guidelines.
7. Kind of security granted as Options under the Scheme.
8. Identity of classes of persons eligible under the scheme:
 - ☐ Permanent employees
 - ☐ Permanent employees outside India
 - ☐ Permanent employees of subsidiary
 - ☐ Permanent employees of holding company
 - ☐ Whole –time directors
 - ☐ Independent directors
9. Total number of securities reserved under the scheme.
10. Number of securities entitled under each option.
11. Total number of options to be granted.
12. Maximum number of Options to be granted per employee in each grant and in aggregate.
13. Exercise price or pricing formula.
14. Whether any amount payable at the time of grant of the Options? If so, quantum of such amount.
15. Lock-in period under the Scheme:
 - ☐ Lock-in period between grant and vesting
 - ☐ Lock-in period after exercise
16. Vesting Period under the Scheme.
17. Maximum period within which the options shall be vested.
18. Exercise Period under the plan.
19. Whether employee can exercise all the Options Vested at one time? Yes/No
20. Whether employee can exercise vested Options at various points of time within the exercise period? Yes/No

21. Whether scheme provides for the procedure for making a fair and reasonable adjustment to the number of options and to the exercise price in case of rights issues, bonus issues and other corporate actions? Clause in Scheme describing such adjustment
22. Description of the appraisal process for determining the eligibility of employees under the scheme.
23. The specified time period within which vested options are to be exercised in the event of termination or resignation of an employee.
24. The specified time period within which options are to be exercised in the event of death of the employee.
25. Whether Plan provides for conditions under which option vested in employees may lapse in case of termination of employment for misconduct? Clause in Scheme describing such adjustment
26. Whether Plan provides for conditions for the grant, vesting and exercise of option in case of employees who are on long leave? Clause in Scheme describing such adjustment
27. Whether amount paid/payable by the employee at the time of the grant of the Option will be forfeited if the employee does not exercise the option within the exercise period? Clause in Scheme describing such adjustment
28. Details of approval of shareholders pursuant to Clause 6.3 of the SEBI (ESOS & ESPS) Guidelines with respect to:
- ☐ Grant of options to employees of subsidiary or holding company
 - ☐ Grant of options to identified employees, during any one year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of the option.
29. Details of the variation made to the scheme along with the rationale therefore and the details of the employees who are beneficiary of such variation:

Company Secretary

Place:

Date:

Documents to be filed with registration statement

1. Copy of Stock Option Scheme/Amended Stock Option Scheme, certified by company secretary.
2. Copy of Notice of AGM/EGM for approving the Scheme/for amending the Scheme/for approving grants under Clause 6.3(a) or (b) of the SEBI (ESOS & ESPS) Guidelines, certified by the company secretary.
3. Copy of resolution of shareholders for approving the Scheme/ for amending the Scheme/for approving grants under Clause 6.3(a) or (b) of the SEBI (ESOS & ESPS) Guidelines, certified by the company secretary.
4. List of Promoters as defined under the SEBI (ESOS & ESPS) Guidelines.
5. Copy of latest Annual Report.
6. Certificate of Auditor on compliance with SEBI (ESOS and ESPS) Guidelines.
7. Specimen copy of Share certificate.
8. Any other relevant documents.

Undertakings

A. The undersigned company hereby undertakes:

1. To file, a post-effective amendment to this statement to include any material information with respect to the scheme of distribution not previously disclosed in the statement or any material change to such information in the statement.
2. To notify, the concerned stock exchanges on which the securities of the company are listed, of each issue of securities pursuant to the exercise of options under the scheme mentioned in this Statement, in the prescribed form, as amended from time to time.
3. That the company shall conform to the accounting policies specified in clause 13.1 of the SEBI (ESOS & ESPS) Guidelines.
4. That the Scheme conforms to the SEBI (ESOS & ESPS) Guidelines.
5. That the company has in place systems/ codes/ procedures to comply with the SEBI (Insider Trading) Regulations.

Signatures

1. Pursuant to the requirements of the SEBI Act/ guidelines, the company certifies that it has reasonable grounds to believe that it meets all the requirements for the filing of this form and has duly caused this statement to be signed on its behalf by the undersigned, thereunto, duly authorized

Name of the company

Sd/-

Name of the Compliance Officer

Designation

Date:

Place:

[2. Certification by Registered Merchant Banker, pursuant to clause 22.8 of SEBI (ESOS & ESPS) Guidelines, 1999:

“Certified that the scheme conforms to the SEBI (Employee Stock Option Scheme & Employee Stock Purchase Scheme) Guidelines, 1999”

Authorised Signatory

Name of the Merchant Banker

Date:

Place:

C. Explanatory Statement

As per the clause 6.2 of the guidelines, the explanatory statement to the notice and the resolution proposed to be passed in general meeting for ESOS shall, inter alia, contain the following information:

- (a) The total number of options to be granted;
- (b) Identification of classes of employees entitled to participate in the ESOS;
- (c) Requirements of vesting and period of vesting;
- (d) Maximum period (subject to clause 9.1) within which the options shall be vested;
- (e) Exercise price or pricing formula;

- (f) Exercise period and process of exercise;
- (g) The appraisal process for determining the eligibility of employees to the ESOS;
- (h) Maximum number of options to be issued per employee and in aggregate;
- (i) A statement to the effect that the company shall conform to the accounting policies specified in clause 13.1;
- (j) The method which the company shall use to value its options whether fair value or intrinsic value;
- (k) The following statement:
'In case the company calculates the employee compensation cost using the intrinsic value of the stock options, the difference between the employee compensation cost so computed and the employee compensation cost that shall have been recognized if it had used the fair value of the options, shall be disclosed in the Directors report and also the impact of this difference on profits and on EPS of the company shall also be disclosed in the Directors' report.'

D. Director's Report

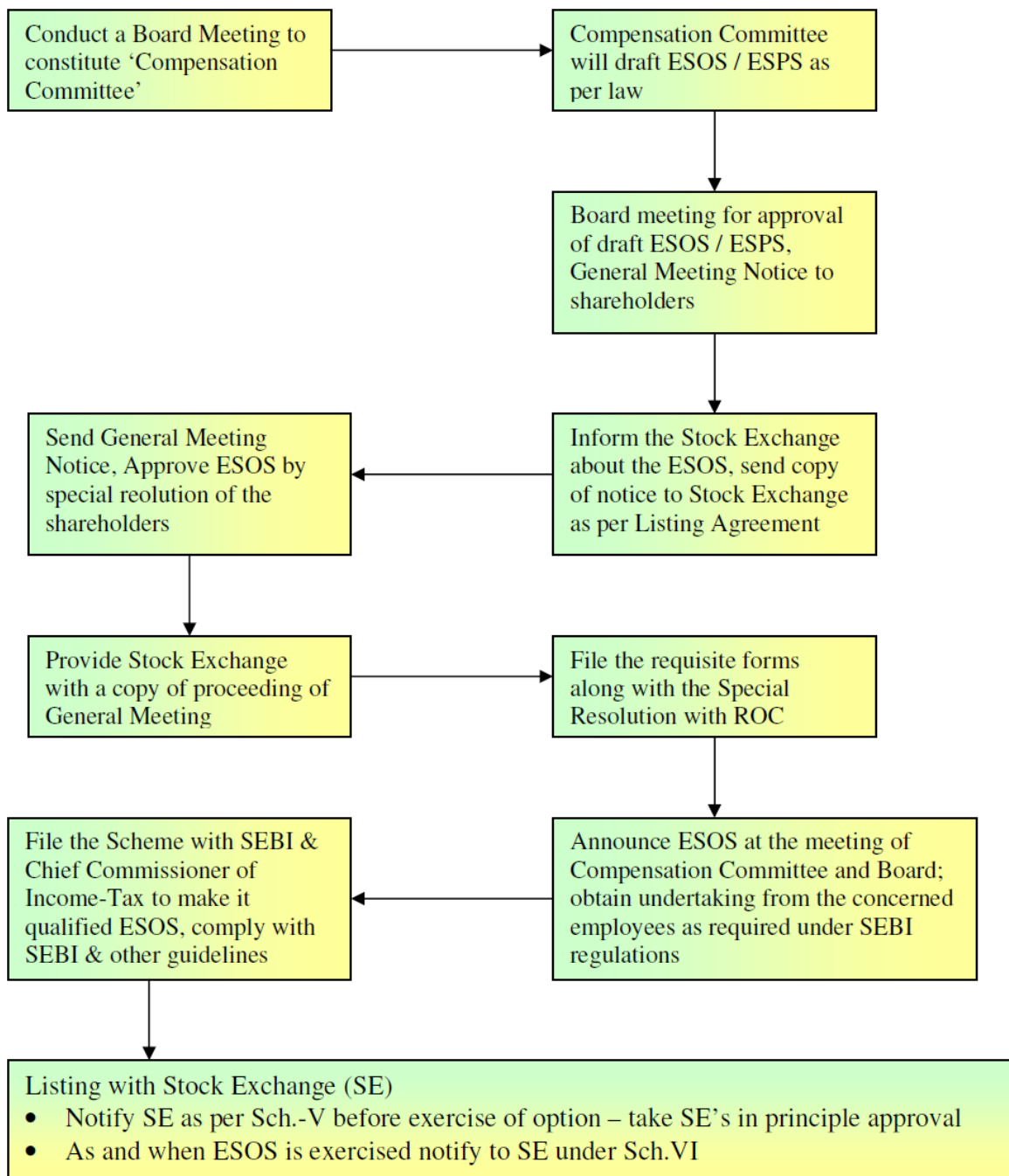
The Board of Directors, shall, inter alia, disclose either in the Directors' Report or in the annexure to the Directors' Report, the following details of the ESOS:

- (a) options granted;
- (b) the pricing formula;
- (c) options vested;
- (d) options exercised;
- (e) the total number of shares arising as a result of exercise of option;
- (f) options lapsed;
- (g) variation of terms of options;
- (h) money realised by exercise of options;
- (i) total number of options in force;
- (j) employee wise details of options granted to:-
 - senior managerial personnel;

- any other employee who receives a grant in any one year of option amounting to 5% or more of option granted during that year.
 - identified employees who were granted option, during any one year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;
- (k) Diluted Earnings Per Share (EPS) pursuant to issue of shares on exercise of option calculated in accordance with Accounting Standard (AS) 20 'Earnings Per Share'.
- (l) Where the company has calculated the employee compensation cost using the intrinsic value of the stock options, the difference between the employee compensation cost so computed and the employee compensation cost that shall have been recognized if it had used the fair value of the options, shall be disclosed. The impact of this difference on profits and on EPS of the company shall also be disclosed.
- (m) Weighted-average exercise prices and weighted-average fair values of options shall be disclosed separately for options whose exercise price either equals or exceeds or is less than the market price of the stock.
- (n) A description of the method and significant assumptions used during the year to estimate the fair values of options, including the following weighted-average information:
- risk-free interest rate,
 - expected life,
 - expected volatility,
 - expected dividends, and
 - the price of the underlying share in market at the time of option grant.]

4.0 Designing an ESOP/ESOS

The whole process of implementing an Employee Stock option Plan/Scheme can be described by the following flowchart:



5.0 Accounting for ESOP

The accounting aspect of ESOP/ESOS is covered in The Securities and Exchange Board of India (Employee stock option Plan and Employee Share Purchase Plan) guidelines, 1999 which is mandatory for listed companies. The unlisted entities, on the other hand, have an option to follow the SEBI guidelines or the guidance note on 'Employee Share Based payments' issued by the Institute of Chartered Accountants of India. The accounting aspect of ESOS is covered in both rules and guidelines as well as in GN (A): 18. Adherence to appropriate norms is essential as in the financial statement of entity the accounting value of the option is treated as the form of employee compensation.

Determination of Value

The accounting value is determined by finding either fair value of the option or intrinsic value of the option.

1. **Intrinsic Value:** Intrinsic value means the excess of the fair value of the share at the date of grant of the option under ESOS over the exercise price of the option. The fair value of the underlying share at the time of grant may be estimated as the book value per share or if the company so chooses the fair value may be estimated based on an independent valuation report. Contrary to this as per GN 18 the fair value of shares would be the market value of the shares.

2. **Fair Value of Option:** Fair value of an option means the price that would obtain for that option in an arm's length transaction between a willing buyer and a willing seller. The fair value for the shares in an ESOS may be calculated and estimated on the basis of guidance provided in the schedule III of the SEBI Guidelines. Option pricing models like Black- Scholes or a binomial model are used to determine the fair value of option. It takes into account as of the grant date the exercise price and expected life of the option, the current fair value 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. 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. The expected life of an award of stock options shall take into account the following factors:

- The expected life must at least include the vesting period.
- The average lengths of time similar grants have remained outstanding in the past. If the company does not have a sufficiently long history of stock option grants, the experience of an appropriately comparable peer group may be taken into consideration.
- The expected life of ESOSs should not be less than half of the exercise period of the ESOSs issued until and unless the same is supported by historical evidences with respect to ESOSs issued by the company earlier.

If the company does not have a sufficiently long history of traded stock prices to estimate the expected volatility of its stock, it may use an estimate based on the estimated volatility of stocks of an appropriately comparable peer group. The estimated dividends of the company over the estimated life of the option may be estimated taking into account the company's past dividend policy as well as the mean dividend yield of an appropriately comparable peer group. Justification should be given for significant assumptions. If at the time of further issue of ESOS there are any changes in the assumptions, reasons for the same shall be given.

5.1 Accounting treatment for employee stock options

When we account for employee stock options, following new accounts come into existence (as per SEBI guidelines)

- a) Employee compensation expense account – This account forms part of the compensation expense account and is taken in the Profit and loss account
- b) Deferred employee compensation expense – This account is created at the time of grant of options for the total amount of compensation expense to be booked. This account is a part of the Balance sheet and forms a negative balance in the Shareholders equity or Net worth.
- c) Employee Stock Options Outstanding account – It is a part of the Shareholders equity and is transitional in nature since it is ultimately transferred to Share Capital, Share Premium or General Reserves.

Accounting for Non Graded Vesting

The amount of employees compensation, determined as above, is the amortized on straight line basis over the period of vesting. On lapse of option due to non-fulfillment of vesting condition, this accounting treatment shall be reversed by a credit to employee compensation expense equal to the amortized portion of the accounting value of the lapsed options and a credit to deferred employee compensation expense equal to the unamortized portion. On lapse of option after vesting, the whole amount of lapsed option shall be reversed by a credit to employee compensation expense.

The accounting treatment specified above can be illustrated by the following numerical example:-

Suppose a company grants 500 options on 1/4/2002 at Rs 40 when the fair value of the shares is Rs 160, the vesting period is two and a half years; the maximum exercise period is one year. Also suppose that 150 unvested options lapse on 1/5/2004, 300 options are exercised on 30/6/2005 and 50 vested options lapse at the end of the exercise period. The accounting value of the option being:

$$500 \times (160-40) = 500 \times 120 = 60,000$$

The accounting entries would be as follows:

1/4/2002	Deferred Employee Compensation Expense <i>Dr.</i>	60,000	
	<i>To Employee Stock Options Outstanding</i>		60,000
	<i>(Grant of 500 options at a discount of Rs 120 each)</i>		
31/3/2003	Employee Compensation Expense <i>Dr.</i>	24,000	
	<i>To Deferred Employee Compensation Expense</i>		24,000
	<i>(Amortisation of the deferred compensation over two and a half years on straight-line basis)</i>		

31/3/2004	Employee Compensation Expense <i>Dr.</i>	24,000	
	<i>To</i> Deferred Employee Compensation Expense (Amortisation of the deferred compensation over two and a half years on straight-line basis)		24,000
1/5/2004	Employee Stock Options Outstanding <i>Dr.</i>	18,000	
	<i>To</i> Employee Compensation Expense		14,400
	Deferred Employee Compensation Expense (Reversal of compensation accounting on lapse of 150 unvested options)		3,600
31/3/2005	Employee Compensation Expense <i>Dr.</i>	8,400	
	<i>To</i> Deferred Employee Compensation Expense (Amortisation of the deferred compensation over two and a half years on straight-line basis)		8,400
30/6/2005	Cash <i>Dr.</i>	12,000	
	Employee Stock Options Outstanding <i>Dr.</i>	36,000	
	<i>To</i> Paid Up Equity Capital		3,000
	<i>To</i> Share Premium Account		45,000
	(Exercise of 300 options at an exercise price of Rs 40 each and an accounting value of Rs 120 each)		
1/10/2005	Employee Stock Options Outstanding <i>Dr.</i>	6,000	
	<i>To</i> Employee Compensation Expense		6,000
	(Reversal of compensation accounting on lapse of 50 vested options at the end of exercise)		

	period)		
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Accounting for Graded Vesting

Prior to amendment in 2008 clause 13.2 of the SEBI guidelines required that the entity has to determine the vesting period for each portion separately and then account for it as if those are separate grants with separate vesting periods. To illustrate this, in case an entity grants 100 options to vest in 4 equal tranches, the accounting will be done for 25 options each year at the end of 1st, 2nd, 3rd and 4th year with the vesting period being 1 year, 2 years, 3 years and 4 years respectively and accounted for on a time-proportion basis. However, the SEBI issued circular no. SEBI/CFD/DIL/ESOP/4/2008/04/08 dated August 4, 2008, w. e. f. August 4, 2008 which suggests the following two options in case of graded vesting :

- the vesting period shall be determined separately for each separate vesting portion of the option, as if the option was, in substance, multiple option and the amount of employee compensation cost shall be accounted for and amortised accordingly on a straight-line basis over the vesting period; or
- the amount of employee compensation cost shall be accounted for and amortised on a straight-line basis over the aggregate vesting period of the entire option (that is, over the vesting period of the last separately vesting portion of the option):

Provided that the amount of employee compensation cost recognized at any date at least equals the fair value or the intrinsic value, as the case may be, of the vested portion of the option at that date.

Accounting Treatment when ESOP administered through Trust

Prior to circular no. SEBI/CFD/DIL/ESOP/3/2004/22/7 dated July 22, 2004, made applicable for all accounting periods commencing on or after June 30, 2003 *in case of ESOS / ESPS were administered through a Trust Route, the ESOS / ESPS Trust was to be consolidated with the company in accordance with the Accounting Standard (AS 21) specified by the Institute of Chartered Accountants of India and the SEBI Guidelines were applicable to the consolidated entity*

However, after the said circular position has changed and now if the ESOPs or ESPS are administered through a trust route, the accounts are to be prepared as if the company itself is administering the ESOP. Hence all the aforementioned accounts will then be prepared in the books of the company and not the trust set up for the purpose. The Guidance note issued by the Institute of Chartered Accountants of India also suggests the same thing but in addition, it also states that for consolidation of accounts under AS 21, this trust should not be considered since consolidation is done for only those entities which provide economic benefits. Trust being set up with the sole objective of administering the ESOP does not fall in this category.

Accounting for re pricing of ESOS

The economic recession has made re-pricing the most talked about issue for reviving the value of stock options in the hands of employees. Many companies are modifying the terms of grant so as to make stock options attractive again. Terms like exercise price, vesting period, exercise period, etc. are being changed in such a manner that the employees are at least at-the-money, if not in-the-money. While such modifications are beneficial to the employees, they generally involve a cost to the company. The accounting charge that will hit the companies' books of accounts should also be considered while deciding on the method or alternative to be adopted for modification. SEBI guidelines do not cover the accounting for modification of terms of ESOS. However, ICAI Guidance Note being more comprehensive has dealt with the issue.

Re-pricing is the word commonly used in India for any change in the Plan features, be it change in exercise price, vesting terms or other conditions. In the Accounting parlance the term used is Modification - covering any change in the terms and conditions of the Options granted. The SEBI Guidelines allow companies to re-price their options, if they are underwater. However, it does not mention anything further on modifications. The Guidance note covers modifications completely, not only re-pricing, but change in vesting period or other terms. Since the Guidance Note is more comprehensive, for accounting treatment of modifications, the Guidance Note shall prevail.

On modification of the terms of grant, the increase in the Fair value pre modification and post modification is required to be accounted for. This difference is called 'incremental cost'. This

‘incremental cost’ is nothing but the incremental benefit being passed on to the employees on modification.

The total expense that would need to be accounted for on modification is –

- Portion of the grant date Fair Value of the options over the original vesting period, plus
- Incremental cost resulting from the modification over the new vesting period.

So, the total expense of the employee share-based payments that have been modified is, at least, the grant date Fair Value.

This is the general rule. However, there is a deviation from that rule if the performance or service conditions (vesting conditions) are not expected to be satisfied at the date of modification.

The accounting for modification of the vesting conditions of the options is consistent with the general modification guidance. If as a result of the modification, a company conveys additional value to the holder of an award, then the company must record incremental compensation cost for those options.

The various forms of modifications and their accounting implications are summarized in the table below

Nature of Modification	Accounting Treatment
Increase in FV/IV post modification as compared to pre modification	Account for the grant date FV/IV over the original vesting period. In addition, an incremental cost is accounted for over the new vesting period.
Decrease in FV/IV post modification as compared to pre modification	Account for the grant date FV/IV over the original vesting period
Increase in number of shares or Options	Account for the grant date FV/IV over the original vesting period. In addition, the FV/IV of the additional options is recorded over the vesting period of the additional options granted.
Decrease in number of shares or options	Account for the grant date FV/IV over the original vesting period. The reduction in the number of options is treated as cancellation

	and their FV/IV is recognized immediately as on the date of modification.
Any other modification beneficial to the employee. For e.g., decrease in vesting period or eliminating a performance condition (other than a market condition).	Account for the grant date FV/IV over the original vesting period. The new vesting conditions are not considered while estimating the number of options that would eventually vest.
Cancellation of options	Treated as acceleration of vesting, grant date FV/IV is accounted immediately as on the date of cancellation
Cash settlement of options	Cash paid in excess of FV/IV is be accounted as an expense.
New options granted in replacement of cancelled options	Treated as a modification of the original grant of options.

5.2 SEBI Guidelines Vs GN A: (18) Employees Share Based Payments

The Guidance Note segregates the stock option plans in 3 types:

- Cash settled – where employees receive cash based on the value of the company's shares
- Equity settled – where employees receive shares
- Employee share based payment plans with cash alternatives – where either the employee or the company has a choice of whether the settlement shall be in cash or shares

In cash settled transaction the expense is recognized by creating a liability whereas in the case of equity settled transaction an 'Employee stock options outstanding account' is created which is a part of the Shareholder's equity or Net worth. Accounting for the third alternative depends on which party has a choice of settlement (employer or employee).

Also, as per the SEBI guidelines, the compensation expense is to be amortized on a straight line basis over the vesting period whereas the Guidance note suggests that the expense should be

recognized over the vesting period on a time proportion basis as and when the services are rendered by the employee.

Another major difference in accounting is that under the SEBI guidelines reversal of expense attributed to the vested options is allowed whereas according to the Guidance note, a best estimate of the options expected to vest is to be made and then accounted for. The expense once accounted for on such basis cannot be reversed

5.3 Comparison with International Financial Reporting Standards

As far as accounting for ESOS at present is concerned the Indian GAAP consists of SEBI Guidelines and the Institutes Guidance Note. However, IFRS 2 relating to share based payments determines the accounting for ESOS as per IFRS. GN A (18) is largely based on IFRS 2 *Share Based Payments*. However, there are certain points of differences between treatment as per IFRS 2, GN A (18) and SEBI Guidelines

- The IFRS 2 has a very large scope as it covers all types of share based payments whether to employees or not. Whereas SEBI guidelines and ICAIs GN A (18) deals only with share based payments to employees
- IFRS2 and GN A (18) deals with three types of share based payments i.e. cash settled, equity settled and share based payments with cash alternatives. However, SEBI guidelines makes no such distinction.
- As per IFRS 2 use of intrinsic value is restricted. It is only allowed in rare cases when it is not possible to measure the fair value of equity instruments granted. Normally all ESOS are valued at fair value. However, GN A (18) and SEBI guidelines allows use of intrinsic value for determining value of option. Here it is important to note that after the proposed date of convergence to IFRS i.e. 1 April, 2011 it will be mandatory in India also to go by IFRS 2 for entities complying with IFRS

5.4 Accounting Treatment for ESOS:

In the financial statement of entity offering shares under ESOS the accounting value of the shares given is treated as the form of employee compensation. The accounting value of shares issued under ESOS shall be equal to the aggregate of price discount over all shares issued under ESOS

during any accounting period. The Price discount means the excess of the fair value of the shares at the date of issue over the price at which they are issued under the ESPS. The fair value of the underlying share at the time of grant may be estimated as the book value per share or if the company so chooses the fair value may be estimated on the basis of an independent valuation report. The accounting treatment prescribed above can be illustrated by the following numerical example :-

Suppose a company issues 500 shares on 1/4/2002 under an ESPS at Rs 40 when the fair value is Rs 160. The accounting value of the shares being:

$$500 \times (160-40) = 500 \times 120 = 60,000$$

The accounting entry would be as follows:

1/4/2002	Cash	<i>Dr.</i>	20,000	
	Employee Compensation Expense	<i>Dr.</i>	60,000	
	<i>To</i> Paid Up Equity Capital			5,000
	<i>To</i> Share Premium Account			75,000
	<i>(Issue of 500 shares under ESPS at a price of Rs 40 each when fair value is Rs 160)</i>			

6.0 Taxation of ESOP/ESPS/Sweat Equity

With abolition of Fringe Benefit Tax from 2009-2010, FBT on ESOPs has been abolished and once again ESOPs have been included in the purview of Perquisites under Section 17 (2). The value of the ESOPs determined on the date of exercise, as the difference between the fair market value of the shares as on the date of exercise and the exercise price, would be taxable as a perquisite in the hands of the employees.

Taxation of ESOP prior to Finance Act 2009

The concept of Fringe Benefit Tax was introduced by Finance Act, 2005 for the first time in India to charge an additional income tax in respect of fringe benefits provided or deemed to have been provided by an employer to his employees. Chapter XIIIH, comprising of sections 115W to 115WL was inserted. Section 115WB dealt with benefits to which Fringe Benefit Tax would apply whereas section 115 WC dealt with valuation of such fringe benefit. Clause (d) was added to subsection (1) of section 115WB, in subsequent year to include into fringe benefit any specified security or sweat equity shares allotted or transferred, directly or indirectly by the employer free of cost or at concessional rate to his employees. Simultaneously, clause (ba) was inserted in subsection (1) of section 115WC. This clause stated that the FMV of the specified securities or sweat equity shares on the date of vesting of shares as reduced by the amount actually paid by employee or recovered from employee in respect of such securities would be considered as fringe benefit. The explanation (i) to this clause stated that “fair market value” means value determined in accordance with the methods as prescribed by the Board. Pursuant to it, Rule 40C was introduced by notification number 264/2007 dated 23/10/07 of Central Board of Direct Taxes to determine the fair market value of such specified securities or sweat equity shares.

Rule 40C:

Determination of FMV for equity listed in recognized stock exchange

As per the rule 40C the FMV of the specified security or sweat equity share, being equity share in the company was to be determined with reference to its fair market value as on date of vesting of option. For listed companies the FMV would be the average of opening and closing prices of the equity on the recognized stock exchange that shows highest volume of trading of the said equity on the vesting date. In case there was no trading of the security in any stock exchange on date of vesting FMV would be **closing price** on date closest to and proceeding the date of vesting on stock exchange where highest volume of trade takes place. In cases where two prices, buy and sell, are quoted, the sell price would be considered in both the cases.

For the purpose, recognized stock exchange would be stock exchange that is for time being recognized by the Central Government under section 4 of Securities Contract Act. Therefore, a company listed in overseas stock exchange or a company giving shares of parent or Group Company which is listed overseas will not be considered as listed in recognized stock exchange and will have to follow procedure laid for unlisted companies.

Determination of FMV for equity of company not listed in recognized stock exchange

For such companies, the FMV for their equity would be determined by the category 1 Merchant Banker registered with Security and Exchange Board of India on the date of vesting of the option or any date earlier than the date of the vesting of the option, not being a date which is more than 180 days earlier than the date of the vesting.

Certain issues still remained unclarified even after issue of rule 40 C. Therefore, the Central government issued an Explanatory Circular on Fringe benefit Tax arising on allotment or transfers of specified securities or sweat equity shares.

Taxation of ESOP from 1-4-2009

The extract of the Finance Act 2009 which provides for the new taxation regime of ESOP, the Charging Section & Quantification of tax, are mentioned below:

In section 17 (2) of Income-tax Act, the following sub-clauses are being substituted for clause (vi) with effect from the 1st day of April, 2010 -

‘(vi) the value of any specified security or sweat equity shares allotted or transferred directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.

Explanation – For the purpose of this clause, -

- a) “specified security” means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 and where employees’ stock option has been granted under any plan or scheme there for, includes the securities offered under such plan or scheme;
- b) “sweat equity shares” means equity shares issued by a company to its employees or its directors at a discount or for consideration other than cash for providing knowhow or making

available rights in the nature of intellectual property rights or value additions, by whatever name called.

c) the value of any specified security or sweat equity shares shall be the fair market value of the specified security or sweat equity shares, as the case maybe, on the date on which the option is exercised by the assessee as reduced by the amount actually paid by, or recovered from the assessee in respect of such security or shares;

d) “fair market value” means the value determined in accordance with the method as may be prescribed;

e) “option” means a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a predetermined price.

Capital Gains

In section 49 of the Income-tax, for sub-section (2AA), the following sub-section shall be inserted with effect from the 1st day of April, 2010, namely:-

“(2AA) where the capital gain arises from the transfer of specified security or sweat equity 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.”

Impact of the changes

The new provisions will apply to all options exercised on or after 1st April 2009. The tax liability will now be determined on the exercise date. Tax would be levied on the difference between the fair market value (FMV) of the shares on the date of exercise and the exercise price. The tax would be levied on this value at the rate of 30% (plus cess).

Incidence of tax

Tax is payable at the time of allotment or transfer of shares, directly or indirectly (through an ESOP trust). All options exercised after 1st April, 2009 are liable to TDS, in which case options vested before 1st April, 2009 but not exercised would also be liable to tax.

Trust Route

Shares allotted or transferred directly or indirectly are covered. The shares transferred through the Trust route would also be included in the tax bracket.

Unclear Issues

There are certain issues which still need clarity. These would be addressed in the rules that would be published.

1. Whether the 'date of exercise' is the date of exercise by the employee or the date on which allotment of shares is done?
2. 'Fair Market Value' for listed and unlisted companies need to be defined. Whether Rule 40C for determination of fair market value is to be used