I. Provisions in the Companies Act, 2013

Since stocks or shares are relatable only to companies (and not to other legal forms such as partnerships or associations), the **Companies Act, 2013** forms the fundamental law governing share-based schemes for employees' benefit.

Section 62(1)(b) of the Companies Act, 2013 allows a company to issue further capital to the employees under a scheme of employees' stock option provided a special resolution is passed and the conditions as prescribed are fulfilled.

Further, **Section 62(1)(a)** of the Companies Act, 2013 allows a company to issue further share capital by way of a rights issue to the existing shareholders. **Section 62(1)(c)** of the Act allows a company to issue share capital to people other than existing shareholders and employees provided that the price of the shares is determined by a valuation report and fulfilment of other prescribed conditions.

Section 2(37) of the Companies Act, 2013 defines "**employees' stock option**" to mean the option given to the directors, officers or employees of a company which enables such directors, officers or employee, the benefit or right to purchase or subscribe to the shares of the company at a pre-determined price.

The fundamental law for employee benefit schemes is the Companies Act, 2013. However, not all schemes may be covered under its provisions, e.g. cash settled SARs

A question that arises here is – **whether all the forms of employee benefit schemes discussed above would qualify as "employees' stock option"**? It would be interesting to answer this question in light of SARs which may only be cash settled and do not necessarily involve an issuance of share to the employee. Such cash-settled SARs, which do not involve a further issue of shares, would not need recourse to Section 62 of the Act. It poses another interesting question, especially in the case of unlisted companies – when such SARs amount to a mere monetary benefit (maybe akin to a bonus payment), would they be governed by the regulatory provisions (explained later).

Further conditions are appended through **Rule 12** of the **Companies (Share Capital and Debentures) Rules, 2014**. The Rule provides that an unlisted company which is not required to comply with the SEBI Regulations[1], shall not offer shares to its employees under ESOP scheme unless it complies with certain requirements. A brief summary of such requirements listed under Rule 12 are as follows:

- The ESOP scheme should be approved by the shareholders by way of a **special resolution**. The notice for such special resolution shall include an **explanatory statement**, which would inform the noticees of the following:

[1] Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014.

- The total number of stock options to be granted
- Manner of identification of the employee
- The requirements of vesting and period of vesting
- Lock-in period
- Method of valuation of options
- Conditions when the options may lapse (i.e. termination due to misconduct etc.,)
- A statement that the company shall comply with the applicable accounting standard.

- The **employee** to whom the shares can be issued is defined to mean 'permanent employee', director (excluding independent director), and employee of holding/subsidiary company.
- Further, **promoters and directors** holding more than 10% of shares of the company cannot be issued shares under the ESOP scheme. However, this condition is not applicable to a notified start-up company.
- **Modification of the scheme**, in respect of options not yet exercised, may be done by passing a special resolution provided that the variation is not prejudicial to the option holders.
- There should be a **minimum period of 1 year** between the grant of options and vesting of options.
- The employees shall not have the right to receive **dividend** or to **vote** or enjoy the benefits of a shareholder in respect of the option granted to them, till shares are issued.
- The options granted **cannot be transferred** by the employee or pledged, hypothecated, or mortgaged by the employee.
- In the event of **death of the employee** during employment, the options shall vest with the legal heirs. In case of permanent incapacitation during employment, all the options granted to the employee shall vest with him on the day of incapacitation.
- The Board of Directors in the **Directors report** u/s 134 of the Act are required to disclose certain prescribed information regarding the ESOP scheme.
- The **register of employee stock options** is to be maintained at the registered office of the company.

However, for listed companies, the requirements of **SEBI (Share based Employees Benefits) Regulations, 2014** ('**SBEB Regulations**') are to be followed. These guidelines are comprehensive and improve upon the deficiencies in the erstwhile **Securities Exchange Board of India (Employee Stock Option Scheme) Guidelines, 1999**. The underlying principle, however, remains to be the same that the scheme should be properly regulated for the benefit of the employees and should not result in

Options affect the value of equity. In order to accurately determine such value and the EPS, the value of options has to be accurately determined.

share price manipulation in any manner. The salient features of the SBEB Regulations are as follows:

- The regulations are applicable to **listed companies** which have a scheme for the direct or indirect benefit of employees and involving the direct or indirect dealing or subscribing or purchasing the securities of the company.
- They provide for implementation of the employee benefit schemes either directly by the company itself or by setting up an irrevocable trust (in common parlance, these are known as **ESOP trusts**. The company would transfer the shares earmarked for employee benefit purposes to such trust irrevocably and would also grant financial assistance to such trusts. It is to be noted that such financial assistance is exempted from the applicability of Section 67 of the Act, which prohibits any company to provide monies for the purpose of purchasing its own shares).
- They provide for the setting-up a **compensation committee** by the company which would determine the detailed terms and conditions of the schemes, including, eligibility of the employees.
- **Modification of the scheme** is permissible provided it is not detrimental to the interests of the employees.
- Similar to Rule 12 for unlisted companies, the options are **non-transferable** and cannot be pledged, hypothecated, or mortgaged.

Further, conditions for **administration of specific schemes** viz. employee stock option schemes, employee stock purchase schemes, stock appreciation rights scheme, general employee benefit scheme and retirement benefit schemes have been provided.

II. Accounting and valuation of ESOPs

As discussed above, options, during the vesting period as well as post vesting, represent the rights of employees to either obtain shares and securities or a monetary benefit. Thus, options are **dilutive instruments** i.e. they result in the dilution or reduction in the value of shareholding by increasing the number of shares while the assets remain unchanged. From an accounting and reporting perspective, thus, it is critical to value the options. While computing the value of a share or the earnings per share (EPS), the valuation of options cannot be ignored.

Simply put, the net worth (or, the **value of equity**) of any company may be simply expressed as the difference between assets and liabilities. From a discounted cash flow perspective, it may be expressed as the difference between the present value of expected free cash flows and the existing debt. To put it in an equation:

Value of a company's equity = Present Value (Future Cash Flows) ***Less*** Existing Debt

However, in case where options have been, and will be, granted (existing and future options respectively), the equation gets modified to:

Value of a company's equity = Present Value (Future Cash Flows) ***Less*** Existing Debt
Less Present Value (Estimated Cost of Existing and Future Options)
Add Present Value (Expected Cash Flow from Options)

In order to arrive at the estimated cost of existing and future options, as used in the above equation, various methods have been traditionally used e.g. the Black Scholes Method. It is noteworthy here that **ICAI Guidance Note** issued in 2005 contains detailed coverage of the manner of various accounting aspects relating to options valuation and reporting. Further, **Ind-AS 102** is now the prescribed standard for such purposes. Such Guidance Note and the Accounting Standard is required to be followed by both listed and unlisted companies[2].

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[2] Rule 12(2)(m) of the Companies (Share Capital and Debentures) Rules, 2014 and Regulation 15 of the SEBI (Share based Employees Benefits) Regulations, 2014 prescribe that the guidance note and accounting standard shall be followed by unlisted and listed companies respectively.