Impact Of Employee Stock Options On The Market Capitalization Of The Company

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INTRODUCTION

Employee stock option plans (ESOP's) are becoming popular in India especially for executives in Information Technology firms. In this case, specific types of employees are allotted the company's shares below the market price. This allotment can be made to employees as an alternative to the bonus payable to them. In case of better financial results, the market price of the company's shares as well as the value of the employee's shareholding increases. It can be used as a profit sharing arrangement by which employees receive, in addition to wages, the company's shares.

An employee stock option is a contract that gives the employees the right, but not an obligation, to subscribe to an entity's shares at a fixed or determined price for a specified period of time. ESO grants help companies to attract and motivate key employees and they align shareholder interests (i.e., an increase in share prices) with the interests of grantees (i.e., an increase in option value). Academic studies demonstrate that granting options can contribute to improving corporate performance by enabling companies to attract and retain talented people who are critical to the company's success. This is particularly true in sectors where the market opportunities are very large and technology changes are very rapid. In addition, options enable young companies to reduce their cash usage and thus avoid issuing stock at unfavorable current valuations. People think that both ESO and Call Options are same because of the similarity of the fundamental function. But they differ and the important distinction is that ESOPs, unlike call options, are corporate securities that are issued by the corporations. Employees Stock Options (ESOPs) have been one of the most controversial topics in financial reporting during the last decade.

In the last decade, firms have increasingly turned to offering employees options and restricted stock (often with restrictions on trading) as part of compensation packages. Some of this trend can be attributed to the entry of young, cash poor technology firms into the market. Many of which have to use equity because they have no choice. However, many larger market cap firms that can afford to pay cash compensation have used stock based compensation as a way of aligning managerial interests with stockholder interests.

Many employees receive equity compensation as a supplement to their salaries. Traditionally, this compensation comes in the form of ESO grants. Firms grant ESOPs as compensation for a number of reasons; to minimize the firms' reported compensation costs, to conserve cash, and to avoid the limits on the tax deductibility of cash compensation under tax law. Market forces determine the total compensation of workers. ESOPs are often part of a package that includes wages, benefits, and working conditions. Firms try to structure such packages to appeal to workers and spur their efforts at the lowest price to the firm. A firm creates value for its owners through its economic activity. In the case of a corporate firm, shareholders are the owners, contributing capital in return for owning the shares of the business. Shareholders possess a so-called residual ownership claim i.e, they bear the ultimate risk of loss and receive the benefits of profitability after all prior claims have been satisfied. Shareholders' risk of loss is limited to their investment and their gain is limited only by a firm's ability to create value.

Under the scheme of employee stock option, employees including managers of a company are offered an option to buy shares (stock) of the company at concessional rates. The amount of stock an employee can buy is limited and is dependent upon his pay/wage level. Generally, employees are restricted from selling the stock for sometime. This restriction period is called as *lock- in -period*. The cost of shares is wholly deducted from the pay. Stock option plans are useful for both- the employees and the company because of the following:

1) Employees have an extra financial interest in the success of the company. Employees will gain when the company performs well and the stock market price of its shares goes up.

2) Employees have to invest some of their money to buy stock options.

3) Employees can build up a sizeable capital for themselves through regular purchase of stock options.

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The management sometimes offers the shares to the employees which enables the company to create goodwill amongst the employees. This enables the company to maintain industrial peace rather than to be used as a method of raising finance. Under this method, the company offers new securities to its employees. Through such sale, the workers become shareholders i.e. co-owners of the company. In this way, co-partnership can be introduced through such a sale, by making workers the shareholders of the company. The company's shares are offered at concessional rates to their workers. Worker's share in the company's profits is paid in the form of equity shares by which they become entitled to participate in the decision-making process.

Shareholders have a principle agent relationship with the management of a firm. Managers are essentially agents of the owners, or principle. Left to their own devices, managers may act in their own best interest, which may not be the same as that of the shareholders, a phenomenon known as the agency problem. Shareholders can encourage managers to take actions that are consistent with their own interests by devising appropriate managerial incentives and then monitoring a manager's performance. Compensating managers with ESOPs may give those executives a stronger incentive to take actions that, for example, increase the price of the firm's stock. ESO grants may also be desirable from the shareholder's stand point, because the options are also used as a motivational device to align managers incentive with shareholder's interests.

Granting stock options for highly compensated employees will be less expensive for firms than other forms of compensation, such as cash salaries or outright grants of stock. For tax purposes, compensation (as well as other expenses) is normally deducted from a firm's income to arrive at its taxable income. ESOPs,therefore, may reduce taxable income and taxes, when cash compensation does not. The past accounting treatment of ESOPs provided an additional incentive for firms to grant options as part of employee compensation because it allows firms to recognize the expenses of some ESOPs at less than their market value in most cases at a value of zero. That treatment helped to accommodate the seemingly conflicting incentive firm's face on reporting their income for financial accounting and for tax proposes. For financial reporting purposes, firms prefer to maximize their reported income, but for tax-reporting purposes, they are interested in minimizing. Prior, accounting standards effectively allowed firms to do both to some extent; they may record a compensation expense of zero for employee stock option grants in their financial reports, but they may also deduct the actual exercise value of those options as compensation expense on their tax returns.

IMPORTANT ASPECTS TO BE KEPT IN MIND ABOUT ESOPs

1.WHAT ARE ESOPs?

An Employee Stock Option Plan is when the company offers its shares to the employees. An ESOP is nothing but an option to buy the company's share at a certain price. This could either be at the market price (price of the share currently listed on the stock exchange), or at a preferential price (price lower than the current market price). If the firm has not yet gone public (shares are not listed on any stock exchange), it could be at whatever price the management fixes it at.

2.WHY WOULD A COMPANY OFFER AN ESOP?

When you invest in shares, you do not invest in the market. You invest in the equity shares of a company. That makes you a shareholder or part owner in the company. Owning an equity share means owning a share in the company business. Companies offer their employees shares because it is considered that having a stake in the company would increase loyalty and motivation substantially.

3.WHEN ARE THEY GIVEN?

It depends on company policy and your designation. There are time limits for availing this scheme. For instance, you can acquire the shares after you complete a particular period of employment. This could be a year, even longer. This is known as the vesting period, and generally ranges from one to five years. If you quit your job before this period is complete, the stock options lapse. Sometimes, the ESOPs are given in a phased out fashion -- 20% in the second year, another 20% in the third year, etc.

4. WHEN ARE THEY TAXED?

The ESOP is not taxed on acquiring the shares. You are taxed on the profit you make when you sell the shares or transfer them. Transfer here refers to when you gift it to someone or transfer it to someone else under an irrevocable deed (they now own it, not you).

5. HOW ARE THEY TAXED?
When you sell any asset you own (house, land, shares, mutual fund units, gold, debentures, bonds), and you make a profit on the sale, it is known as capital gain. The tax you pay on this profit is called the capital gains tax. Capital gains tax is computed on the difference between the sale price and the issue price (the price at which shares are offered to you).If you sell the shares within a year of allotment (within 12 months of acquiring them), it is a short-term capital gain. If you sell the shares after a year of allotment (after 12 months of acquiring them), it is a long -term capital gain.

6.WHAT IF THEY ARE LISTED ABROAD AND SOLD ABROAD?
This depends on whether you are a resident or non-resident Indian. If you are a non-resident, it will not be taxable, as the gains occur outside India, unless the money is received in India. If you are a resident in India, then you will be taxed on the gains. Long-term capital gain is taxed at 20%. Short-term capital gain is added to your overall income and taxed according to your slab rate.

7.WHAT IF THEY ARE LISTED AND SOLD IN INDIA?
The taxability depends on the nature of gain at the time of sale. If you have a short-term capital gain, you have to pay tax at the rate of 10% (plus surcharge if applicable). Long-term gains are exempt from tax.

8.DOES ONE HAVE TO PAY A SECURITY TRANSACTION TAX IF SOLD IN INDIA OR ABROAD?
If you sell your shares on or after October 1, 2004, you need to pay the Securities Transaction Tax in India. Also the STT is leviable in abroad as per their rules.

9.CAN ONE AVAIL OF INDEXATION?
You use indexation when you calculate tax taking into account the inflation. This is good because it reduces the amount of capital gain and the amount you end up paying as tax. Indexation is available only for long-term capital gains. Since the long-term capital gains on shares and options are not taxable now, it is not required.

10.CAN ONE INVEST THE PROFIT TO AVOID TAX?
Long-term capital gain on shares are exempt, so this does not arise. There is no provision to invest the short-term capital gains to avoid tax.

REVEIW OF LITERATURE
In order to find out the gaps in the studies, it is pertinent to review the available literature on the related aspects of the present study. The studies on the performance of employee stock option scheme in India is a wide area, each and every area can be studied in brief.

Madhani ,M, Pankaj, (1) in his book has expressed about employee stock option accounting scheme. He has highlighted benefits which employees derived by adopting employee stock option scheme. Firms grant ESOPs compensation for a number of reasons; to minimize the firms' reported compensation costs, to conserve cash, and to avoid the limits on the tax deductibility of cash compensation under the tax law forms the main context of his book.

Damodaran Aswath (2) in his book mentions about equity based compensation and restricted option scheme. The author has made an attempt to express characteristics of option grants, conventional treatment, debate about expensing option. In his book, he has also given importance to option effect on value and option effect on pricing models.

Khincha Padamchand H. (3) in his book explains about International principles for employee stock option scheme. He has highlighted important aspects related to taxation plans of employee stock option plans at the time of Grants, Vesting, at the time of exercise, at the time of sale, International tax aspects of Employee stock option schemes.

Dhond Arvind, (4) in his book highlighted important aspects to be kept in mind about employee stock option scheme. It also highlighted weak problems faced by employee stock option scheme.

Committee Report on Employee Stock Option scheme by SEBI (5), this report highlights guidelines on employee stock option scheme/employee stock option plans. It also highlights various definitions, terms, disclosures, Accounting policies.

Business Line,2007 Business daily from THE HINDU group of publications (6),this publication highlights about taxation aspects related to Employee stock option scheme. It also deals with various tax treatments related to buy back of shares, transfer of shares, sales of shares etc.

OBJECTIVE

In research, although the aim is to achieve the maximum, there are always constraints of time, efforts and resources. The objectives are being framed to find out certain details considering the above limitations. The following are the objectives of the study:

1. It aims to study relationship between ESOP's with the market capitalization of the company.
2. It aims to study accounting and taxation aspects of ESOP's.
3. It aims to study ESOP's V/s Non ESOP's.

RESEARCH METHODOLOGY

- **Research Type:** The descriptive research method will be used.
- **Sample Design:**

Sample: 18 companies from different sectors
Sampling Technique: Random Sampling.

- **Data Sources:**

Secondary Data: Secondary Data will be collected from banks, journals, news articles etc.
Main source: Capital online

HYPOTHESES OF THE STUDY

In the light of the above-cited objectives, the researcher for the present study has set the following hypothesis:

- **ESOPs are beneficial to the employees , which is favourable to the firm in return.**
- **ESOPs correlates with the market capitalization of the company.**

Based on the theoretical data, tables, diagrams and secondary data, the hypothesis is formulated by the researcher is being examined.

SOURCES OF DATA

In this research, secondary data will be used. All the data necessary for this study will be taken from:

- Various books written by different authors.
- Articles from journals and periodicals.
- Capital online.
- Official records.
- Libraries.

UTILITY OF THE STUDY

This study is a careful analysis of the financial aspects and evaluation of the ESOPs in particular with an objective to draw valid conclusions and give valuable suggestions. It also focuses on the prevalent problems relating to the ESOPs and its correlation with market capitalization of the firm. The future opportunities and challenges ahead in stores for employees have attracted the researcher to select ESOPs for his study.

ANALYSIS AND INTERPRETATIONS

Noted that all options do, in fact option issued and listed by the option exchanges have effect on the market capitalizations of the firms .It can be negative or positive impact, but there is effect in market capitalization of firm who issues ESOP. The option issued by firms do have an effect on value per share, since there is a chance that they will be exercised in the near or far future. Given that these options offer the right to individuals to buy stock at fixed price. They will be exercised only if the stock prices rises above that exercise price. When firms grant options to employees, it is existing stockholders who pay for these options. As analysis from Table1, it can be seen that:

- Hindalco allotted 227454 shares as ESOP ,but as can be seen from the data, their market cap stands negative in 2009. Infact, in 2008, their market cap was positive . In 2009, they issued ESOP, their Market was Negative due to reduction in sales by 16.20 % because of which their profits went down by 35%.
- Indian Aluminium didn't go for ESOP -their market cap was stable .

- Hindustan Unilever allotted 67440 shares as ESOP , their Market Cap improved slightly , it was slightly because of issue of ESOPs, but mostly because of their increase in revenue earnings.
- Johnson & Johnson didn't go for ESOP- their Market Cap was stable, their sales were declining, even though their market was stable.
- All the IT companies issued ESOP, but it was very minute impact on the value of the firm, in all the IT companies, Market cap was negative inspite of an issue of ESOP . This was mainly due to reduction in their revenue earnings .
- TCS didn't issue ESOP in 2009 and there's no any impact on their Market cap.
- DLF Ltd. market Cap became negative in 2009 as compared to 2008 which was zero inspite of issue of ESOP- this was due to their reduction in sales by 67%.
- Currently, gains from employee stock options are assessed to tax as income in the year in which the options are exercised. Unless the employee has arranged to pay his tax by installments, including the tax on stock option gains, the tax becomes due within one month after it is assessed.
- Last October, MOF implemented the Qualified ESOP Scheme, which allows employees to defer payment of tax on gains arising from stock options for up to 5 years, subject to an interest charge at prime rate. The scheme was introduced to alleviate the cash flow problems faced by some employees who do not sell their shares after exercising the options.
- Under the Entrepreneurial ESOP Scheme, an employee of a company can enjoy tax exemption of 50% of up to $10 million of stock option gains arising over a period of 10 years, if certain criteria are met.
- With the recent increasing trends of multinationals granting huge amount of incentive compensation to attract and retain talent in the form of ESOPs, the value of the ESOP benefit will fall under the Fringe Benefit Taxation (FBT) regime.

CONCLUSIONS

ESOPs do have impact on the Market Capitalisation of a firm, but its impact is very nominal, there are other factors like increase in sales, revenues, other incomes, expenditure- which has major impact on market capitalization of the firm. ESOP has taxation advantage. Whether ESOP is issued or not issued, it has very marginal impact on the Market capitalization of the firm.

LIMITATIONS OF THE STUDY

The researcher has tried, to the best of her abilities, to get the closest information to make the research as authentic as possible considering the time and resources constraints. As it is an individual attempt to study, it was not viable to carry out the study on all sectors and even firms were selected as per convenience and random sampling. Consequently, it has to be limited because of time and other resource constraints. The study was restricted only to impact an ESOP issue, other factors were not considered for the study.

Table 1 : Market Cap Of The Firm

Company	Hindalco Industries Ltd.			Indian Aluminium Company Ltd.			Johnson & Johnson Ltd.			Hindustan Lever Ltd.		
Years	2009	2008	2007	2009	2008	2007	2009	2008	2007	2009	2008	2007
Market Cap	-56.34	33.83	-28.58	0	0	0	0	0	0	11.48	-1.18	10.06

Table 1 : Market Cap Of The Firm (Contd.)

Company	HCL Technologies Ltd.			Infosys Technologies Ltd.			Satyam Comp. Services			Tech Mahindra Ltd.		
Years	2009	2008	2007	2009	2008	2007	2009	2008	2007	2009	2008	2007
Market Cap	-26.83	40.6	-30.81	-7.28	-27.38	37.65	-15.38	13.45	111.27	-62.37	-50.38	0

Company	TCS Ltd.			DLF Ltd.			Unitech Limited			State Bank of India		
Years	2009	2008	2007	2009	2008	2007	2009	2008	2007	2009	2008	2007
Market Cap	-33.41	-34.14	28.64	-74.25	0	0	-87.34	42.58	803.73	-32.93	93.21	2.57

Company	Punjab National Bank			ACC Ltd.			Birla Corporation Ltd.			Ultra Tech Cement Ltd.		
Years	2009	2008	2007	2009	2008	2007	2009	2008	2007	2009	2008	2007
Market Cap	-19.14	7.74	0.1	-53.34	-5.45	106.26	-9.37	2.94	-40.36	-29.35	1.22	12.65

Company	Bombay Dyeing & Mfg Comp.Ltd.			Hinduja Ventures Ltd.			Andhra Sugars Limited		
Years	2009	2008	2007	2009	2008	2007	2009	2008	2007
Market Cap	-72.66	13.58	-9.08	-72.31	-71.77	16.47	-27.23	-5.5	-58.65

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