Items	Description of Module
Subject Name	Human Resource Management
Paper Name	Performance and Compensation Management
Module Title	Stock Based Compensation
Module Id	Module No. – 32
Pre- Requisites	Basic understanding of compensation
Objectives	To develop effective understanding about stock based compensation
Keywords	Stock based compensation, types, activities in stock based compensation

QUADRANT-I

1.	Module 32: Stock Based Compensation
2.	Learning Outcomes
3.	Introduction
4.	Meaning of Stock Based Compensation
5.	Kinds of stock Based Compensation
6.	Methods to measure Stock Based Compensation
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1. **Module 32:** Stock Based Compensation
2. **Learning Outcomes**:

   By the end of this module, students will be able to

   - Understand the concept of Stock based compensation
   - Identify different kinds of stock based compensation
   - Identify different activities involved in stock based compensation

3. **Introduction**

The history of economic progress had long back laid the foundation of separation of ownership and management. Due to formation of companies, huge pool of resources is created that creates synergy of fantastic development at all fronts – whether economic or social. Pooling creates greater efficiency, enlargement in scale of production and transfers risk to diversified stake holders. In spite of huge amount of benefits, separation of management and ownership involves various types of cost.

Separation gives rise to costs because the priorities of the principal (share holders) and agents (employee) differ. Due to this reason, employees may sometime act in a manner that is not very beneficial to the share holder. The use of stock based compensation is actually looked at one of the best ways of aligning the interests of the share holders and the employees. In the past few years stock options have enlarged as a significant component of compensation for executives and employees. Actually stock options give the employee the right to purchase shares in future at a specified price. This means that higher value of the company is associated with higher value of stock option. This intern implies that the financial goals of employees are directly related to those of the share holders.

Studies\Surveys have proved that stock options are increasingly being used at all levels of organisations. It is also believed that stock options are a useful way to attract and retain employees especially executive. Stock options seem to be greatmotivators in organisations where there may be cash crunch. So using this method the organisation can save some cash.

4. Meaning of Stock Based Compensation

Stock option plan plays animportant role in compensation package which is offered to the equity participates. Stock option means right to purchase a definite number of shares of a company's stock at a definite price for a definite period of time. Companiesnormally grant fixed option, where the exercise price is fixed and the number of shares can be determined at the grant date. The exercise price is normally set equal to the market price of the underlying stock at the grant date and remains fixed till the life of the option, although there are few exceptions. Employees stock option provides a vesting period of several years before which the stock option cannot be alter. Vesting period is a time period under which employees becomes eligible to actually own the stock.

Source:https://www.wallstreetprep.com/blog/stock-based-compensation-treatment-dcf-almost-always-wrong/

Stock option is used as a long term compensation method by the companies. Options are frequently granted to executive and other employees as an alternative to raise the base compensation. Few of the reasons for using stock options are:-

- Options help companies to cope up with labour markets
- Options stimulate job creation in knowledge related industries.
- Options are tax-efficient way to pay employees.
- Options offer an opportunity to reduce employee's base compensation. This balances the huge gap between executive and other employees.
- Employees develop interests in the organisational activities just as share holders have once they have the opportunities to opt for options.

It is scattered through the management and professional ranks. Fraction of the reason for the increase in stock options has been the rigid labour market and the explosion in high technology job creation and economic growth. Murphy (1998) argues that the academic evidence "directly linking current grants to future performance is frankly, rather flimsy". One of the basic goal that is applied on stock options is the observation that a company with a broader stock-based compensation plan may face a significant raise in its share holder value over a certain period of time. A controversy may arise if this company is compared with its industrial group, because it is difficult to tell whether employees did well or share holders did well, which may prove to be a hose if the company actually did worse than the rest of its industry group.

5. Kind of Stock-Based Compensation

The term "stock-based compensation" is a wide term embraces the compensation of an employee in stocks, stock options, stock appreciation rights and other stock-related awards.Stock-based compensation can be classified into two categories as follows:

A. **Restricted Stock Plan:** The most traditional form of stock award was grant of stock at the completion of a specified period of satisfactory service. There may be a clause that a specified number of restricted stocksare granted on achievement of some performance goal or attainment of a specified level of targets. A point worth noting is that grant o stock doesn't mean ownership of shares at a later date. The share units accrue dividends during the deferred period that are credited to the account of the employee either as cash or as additional stock.

Merits:

- Incentives plan can be alter as and when demanded
- There is no dilution of the issued share capital as no share is transferred on exercise of the option
- Work efforts is aligned to organizational growth and progress
- Minimum or very low administration cost
- Organisation enjoys the tax rebate benefits.

Demerits

- Cash flow cost is also included
- Bonus in the hands of employees is also chargeable to income tax.

B. **Employees Stock Purchase Plan:** An employee stock purchase plan is a stock purchase warrant issued by a company to an employee in exchange for his services. This plan allows purchase of company's stock at regular intervals. Sometimes in place of compensating the employee with cash, the employee gets an option to purchase the stocks of the company. Employee stock option are a means of linking compensation to the stock price, which is a measure of company performance, and are a means of minimizing the agency problem.

Source:http://www.getsalesforcebenefits.com/your-benefits/financial/employee-stock-purchase-plan-espp

Generally, these purchase adjusted against deductions in employees compensation. In such deals brokerage fee is nil. Often, the plan supports purchase to be made at a discount from thr fair market value of the stock.

Merits:

- Ownership in the company through instant stock purchase;
- Motivation for improving individual, group and organizational performance; and
- Deferred compensation normally yield higher return

Demerits:

- Share capital of the company increases
- Cash flows over time; and
- Stock market fluctuations and risk play significant role.

6. Methods to Measure Stock-Based Compensation

There are two methods to measure stock-based compensations:-

6.1. The Intrinsic Value Method :- This method is used to measure compensation expenses in excess, if any of the quoted price of the stock at the measurement date over the amount of which the employee must pay to acquire the stocks. If the exercise price of the stock is equal to or greater than the market price of the stock at grant date, then no intrinsic value and no compensation expenses would be recorded in the income statement.Factors which may influence the price of an option:-

- Price of underlying assets
- Striking price of option.
- Remaining time till maturity date.
- Expected dividend on underlying stock.
- Risk-free interest rate for the expected life of the option.

6.2. The Fair Value Method: - This method is used to measure the compensation cost on the grant date of the option which is based on the estimated fair value of the option, which is determined by using option pricing model. Stock options normally determined as a fair value at grant date because of time. Normally many years, during which option was excisable and that amount was posted as an expense in the income statement of the organisation.

7. **Activities Involved In Stock Based Compensation**

Stock based compensation involves the following activities:-

a) **Granting Activities: -** It includes decisions relating to number of grants, grant dates, hock-in period and date on which stock options will be provided by the compensation committee and the board of directors.

b) **Administration Activities: -** It includes reconcilingemployee’s data with the given information, ensuring booking in financial statements of the organisation data on forfeiture, stock exercise patterns, and deciding methods for calculations.

Source: https://www.shutterstock.com/search/public+administration

c) **Calculating Activities: -** It helps in rationalising the assumption which are used in calculation and forfeiture. It involves the documenting all such calculation and forfeiture assumptions.

d) **Reporting Activities: -** It includes reporting stock compensation details in balance sheets of the organisations for ensuring appropriate income tax reporting. Maintaining proper recordsof internal and statutory audit is to ensure that it compliance with SEBI guidelines.

8. **Guidelines of SEBI on Stock-Based Compensation**

Employee stock option scheme and employee stock purchase scheme guidelines, 1999 of securities and exchange board of India (SEBI) provides the following guidelines as under:

8.1. Definitions:

- "Employee compensation" means the total cost incurred by the company towards employee compensation including basic salary, dearness allowance, other allowances, bonus and commission including the value of all perquisites provided but does not include: (a) The fair value of the option granted under an employee stock option scheme; and (b) the discount at which shares are issued under an employee stock purchase.

"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.

8.2. Compensation Committee: - Compensation committee refers to a committee which consist of a majority of independent directors. The compensation committee construct the detailed terms and conditions of the ESOS;

- The quantum of option to be allowed under ESOS per employee
- Situations under which option is invested in employees may help lapse in case of termination of employment of misconduct;
- It include time period with in which the employee shall exercise the vested options in the event of termination or resignation of an employee
- An employee has the right to exercise all the options vested in him at one time or at different point of time with in the exercise period.

The compensation committee should frame suitable policies and system to make sure 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 related to securities market) Regulations, 1995 by any employee.

8.3. Eligibility to Participate in ESOS:-

- An employee is eligible to participate in ESOS of the organisation;
- If an employee is a promoter or comes under the promoters group is not eligible to participate in ESOS; and
- If a director directly or indirectly holds more than 10% of the outstanding equity shares of the company is not eligible to participate in ESOS.

8.4. Shareholder Approval:-

- ESOS can't be offered to the employees unless and until shareholders of the organisation approve ESOS in the general meeting by passing a special resolution.
- The resolution proposal passed in general meeting for ESOS should contain the following information.
  - ➢ Total number of options to be granted
  - ➢ Identification of classes of employees who have right to participate in ESOS
  - ➢ Need of vesting and period of vesting
  - ➢ Maximum period with in which the options shall be vested
  - ➢ Exercise price or pricing formula
  - ➢ Exercise period and process of exercise

- ➢ Maximum number of options to be issued per employee
- ➢ The appraisal process for determining the eligibility of employees to the ESOS.

8.5. Variation of Terms of ESOS:-

Organisation can't change the terms of the ESOS at any cost, which may be detrimental to the interest of the employees.

Source: http://signatureanalytics.com/seminar-recap-employee-stock-ownership-plans-esop/

8.6. Lock-in Period and Rights:-

- There should be a maximum time gap of one year between the grant of options and vesting of option;
- The organisation have the freedom to specify the lock-in period for the shares issued pursuant to exercise of option
- Employees don't have right to receive any dividend or to vote or to enjoy the benefits of a shareholder in respect of option granted to him, till shares are issued on exercise of option.

8.7. Consequence of Failure to Exercise Option:-

If any amount payable by the employee at the time of grant of option:

- May be forfeited by the company if the option is not exercised by the employee within the exercise period
- Amount can be refunded to the employee if the option is not vested due to non-fulfilment of condition-related to vesting of option as per the ESOS.

8.8. Non-Transferability of Option:-

- Employees can't transfer their option to any other person

- Only those employees are entitled to exercise the option to which option is granted, no other person can do.
- The option granted to the employee while in employment, all the option granted t him till the date o his death shall be transferred to his legal heirs or nominees.
- If the employees becomes incapable while in employment, all the option provided to him as on the date of permanent incapacitation, shall vest in him on that day.
- In case of resignation of the employees, all options not vested as on that day shall expire.

8.9. Disclosure in the Director's Report:-

The board of director's disclose either in the directors report or in the annexure to the directors report of the ESOS:

- The pricing formula
- Options granted
- Options vested
- Options exercised
- The total number of shares arising as a result of exercise of option
- Options lapsed
- Variation of terms of options
- Money realized by exercise of options
- Total number of options in force.

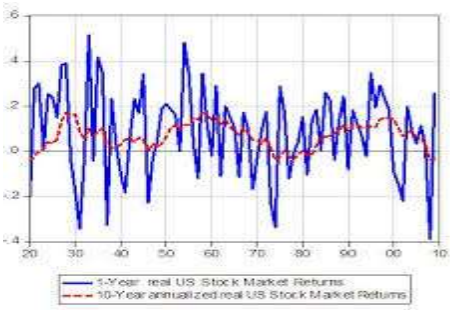
8.10. Certificate from Auditors:

The board of directors places an auditor's certificate before the shareholders in the annual general meeting that ESOS has been implemented in accordance with the guidelines and also in turn with resolutions of the company.

9. Demerits of Stock-Based Compensation

A well designed stock-based compensation plan is the best way to show organisational performance, but stock-based compensation has various criticisms which are as follows:

a) Fluctuations in Stock Market: - Value of stock varies at different point of time, due to fluctuations in stock market and which is beyond the control of the employees the companies. In a 'bullish' market, the value of stock raise significantly with the rise in income of the employees whereas in 'bearish' market, the income of employees through stocks may be significantly decreased.



Source:http://voxeu.org/article/demographics-and-stock-market-fluctuations

b) **Cost of Option:** - Most of the time employeesdon't want to pay the cost which is close to the full cost of their option; therefore it is inefficient substitute for cash compensation and a poor way to attract employees.

c) **Attrition:** - If the stock prices decrease below the exercise prices then the employees will leave their current companies and join the offer of the competitors new compensation package.

d) **Not UniversallyApplicable:** - Stock based compensation cannot be implemented for the employees working in government services or non-stock companies.

e) **Deep Pockets:** - Itneeds to acquire sufficient funds to exercise the stock options by the employees.

f) **Relative Unattractiveness:** -It will not attract any employee with high cash needs than different financial needs.

g) **Managerial Manipulation:** - It provides an incentive for managers so that unrealistic expectations can be built and that may raise the stock price even if the process of creating the unrealistic expectations irreparably harms the company.

h) **Enhanced Equity Base:** - It raises the capital base of the organisation which will lead to fall in stock prices. If the organisation issues the large number of stock to the employees then there will be a significant fall in the stock prices. As stock prices falls not only employee's stock-based income will fall but ROI for share holders will also fall.

10. Summary:

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