Employee Stock Option Plans/Equity Incentive Plans (commonly referred to as ESOPs) have been in practice for a long time, and are being increasingly used as a compensation tool by both multi-national and Indian companies. The popular reasons for implementing ESOPs are wealth creation for employees, retention, attracting new talent and inculcating the feeling of employee ownership to motivate employees.

Companies generally consider various aspects while designing ESOPs. These, among other things, include:
- Industry practice around designing ESOPs.
- Discount offered to employees.
- Impact on company’s financials.
- Shareholding dilution.
- Tax implications both from an employer and employee perspective.
- Accounting implications.
- Regulatory implications, viz. Company law, Securities and Exchange Board of India (SEBI) Regulations, Foreign Exchange Regulations, etc.
- Administrative aspects of implementing an ESOP.

KPMG in India carried out a Survey with the following objectives:
- Collation of data regarding the existing practices among multi-national companies and Indian listed and unlisted companies.
- Sharing insights with participants as to the best practices, key differentiators and trends.

This Survey report provides information on ESOPs based on the data gathered from the respondents.

We are hopeful that this report will be beneficial to companies with existing ESOPs and also to those contemplating to roll-out new plans.

Sanjiv Chaudhary  
Executive Director  
KPMG in India

Parizad Sirwalla  
Executive Director  
KPMG in India
Executive summary

- Information Communication and Entertainment (ICE) sector dominates the ESOP space followed by Financial Services and Private Equity and Manufacturing and Consumer Goods sector respectively.

- Indian companies with overseas operations are increasingly awarding equity incentives to attract and retain talent.

- Indian companies continue to prefer simple Stock Options over other types of equity-linked incentive plans.

- Indian companies prefer to incentivise only their key employees. Generally, there is one uniform plan implemented to cover employees at different levels.

- Retention continues to be one of the key driver for ESOPs.

- Companies generally do not review their plans periodically to keep pace and align with the changing business environment.

- Generally, unlisted/private companies do not inform their employees on Fair Market Value (FMV) of the shares on a periodic basis.

- Companies believe that ESOPs enhance productivity, motivate employees’ and increase employees’ interest in the company’s overall performance.

- Considering the accounting impact, companies are generally averse to granting options at a discount.

- A vesting schedule of three to four years with annualised vesting is prevalent. Generally, ‘Performance’ is not a common criterion amongst Indian companies for determining the vesting schedule. It is still very much time based.

- The majority of companies generally provide a window of two to five years to exercise vested options with no lock-in thereafter.
## Table of Content

- Overview of ESOPs 01
- ESOPs - Tax implications in India 02
- Global trends 03
- Survey analysis - Overview 04
- Survey analysis - Results 05
Overview of ESOPs

ESOPs are one of the important tools to attract and retain employees. The feeling of ownership encourages employees to have long-term career aspirations in the organisation.

It is important to ensure that the ESOP is attractive for employees, simple to understand and administer and compliant with various tax and regulatory requirements. An appropriate plan, that is compliant with the current provisions of income-tax, corporate law, foreign exchange regulations, listing requirements, etc. has to be drafted. In recent times, accounting implications relating to ESOPs have also undergone substantial changes and have become a critical factor in the decision-making process.

Companies have substantial flexibility to design the plan catering to their needs. Usually, companies adopt one or more of the following types of plans, with variations in the specific terms to make it relevant to its business needs and objectives.

- **Employee Stock Option Scheme (ESOS)**
  An ESOS is a right to buy shares at a pre-determined price. The option granted under the plan confers a right but not an obligation on the employee. Stock options are subject to vesting, requiring continued service over a specified period of time. Upon vesting of options, employees can exercise the options to get shares, by paying the pre-determined exercise price.

- **Employee Stock Purchase Plan (ESPP)**
  An ESPP allows employees to purchase company shares, often at a discount from FMV at grant or exercise. The plan term determines the date and price at which the employee is entitled to purchase company stock.

- **Stock Appreciation Right (SAR) / Phantom Equity Plan (PEP)**
  Under SAR/PEP, the employees are allotted notional shares/units at a pre-determined price. On completion of vesting conditions, the employee is paid cash equivalent of the net gain i.e. appreciation in the price of underlying shares without any cash investment. These plans generally result in cash outflow for the company.

- **Restricted Stock Award (RSA)**
  Under RSA, an employee receives an award of stock subject to certain underlying conditions. If the underlying conditions are not met, the shares are forfeited. The employee is considered to be the owner of the shares from the date of award with entitlement to receive dividends and voting rights. The forfeiture conditions may be based on continued service over a specified period of time. The employee may be required to pay for RSA at grant which may be at a discount or more usually is awarded the stock at no cost.

- **Restricted Stock Unit (RSU)**
  Under RSU, an employee is awarded an entitlement to receive stock at some specified date in the future subject to certain conditions. These conditions may relate to performance or tenure of employment. Until shares are actually delivered, the employee is not a shareholder and does not have voting rights or rights to receive dividends. It is important to note that RSU is not an immediate transfer of shares subject to forfeiture, but a promise to give shares in the future. RSUs are generally entitled to quasi-dividends.
ESOPs - Tax implications in India

Taxation of ESOPs in India has witnessed continuous change. Up to the financial year ending March 1999, there were no specific provisions for taxing the benefits arising from ESOPs. The ESOPs were generally taxed as a perquisite in the hands of the employees on the difference between the FMV of the stock on the date of vesting of the options and the exercise price. Subsequently, there was a concessional tax treatment for ESOPs, which were designed in accordance with prescribed ESOP Guidelines. The taxation triggered only at the time of sale of the shares for such qualified ESOPs. Unqualified ESOPs were taxable as a perquisite on the difference between the FMV on the date of vesting/exercise and the exercise price.

During the period April 2007 to March 2009, employer was required to pay Fringe Benefit Tax (FBT) on benefit derived by employee from ESOPs. The employer was allowed to recover such FBT from the employees.

Currently, ESOP benefits are taxable as perquisite and form part of employees salary income. The employer is required to withhold tax at source in respect of such perquisite.

The perquisite value is computed as the difference between the FMV of the share on the date of exercise and the exercise price. There are specific valuation rules prescribed for listed and unlisted companies. Unlisted companies need to determine the FMV by a Category I Merchant Banker registered with SEBI.

The incremental gain (i.e. difference between sale consideration and the FMV on the date of exercise), on sale of shares is considered a capital gain for the employee. For computing capital gains, the FMV on the date of exercise becomes the cost base. The capital gains tax treatment further depends on the holding period and whether the shares are sold on a recognised stock exchange in India.
• Equity plans have been a popular part of the executive remuneration package for a number of years in many countries and their use has enhanced globally in recent years. The structure of such plans is largely driven by respective local tax laws and regulations. The primary incentive mechanism remains either market value share options, or some form of performance shares/RSUs, with the latter becoming more predominant in many countries. RSA is also common in some countries, notably the United States (US).

• The recent economic crisis has not led to significant changes in the structure of majority of the plans. However, there has been a debate regarding the need for an increase in transparency and disclosure of such equity plans.

• In particular, scrutiny by stakeholders and Governments has focused on the use of performance measures attached to awards. Companies need to justify their choice of measure and to demonstrate that awards will vest only if performance is strong and sustainable. Earnings Per Share and total shareholder return/share price measures remain common.

• The size of the awards has also been criticised in some instances, particularly, where this is linked to a percentage of salary. As share prices had fallen, this resulted in an increase in the number of shares awarded to executives. The shareholders were concerned that windfall gains could be made by executives as global stock markets recover, unless award sizes were reduced. Stock market performance over the last one year has to a certain extent taken care of this concern.

• Regulatory changes have also impacted the plan design, e.g. Capital Requirements Directive III in the European Union (EU) stipulates a minimum level of deferral of bonus. This is likely to increase in the use of deferred bonus plans by the Financial Services sector across the EU. Many other countries, including the US, have also introduced or are contemplating introducing regulations having an impact on pay arrangements including long-term incentive plans in the Financial Services sector.

• In spite of increased scrutiny, equity plans still remain a key part of executive remuneration packages and their global spread is likely to continue.
The Survey was conducted by KPMG in India seeking inputs from multinational companies and Indian listed and unlisted companies.

This Survey report is designed to be a guide in the context of equity-linked incentive plans. As the Survey was the first of its kind conducted by KPMG, there was no previous data available to benchmark and compare the Survey results.

While the data covered in the Survey report provides useful insights, it is imperative to note that certain information could be dated and is linked to the personal circumstances of each of the respondent companies. It is recommended to do an independent assessment before taking any policy decision.

To the extent possible, we have bifurcated the data into groupings by industry/sector, type of company, viz. listed and closely held companies, etc.

The Survey was divided into five sections:

A) Basic information of the company.
B) Particulars of ESOPs – General.
C) Conditions of grant.
D) Conditions of vesting.
E) Conditions of exercise.

Each section of the Survey aimed at collating information in respect of existing ESOPs in the company, or the type of plan that the company was proposing to implement.

Over 350 companies participated in the Survey. Out of these, 203 companies had either implemented an ESOP or were planning to introduce a new plan.

The remaining companies (approximately 150) did not have ESOPs and were also not proposing to roll-out in the immediate future.
1 Participation - Industry

Out of the 203 companies having an active ESOP or who were considering implementing a plan:

- Approximately 40 percent (82) of respondents were from the ICE sector; and
- Approximately 16 percent of respondents were each from the Financial Services and Private Equity sector (33) and the Manufacturing and Consumer Goods sector (32) respectively.

It appears that ESOPs continue to be predominantly concentrated in the ICE sector, though companies in the Financial Services and Private Equity sector and the Manufacturing and Consumer Goods sector respectively are also increasingly implementing ESOPs. ESOPs are yet to penetrate into other sectors.

Source: KPMG’s ESOP Survey, 2011
Participation - Company

Of the 203 companies:

- Nearly 42 percent (85) of companies are public listed companies.
- The remaining 58 percent (118) are unlisted companies.
- Nearly 57 percent (116) are Indian companies equally split into listed companies (59) and unlisted (57).
- Out of Indian unlisted companies (57), approximately 65 percent (37) of companies are contemplating an Initial Public Offering (IPO).

The trend indicates that even closely held companies are offering stock options to their employees to enable them to participate in the growth of the company and create value.

Plans for listing / IPO

Many unlisted Indian companies are contemplating an IPO which would provide a tax efficient exit mechanism to the employees.
Overseas operations

Of the 203 companies:

- Nearly 43 percent (87) of companies are subsidiaries of multi-national companies.
- The remaining 57 percent (116) are Indian companies.
- Nearly 76 percent (155) of companies mentioned that they are Indian companies having either overseas subsidiaries or an overseas parent or both.
- Nearly 33 percent (68) of respondents are Indian companies having overseas subsidiaries.

The chart below depicts the overseas relationship of Indian companies.

Operations of the company

Source: KPMG’s ESOP Survey, 2011

It indicates that multi-national companies consider ESOPs as a key mode of incentivising their employees. Interestingly, Indian companies having global operations are also adopting equity-linked incentives for their employees.

Out of 68 Indian companies having overseas subsidiaries, approximately 59 percent (40) of companies have granted ESOPs to the employees of their overseas subsidiaries.

Overseas operation: Indian companies grant of options

Source: KPMG’s ESOP Survey, 2011
Security under the plan

Of the 203 companies, 95 percent of companies mentioned that their plans are linked to equity shares and balance companies linked them to warrants and other securities.

It appears that Indian companies continue to follow the conventional mode of incentivising their employees through ESOPs. Except a few companies, Indian companies are yet to evolve plans which are linked to warrants/other securities which carry a lower risk of fluctuations as compared to equity shares.

Source: KPMG’s ESOP Survey, 2011
Note: The data does not add up to the number of respondents (203), as some companies have multiple plans.
5 Type of plans

In respect of the various types of plan:

- Nearly 64 percent (95) of Indian companies have implemented a Stock Option Plan as compared to 36 percent (54) of foreign companies;
- Only 35 percent (13) of Indian companies have ESPPs as compared to 65 percent (24) of foreign companies;
- Approximately 50 percent (14) of companies (both Indian and foreign) have SAR/PEP;
- Only 21 percent (3) of Indian companies have RSA as compared to 79 percent (11) of foreign companies;
- Only 23 percent (10) of Indian companies have implemented RSU as compared to 77 percent (33) of foreign companies; and
- Nearly 43 percent (6) of Indian companies have implemented ‘other’ plans as compared to 57 percent (8) of foreign companies. Few companies had implemented plans linked to mutual funds or specific to bonus shares.

Plan in operation

Source: KPMG’s ESOP Survey, 2011

Note: The data does not add up to the number of respondents (203), as some companies have multiple plans.

Predominantly, a stock option plan is the most preferred plan amongst the Indian companies. In comparison to foreign companies, the Indian companies are yet to explore other variants of equity-linked incentive plans.
Coverage of employees i.e. different plans applicable and the level of employees covered

Nearly 56 percent (114) of the responding companies indicated that their plans are applicable uniformly to all employees i.e. they do not have different plans for different levels of employees.

Uniformity of plan

Source: KPMG's ESOP Survey, 2011

Furthermore, 85 percent (173) of the companies indicated that options/stocks are granted only to select eligible employees. However, 15 percent (30) of the companies considered granting options/stocks to all their employees.

Coverage of employees

Source: KPMG's ESOP Survey, 2011

The proportion of both listed and unlisted companies in terms of coverage of eligible employees is broadly comparable.

Grant preference of companies towards employees

Source: KPMG's ESOP Survey, 2011
The trend indicates that companies are considering attaining diverse objectives, with ‘retention’ continuing to be one of the key objectives.

Objective for implementation

The key objectives indicated by the companies for implementing the ESOPs were – retention, employee ownership, wealth creation, performance targets and monetary reward. The chart depicts other objectives also considered by respondents.

Indian companies appear to be restrictive in utilising higher capital base towards stock options. They usually earmark a small percentage of share capital for their employees. On the other hand, there are companies which are aligning to remain parallel with global trends by earmarking higher capital infusion for their employees.
Review of the plan

Nearly 44 percent of the respondents indicated that they either review their ESOP structure annually (89) or once every three years (90).

Information regarding companies valuations

The respondents indicated that of the 58 percent (118) unlisted companies, 35 percent (41) of the companies use their audited financials to inform their employees in respect of their company valuation.

Generally, annual audited financials are used as a basis for valuation of shares and accordingly communicating this to their employees. It appears that many unlisted/private companies do not keep their employees informed of the valuation of the shares.

Companies may also consider alternative basis of valuation to reflect a value closer to the market value and thereby build transparency and enhance the motivation levels of employees.
Impact of ESOPs

Nearly 40 percent of the respondents confirmed that ESOPs have definitely motivated their employees towards better performance and nearly 11 percent indicated that they have improved the company’s profitability. Furthermore, around 29 percent of respondents felt that ESOPs have improved retention and brought in a sense of ownership.

With respect to other parameters such as improvement in productivity, profitability, job satisfaction, ability to recruit, controlling compensation costs, etc., the responses were more or less neutral.

Impact of ESOPs

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Motivated employees</td>
<td>40%</td>
</tr>
<tr>
<td>Improved profitability</td>
<td>20%</td>
</tr>
<tr>
<td>Improved employee retention</td>
<td>12%</td>
</tr>
<tr>
<td>Brought in sense of ownership</td>
<td>9%</td>
</tr>
<tr>
<td>Can’t say</td>
<td>2%</td>
</tr>
<tr>
<td>Definitely Yes</td>
<td>21%</td>
</tr>
<tr>
<td>To a Large Extent</td>
<td>25%</td>
</tr>
<tr>
<td>To Some Extent</td>
<td>11%</td>
</tr>
<tr>
<td>Definitely No</td>
<td>16%</td>
</tr>
</tbody>
</table>

Source: KPMG’s ESOP Survey, 2011
Note: The chart has been prepared considering multiple responses of the companies.

The Survey indicates that ESOPs serve as a significant tool in improving productivity, motivating employees and increasing their interest in the company’s performance.

Grants

Timeline

The majority of respondents (nearly 80 percent) have indicated that they grant options/stock on an annual basis.

Timelines

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual</td>
<td>80%</td>
</tr>
<tr>
<td>Quarterly</td>
<td>10%</td>
</tr>
<tr>
<td>Semi-Annual</td>
<td>7%</td>
</tr>
<tr>
<td>Monthly</td>
<td>3%</td>
</tr>
</tbody>
</table>

Source: KPMG’s ESOP Survey, 2011
Note: The data does not add-up to the number of respondents (203), as some companies have multiple plans.
It appears that companies generally consider an annualised grant to link this with the performance cycle of their employees.

Criteria

Nearly 36 percent of the respondents confirmed that the main criterion for grants was the level of employees and approximately 30 percent of the respondents indicated performance as another major criterion.

Discount on market value

Nearly 42 percent of the respondents indicated that they do not offer any discount to the FMV of the share.

Source: KPMG’s ESOP Survey, 2011
Note: The data does not add up to the number of respondents (203), as some companies have multiple plans.

Considering the accounting impact on the financials, nearly 42 percent of the companies were averse to making grants at a discounted value.
Vesting Timeline
Amongst the different types of plans, the majority of respondents had a vesting period of up to three years for the options/stock.

Vesting timeline

Source: KPMG’s ESOP Survey, 2011
Note: The data does not add up to the number of respondents (203), as some companies have multiple plans.

Schedule
On a uniform basis, the majority of the respondents (60 percent) indicated that options vested annually. However, a sizeable portion of respondents (27 percent) also mentioned ‘cliff vesting’ i.e. at the end of the specified period.

Vesting schedule

Source: KPMG’s ESOP Survey, 2011
Note: The data does not add up to the number of respondents (203), as some companies have multiple plans.
Percentage over timeline
Amongst respondents, the majority of the companies (nearly 54 percent) indicated that the options/stock vest equally over the vesting period. A few respondents indicated a gradual increase over the vesting period (31 percent).

Vesting percentage over the timeline

![Vesting percentage chart]

Source: KPMG’s ESOP Survey, 2011
Note: The data does not add up to the number of respondents (203), as some companies have multiple plans.

Basis
Nearly 56 percent of the respondents indicated that vesting was determined based on time period. Interestingly, around 37 percent of the respondents indicated that vesting is based on a combination of both time and performance. Very few companies indicated that their vesting schedule is linked only to the performance of their employees.

Basis of vesting

![Basis of vesting chart]

Source: KPMG’s ESOP Survey, 2011
Note: The data does not add up to the number of respondents (203), as some companies have multiple plans.
Exercise

Timeline

Nearly 47 percent of the respondents indicated that they have an exercise period of two to five years.

Exercise timeline

Source: KPMG’s ESOP Survey, 2011
Note: The data does not add up to the number of respondents (203), as some companies have multiple plans.

Lock-in Period

The majority of respondents (nearly 51 percent) mentioned that they did not keep a lock-in period for the shares allotted.

Lock in period

Source: KPMG’s ESOP Survey, 2011
Note: The data does not add up to the number of respondents (203), as some companies have multiple plans.
Funding

Nearly 32 percent of the respondents indicated that the company supported funding for exercise. However, the majority (approximately 42 percent) of the respondents indicated that the funding was the employee’s responsibility and was done through a mode other than salary deduction.

Mode of funding

Source: KPMG’s ESOP Survey, 2011

Note: The data does not add-up to the number of respondents (203), as some companies have multiple plans.

Cashless

Nearly 44 percent of the respondents answered in the affirmative in respect of providing the choice of a cashless exercise of options to the employees.

This indicates the companies’ willingness to have a cash outflow if it is for the benefit of the employees. However, a cashless exercise does not promote a sense of ownership for the employees.

Cashless exercise

Source: KPMG’s ESOP Survey, 2011

The results also indicate that the concept of cashless is common in foreign companies as compared to Indian companies.

Willingness to use: Cashless exercise

Source: KPMG’s ESOP Survey, 2011
Conclusion
The Survey results indicate that more and more companies are considering equity-linked incentive plans as an avenue to incentivise their employees. Generally, companies consider ESOPs for the following key reasons:

- The market pays the upside to its employees.
- There is no cash outflow for the company.
- Helps in retaining and attracting talent.
- Provides sense of ownership to employees.

The convergence of International Financial Reporting Standards (IFRS) is also making companies re-look at their existing plans to mitigate an accounting hit from an IFRS perspective. In practice, it is seen that many companies consider accelerating their vesting schedule to reduce the accounting impact under IFRS.

Specific regulations governing ESOPs viz., Company law, SEBI Regulations, Foreign Exchange Regulations, etc. need to be evaluated while designing an ESOP.

There is no universal formula of determining eligibility criteria and basis of allocation to employees.

Each company needs to assess/evaluate various parameters prior to conceptualising its incentive mechanism. Needless to say, this would be based on the company’s business model, future plans and overall need to attract, retain, motivate and reward employees.
Are your employees happy?

Attracting and retaining competent professionals is an uphill task faced by all organisations. Besides cash rewards, it is important for any organisation to make its employees believe that their personal growth is linked to the growth of the organisation. ESOPs are one of the important tools to achieve this objective. The feeling of ownership aligns employees’ aspirations with the long-term objectives of the organisation.

To learn more about how we can help, contact:

Sanjiv Chaudhary
Executive Director
T: +91 124 334 5032
E: schaudhary@kpmg.com

Parizad Sirwalla
Executive Director
T: +91 22 3090 2010
E: psirwalla@kpmg.com

Or visit us at kpmg.com/in
Contact us

**Dinesh Kanabar**
Deputy CEO and Chairman Tax  
T: +91 (22) 3090 1661  
E: dkanabar@kpmg.com

**Uday Ved**
Head of Tax  
T: +91 (22) 3090 2130  
E: uved@kpmg.com

**Sanjiv Chaudhary**
Executive Director  
T: +91 124 334 5032  
E: schaudhary@kpmg.com

**Parizad Sirwalla**
Executive Director  
T: +91 22 3090 2010  
E: psirwalla@kpmg.com

**Surendra Pareek**
Director  
T: +91 22 3090 1717  
E: spareek@kpmg.com

**Ashish Gupta**
Director  
T: +91 124 307 4342  
E: agupta1@kpmg.com

kpmg.com/in

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