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ESOP Valuation

The CFO's Strategy for ESOP: Key Insights for Indian Startups

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EXECUTIVE SUMMARY

As Indian startups navigate rapid growth and competitive landscapes, Employee Stock Option Plans (ESOPs) have emerged as a pivotal tool for attracting and retaining top talent. However, effective ESOP valuation presents a complex challenge, requiring a nuanced approach that balances accuracy, compliance, and strategic alignment.

This report, **"The CFO's Strategy for ESOP: Key Insights for Indian Startups,"** delves into the critical aspects of ESOP valuation in the Indian market. It provides CFOs with essential strategies for navigating the complexities of stock option pricing and taxation.

The analysis explores valuation models such as Black-Scholes, covers regulatory compliance under the Companies Act, Income Tax Act, and SEBI guidelines, and includes case studies of Indian startups that have successfully implemented ESOPs.

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WHY COMPANIES OFFER ESOPS

In the startup ecosystem, an Employee Stock Option Plan (ESOP) is a crucial mechanism that enables startups to provide stock options to their employees. This plan allows employees to purchase company shares at a predetermined exercise price following a specified vesting period.

Key Benefits of ESOPs

- **Enhance Performance:** ESOPs motivate employees to perform well by tying their success to the company's stock value.
- **Align Objectives:** By offering stock ownership, ESOPs align employees' goals with those of shareholders, promoting a unified vision for long-term growth.
- **Attract and Retain Talent:** ESOPs are a powerful tool for drawing and keeping top talent, providing opportunities for substantial financial gain.
- **Encourage Ownership:** ESOPs help develop a strong sense of ownership and commitment among employees, boosting engagement and loyalty.

Here are the types of ESOPs that companies typically offer to employees:

1. **Employee Stock Option Scheme (ESOS):** Grants employees the opportunity to purchase company shares at a predetermined price, usually set below the current market value. These options are typically included in a compensation package and are subject to specific performance goals and a defined vesting period.
2. **Employee Stock Purchase Plan (ESPP):** Allows employees to acquire company stock at a discounted price through regular payroll deductions. This plan facilitates gradual ownership accumulation and encourages employee investment in the company's long-term success.
3. **Restricted Stock Award (RSA):** A form of equity compensation where employees are awarded a specific number of company shares, subject to certain conditions. These conditions usually involve a vesting period and may also be tied to performance targets.
4. **Restricted Stock Units (RSUs):** A type of equity compensation where employees receive shares that vest based on meeting specific conditions, such as length of service or performance achievements. Once these conditions are satisfied, RSUs convert into actual shares of company stock.
5. **Stock Appreciation Rights (SARs):** Stock Appreciation Rights (SARs) are performance-based incentives linked to the company's performance, evaluated based on the company's share price. Upon exercising the option, the company can either issue shares or provide a cash equivalent of the shares.
6. **Phantom Equity Plan (PEP):** Awards employees cash bonuses based on the value of company stock, without issuing actual shares. These are often referred to as virtual stock options in some regions.
7. **Sweat Equity:** This concept involves rewarding employees or directors with shares either at no cost or at a reduced price in recognition of their contribution of specialized knowledge or intellectual property.
8. **Incentive Stock Options (ISOs):** In the U.S., ISOs offer employees the chance to purchase shares at a fixed price within a certain timeframe, benefiting from favorable tax treatment under specific statutory requirements.
9. **Company Share Option Plan (CSOP):** A UK-based scheme where employees and directors with less than a 30% ownership stake can be granted options to buy shares at a fixed price for future exercise.

For startups, Employee Stock Option Plans (ESOPs) offer several crucial advantages:

- **Improved Cash Flow Management:** Offering stock options helps startups conserve cash that might otherwise be used for higher salaries or bonuses. This is especially beneficial for startups and growing companies with tight cash flow, allowing them to allocate resources to essential business areas while still providing competitive compensation.
- **Appealing to Investors:** ESOPs make a company more attractive to investors by showing a strong commitment to employee ownership and aligning employee interests with those of shareholders. This alignment can lead to better investment terms or valuations, as it signals a focus on long-term growth and sustainability.
- **Reduced Salary Pressure:** By incorporating stock options, startups can offer competitive compensation without immediately increasing cash salaries, which helps in attracting and retaining talent while managing financial resources effectively.

While ESOPs offer many benefits, there are also potential downsides to be aware of:

- **Valuation and Liquidity:** Startups may face difficulties with stock valuation and liquidity. The value of stock options can be uncertain, and there may be limited opportunities to sell shares until the company goes public or is acquired.
- **Complexity:** Administering ESOPs can be complex and may require detailed legal and financial planning to ensure regulatory compliance and effective management of the plan.
- **Dilution:** Issuing stock options can dilute the ownership percentage of existing shareholders, which may be a concern for founders and early investors.

How Excedor Can Empower Your Startup

Excedor streamlines ESOP management with expert valuation services and compliance assurance. We mitigate valuation uncertainties and handle the complexities of administration, helping you leverage the benefits of your ESOP to attract top talent and investors. Partner with Excedor to optimize your ESOP and drive your startup’s success.

2 THE IMPORTANCE OF ESOP VALUATION FOR BUSINESSES

ESOP valuation plays a critical role for companies offering stock option plans to employees. Here's why:

1. Accounting for ESOPs:

Under Ind AS 102, accounting for Employee Stock Options (ESOPs) requires careful treatment to ensure accurate financial reporting. Here's an overview of how ESOPs are accounted for under this standard:

- **Expense Recognition**: According to Ind AS 102, companies must account for Employee Stock Options (ESOPs) as compensation expenses across the vesting period. The expense, calculated based on the fair value of the options at the grant date, is recorded in the financial statements and spread over the vesting period, during which employees gain the right to exercise the options
- **Fair Value Measurement:** Ind AS 102 offers three methods for estimating the fair value of stock options: the Black-Scholes model, the Binomial model, and the Monte Carlo simulation model. The Black-Scholes model is the most frequently employed method by both public and private companies in India.
- However, companies adhering to the Accounting Standards Rules, 2006 (as per the Guidance Note on Accounting for Share-Based Payments issued by ICAI in 2020) have the option to use either intrinsic value or fair value for measurement.

2. Tax Compliance for ESOPs:

Tax compliance for ESOPs in India involves both corporate and employee taxation aspects:

- **Perquisite Value Calculation:** Under Section 17(2) of the Income Tax Act, 1961, the perquisite value of ESOPs is determined as the difference between the Fair Market Value (FMV) of the shares at the time of exercise and the exercise price paid by the employee. This perquisite value is considered taxable income for the employee at the time of exercise. For instance, if an employee exercises options at ₹100 per share when the FMV is ₹150, the perquisite value is ₹50 per share, which is taxable. However, as per the Budget 2020 amendment, if an employee receives ESOPs from an eligible startup, the tax on the perquisite is deferred until the earlier of five years from allotment, the date of sale, or the date of exit from the company.
- **Timing of Taxation**: Employees are taxed on the perquisite value in the financial year when they exercise the stock options. The FMV of the shares is determined on the date of exercise, and the perquisite income is added to the employee's taxable income for that year.
- **Tax Withholding**: As per Section 192 of the Income Tax Act, companies must withhold tax on the perquisite value at the time of exercise and remit this amount to the tax authorities. This process involves calculating the TDS based on the employee's income tax slab rate and ensuring timely and accurate remittance to comply with Indian tax regulations.
- **Tax Deductibility for Companies**: Companies can claim a tax deduction for the expense related to ESOPs under Section 37(1) of the Income Tax Act, 1961. The deductible amount is the expense recognized in the profit and loss account, which helps reduce the company's taxable income. Compliance with tax regulations ensures that the company maximizes its tax benefits and avoids penalties.

In summary, accounting for ESOPs involves recognizing compensation expenses over the vesting period using fair value models. Tax compliance requires calculating the perquisite value, managing withholdings, and ensuring proper deductions. Both companies and employees must navigate these regulations to maintain accurate financial reporting and effective tax management.

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REGULATORY COMPLIANCE FOR ESOPS IN INDIA

The regulatory framework for ESOPs is governed primarily by SEBI, the Companies Act of 2013, the Income Tax Act of 1961, and RBI regulations.

1. **SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021**
    - The SEBI (Share-Based Employee Benefits and Sweat Equity) Regulations, 2021 provide guidance on granting various types of ESOPs and related benefits to specific categories of employees. These regulations apply to companies listed on recognized stock exchanges in India that have an ESOP scheme in compliance with these regulations. (Reg. 1)
    - Pricing: Companies have the flexibility to set the exercise price for shares or options, provided it conforms to prescribed accounting policies. (Reg. 17)
    - Lock-in Period: A minimum vesting period of one year is required. However, companies can define the lock-in period for shares issued upon the exercise of options. (Reg. 18)

2. Companies Act, 2013

- Under the Companies Act, 2013, an "employee stock option" is defined as an option given to directors, officers, or employees of a company or its holding or subsidiary companies. (Section 2(37))
- This option allows them to buy or subscribe to the company's securities at a predetermined price on a future date. This Act should be considered alongside related regulations, including The Companies (Share Capital and Debenture) Rules, 2014, which govern the issuance of ESOPs for unlisted and private companies.
- Accounting: Companies are required to comply with Indian Accounting Standards (Ind AS 102)/ Accounting Standards Rules, 2006 read with Guidance Note on Accounting for Share based Payments issued by ICAI in 2020, for recording ESOP expenses throughout the vesting period. This entails documenting the expense in financial statements and making adjustments based on the vesting schedule.

3. Income Tax Act, 1961

- Perquisite Value: The perquisite value, which represents the difference between the fair market value (FMV) of shares at the time of exercise and the exercise price, is considered taxable income for the employee in the year the options are exercised.
- Tax Withholding: It is mandatory for companies to withhold tax on the perquisite value when the options are exercised and to remit this amount to the tax authorities. The rate at which tax is withheld depends on the employee's income tax bracket.
- Tax Deductibility: Companies can deduct the expenses related to ESOPs as recognized in their financial statements, which helps in reducing their taxable income.

4. RBI Regulations

The Central Government and the Reserve Bank of India (RBI) have set forth rules and regulations under the Foreign Exchange Management Act, 1999 (FEMA) concerning Overseas Direct Investment (ODI) and Foreign Direct Investment (FDI) that govern Employee Stock Option Plans (ESOPs). These regulations outline the procedures for issuing Indian securities to employees residing outside India and for issuing foreign securities to employees based within India.

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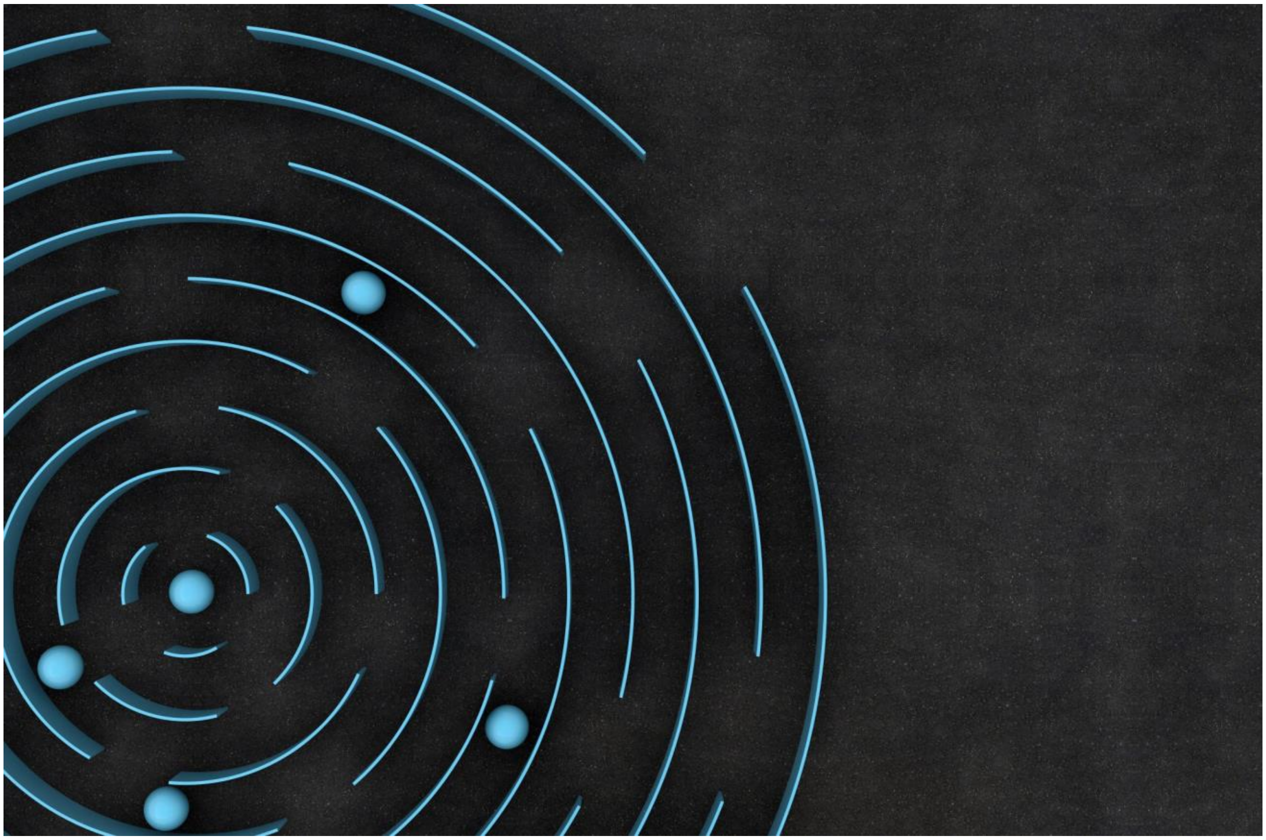
CASE STUDY



ACCOUNTING AND TAXATION OF ESOPS

Navigating the intricacies of ESOPs is essential for companies aiming to achieve financial precision and regulatory compliance. Proper accounting and taxation of ESOPs not only ensure adherence to legal standards but also maximize the financial benefits of these plans. Here's an in-depth exploration of the accounting and taxation facets of ESOPs:

XYZ Technologies Ltd. has rolled out an Employee Stock Option Plan (ESOP) aimed at boosting employee motivation and improving retention rates. This case study delves into the intricate accounting practices under Ind AS 102 and the tax implications associated with ESOPs. It includes a detailed analysis of valuation using the Black-Scholes model and examines the tax consequences at different stages of the ESOP lifecycle.

1. Executive Summary
Company Name: XYZ Technologies Ltd.
Sector: Information Technology
Location: Bangalore, India
ESOP Plan Launch Date: January 15, 2023

2. ESOP Plan Details (Grant Information):

- **Options Granted:** 100,000 shares
- **Exercise Price:** ₹100 per share
- **Vesting Period:** 4 years (25% vesting each year)
- **Exercise Period:** 10 years from the grant date
- **Fair Market Value (FMV) at Grant Date:** ₹120 per share

3. Accounting for ESOP (Valuation Using Black-Scholes Model):

- **FMV (S):** ₹120
- **Exercise Price (X):** ₹100
- **Time to Expiry (T):** 10 years
- **Volatility (σ):** 25%
- **Risk-Free Rate (r):** 6%
- **Total Fair Value per Option:** ₹70.31 as per Black Scholes Method

Expense Recognition:

- **Total Expense to be Recognized:** ₹7,031,000 (100,000 options × ₹70.31)
- **Annual Expense (Over 4 Years):** ₹1,757,750

Private Companies: For private companies valuing ESOPs is often more challenging due to the absence of a market price for shares. Typically, independent valuation experts are used to determine the fair market value.

4. Taxation of ESOPs

a. At Grant:

- **Tax Implications:** No immediate tax liability for employees.

b. At Vesting:

- **Tax Implications:** No tax at the vesting stage.

c. At Exercise:

Perquisite Value Calculation:

- **FMV on Exercise Date:** ₹150
- **Exercise Price:** ₹100
- **Perquisite Value per Share:** ₹50
- **Total Perquisite Value:** ₹1,000,000 (20,000 options × ₹50)

Tax Treatment:

- **Taxable Income:** ₹1,000,000 added to the employee's salary income.
- **Tax Withholding:** Company must withhold tax based on the employee's income tax slab.

d. At Sale:

- When securities obtained through ESOPs are later sold by the employee, any resulting gains will be taxed under 'Capital Gains'. The tax treatment of these gains depends on the type of security and the duration of the holding period.

In conclusion, accurate ESOP valuation is pivotal for CFOs to navigate the complexities of financial reporting and regulatory compliance. This case study underscores how precise valuation, using models like Black-Scholes, and understanding the tax implications at each stage are crucial for strategic financial management. Effective valuation ensures that stock options serve as a powerful tool for motivating employees, aligning their goals with those of the company, and optimizing overall financial outcomes.

IPOs Making Employees Millionaires Due to ESOPs:

Zomato

IPO Date: July 2021

Initial Stock Price: ₹76**, Current Stock Price:** ₹250

Monetary Gain: ₹17.4 lakh per 10,000 shares

Percentage Change: 229%

Employee Benefit: Employees who were granted ESOPs either during or prior to the IPO have witnessed a remarkable surge in their equity value. With the stock price more than tripling, these employees have realized a gain of ₹17.4 lakh per 10,000 shares. This substantial increase underscores the significant financial rewards possible through ESOPs in a successful IPO scenario.

Policybazaar

IPO Date: November 2021

Initial Stock Price: ₹980**, Current Stock Price:** ₹1,720

Monetary Gain: ₹74 lakh per 10,000 shares

Percentage Change: 75%

Employee Benefit: Employees who received ESOPs at ₹980 have experienced a notable enhancement in their equity value, realizing a gain of ₹74 lakh per 10,000 shares. The 75% rise in stock price highlights the impressive financial benefits of ESOPs, reflecting the potential for substantial wealth creation when a company performs well post-IPO.

Meta Platforms Inc (Facebook)

IPO Date: May 2012

Initial Stock Price: $38**, Current Stock Price:** $516

Monetary Gain: $4.78 Mn per 10,000 shares

Percentage Change: 1,257%

Employee Benefit: Employees granted ESOPs at or before Facebook's IPO price have seen their shares increase over 1,200% in value, yielding a gain of $4.78 million per 10,000 shares, highlighting the exceptional rewards ESOPs can offer in high-growth tech IPOs.

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ROLE OF EXCEDOR VALUERS IN ESOP VALUATION

Unlock the full potential of your ESOPs with Excedor, the premier name in ESOP valuation services. We empower CFOs with unparalleled support and expertise to navigate the complexities of ESOP valuation. Here's how we deliver exceptional value:

Specialized Valuation Services

- **Expertise:** Our seasoned valuation professionals leverage advanced models like Black-Scholes and Binomial, along with globally accepted methodologies, to accurately determine the Fair Market Value (FMV) of shares and options.
- **Regulatory Compliance:** We ensure that all valuations adhere to stringent regulatory requirements, including the Companies Act, SEBI regulations, and Ind AS 102, safeguarding your organization against compliance risks.

Comprehensive ESOP Lifecycle Support

- **Grant Phase:** At the outset, Excedor helps set the exercise price with precision, performing valuations at the grant date using approved models and international standards. This ensures your ESOPs are compliant and strategically aligned from day one.
- **Ongoing Valuations:** We offer continuous valuations to adapt to market fluctuations, ensuring that the FMV remains accurate throughout the vesting and exercise periods.

Partner with Excedor

Choose Excedor to ensure precise ESOP valuations, streamlined compliance, and enhanced financial management. Elevate your ESOP strategy with our expert services and drive your company's success.

Contact Excedor today to transform ESOP valuation with excellence

EXCEDOR VALUATION SERVICES

- Valuation of Brands, Goodwill, Other Intangible Assets & Intellectual Property
- Valuation of Financial Securities, Instruments & Derivatives
- Valuation of Industrial Assets and Plant & Machinery
- Valuation of Real Estate
- Purchase Price Allocations (PPA) for Mergers & Acquisition (M&A)
- Valuation of ESOPs
- Valuation for Tax, Transfer Pricing and Company Law Matters
- Fairness Opinions
- Determination of Swap Ratio under Mergers and Demergers
- Litigation and Dispute Valuation Services

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