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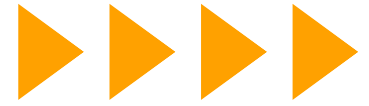

Employee Stock Options

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Employee stock options as a form of employee benefits

The greatest challenge within the modern organisation arises as a conflict between management and ownership. Maximisation of profitability (notably, short term) to ensure growth of shareholder wealth must be delicately balanced with employee interests. Substantive employee benefit expenses are likely be incurred to uphold employee morale and reduce attrition, which negatively impacts the bottom line of companies.

While it is true that monetary incentives serve as a direct form of motivation for employees, the purpose of interest alignment may not be served. This predicament has led to the creation of alternative forms of incentives such as share based payments.

In this newsletter, we shall explore the basic concepts of accounting and valuation for such share-based payments.

Share based payments

Share based payments are payments made by an entity to its providers of goods or services, including its employees, in the form of equity instruments of the entity or cash amounts based on the value of such equity instruments. It is an agreement between the entity and the provider of goods or services where the latter is entitled to receive either:

- **Cash settled payments** i.e. the payment is made in the form of cash or others assets in amounts that are based on the price (or value) of equity instruments of the entity.
- **Equity settled payments** i.e. payment is made in the form of equity shares of the entity.

Employee stock option plans (ESOP)

As one of the most common types of share-based payments adopted by companies, an employee stock option plan, popularly known as ESOP, is a type of employee benefit plan which is intended to encourage employees to acquire stocks or ownership in the company. As the name suggests, it is structured as an option on the equity shares of the company, which gives the employee a right but not an obligation to exercise the option upon the satisfaction of certain pre-determined conditions, called vesting conditions.

Vesting conditions

The employee's right to receive or retain an award are contingent on the satisfaction of certain conditions termed vesting conditions. There are typically two types of vesting conditions:

Service conditions solely depend on employee rendering service for the requisite service period. It is important to note that accelerated vesting due to employee's death, disability or termination without cause is a service condition. For example, the option shall vest after the employee has completed three years of service with the company.

Performance conditions involve the employee rendering services for a specified explicit or implicit period of time and achieving a specified performance target. They are further bifurcated into **market and non-market conditions.**

Non-market conditions are contingent on satisfaction of conditions related to the company's internal operations or the employee's performance. For example, the option shall vest when the employee manages to secure 20 clients a year, or when the company achieves a sales target of USD 2 million per quarter.

Market conditions on the other hand, relate to the achievement of either:

1. A specific price of the company's shares or a specific intrinsic value indexed solely to the shares. For example, the option shall vest when the company's stock rises by 25%, anytime during a three-year period.

2. A specified price of the company's shares in terms of a similar (or index of similar) equity securities. For example, the option price of the share shall increase or decrease on 31 December each year of the vesting period, by the same percentage that the corresponding index has increased or decreased.

Despite the vesting conditions, ESOPs, particularly in recent times, have been an attractive employee benefit and corporate financing tool. We elaborate on this further below:

Benefits of ESOPs

On the surface, the primary ESOP benefits for the organisation seem to entail boosting employee morale and retention. However, organizations might avoid financial compensations as an incentive with the use of ESOP choices and achieve saving on immediate cash outflow. For firms that are establishing or extending their company's strategies/operations on a larger scale, paying their employees with ESOPs might offer a more viable alternative than monetary awards.

ESOP structures also allow for multiple tax advantages. Since contributions to the ESOP are fully tax deductible in some jurisdictions, an employer can fund both the principal and the interest payment on an ESOPs debt service with pre-tax dollars. ESOPs can also be used as a technique for corporate finance to raise additional equity, refinance outstanding debt or acquire assets.

ESOPs provide numerous benefits to the employees of the organization as well. An ESOP can provide an employee with significant retirement assets if they are employed by the company for a significant period and the company's shares has appreciated over the years to retirement. It does not only enhance job security of the employees but also increases their commitment to work. ESOPs thus, are a compelling way of attracting and retaining high-quality employees who generate immense value for the company.

ESOPs are governed by a multitude of accounting standards that the entity must comply with, which we elaborate in the next section.

Accounting guidance of ESOPs

Accounting for share-based payments issued in exchange for employee services under IFRS is addressed by IFRS 2: Share-based Payment. The recognition and reporting under the standards are discussed hereafter.

Recognition of compensation cost

The standards require the cost of ESOPs to be recognized over the requisite service period. A corresponding equity or liability is recognized for an amount equal to the cost. In case of performance conditions, a company should recognize compensation cost if and when the company concludes that the performance condition will be achieved. Compensation cost resulting from the share-based payments should be recognized in the company's financial statements in the same manner as cash compensation.

How and when to measure the compensation cost?

A share-based payment transaction with employees should be measured based on the fair value of the equity instruments issued. According to the standards, the fair value of equity instruments issued, should be measured based on the grant date. The grant date is a date when the following criteria are fulfilled:

- Both parties have agreed to a share-based payment arrangement and its conditions (sometimes the agreement may be implicit, i.e. no documents need to be signed), and
- All necessary approvals have been obtained (e.g. approval by shareholders or the board of directors).

For equity settled ESOPs, the fair value of equity instruments is set at a grant date and remains unchanged, while in the case of cash settled ESOPs, the fair value of the option granted is remeasured at each reporting date.

If traded options with similar terms and conditions do not exist, the fair value of the options granted shall be estimated by applying an option pricing model. The following discussion elaborates on methods of estimating the fair value using option pricing models.

Option pricing models

The standards not only provide for accounting recognition but also valuation methods that can used for ESOPs. Regardless of the valuation technique or model selected, the standards explicitly require that the assumptions used in an option pricing model be reasonable and supportable.

Commonly used valuation techniques are:

- Black-Scholes-Merton (Black-Scholes) model
- Lattice (e.g., Binomial) model

Black scholes model (“BSM”)

Black-Scholes is an option pricing model used to determine the fair value for a call or a put option based on variables such as volatility, type of option, underlying stock price, time, strike price, and risk-free rate. The model assumes that the option follows Geometric Brownian motion with constant drift and volatility. Brownian motion is a stochastic process i.e. assumes the stock price of the company follows a random walk.

Binomial model

A binomial model uses an iterative procedure, allowing for the specification of nodes, or points in time, during the time span between the valuation date and the option’s expiration date. It can value an American-style option, which can be exercised before the end of its term. The model reduces possibilities of price changes and removes the possibility for arbitrage. The binomial is an open-form or lattice model. It creates a tree of possible future stock-price movements and ‘induces’ the option’s price.

The steps for a binomial model are:

- First, we plot the two possible future stock prices.
- Second, we translate the stock prices into future option values
- Third, we discount the future values into a single present value.

The underlying procedure of both the option pricing models is the same i.e. project the future price of the underlying shares and the option value at each level of such projected price, but the distinguishing characteristic is that BSM values the option in continuous time while binomial values option in discrete time.

Disclosure requirements

An entity is required to disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period and how the fair value of the equity instruments granted during the period was determined.

Following is the summary of the disclosure requirements under the standards:

- Description of the arrangement including the vesting conditions, contractual term and number of shares authorized for such awards
- Method applied to measure compensation cost
- Weighted average exercise price and weighted average fair value of the stock options
- Description of the significant assumptions used to estimate the fair value of the stock options
- Total compensation cost

Concluding thoughts

ESOPs, as a concept, has evolved as a solution to the conflict between management and ownership, and has grown to become a popular incentive, particularly for nascent companies. ESOPs form a part of the employees' compensation package through which an effort is made to align the interests of the employees with that of the shareholders.

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