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# THE HUMAN FACTOR

## COMPENSATION & BENEFITS

A CROSS-NATIONAL STUDY



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# UNLOCK THE POWER OF STOCK

**SHALIN S DIVATIA**, FOUNDER AND DIRECTOR, PARADIGM ESOP CONSULTANTS PVT LTD, TELLS **ALANKRITA SRIVASTAVA** ABOUT THE FAST-CATCHING COMPENSATION TREND OF ESOPs, WHICH IS HERE TO STAY

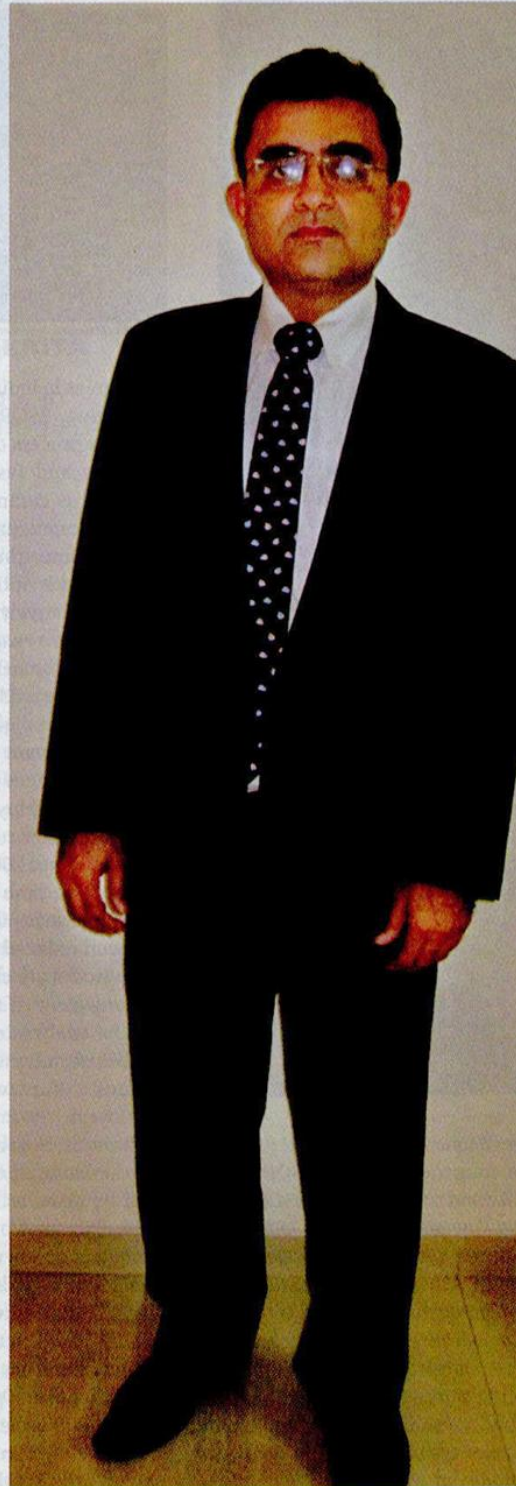
**S**halin S Divatia has been designing ESOP policies for past 12 years for companies like, Kingfisher Airlines Limited, Nicolas Piramal Ltd., and Birla Consultancy and Software Services. Having extensively researched on the current international and Indian scenarios on ESOPs, he is a certified chartered accountant and a company secretary.

**Q. How do ESOPs make a difference in a company's compensation policy?**

**A.** ESOPs help companies to moderate the increase in salaries year on year. They also help fast growing companies with aggressive business models to attract good talent from more established companies at lower salaries for the wealth creation opportunity that ESOPs throw up. They became an important component of variable pay. This benefited both employers and employees. Employers, because it could attract and reward the best talent even with moderation in salary increase. Employees, because ESOPs enabled them to get rewards based on the wealth they created which few companies could ever afford in terms of direct cash payments. Of course, tax breaks in the initial years only made the reward sweeter. But most importantly, philosophically, the employee rewards were sought to be related to company performance and this, in turn, directly benefited the non-employee shareholder. To sum-up, it became a win-win situation for all stakeholders.

**Q. Do ESOPs affect books of accounts?**

**A.** Conceptually the gains under ESOPs are paid by the market by way of dilution of owners equity rather than a cash outflow from the company. Under the current framework on accounting, most companies adopt the intrinsic method for



accounting of stock options which recognises only the difference between the market price as on the date of grant and the grant price. In case the difference is nil, no ESOP compensation is required to be recognised in books. ESOPs offer value advantage since the time period of the option grant is long, and over this period a fixed price option can be quite valuable. I quote my business partner Mr. Umesh K Gala, that current SEBI ESOP guidelines require only a footnote disclosure of the accounting hit had the fair value of accounting for options as per Black Scholes Model or a similar option valuation model been adopted. Even the guidance note laid down by the ICAI does not mandatorily require the fair value of accounting to be fol-



## ESOPs CAN HELP INDIAN COMPANIES TO MINIMISE THE DIFFERENCE IN THE OVERALL VALUE OF COMPENSATION AS OPPOSED TO ESTABLISHED MNCs

lowed. It permits a footnote disclosure of additional accounting hit, had the fair value of accounting been followed. In the case of intrinsic method, a small portion or often nil amount of the ESOP compensation is provided in books. Even in the case of fair value method a much smaller portion of the gains that employees make is accounted as a hit in the books. Hence, ESOPs help companies lower the account hit and the cash outflow to the company.

### Q. Factors a company considers before offering ESOPs?

A. Host of factors:

- Overall business objectives.
- Current HR profile and need for talent in the company.
- Growth opportunities and how an incentivised workforce can make a difference to growth in a shorter span.
- Need to align the interest of employees with that of the company and its shareholders.
- Exit opportunities available to employees under the ESOPs.

• Wealth creation potential under the ESOPs. However, ESOP design has to be tailor made for each company. There is no ready solution applicable for any companies.

### Q. How ESOPs benefits differ for an MNC and a homegrown organisation?

A. ESOPs can help Indian companies to minimise the difference in the overall value of compensation as opposed to more established MNCs. Typically, MNCs have a common ESOP plan at a global level. This also means that employee reward is not directly related to performance of the company they work for but performance at the global level. Under the current economic situation, the growth is quite sluggish. For home grown companies which offer ESOPs, the rewards on the back of solid growth of the Indian economy is quite high.

### Q. ESOPs are increasingly being used as a tool for compensating new employees, your views?

A. Grant of ESOPs draws comparison and occasionally discontent. Especially when ESOPs are granted for the first time to old and new employees simultaneously. It requires to balance the need to factor seniority of the older ones and to incentivise the recent joiners.

### Q. Are there any concerns attached to this virtual incentive?

A. ESOPs deal with: first, the ownership in the sense of the capital dilution which ESOPs cause and second, employees for whom ESOPs create the wealth. i.e., the owners of the business. Hence, it is essential to balance the two in the sense of a *quid pro quo*. Employer must create wealth to be entitled to its benefit and conversely must share a part. The other important issues are cash outflow and accounting hit.

### Q. The upcoming trends that you anticipate in ESOPs?

A. Today, capital is more freely available than at any other time. Another trend is increasing realisation of entrepreneurs that wealth is created and protected by merit. Hence, the importance of talent would increase. The best way to attract and retain talent would be to incentivise them by a stake in what they create. This can be done only through ESOPs.

Another trend is for companies to come up with ongoing ESOP plan and not restrict it to a one-off event. Broad-basing of ESOPs across all levels in an organisation will also gain traction. In a nutshell, ESOPs are here to stay and spread.

### Q. Any company you admire for best ESOPs practice?

A. Best ESOPs practice is not merely a function of ESOP design. Good corporate governance and transparency in financial reporting are also an integral part. There are many such companies and it is difficult to single out any. Though in my opinion, Infosys in the IT sector and ITC in the FMCG sector are excellent examples of companies which meet the criteria for best ESOPs practice in India Inc. ■