



## INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE AND MANAGEMENT

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**ESOP DESIGN PRACTICES IN INDIAN IT & ITES AND PHARMACEUTICAL INDUSTRIES**

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**ABSTRACT**

*Motivating, rewarding and retaining top performers are key business objectives for any business that seeks to successfully maintain or exceed growth expectations. Stock options are recognized as an effective tool to attract, reward, retain and motivate the employees. Higher degrees of employee productivity and commitment are sure keys to unlock the doors of success and profitability for the organization. Employee Stock Option Plans (ESOP) is one of the important and widely used tools for gaining employee commitment and ensure employee retention and motivation. This study used secondary data pertaining to Indian IT&ITES and Pharmaceutical companies between 1999 and 2010 to analyse the ESOP design practices adopted by these companies. The findings indicate that these companies are clearer about their ESOP practices post SEBI ESOP&ESPP Guidelines, 1999. However, the study further reveals that Indian industries can benefit more by exploiting the full potential of ESOPs by designing, communicating and implementing their plans in a more appropriate manner.*

**KEYWORDS**

ESOP, ESO, SEBI, Pharmaceutical.

**INTRODUCTION**

A stock option is a right and not an obligation, of the option holder to acquire shares of a company during a specified period at a pre-determined price. Worldwide, stock options are used to create a sense of ownership among the employees, provide an opportunity to employees to share the growth of the company, create long term wealth in the hands of the employees and provide performance linked rewards to the employees. ESOPs originally were created with the idea that employees, given an ownership stake in the company, would have the incentive to increase its productivity and performance. Improvements in morale and job satisfaction brought about through employee stock options are expected to promote the overall productivity and competitiveness of employees. This will ultimately result in increased organizational performance that would fetch a competitive edge for the organization in the market front.

Under Employee Stock Options Plans, on the basis of years of service, performance or some such criteria, as decided by the company, employees of the company are granted stocks of the company at a pre-determined price. These stocks will vest with the employees over a period of time in the future. During that period, the employees can trade these stocks and benefit out of it.

The objective of granting options is to reward and retain highest levels of talent, ensure sustained commitment and motivation of the highest order from employees and create substantial wealth for the employees through participation in the growth, development and net worth of the company. In the western countries, an ESOP is a qualified employee benefit plan that can substitute for or supplement a company's retirement plan. Money borrowed by a trust (ESOT) set up under the plan and guaranteed by the corporation is used to purchase the firm's common stock in the open market or from the corporate treasury. These shares are then distributed to employees over time on the basis of years of service or an alternative allocation method as decided upon by the organization. The loan used to purchase the shares is paid off over time from employee contributions.

In India ESOP adoption is still in its early stage. Indian companies use stock options to attract and retain employees. ESOPs have been in vogue for over a decade in India and they still create excitement and hope among employees to own shares of the employer company and create wealth all on a sudden in tandem with movements in stock market. Information Technology, communication, entertainment, financial, pharmaceutical and technology driven companies use ESOPs as a tool to reward and motivate employees.

**INDIAN IT& ITES AND PHARMACEUTICAL INDUSTRIES**

Information Technology, Information Technology Enabled Services and Pharmaceutical industries are major contributors to the Indian economy. These are knowledge-based industries whose vital assets are their human resources. There is a great need to retain and satisfy these assets in order to get the best performance out of them. It is very crucial to ensure that the key employees do not leave the organization, because there is the danger of these key employees taking vital knowledge and information with them when they leave the organization. This is more a sensitive issue, since these employees will be absorbed by competitors who could use these vital knowledge and information to get a competitive edge over the others.

Moreover, attrition levels are of high concern in these industries especially during the last few years when employees were seen to be more mobile. Strong and effective strategies have to be formulated and adopted in order to retain the employees in the organizations for longer tenures. This will help the organizations in cutting down their hiring costs and training costs to a great extent, which will in turn tell upon the performance and profitability of the organizations.

ESOPs are highly recognized tools for creating a sense of belongingness and commitment in the employees, which is very crucial for the success of every organization. Offering a stake in the ownership of the organization is bound to have positive impact on the employees and motivate them to contribute their best performance to their organizations.

**REVIEW OF LITERATURE**

Firms are likely to use stock options to retain their key employees who can take with them some special skill or know-how that can be used by the competitors. Oyer and Schaefer (2005) opine that the firms with stock returns close to the industry returns are likely to compete for the same set of workers. However, stock options can help to maintain the aggregate incentive level for the employees in the face of changing labour market conditions (Kadia and Mazumdar, 2002). When firms have considerable intangible assets and growth opportunities, the retention of key employees becomes critical for the value creation. The benefits of growth opportunities depend on the availability of potential employees in the company (Smith and Watts, 1992). While growth opportunities increase the

likelihood of using stock options to align the interests of shareholders with the employees, if the growth opportunities are greatly related to the human capital, the use of stock options may also reflect the purpose of retaining the potential employees (Core and Qian, 2000). ESOP Direct (2001) conducted a survey in 28 IT and 12 Non-IT companies. The survey addresses the finer aspects of ESOP Design practices in India. Attempt is made to interpret the findings relevant to sectors (IT versus Non-IT) and also within the sectors, in terms of whether companies are looking at structures unique to their requirements or is everyone following each other. The survey has tried to analyse the impact of the SEBI guidelines on ESOP and has compared it against global trends, particularly in the U.S. Some of the major findings of this study are: There is no uniform legal structure followed by the companies. While around 58% of the companies have preferred a direct route (without an ESOP trust) a significant number (42%) of companies have preferred a Trust route; Both IT and Non-IT companies give more weightage to individual performance when it comes to deciding the number of options granted. Relatively less importance is given to Salary grade, Position or Title. There is no difference in the practices followed by IT and Non-IT companies with respect to the term of the options. The term is of less than four years.

### OBJECTIVES OF THE STUDY

- To study ESOP design practices in Indian IT & ITES companies and Pharmaceutical companies
- To compare ESOP design practices in Indian IT & ITES companies and Pharmaceutical companies

### SCOPE OF THE STUDY

This study is an attempt to identify and analyse the macro trends of ESOP phenomenon in India. The study covers IT & ITES industry and Pharmaceutical industry in India. ESOP practices adopted by Indian IT & ITES and Pharmaceutical sectors are investigated and compared with an objective of identifying the trends followed by majority of these knowledge-based industries which could be of help for firms in the other sectors for designing their employee stock options plans or schemes.

### RESEARCH DESIGN AND DATA

This is an Analytical Research. Facts and information are already available. These facts and information are analysed to make critical evaluation. Data set of Indian listed companies in Information Technology, Information Technology Enabled Services and Pharmaceutical industries during the period 1999 to 2010 have been utilized for this study.

These industries are selected as a dataset for the research for the following major reasons:

- Prevalence of ESOP in these industries
- Requirement for talent retention in these knowledge-based industries

The study used secondary data. Secondary data are obtained from published material and documents. Data are gathered from Annual reports of companies, companies' websites, NSE publications, Capitaline database and Prowess database of CMIE (Center for Monitoring Indian Economy).

For studying ESOP design practices in these firms, data pertaining to the period 1999-2010 are considered because most of ESOP schemes were granted post 1999, after SEBI ESOS & ESPP Guidelines, 1999 (Securities Exchange of Board of India (Employees Stock Options Schemes and Employees Stock Purchase Plans Guidelines)).

### SAMPLING DESIGN

Disproportional Stratified Sampling is used for this study. A sample of 46 listed companies has been selected – 23 companies from IT & ITES sector and 23 companies from pharmaceutical sector. The companies are listed either on Bombay Stock Exchange (BSE) or National Stock Exchange (NSE) or both the exchanges. The sample comprises of listed companies that have announced ESOPs during the period 1999 – 2010.

### STATISTICAL TOOLS

Descriptive analysis, Percentage analysis, Karl Pearson's correlation, Trend Lines, Bar diagrams and Pie diagrams are used for the analysis and interpretation of data.

### ANALYSIS AND INTERPRETATION

Data collected for the study are tabulated and analysed in order to give meaningful interpretations regarding ESOP design practices adopted by companies in Indian IT&ITES and Pharmaceutical industries.

**TABLE 1: TABLE SHOWING THE NUMBER OF PLANS ANNOUNCED BY IT & ITES AND PHARMACEUTICAL COMPANIES:**

No. of Plans	IT & ITES Companies		Pharmaceutical Companies	
	No. of Firms	Percentage	No. of Firms	Percentage
1	1	4.3%	11	47.8%
2	5	21.7%	6	26.1%
3	7	30.4%	4	17.4%
4	5	21.7%	2	8.7%
5	0	0%	0	0%
6	4	17.4%	0	0%
7	0	0%	0	0%
8	0	0%	0	0%
9	1	4.3%	0	0%
Total	23	100%	23	100%

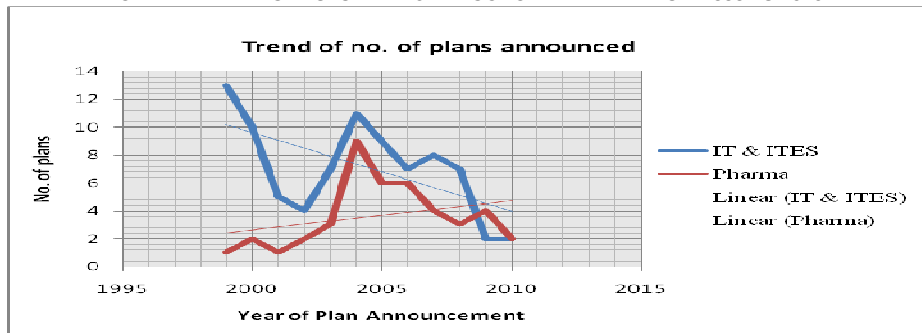
Table 1 shows that the least number of plans announced by an individual company in the IT&ITES industry is one and the highest number of plans announced is nine. The least number of plans announced by an individual pharmaceutical company is one and the highest number of plans announced is four.

**TABLE 2: NO. OF PLANS ANNOUNCED PER YEAR FROM 1999 TO 2010: DESCRIPTIVE STATISTICS**

Industry	N	Minimum	Maximum	Mean	Std. Deviation
IT&ITES	12	2	13	7.08	3.423
Pharmaceuticals	12	1	9	3.58	2.392

Table 2 indicates that between the years 1999 and 2010, number of plans ranging between a minimum of two plans and a maximum of thirteen plans were announced by IT&ITES companies. Moreover, during the same period, number of plans ranging between a minimum of one plan and a maximum of nine plans were announced by pharmaceutical companies.

CHART 1: TREND OF NO. OF PLANS ANNOUNCED PER YEAR FROM 1999 TO 2010



Trend lines of number of ESOP announcements drawn in Chart 1 show that there is an upward trend or growing trend in the number of plan announcements in the Pharmaceutical industry, whereas there is a downward trend or decreasing or declining trend in the number of plan announcements in the IT&ITES industry during the period between 1999 and 2010.

CHART 2: CHART SHOWING COMPANY-WISE ESOP PLAN DESIGN IN IT & ITES INDUSTRY

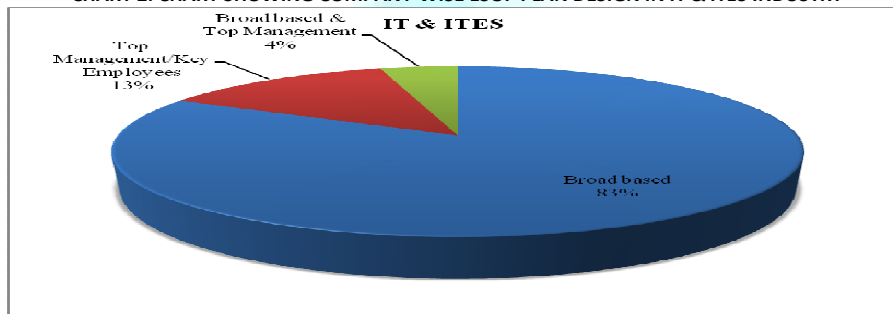


Chart 2 exhibits the ESOP plan design adopted by IT&ITES companies. 83% of the companies have Broad based ESOP plans covering employees at various levels, 13% of the companies have announced ESOP for Top Management or Key employees only and 4% have announced a combination of Broad based and Key employees ESOPs.

CHART 3: CHART SHOWING COMPANY-WISE ESOP PLAN DESIGN IN PHARMACEUTICAL INDUSTRY

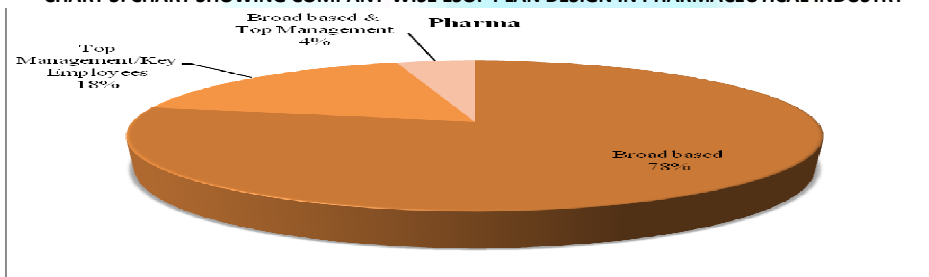


Chart 3 exhibits the ESOP plan design adopted by Pharmaceutical companies. 78% of the companies have Broad based ESOP plans covering employees at various levels, 18% of the companies have announced ESOP for Top Management or Key employees only and 4% have announced a combination of Broad based and Key employees ESOPs.

TABLE 3: TABLE SHOWING INDIVIDUAL PLAN-WISE DESIGN OF ESOP IN IT & ITES AND PHARMACEUTICAL INDUSTRIES

Plan Design – Plan-wise				
Design of Plans	IT & ITES Companies		Pharmaceutical Companies	
	No. of Plans	Percentage	No. of Plans	Percentage
Broad based	75	88.2%	33	76.7%
Top Management /Key Employees	10	11.8%	10	23.3%
Total	85	100%	43	100%

Table 3 shows individual plan-wise design of Employee Stock Options Plans in IT&ITES and Pharmaceutical companies. 88.2% of IT&ITES companies and 76.7% of Pharmaceutical companies have announced Broad-based plans under which options have been granted to employees at different levels. 11.8% of IT&ITES and 23.3% of Pharmaceutical companies have announced ESOPs only for the Key employees.

Although retention of key employees is most crucial for the companies, the sample companies have employee stock options plans under which options have been granted to employees belonging to different levels in the companies. Hence, the plans are broad-based in nature.

This is common in both IT&ITES and Pharmaceutical industries which is evident from the percentage of sample companies that have offered broad-based plans to their employees.

TABLE 4: PLAN DESIGN: SIGNIFICANT CORRELATION BETWEEN IT&ITES AND PHARMACEUTICAL COMPANIES: CORRELATIONS

INDUSTRY		ITITES	PHARMA
IT&ITES	Pearson Correlation	1	.998*
	Sig. (2-tailed)		.041
PHARMA	Pearson Correlation	.998*	1
	Sig. (2-tailed)	.041	

\*. Correlation is significant at the 0.05 level (2-tailed)



Table 4 shows the correlations between IT&ITES and Pharmaceutical companies with regard to the plan design adopted for ESOPs. There is a high degree positive correlation (.998) which is significant at 0.05 level of confidence. This shows that the plan designs adopted by these firms are highly similar in nature.

TABLE 5: TABLE SHOWING SPECIFIC SIGNIFICANT GRANTS OF OPTIONS TO VARIOUS CATEGORIES OF EMPLOYEES BY IT & ITES AND PHARMACEUTICAL INDUSTRIES

Specific significant grants of options Category of employees covered	IT & ITES companies		Pharmaceutical companies	
	No. of Plans	Percentage	No. of Plans	Percentage
Senior Managers	21	24.7%	15	34.9%
Individual employee getting 5% or more options during a particular year	7	8.2%	0	0%
Individual employee getting 1% or more options during a particular year	3	3.5%	0	0%
Senior Managers and Individual employees getting 5% or more options during a particular year	8	9.4%	5	11.6%
Senior Managers and Individual employees getting 1% or more options during a particular year	1	1.2%	0	0%
Individual employees getting 5% or more during a particular year and Individual employees getting 1% or more options during a particular year	0	0%	0	0%
All three of the above present	3	3.5%	1	2.3%
None of the above present	42	49.4%	22	51.2%
Total	85	100%	43	100%

Table 5 indicates that under majority of the plans both in IT&ITES and Pharmaceutical industries, no significant grants of options have been made to particular categories of employees. Under 24.7% of plans in the IT&ITES companies and 34.9% of plans in the Pharmaceutical companies, significant options grants have been made to senior managers.

TABLE 6: TABLE SHOWING VALUATION MODEL ADOPTED FOR OPTIONS VALUATION

Valuation Model				
Model	IT & ITES Companies		Pharmaceutical Companies	
	No. of Firms	Percentage	No. of Firms	Percentage
Intrinsic Value Method	13	56.5%	15	65.2%
Fair Value Method	10	43.5%	8	34.8%
Total	23	100%	23	100%

Table 6 shows that 56.5% of IT&ITES and 65.2% of Pharmaceutical companies have adopted Intrinsic value method for the valuation of the options and the rest of the companies, 43.5% and 34.8% of the IT&ITES and Pharmaceutical companies respectively have adopted Fair value method for valuation of options issued by them.

TABLE 7: TABLE SHOWING THE ROUTE ADOPTED FOR ESOP ADMINISTRATION BY COMPANIES IN IT & ITES AND PHARMACEUTICAL INDUSTRIES

Route adopted for ESOP Administration				
Route	IT & ITES Companies		Pharmaceutical Companies	
	No. of Firms	Percentage	No. of Firms	Percentage
Trust Route	4	17.4%	4	17.4%
Direct Route	14	60.9%	19	82.6%
Both	5	21.7%	0	0%
Total	23	100%	23	100%

Table 7 shows that 60.9% and 82.6% of IT&ITES and Pharmaceutical companies respectively have adopted the direct route for the administration of Employee Stock Options Plans in their companies. 17.4% of both have adopted Trust route and 21.7% of IT&ITES companies have used a combination of both these routes.

CHART 4: CHART SHOWING THE PRICING FORMULA ADOPTED FOR PRICING OF OPTIONS

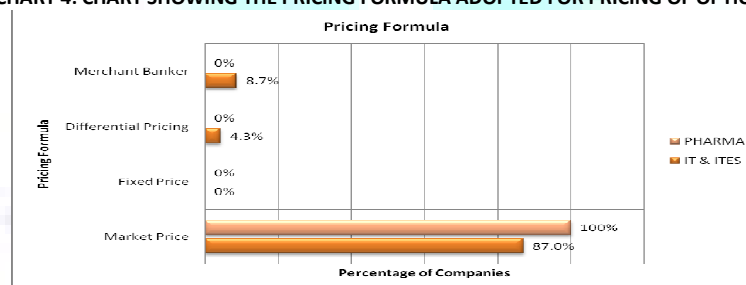


Chart 4 depicts that 100% of the Pharmaceutical companies and 87% of IT&ITES companies have granted their options at the Market price. Among IT&ITES companies, only 4.3% have adopted differential pricing formula and 8.7% have priced their options as per the formula given by merchant bankers.

CHART 5: CHART SHOWING THE BASIS FOR GRANTING OPTIONS TO EMPLOYEES IN IT & ITES AND PHARMACEUTICAL COMPANIES

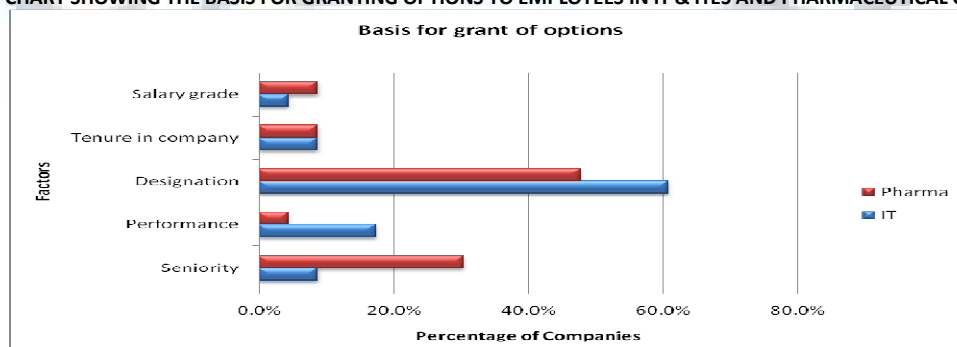


Chart 5 shows the various factors on the basis of which options have been granted to the employees in IT&ITES and pharmaceutical industries. Designation of the employees (60.9% and 47.8% respectively for IT&ITES and Pharmaceutical companies) ranks as the primary factor for options grants in both the industries followed by seniority and performance of the employees.

TABLE 8: TABLE SHOWING THE BASIS FOR VESTING OF OPTIONS IN IT & ITES AND PHARMACEUTICAL COMPANIES

Basis for vesting of options / Conditional vesting				
Basis for vesting	IT & ITES Companies		Pharmaceutical Companies	
	No. of Firms	Percentage	No. of Firms	Percentage
Time based	17	73.9%	22	95.7%
Performance based	4	17.4%	1	4.3%
Both	2	8.7%	0	0%
Total	23	100%	23	100%

Table 8 shows that 73.9% of IT&ITES companies and 95.7% of Pharmaceutical companies have time based vesting of options. 17.4% of IT&ITES companies and 4.3% of Pharmaceutical companies have performance based vesting of options. In 8.7% of IT&ITES options vest on the basis of time as well as performance of employees.

CHART 6: CHART SHOWING FREQUENCY OF OPTIONS GRANTS BY IT & ITES AND PHARMACEUTICAL COMPANIES

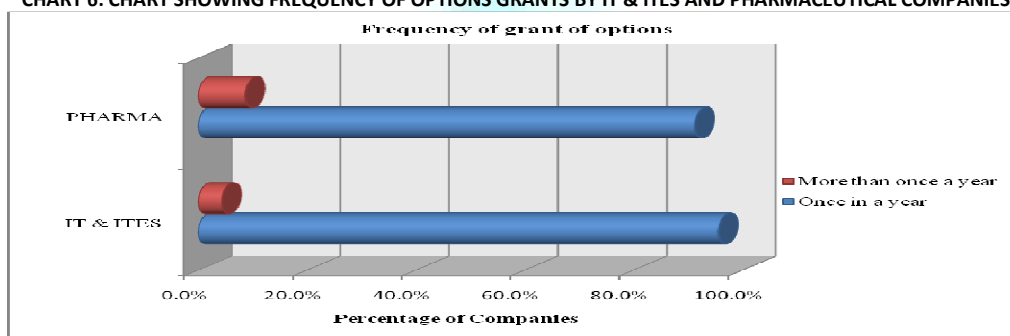


Chart 6 depicts that 73.9% of IT&ITES companies and 95.7% of Pharmaceutical companies grant employee stock options only once in a year and the rest of the companies grant options more than once a year.

TABLE 9: TABLE SHOWING THE VESTING PATTERN / VESTING SCHEDULE OF OPTIONS GRANTED BY IT & ITES AND PHARMACEUTICAL COMPANIES

Vesting pattern / Vesting Schedule				
Vesting Schedule	IT & ITES Companies		Pharmaceutical Companies	
	No. of Firms	Percentage	No. of Firms	Percentage
Uniform for all options	23	100%	23	100%
Differentiated for Senior Management and Juniors	0	0%	0	0%
Total	23	100%	23	100%

Table 9 shows that 100% of both IT&ITES and Pharmaceutical companies follow uniform vesting schedule for their senior managers and junior employees.

CHART 7: CHART SHOWING THE LIFE OF OPTIONS GRANTED (VESTING AND EXERCISE PERIOD OF OPTIONS) BY IT & ITES AND PHARMACEUTICAL COMPANIES

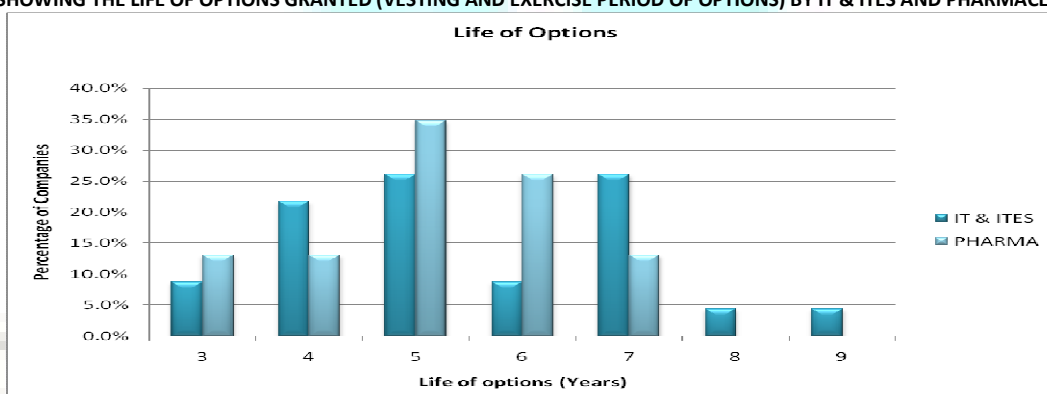


Chart 7 depicts that the life of the stock options granted by IT&ITES companies vary between three to nine years and those of Pharmaceutical companies vary between three to seven years. 26.1% of plans in IT&ITES and 34.8% of plans in Pharmaceutical companies have five years life, 26.1% of plans in IT&ITES and the same percentage of plans in Pharmaceutical companies have seven years and six years respectively as their life periods.

TABLE 10: TABLE SHOWING THE PURPOSE FOR ISSUING ESOP BY IT & ITES AND PHARMACEUTICAL COMPANIES

Purpose of ESOP				
Purpose of ESOP	IT & ITES Companies		Pharmaceutical Companies	
	No. of Companies	Percentage	No. of Companies	Percentage
Attracting Talent	10	43.5%	5	21.7%
Compensation	2	8.7%	2	8.7%
Incentive/Reward	11	47.8%	10	43.5%
Motivation	4	17.4%	9	39.1%
Retaining Talent	20	87.0%	16	69.6%
Sharing Ownership	2	8.7%	2	8.7%
Sharing Wealth	8	34.8%	3	13.0%

Table 10 lists down the purposes for which employee stock options are granted by IT&ITES and Pharmaceutical companies. Retention of talent ranks as the primary purpose of ESOP issues in both the industries followed by incentives, motivation, attraction of talent and sharing wealth as the second, third, fourth and fifth factors respectively. Factors such as ESOP as a component of employee compensation and a mode of sharing ownership with the employees share the sixth place as purposes of employee stock option plans issues.

## FINDINGS

The significant findings of the study are as follows:

- The maximum number of plans announced by individual IT&ITES companies is nine and the minimum is one. The maximum number of plans announced by individual Pharmaceutical companies is four and the minimum is two.
- IT&ITES firms have announced a maximum of 13 plans and a minimum of two plans in a single year during the period between 1999 and 2010. Pharmaceutical firms have announced a maximum of nine plans and a minimum of one plan in a single year during the period between 1999 and 2010.
- The trend of plan announcements shows that the number of plans announced by Pharmaceutical companies show an increasing trend whereas that of IT&ITES companies show a declining trend.
- Majority of companies in both industries have announced Broad based stock options plans covering various categories of employees.
- Plan design adopted by companies in both industries is highly similar.
- Under majority of the plans in both industries, no specific significant grants of options have been made to any specific categories of employees.
- Majority of companies in both industries have adopted intrinsic value method for valuation of their stock options.
- In both industries, majority of the companies have adopted direct route for ESOP administration instead of trust route.
- All pharmaceutical companies and majority of IT&ITES companies have issued their employee stock options at market price.
- Primary basis for grant of employee stock options in both industries is designation of the employees followed by seniority and performance of employees as the second and third factors respectively.
- Time based vesting schedule is followed by majority of the companies in both industries.
- Options are issued only once a year by majority of the companies in both industries.
- Uniform vesting schedule of options for both senior and junior employees is followed in both industries by majority of companies.
- The options issued have a life period between three to nine years with a mean life of five years.
- Retention of talent has been identified as the primary purpose of ESOP issues in both industries.

## CONCLUSION

The study revealed that Indian companies are clearer about their ESOP design practices after the SEBI ESOS & ESPP (Employees Stock Options Schemes and Employees Stock Purchase Plans) Guidelines, 1999. Still the number of plans announced is significantly low considering the benefits of ESOPs. Companies are yet to exploit the full potential of ESOPs given the present corporate scenario that calls for long term strategies for gaining competitive edge by companies in every sector of the economy.

ESOP is an ideal way to bring the key employees as well as a broad category of employees under the ownership or stakeholders tag. Moreover, ESOPs have great potential to attract prospective key employees to an organization if offered as part of the compensation package at the time of hiring. Hence, organizations can benefit by integrating employee stock options into the compensation packages of new hires. If designed, communicated and implemented systematically and carefully, ESOPs will go a long way in serving as an effective tool of employee compensation, reward, motivation and retention.

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## APPENDIX

### LIST OF SAMPLE COMPANIES

S.NO	IT&ITES COMPANIES	PHARMACEUTICAL COMPANIES
1	Datamatics Technologies Limited	Aurobindo Pharma Limited
2	Educomp Solutions Limited	Bal Pharma Limited
3	FCS Software Solutions Limited	Biocon Limited
4	Firstsource Solutions Limited	Dabur India Limited
5	Geometric Limited	Divi's Laboratories Limited
6	HCL Infosystems Limited	Dr.Reddy's Laboratories Limited
7	HCL Technologies Limited	Elder Pharmaceuticals Limited
8	Hexaware Technologies Limited	Glenmark Pharmaceuticals Limited
9	Info Edge (India) Limited	Ind-Swift Laboratories Limited
10	Infosys Technologies Limited	Ipsa Laboratories Limited
11	KPIT Cummins Infosystems Limited	J.B.Chemicals & Pharmaceuticals Limited
12	Mastek Limited	Lupin Limited
13	Mindteck India Limited	Matrix Laboratories Limited
14	MindTree Limited	NATCO Pharma Limited
15	Mphasis Limited	Orchid Chemicals & Pharmaceuticals Limited
16	NIIT Limited	Piramal Healthcare Limited
17	Northgate Technologies Limited	Ranbaxy Laboratories Limited
18	Patni Computer Systems Limited	Shasun Chemicals and Drugs Limited
19	Polaris Software Lab Limited	Strides Arcolab Limited
20	Ramco Systems Limited	Suven Life Sciences Limited
21	Tech Mahindra Limited	Unichem Laboratories Limited
22	Wipro Technologies Limited	Venus Remedies Limited
23	Zensar Technologies Limited	Zenotech Laboratories Limited

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