



Impact of Employee Stock Options on Firm Performance

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ABSTRACT

Employee stock option is the worldwide phenomena now. The popularity of broad based employee stock option plans in India has increased only in 2000 due to the escalation in the Indian Industry. Worldwide, stock options are used to create a sense of ownership among the 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 are seen as an important human resource tool, the rationale behind ESOPs is that they will help companies to retain staff, attract talent, motivate employees and enable them to share the long term growth of the companies as well as the shareholders. The present paper makes an empirical study on the sample of 59 software companies listed in Indian stock market which has adopted employee stock option plan and analyze its impact on firm performance.

KEYWORDS: Employee Stock Options, Companies, Performance

1. Introduction

Employee Stock Option Schemes ("ESOSs") once unheard of in India are gaining popularity rapidly, especially during the past few years. Faced with the problem of poaching and brain drain, the software industry especially has realized the importance of employee stock options to recruit and retain the best talents. The technology world is divided about where ESOPs or employee stock options originated in India. Azim Premji led Wipro first brought the concept to India in the late 1980s. Infosys, the country's second largest IT services firm, was the first to offer stock options to employees when it went public in 1993 (ESOP Direct, 2011). Buoyant stock markets, coupled with brighter business prospects, are prompting companies to offer stock options to retain talented employees in India. Companies in India, which had introduced employee stock plans and their variants during the period 1994 - 1999, were not called stock options, because there were no options given by the company. The SEBI has formulated Securities and Exchange Board of India (Employee Stock Option Scheme/ Employee Stock Purchase Scheme) Guidelines 1999 to regulate ESOPs.

In India ESOP, adoption is still in its nascent 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, Pharmaceutical, Communication, Entertainment, Financial and Technology driven companies use ESOPs as a tool to reward and motivate employees. Though originally conceived as long-term incentive plans, ESOPs were used as short-term incentives due to the boom in share prices in Pharmaceutical, Technology and Manufacturing sector.

1.1 History of Employee Stock Option Plan

ESOPs as a financial instrument were the brainchild of a visionary economist named Louis Kelso, who said that for capitalism to survive there needed to be more capitalists. In 1956, Peninsula Newspapers, Inc. approaches Louis Kelso to develop a succession plan. Louis Kelso structured an employee ownership plan in 1957, acquiring external funds for employees to purchase new equity. Stock ownership and Option plans have come a long way in their variety as well as their intensity of application.

1.2 Definitions

ESOPs, "Employees Stock Ownership Plans" or "Employees Stock Options Plans" is the generic term for a basket of instruments and incentive schemes provided to the employees of the company to motivate, reward, remunerate and to retain the employees. Fiore (1990) defined

ESOP as an employee "contribution plan designed to invest primarily in the stock of the company providing benefits to both the sponsoring corporation and the participating employees". ESOP is unique reward system. Such systems endeavor to motivate employees, increase participation, and enhance productivity to improve organizational competitive advantage.

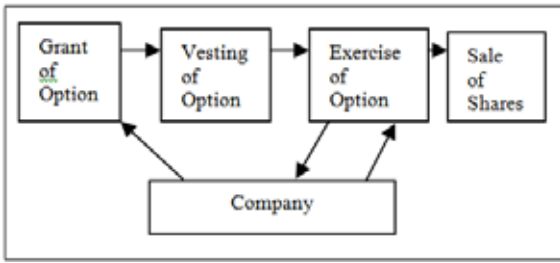
According to Securities Exchange Board of India ESOP/ESPS Guidelines (1999) "employee stock option" means the option given to the whole-time Directors, Officers or employees of a company which gives such Directors, Officers or employees, the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a predetermined price. "Employee stock purchase scheme (ESPS)" means a scheme under which the company offers shares to employees as part of a public issue or otherwise.

2. Mechanism of ESOPs

A stock option is defined under the guidelines as "a right but not an obligation granted to an employee in pursuance of the employee stock option scheme to apply for shares of the company at a pre-determined price". According to the guidelines issuance of ESOP rely on the twin principles of complete disclosure and shareholder approval. The company cannot offer ESOPs unless the shareholders of the company approve ESOPs by passing a special resolution in the general meeting. At the time of seeking the approval of the shareholders, the exercise price or the pricing formula has to be disclosed or determined by the company.

The option can be converted to shares if the holder of the option fulfills certain conditions. These conditions are the "vesting criteria" and it is based on number of years of continued service after receiving the option, or satisfaction of some performance goals either by the option holder, or by both. When the vesting criteria are satisfied, the options are said to be "vested". A vested option gives the option holder the right to exercise the allotted shares of the company. If the employee is terminated for misconduct, then the vested option may lapse. Exercise of an option is the process by which a vested option is converted into shares by payment of the exercise price. The exercise price is normally determined at the time the option is granted to the employee. The option holder is not entitled to either dividend or voting rights until he exercises his option and is allotted shares.

Figure 1 Mechanism of ESOPs



Source: Nishith Desai Associates and The Economic Times

3. Objective

The main objective of the study is to examine if firm size is associated with the impact of broad-based stock options in Indian Software companies. This paper draws on theory about how firm size affects the performance potential of broad-based stock options and their ultimate effect on firm productivity, return on assets, net profit margin and capital intensity.

4. Methodology

The data for the study are drawn from the Centre for Monitoring Indian Economy (CMIE) PROWESS data base. The companies were selected based on the criteria that the companies should have allotted/ adopted ESOP between April 2000 to 2008. The year of adoption/ allotment of ESOPs were taken as 0, four years prior to adoption of ESOP were taken as -4, -3, -2, -1 and four years after adoption of ESOP was taken as +4, +3, +2, +1. Based on this criterion 59 software companies which are listed in Bombay stock exchange were selected for the study.

4.1 Dependent and Independent Variables

Three dependent variables that reflect different aspects of firm performance are; Productivity, Return on Assets (ROA), and Profit margins. For each firm, 4-year averages for both dependent and independent variables are used for the both pre ESOP adoption period and post ESOP adoption period. The employee stock option companies are divided both in the pre and post ESOP allotment into three size categories based on average employment small (less than 500 employees), medium (500 to 5000 employees) and large (more than 5000 employees). The methodology and variables adopted for the study was similar to that used by Sesil and Kroumova (2005)

5. Results

Table 1 indicates that prior to issue of employee stock options 27.11% are small firms (16 firms with less than 500 employees), 59.32 % are medium sized firms (35 firms with 500- 5000 employees); and 13.55% are large sized corporations (8 firms with 5000 or more employees). After allotment of employee stock options i.e. post ESOP only 5.08 % are small firms (3 firms with less than 500 employees), 71.18 % are medium sized firms (42 firms with 500-5000 employees); and 23.72 % are large sized corporations (14 firms with 5000 or more employees). This shows that after allotment of employee stock options the employee size has grown considerably in software firms.

Within each size category after allotment of ESOP, companies have shown higher productivity, return on asset, and capital intensity. But there is no impact on net profit margin in post ESOP allotment. Comparing small to large stock option companies using simple means indicate that productivity level is high in small firms (mean 2.0), medium firms (mean 1.2) and large firms (mean 1.4) post ESOP allotment. But return on assets has decreased in small firms (mean 13) in post ESOP allotment periods, whereas incase of medium sized firms and large firms return on assets has increased considerably (mean 120 and mean 163) in post ESOP periods. Increased capital intensity (small firms mean 1.7; medium firms mean 0.9; large firms mean 0.4) in post ESOP allotment indicates that firms started to intensify capital to push up productivity of the employees. The net profit margin of the companies in post ESOP

allotment did increase significantly across the small, medium and large firms. This indicates that other than employee efforts other factors such as business cycle may intervene in earnings of the company.

Table 2 indicates that there is significant relationship between productivity and capital intensity (p.value 0.00 < 0.01). There is significant relationship between return on assets and net profit margin (p.value 0.00 < 0.01). Also the relationship between return on assets and employment is positive and it is significant (p.value 0.00 < 0.01).

Table 3 indicates that after/post ESOP allotment there is significant relationship between company productivity and return on assets of the company (p.value 0.0 < 0.05). The company's productivity has improved the return on assets of the company. It is also noted that there is significant relationship between employment and company productivity (p.value 0.0 < 0.05). The employee size has increased after ESOP allotment. The relationship between capital intensity and employment is negative and it is statistically significant.

6. Discussion and Conclusion

This paper provides evidence that ESOP software firms perform better in post ESOP allotment periods across all firm size. But with respect to net profit margin, ESOP allotment has not improved the profit margins of the company in spite of improved productivity performance. Correlation analysis also indicates that there is significant relationship between company productivity, return on assets and employee size. Employee size has increased significantly in post ESOP periods. The study indicates that employee behaviors that enhance productivity (e.g. working harder, longer, and smarter, sharing information, monitoring and coaching one another) are apparently more prevalent in stock option firms which have resulted in improved productivity. The results are congruent with Sesil and Kroumova (2005) finding that equity compensation motivates productivity enhancing behaviors and activities and its effect may be at least partially due to the expectation of financial rewards.

APPENDIX

Table 1 Mean, Standard Deviation and Company Size

Variables	Pre ESOP (N=59)						Post ESOP (N=59)					
	Small		Medium		Large		Small		Medium		Large	
	M	SD	M	SD	M	SD	M	SD	M	SD	M	SD
Productivity	0.18	1	-0.1	0.92	-0	0.8	2	1	1.2	0.88	1.4	0.76
ROA	15.8	69.3	50.1	58	71	42	13	14.7	120	114	163	135
Net Profit Margin	-15	80.4	10	23.3	21	11	-14	60.8	10.1	33.5	13.7	14.1
Ln Employment	4.94	0.57	6.86	0.81	9	1.2	5	1	7.1	0.87	9.8	1.05
Ln Capital Intensity	0.81	1.05	0.37	1.11	0.4	0.9	1.7	1.5	0.9	1.14	0.4	0.85
Sample Size	16		35		8		3		42		14	
M= Mean	SD= Standard Deviation											

Table 2 Correlations of all Variables (Pre ESOP; N= 59)

Variables		Pre Productivity	Pre ROA	Pre Profit Margin	Pre Ln Employment	Pre Lncapital Intensity
Productivity	Pearson Correlation	1	0	0.2	-0.1	0.6**
	Sig. (2-tailed)		0.7	0.2	0.7	0
ROA	Pearson Correlation	0	1	0.7**	0.4**	-0.1
	Sig. (2-tailed)	0.7		0	0	0.3
Profit margin	Pearson Correlation	0.2	0.7**	1	0.3*	0
	Sig. (2-tailed)	0.2	0		0	0.8
Ln Employment	Pearson Correlation	-0.1	0.4**	0.3*	1	-0.2
	Sig. (2-tailed)	0.7	0	0		0.2
Lncapital Intensity	Pearson Correlation	0.6**	-0.1	0	-0.2	1
	Sig. (2-tailed)	0	0.3	0.8	0.2	

**Correlation is significant at the 0.01 level (2-tailed).

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

Table 3 Correlation of all Variables (Post ESOP; N= 59)

Variables		Post Productivity	Post ROA	Post Profit Margin	Post LnEmployment	Post LnCapital Intensity
Post	Pearson Correlation	1	0.3*	0.2	0.3**	0
Productivity	Sig. (2-tailed)		0	0.1	0	0.8
Post ROA	Pearson Correlation	0.3*	1	0.1	0.2	0
	Sig. (2-tailed)	0		0.3	0.2	0.8
Post Profit Margin	Pearson Correlation	0.2	0.1	1	0.1	0
	Sig. (2-tailed)	0.1	0.3		0.6	0.7
Post LnEmployment	Pearson Correlation	0.3**	0.2	0.1	1	-0.3*
	Sig. (2-tailed)	0	0.2	0.6		0
Post LnCapital Intensity	Pearson Correlation	0	0	0	-0.3*	1
	Sig. (2-tailed)	0.8	0.8	0.7	0	

**Correlation is significant at the 0.01 level (2-tailed).

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

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