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Employee Stock Option Plan (ESOP) is a plan through which a company awards Stock Options to the employees based on their performance. An employee stock option is a call option meaning that under an ESOP, the employees have the right and not an obligation to buy the shares of the company on a predetermined date at a predetermined price. The objective of ESOP is to motivate the employees to perform better and improve shareholders' value. Apart from giving financial gains to the employees, ESOP also creates a sense of belonging and ownership amongst the employees. The Accounting Valuation is needed for working out the Employee Compensation Cost at the time of ESOP Grants itself which is apportioned over the vesting period of ESOP.

There are two methods of doing ESOP Valuations- Intrinsic Value Method & Fair Value Method-

•Intrinsic Value• is the excess of the market price of the share under ESOP over the exercise price of the Option (including upfront payment, if any). Example: - A company grants an ESOP to its employees whose current market price (CMP) of the share is Rs 100 which can be exercised after 2 years for Rs 70. In this case the intrinsic value of options shall be Rs 30/- ( $100 - 70$ ). However if the CMP was Rs.50 instead, there would be no intrinsic value of the option since the exercise price is more than CMP and in this case options could not be exercised and instead stand lapsed.

"Fair Value" of an ESOP is estimated using an option-pricing model like, the Black-Scholes or a binomial model. For undertaking fair valuation of ESOPs, the Black-Scholes model is mostly preferred as it takes into account the various other factors like Time Value, Interest Rate, Volatility, Dividend yield etc. These factors are not considered under Intrinsic Value method which may lead to under estimation of Employee Compensation Cost.

The Black Scholes Model considers various external factors that affect the value of the ESOP whereas the intrinsic value method considers only factors internal to the Option offered.

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