What is an ESOP?

ESOP - Employee stock option plan help companies to attract and retain employees by offering an opportunity to acquire shares. Before an IPO, companies should formulate ESOP policy, understand tax and accounting treatment, employee rights and benefits and identify the disclosures to be given in the Draft Red Herring Prospectus. Early review can reduce regulatory queries, last-minute changes and inconsistencies in IPO documents.

Now, let's understand the key issues to resolve before filing the Draft Red Herring Prospectus.

ESOP Scheme and Regulatory Compliance

- Check the ESOP scheme against applicable requirements, including the Companies Act, 2013 and rules made thereunder, including SEBI regulations, where applicable.
- Ensure the board or shareholder approval, as applicable, grant letters, vesting terms, exercise conditions and prerequisites have already been determined.

ESOP Capitalisation Table

- Reconcile the ESOP scheme with employee records, pre and post issue capital, previous allotment records, if any, and the capitalisation table.
- Clearly separate granted, vested, exercised, outstanding unvested and available grant options.
- Analyse and correct discrepancies in the shareholding pattern.

Treatment of Outstanding Options

- Segregate as to how vested and unvested options will be handled before and after listing.
- Review policy stating the probability of having a high employee turnover.
- Check any proposed vesting acceleration or exercise period extension against scheme terms, law and approval requirements.

Exercise Price, Valuation and Dilution

- Verify the exercise price and the valuation for each grant of option.
- Assess accounting, tax and disclosure implications where the exercise price differs from the expected IPO valuation.
- Calculate potential dilution from outstanding options and shares issuable on exercise.

Tax Implications

- Review potential tax implications at exercise and capital gains tax on a later sale.
- Explain potential tax liabilities to employees and obtain professional advice where needed.

Accounting and Financial Reporting

- Review accounting for granting, vesting, cancellations and modifications under applicable standards.
- Ensure ESOP calculations and disclosures match the financial statements.
- Resolve unexplained differences before finalising DRHP financial information.

DRHP Disclosures

- Disclose relevant scheme terms, options granted, outstanding, exercised, shares allotted, unallotted, material amendments and potential dilution, as applicable.
- Cross-check disclosures against statutory records, audited financial statements and the capitalisation table.
- Review material grants or arrangements involving senior management for specific disclosure requirements.

Conclusion

A pre-IPO ESOP review should confirm legal compliance, accurate records, clear treatment of employee rights, appropriate tax and accounting treatment, and consistent disclosures. Companies should work with their legal advisers, merchant bankers, auditors and tax advisers to resolve issues before filing the DRHP.

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