

Executive Stock Option and Blockholder Ownership as Governance Mechanisms on Firm Performance

Ahmad Ibn Ibrahimy

Department of Accounting and Finance
Universiti Malaysia Sarawak
Sarawak, Malaysia

Rubi Ahmad

Department of Finance and Banking
Universiti Malaya
Malaysia

Mohamed Albaity

Department of Finance and Economics
University of Sharjah
Sharjah, United Arab Emirates

Abstract

Separation of ownership and control led to agency conflicts between the majority and minority shareholders in South East Asian Corporations. Using panel data pooled GLS estimations, this study investigates the effects of Executive Stock Option (ESO) granting and blockholder ownership on firm performance of Malaysian non-financial listed companies. A positive significant increased relationship between ESO granting and firm performance is found which conform incentive alignment hypothesis, coupled with the modest effect of blockholder ownership while considering both market and accounting based performance measurements. These explanatory variables are in tandem with the enhancement of future revenues by alleviating the conflicts between shareholders and managers of Malaysian firms. The low positive relationship is indicating the blockholder ownership as a monitoring device that has modest power. Additionally, industry effects on firm performance also been observed.

Keywords: Blockholder Ownership, Executive Stock Option (ESO) Granting, Executive Stock Option Scheme (ESOs), Firm Performance, Malaysia, Panel Data Analysis.

1.0 Introduction

In modern corporations, businesses are managed potentially by two parties - shareholders and managers (Hadani et al., 2011). Shareholders usually do not manage their businesses by themselves; instead they hire the managers to do so. Consequently, this creates asymmetric information problems, first addressed by Jensen and Meckling (1976). This separation issue exists in the organizations partly because of the advantages of specialization of management and risk bearing; and also due to agency problem arising from the separation. These conflicts of interests, coupled with costly perfect contracts writing or keeping an eye on the controllers, eventually reduce the value of the firm; other aspects kept equal (Denis and McConnell, 2003). These ideas outline the basis for corporate governance mechanisms that result from the separation of ownership and control. The main objective of this study, therefore, is to verify the likelihood of Executive Stock Option Scheme (ESOs) in reducing the agency conflicts among stakeholders. Given the scenario of Malaysia where the owners are present in the management (Claessens et al., 2002), ESOs raises a question as to whether it is intended to adopt for their own benefits. The second key objective is to explore the impact of blockholder ownership on certain major corporate decisions that affect firm value. In this study, Executive Stock Option (ESO) granting is considered to validate the purpose of ESOs adoption where blockholder ownership is also in the management of the company. We found that Malaysian executives are tying their wealth by ESOs adoption where executives may expropriate minority shareholders' wealth due to poor corporate governance structure.

Two-thirds of the Malaysian firms are each controlled by a single shareholder with high ownership concentration; and the limited conflict between large shareholders and managers (Claessens et al., 2000) has a different set of agency problem all together. These corporate scenarios of Malaysian firms differ from the developed markets' dispersed ownership structure, where introduction of ESOs is a burning question of aligning the interests between executives and the shareholders.

According to Zhuang (2001), Asian countries are characterized by concentrated ownership and weak regulatory structures, leading to a weak corporate governance setting. For managers who are from the same family of large controlling shareholders, the conflicts of interest between managers (agents) and shareholders (principals) are limited. With the implementation of interest alignment mechanisms in 1989, the Malaysian corporate scenario suggests potential conflicts between concentrated ownership and minority shareholders of the firms rather than the conflicts between managers and shareholders. Consequently, when large shareholders are the board members, decisions carried out by them are a question of whether it would incline to benefit them at the cost of minority shareholders. This refers to the issue of conflicts between majority and minority shareholders in Asian countries (Claessens and Fan, 2002). Therefore, the high concentrated ownership (Haniffa and Hudaib, 2006), the presence of weak corporate governance in Asian countries (Cheung and Chan, 2004; Zhuang, 2001), and the limited minority rights are the motivations of this study that allow us to test the effectiveness of governance mechanisms in Malaysia.

2.0 Literature Review

Separation of decision making and risk bearing functions detected in large companies is ordinary to other businesses such as partnership, financial or non-profits (Fama and Jensen, 1983). Any reformation of corporate governance requires the legal and regulatory structures and their enforcement where the executives (Cui and Mak, 2002; Ittner et al., 2003; Kato et al., 2005; Mehran and Tracy, 2001) and blockholder (Minguez-Vera and Martin-Ugedo, 2007; Shleifer and Vishny, 1986; Thomsen and Pedersen, 2000) play an important role. The efficient management or the blockholder, thereby, ensure both controlled and dispersed shareholders of their returns to increase shareholders' value (De Andres et al., 2005). The most significant expropriation of shareholders' wealth takes place when managers entrench themselves even if they are not capable of running the business (Shleifer and Vishny, 1989). In essence, agency theory addresses the contracting problem among self-interested individuals with the main objective of minimizing total agency costs. The main understanding is the recognition that parties who bear the agency costs would like to minimize it in any contracting relationship. Monitoring and bonding activities take place where the marginal benefit equals the marginal costs of reducing the residual loss. Options thus work as a tool of controlling the incentives of managers of taking little risk in a project. Share options also help to control underleveraged problems, since high leverage is more attractive to managers as it increases the variance of the equity and hence, the value of the option.

According to agency theory, pay performance link is expected to be affected by the firm's ownership structure. To measure the impact of corporate control by ownership structure on top executives' compensation of non-financial Japanese firms, Mazumder (2017) demonstrated that institutional ownership is negatively correlated to the level of executives' compensation. On the other hand, Chen et al. (2013) examined the determinants and consequences of stock option compensation of state-controlled Chinese firms and found that firms granted directors a significant number of stock options in response to the demand of foreign investors. Results are consistent with the stock options granted to directors of many state-controlled firms are not genuine compensation. To explore how stock options granted are used for executive remuneration in Italian blockholder dominated non-financial listed firms, Melis et al. (2012) found that stock option design seems to be better explained by rent extraction theory than by optimal contracting theory. Whether the incentive role of executive stock option (ESO) of American firms depends on their level, Essid (2012) found that ESO decreases the earning management and represents an additional control mechanism. A long term alignment of interests is found at low levels of ESO but at high levels, ESO becomes an additional source of agency conflict in the short and long runs. Jiang et al. (2009) investigated the effect of ownership concentration on CEO compensation and firm performance of New Zealand firms and found a non-linear relationship. Bacha et al. (2009) examined Malaysian ESO firms and their matched industry peers and found ESO firm stocks to have marginally higher mean returns and lower volatility than do their pre-ESO peers. On the other hand, Ismail et al. (2017) examined the effect of stock option plan on firm performance and found that granting stock option plans do not entirely lead to improvements over firm performance in Malaysia. In view of these contractual settings, the rest of the paper discusses ESO granting and blockholder' effects as corporate governance mechanisms to explore executives' incentive of ESOs adoption.

3.0 Methodology and Data

The main objective of this study is to verify the likelihood of ESO granting whether it is reducing the agency conflicts between stakeholders. The second key objective is to explore the prospect of blockholder ownership motives and their impact on certain major corporate decisions that affect firm value. With the sample of the study comprising all ESOs adopted firms who granted ESO, the study also investigates the relationship between the firm specific variables and firm performance. As ESO granting is an internal decision, therefore, firm specific variables may produce rational explanations to its granting. The firm specific risk variables, leverage, growth, size, age of the firm and industries a firm belongs; also include different shareholding characteristics of the firm.

This study incorporated panel data approaches to determine the impact of ESO granting and blockholder ownership on firm performance of Malaysian non-financial listed companies. It is the longitudinal data which allows observing the changes of outcomes over time (Hsiao, 2007) of sample companies, using the regression equation for yearly ESO granting as a dummy variable (Hillegeist and Penalva, 2003). Since the sample is selected on purposive sampling basis, the study adopted the panel data technique, which takes into account the heterogeneity effects of companies selected (Hermalin and Wallace, 2001). Heteroskedasticity and autocorrelation problems of error terms are treated by using the corrected standard error models as it is provided by EViews software. The standard error correction model assumes that error term has same variances over time across units. When this assumption is violated we say that there is heteroskedasticity problem. Autocorrelation is an assumption that there is correlation between observations ordered in time or space. Since panel data is composed of both time series and cross sectional data, it is necessary to test the variables for the unit root problem. To detect the problem of unit root or non-stationarity, Levin, Lin and Chu (2002) unit root test is performed. Moreover, to ensure the independency of explanatory variables considered, simple correlation analysis is performed to detect multicollinearity problem.

Executive Stock Option (ESO) is based on the contract which gives the recipient the right to buy a share of stock at a predetermined price (striking price) for a pre-specified term (Murphy, 1999). Here, ESO granting is a dummy variable taking a value of 1 if firm grants ESO for the particular year, otherwise 0 (Trébucq, 2004). Blockholder is defined as cumulative percentage ownership of all shareholders who own 5% or more (Bhabra, 2007; Thomsen et al., 2006). If blockholder ownership is not available for the firm, the indicator variable set in 1 (McConnell et al., 2008). Industries are dummy variables that equal to 1 if a firm reports it as belonging to a particular industry, zero otherwise (Ittner et al., 2003; Lemmon and Lins, 2003). There are total eight (8) industries under Bursa Malaysia (formerly known as Kuala Lumpur Stock Exchange) non-financial companies. Therefore, seven (7) industries are considered in this study and coded as dummy variables. The study covers 1407 observations of Malaysian non-financial listed companies to observe the relationship between corporate governance mechanisms and firm performance. Historical or secondary data are used for the period of 2002 to 2008. Table 1 below summarizes the industries and their weights on the overall sample.

Table 1: Industry Membership of Sample Firms

Industry	Number of Companies	Firms Percentage
Industrial Products (IP)	123	61%
Consumer Goods (CG)	41	20%
Consumer Service (CS)	14	7%
Oil and Gas (OG)	2	1%
Technology (T)	14	7%
Telecommunication (TC)	2	1%
Utilities (U)	5	3%
Total	201	100%

In finding out the sources of data, ESO granting and blockholder ownership data are extracted directly from the respective Annual Reports. The financial companies are excluded because of their distinctive accounting standards (Lemmon and Lins, 2003). The seven-years period is chosen to capture the actual picture concerning the movement of firm’s performance especially after Asian Financial Crisis of 1997-1998. The empirical relationships for firm *i* in the year *t* are given below:

$$TQ_{it} = \alpha + \sum \beta_1 ESO_{it} + \beta_2 BL_{it} + \beta_3 RV_{it} + \beta_4 PV_{it} + \beta_5 DR_{it} + \beta_6 G_{it} + \beta_7 S_{it} + \beta_8 A_{it} + \sum \gamma_9 IND_{it} + u_{it} \quad (i)$$

$$ROA_{it} = \delta + \sum \zeta_1 ESO_{it} + \zeta_2 BL_{it} + \zeta_3 RV_{it} + \zeta_4 PV_{it} + \zeta_5 DR_{it} + \zeta_6 G_{it} + \zeta_7 S_{it} + \zeta_8 A_{it} + \sum \eta_9 IND_{it} + u_{it} \quad (ii)$$

$$ROE_{it} = \theta + \sum \lambda_1 ESO_{it} + \lambda_2 BL_{it} + \lambda_3 RV_{it} + \lambda_4 PV_{it} + \lambda_5 DR_{it} + \lambda_6 G_{it} + \lambda_7 S_{it} + \lambda_8 A_{it} + \sum \mu_9 IND_{it} + u_{it} \quad (iii)$$

Where, TQ = Tobin’s Q; ROA = Return on Assets; ROE = Return on Equity; ESO = Executive Stock Option Granting (Yearly dummy variable, 1 or 0; for ESO granting 2002 to ESO granting 2007); BL = Blockholder Ownership; RV = Return Volatility; PV = Profit Volatility; DR = Debt Ratio; G = Growth of the Firm; S = Firm Size; A= Age of the Firm; IND = Industry Dummy.

4.0 Findings and Analyses

This study is directed to examine the effects of ESO granting and blockholder ownership against firm performance based on corporate governance environments in Malaysia. The majority of the developed markets are characterized by agency conflicts between managers and the shareholders. Unlike developed markets, emerging markets are prone to have agency conflicts between majority and minority shareholders. According to research issues, analyses are discussed separately against Tobin’s Q, Return on Assets (ROA) and Return on Equity (ROE) as firm performance.

Following Lambert et al. (1991) and McConnell and Servaes (1990), our main objective deals with the combination effects of ESO granting and blockholder ownership on firm performance, after controlling firm specific variables while considering both market based and accounting based performance measurements.

4.1 ESO Granting and Blockholder Effects on Firm Performance (TQ)

Table 2 demonstrates the results of pooled GLS regression estimations testing the effects of respective hypotheses on firm performance (TQ) with industry effects. ESO granting in year 2003 and year 2006 are positively significant by the estimator at 1% and 5% significant level respectively. Increasing rates of the coefficients suggest that ESO granting is tying the executives more closely to firm performance, eventually supporting convergence of interests / incentive alignment hypothesis. This result is similar to Bacha et al. (2009) but contrast with Ismail et al. (2017) findings. On the other hand, blockholder is positively correlated with firm performance. The insignificant positive correlation of blockholder may refer to the effects on performance with limited influence.

Table 2: Pooled GLS Estimations with Industries (TQ)

Variables	Pooled GLS
Intercept	1.22***
ESO granting (2002)	0.04
ESO granting (2003)	0.19***
ESO granting (2004)	0.07
ESO granting (2005)	-0.003
ESO granting (2006)	0.25**
ESO granting (2007)	0.19
Blockholder (BL)	0.0005
Return Volatility (RV)	-0.30
Profit Volatility (PV)	0.04***
Debt Ratio (DR)	-0.005***
Growth (G)	0.002**
Size (S)	0.02*
Age (A)	-0.08***
Industrial Products (IP)	-0.07
Consumer Goods (CG)	-0.02
Consumer Service (CS)	0.18
Oil and Gas (OG)	1.01***
Technology (T)	0.31***
Telecommunication (TC)	0.55**
Utilities (U)	0.01
R ²	0.29
Adjusted R ²	0.28
F-statistic	27.88***

*** 1% Significant level ** 5% Significant level * 10% Significant level

Risk levels are assessed by return volatility, which is negatively insignificant; and by profit volatility, which is positively significant at 1% level with firm performance by the estimator. The inverse relationship of return volatility may indicate that increased variability of stock return could reduce the magnitude of option grants, therefore reducing the firm performance. This is revealed by Ibrahimy and Ahmad (2013) who have shown that the number of ESOs in Malaysia decreased between the years 2002 and 2008. At the same time, the parallel relationship of profit volatility with firm performance could increase the monitoring of management; thereby enhancing firm performance (Demsetz and Lehn, 1985). Debt ratio (leverage) is negatively significant at 1% level by the estimator, which implies that the larger the leverage, the smaller the pay-performance ratio of top management compensation. Therefore, low debt ratio of firms employing ESOs is justifiable with significant firm performance (John and John, 1993). Growth is positively significant at 5% level, which may refer to proper use of proceeds of selecting positive net present value projects by executives to service the debt.

Size of the firm is positively significant at 10% level with performance by the estimator, referring to the bigger sizes having better performance. Finally, age is negatively correlated with firm performance at 1% significance level by the estimator, representing older firms having poor performance compared to young firms.

4.2 ESO Granting and Blockholder Effects on Firm Performance (ROA)

Table 3 shows the results of pooled GLS regression estimations to test the effects of respective hypotheses on firm performance (ROA) with industry effects. Consistent with previous results, GLS estimations of ESO granting effects through the years are indicating increased variability of profitability of accounting based measures compared to market based measures of performance (Lambert and Larcker, 1987). Blockholder is now positively significant at 1% level with low effects of beta coefficient. This positive relationship of blockholder is supporting the monitoring hypothesis. The result indicates that blockholder does have a little influence on firm performance that reduces agency costs as a governance mechanism.

At this time, return volatility is negatively significant with firm performance by the estimator at 1% level. Risk level is also assessed by profit volatility, which is negatively correlated with firm performance. While high profit insists close monitoring of executives by owners, this variable is incorporated in the model to gauge the instability of managerial actions to reflect year to year fluctuations in underlying business conditions. Among other control variables, growth is positively significant and debt ratio is negatively significant with firm performance (ROA) at 1% level for the estimators, which validate findings from the previous section. Firm size is positively significant at 1% level with higher magnitude of regression coefficient. Finally, age of the firm is positively correlated with firm performance when considering accounting based measures of performance.

Table 3: Pooled GLS Estimations with Industries (ROA)

Variables	Pooled GLS
Intercept	-18.99***
ESO granting (2002)	1.29**
ESO granting (2003)	0.65
ESO granting (2004)	1.88***
ESO granting (2005)	1.50*
ESO granting (2006)	1.63*
ESO granting (2007)	3.96*
Blockholder (BL)	0.02***
Return Volatility (RV)	-19.07***
Profit Volatility (PV)	-0.10
Debt Ratio (DR)	-0.14***
Growth (G)	0.05***
Size (S)	1.28***
Age (A)	0.34
Industrial Products (IP)	-3.01***
Consumer Goods (CG)	-1.76**
Consumer Service (CS)	-1.24
Oil and Gas (OG)	3.54***
Technology (T)	-7.23***
Telecommunication (TC)	-2.53
Utilities (U)	-5.35***
R ²	0.26
Adjusted R ²	0.25
F-statistic	23.88***

*** 1% Significant level ** 5% Significant level * 10% Significant level

4.3 ESO Granting and Blockholder Effects on Firm Performance (ROE)

Table 4 displays the results of pooled GLS regression estimations to test the effects of respective hypotheses on firm performance (ROE) with industry effects.

The result reports similar evidences where ESO granting in year 2004, year 2006 and year 2007 are positively significant with firm performance. On the other hand, blockholder ownership is positively significant with firm performance. Overall, this positive relationship is indicating a modest influence of blockholder ownership on firm performance of ESOs adopted firms. Among control variables, return volatility is still negatively significant with higher magnitude of beta coefficient. Profit volatility is found to have a negative relationship at 10% significant level with firm performance. Debt ratio and growth are consistently significant at 1% level where leverage (debt ratio) is negatively and growth is positively correlated with firm performance. The increased magnitude of the coefficients of these variables is indicating the financial importance of Malaysian economy. Firm size is positively significant with firm performance at 1% level, which exposes high magnitude of coefficients of accounting based measures of performance. Firm's age is negatively correlated with firm performance which contrasts market based performance measure.

Table 4: Pooled GLS Estimations with Industries (ROE)

Variables	Pooled GLS
Intercept	-40.35***
ESO granting (2002)	1.66
ESO granting (2003)	1.07
ESO granting (2004)	3.42**
ESO granting (2005)	3.37
ESO granting (2006)	3.28*
ESO granting (2007)	11.66**
Blockholder (BL)	0.03*
Return Volatility (RV)	-23.37***
Profit Volatility (PV)	-0.63*
Debt Ratio (DR)	-0.19***
Growth (G)	0.10***
Size (S)	2.64***
Age (A)	0.38
Industrial Products (IP)	-5.23***
Consumer Goods (CG)	-2.93**
Consumer Service (CS)	-1.72
Oil and Gas (OG)	8.22***
Technology (T)	-9.83***
Telecommunication (TC)	-0.13
Utilities (U)	-5.68***
R ²	0.22
Adjusted R ²	0.21
F-statistic	19.42***

*** 1% Significant level ** 5% Significant level * 10% Significant level

Tables 2, 3 and 4 also reveal the GLS estimators results of industry effects as they are strongly linked with the presence of ESOs (Canyon and Murphy, 2000). Results show that the Oil and Gas industry is positively significant with firm performance by both market and accounting based performance measurements at 1% level, indicating the better product market competition in this industry. Besides, firms belonging to this industry are highly significant for both measurements, which have a high possibility of possessing ESOs. Consumer Service, Technology and Telecommunication industries divulge contradictory effects by market and accounting based measures. It is observed that the contribution of Oil and Gas industry is comparatively higher (as the magnitude of the coefficients) than other industries in Malaysian economy. Industrial Products and Consumer Goods are negatively correlated with firm performance and they are highly significant with accounting based measures of performance, suggesting poor market competition in these dominating sectors. Nonetheless, the significant inverse correlation of Utility industry with accounting based firm performance is indicating the lacking of proper monitoring by regulatory commission of this industry.

This, in turn relates the managerial inability to prepare rate of return and maintaining low costs that finally affects profitability. Overall, the evidences of industry effects follow similar trends. In terms of goodness of fit of the model, both accounting based measures explain similar degrees of variation.

5.0 Conclusion

In this study, the motivation of ESO granting to alleviate the agency problem is considered to validate the purpose of ESOs adoption where blockholder ownership is also in the management of the firm. As there is controversy about ownership effects on performance among academicians and practitioners, there is a necessity of empirical research for feasible logical explanations. This study combined ESO granting and blockholder ownership to test the respective hypotheses while considering industry effects. Using a total of 201 companies to examine their effectiveness in controlling managerial opportunism that reduces agency problem, this study found results that conform to US-based findings as well as results that contrast them.

As the magnitude of the coefficients between ESO granting and market performance indicates the rationality (Jensen and Murphy, 1990) of ESOs adoption, the increasing positive coefficients of ESO granting is supporting the incentive alignment hypothesis as a corporate governance mechanism. Besides, these explanatory variables are in tandem with the enhancement of future revenues by alleviating the conflicts between shareholders and managers of Malaysian firms. However, this increasing magnitude of beta coefficients does not necessarily comply with the agency theory perspective that indicates a good or bad contract. On the other hand, blockholder ownership is positively significant with low magnitude of coefficients by both accounting based performances. The low positive relationship is indicating that the blockholder as a monitoring device has modest power. Due to asymmetric information between insiders and outsiders, such ESOs adoption could be also an alternate way of minority shareholders' wealth expropriation in the scenario of Malaysian poor corporate governance structure. Considering economic sharp contractions in year 2005 and year 2007 of Malaysian economy, the increasing rate of beta coefficients of ESO granting over years is the conformity of firm performance as a monotonic function of ESOs adoption. Taking both results together, one can conclude that introduction of ESOs and blockholders' existence in Malaysia work as corporate governance mechanism tools to mitigate the agency problem between executives and the shareholders to enhance firm performance.

Collectively, the results give a snapshot of the possibility of the message that executives are tying their wealth for long term performance by ESOs adoption in Malaysia. If stock option granting is intended to align interests, executives would strive for better performance; that will eventually enrich their wealth by increasing the stock price. On the contrary, executives could exert control over compensation setting procedures to benefit them rather than striving for better performance (Bebchuk and Fried, 2003). Such consequences are not unusual as Malaysian corporate sectors are still managed by founding family shareholders as claimed by Claessens et al. (2000). In other words, executives may expropriate minority shareholders' wealth due to poor corporate governance structure in Malaysia.

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