

**THE USE OF ESOS AS INTEREST ALIGNMENT MECHANISM IN MALAYSIA:
A MISMATCHED OF A PROBLEM AND SOLUTIONS**

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A MISMATCHED OF A PROBLEM AND SOLUTIONS**

by

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To all who contributes to this humble journey of enlighten, I thank you.

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PENGGUNAAN ESOS SEBAGAI MEKANISMA PENYELARASAN KEPENTINGAN DI MALAYSIA: SUATU KETIDAKPADANAN ANTARA MASALAH DAN PENYELESAIAN

ABSTRAK

Skim Opsyen Saham Eksekutif (ESOS) sering digunakan sebagai instrumen penyatuan kepentingan pengurus dengan pemilik (masalah agensi jenis I) terutama sekali kerana keserakan saham pemilikan. Namun kebelakangan ini pelaksanaan ESOS menjadi popular di kalangan firma yang mempunyai konsentrasi milikan yang tinggi di mana pemilik juga sebahagian daripada pengurusan (masalah agensi jenis II). Oleh itu, kajian ini bertujuan untuk memahami tujuan pelaksanaan ESOS dalam persekitaran di mana pemilik telah menjadi sebahagian dari pihak pengurusan dan tiada pemasalahan asimetri maklumat sepertimana berlaku dalam pemasalahan agensi jenis I.

Dengan menggunakan kaedah *matched pair*, ia mengkaji penentu pelaksanaan ESOS, keputusan untuk memasukkan atau mengeneipkan klausa retensi, prestasi firma selepas pelaksanaan, dan penggajian eksekutif terhadap 428 firms yang disenaraikan (214 pelaksana dan 214 bukan-pelaksana *matched pair*) di Bursa Malaysia. Secara keseluruhan, kajian mendapati keputusan untuk mengisu atau melaksanakan ESOS didorongi oleh gelagat *moral hazard*. Walau bagaimanapun, ianya diimbangi (secara lemah) dengan adanya pelabur institusi termasuk pihak kerajaan.

Dalam kajian penentuan ESOS, hanya perubahan dalam saiz didapati penting dan selaras dengan teori, tetapi berkemungkinan kesan dari manipulasi pengurusan perolehan oleh firma. Firma milikan keluarga cenderung untuk melaksana ESOS berbanding firma jenis lain. Dapatan ini mempersoalkan motif sebenar firma milikan keluarga terutama sekali dengan konsentrasi milikan yang tinggi. Tambahan pula, firma milikan keluarga yang lebih cenderung untuk tidak memasukkan klausa retensi dalam ESOS memanjangkan lagi perdebatan.

ESOS juga gagal sebagai pemangkin prestasi yang lebih baik selepas pelaksanaan dengan adanya pembuktian statistik yang tidak signifikan di antara pelaksana dan bukan-pelaksana. Akhir sekali, dari pembuktian kajian menunjukkan bahawa penggajian eksekutif tidak digunakan untuk memberi ganjaran kepada pengurus berdasarkan prestasi dan firma milikan keluarga lebih cenderung untuk memberi penggajian yang lebih tinggi berbanding firma jenis lain, seterusnya mengesahkan pembuktian sebelumnya.

THE USE OF ESOS AS INTEREST ALIGNMENT MECHANISM IN MALAYSIA: A MISMATCHED OF A PROBLEM AND SOLUTIONS

ABSTRACT

Executive' Share Option Scheme (ESOS) has always been used as an instrument to converge the interests of managers with that of the owners (type I agency problem) particularly when the share ownership is dispersed. However, of late ESOS adoption has been popular among the firms with high ownership concentration where owners are also part of the management (type II agency problem). Therefore, this study aims to understand the reasons for adopting ESOS in an environment where owners are already part of the management team and there is no information asymmetry problem as faced under the type I agency problem.

Using matched pair methodology, it study determinants of ESOS adoptions, decision to include or exclude retention clause, firm's post performances, and executive' remuneration on 428 listed firms (214 adopters and 214 matched pair non-adopters) in Malaysian Bourse. Overall, the study finds that the decision to issue or adopt ESOS is driven by moral hazard behaviour, though this is balance (albeit only weakly) by the presence of institutional investors including the government.

In determinants of ESOS study, only change in size is found to be important and in-line with the theory, but could be subjected to earning management manipulation by the firm. Family owned firms are likely to adopt ESOS than other types of firms. This finding question the ultimate motive of family owned firms especially in light of high ownership concentration. Moreover, family owned firms would incline not to include retention clause in the ESOS, fuelling the debate further.

ESOS adoption also fails to be a catalyst for better post-performance as evidenced by non-statistical significance between adopters and non-adopters. Lastly, evidence from the study shows that executive' remuneration is not being used to reward managers based on performances and family owned firms are likely to give higher remuneration than any other type of firms confirming the priori.

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LIST OF ABBREVIATIONS

Abbreviations	Refers to
%IndD	Percentage of independent directors
%INSSH	Percentage of institutional shareholdings
Blkowner	Equity own by substantial shareholders
BVA	Book value of assets
BVL	Book value of liabilities
ChgNPM	Change of net profit margin -t1,t
ChgROA	Change of returns on asset -t1,t
D/A	Debt to asset ratio
D/E	Debt to equity ratio
DumD	Dummy variable of dual directorship
DumF	Dummy variable of 'family-owned' firms
DumGLC	Dummy variable of GLCs
DumMNC	Dummy variable of MNCs
EPF	Employee Providence Fund
ESOS	Executives share option schemes
ESOP	Executives share option plans
GDP	Gross Domestic Production
GLC	Government-linked companies
IDVSH	Individual block shareholders
INSSH	Institutional block shareholders
InRemu	Log total remuneration
InRev	Log total revenue
InTA	Logarithm of total asset
MASB	Malaysian Accounting Standard Board
MB	Malaysian Bourse
MBR	Market-to-book
MINHOLD	Average minimum holding period
MSE	Malaysian Stock Exchange
MSH	Managerial shareholders
MVE	Market value of the equity
NPM	Net profit margin
OPM	Operating profit margins
PNB	Permodalan Nasional Berhad
ROA	Return on assets
ROE	Return on equity
SC	Securities Commission of Malaysia
SEA	South East Asia
SESDAQ	Stock Exchange of Singapore Dealing and Automated Quotation System
SFAS	Statement of Financial Accounting Standard
TIE	Times-interest-earned
US	United States of America

CHAPTER 1

INTRODUCTION

1.0 Introduction

The introduction of Modern Corporation has marked a new era in managing business. Owner does not manage the business himself. Instead, professional managers are hired to do the job. The concept of multiple owners is also brought the fore, marking the new wave in conducting business. Traditionally, owners and managers are the same people. However, with the modern corporation philosophy, specialists (professionals) are running the business on behalf of the owners. Whilst the philosophy helps to overcome the lack of competency to manage the firm, it has at the same time brought new set of problem with it that is the agency problem.

Agency problem arises when one party has more knowledge than the other and the behaviour cannot be directly observed or monitored at all times. As Jensen and Meckling (1976) points out, professional managers have the incentives to take on decisions that may not be in the best interest of the owners but may well maximize the utility of the decision makers (managers).

In general, theory of the firm and agency theory contends that executives, acting as agents for owners, may pursue strategies to meet their

own utility rather than that of the owners. Therefore, to reduce agency problems there should be mechanisms that align and safeguard not only shareholders' interest but also executives' financial well-being. An example of a tool for interest alignments would be through Executive' Share Option Scheme (ESOS).

ESOS' or ESOP's usefulness as an instrument to align managers' interest with owners is well documented in developed market. Examples of such studies on the field are those by Agrawal and Knoeber, 1996; Bizjak, Brickley, and Coles, 1993; Bradbury, Ching, and Mak, 1999; Core, and Guay, 2001; DeFusco, Johnson, Zorn, 1990; Ding and Sun, 2001; Hartzell and Starks, 2003; Hillegeist and Penalva, 2004; John and John, 1993; Lee, 1991; Lins, 2000; Matsunaga, 1995; Mehran, 1995; Mehran, Nogler and Schwartz, 1998; Murphy, 1985, 1986, 1998, 1999, 2002, 2003; Palia, Cornett, Hovakimian and Tehranian, 2003; Pugh, Oswald, and Jahera, 2000; Yeo, Chen, Ho and Lee, 1999; and Yermack, 1995. These studies almost conclusively find that ESOS can align the interest of executives and shareholders. Thus, lowering agency cost and problems provides better accounting, financial, as well as share price performances. In other words, ESOS or ESOP works the way it was intended to. For example, it solves the problem between managers and owners by making the managers share part of the consequences of their decisions.

Although later literatures (see Bebchuk, Fried, and Walker, 2002; Bebchuk, and Fried, 2004; Coulton, and Taylor, 2002; Defina, Harris and Ramsay, 1994; Gerety, Hoi, and Robin, 2001; Hanlon, Rajgopal, and Shevlin, 2003; Holthausen, Larcker, and Sloan, 1995; Izan, Sidhu, and Taylor, 1998;

Martin, and Thomas, 2005) began to question the usefulness of ESOS, the general feeling that ESOS works as part of the tool that solves conflict between managers and owners remains.

Throughout this proposal the term ESOS and executives share options plans (ESOP, as it is widely known in most part of the world) are used interchangeably as they represent the same concept of offering eligible executives the right to purchase a fixed number of employer's common stock at a predetermined price over a finite horizon.

1.1 Background of Malaysian Corporate Sector

The Malaysian capital markets are growing with the total capitalization of RM553 billion or 185 percent of GDP in December 1999 to 963 companies trading in 2004 with market capitalization stands at RM722 billions with nominal shares value of RM233 billions (Bursa Malaysian, 2005 Annual Report). In 2000, the Malaysian Bourse (MB) or previously known as Kuala Lumpur Stock Exchange (KLSE) had 757 listed firms in the first board compared to only 285 firms in 1990, with annual growth of 30 percent over the same period (Khatri, Leruth and Piesse, 2002).

Malaysian corporate sector like corporate sectors in other countries in the region and other developing market is characterized by an insider system of corporate governance (as shown in Table 1.1 and Table 1.2) where high level of ownership concentration, cross holdings and significant participation of owners in management are apparent (see; Claessens, Djankov and Lang, 2000; Lemmons and Lins, 2001, and Mitton, 2002 for references).

Table 1.1
Controls of Publicly Traded Companies in Selected Country (20% cut-off)

	Widely held (%)	Family firms (%)	State owns (%)	Widely held Financial (%)	Widely held Corp. (%)
Australia	65	5	5	0	25
France	60	20	15	5	0
Germany	50	10	25	15	0
UK	100	0	0	0	0
US	80	20	0	0	0
Japan	79.8	9.7	0.8	6.5	3.2
Greece	10	50	30	10	0
Hong Kong	10	70	5	5	10
Singapore	5.4	55.4	23.5	4.1	11.5
Malaysia	10.3	67.2	13.4	2.3	6.7

Source: for Japan, Singapore, and Malaysia; Claessens, S., Djankov, S. and Lang, L. (2000) and for Australia, France, Germany, United States, United Kingdom, Greece, and Hong Kong; La Porta. R., .Lopez de-Silanes, F., Shleifer, A., Vishny R., (1998)

From Table 1.1, it is clear that Malaysian market, family ownership concentration (having more than 20 percents of firm shareholding) is apparent where more than 2/3 of listed firm in the KLSE falls into family' firm category. Figures in Table 1.1 also substantiate claims that developed market ownerships are different to those in developing market. In the developing market, firm' ownership are disperse and widely held by numerous shareholders and the environment is vice-versa in developing market. In the developing market, firm' ownership is mostly held by either family members or state holdings. Due to differences in firm' ownership environments, this phenomenon indicates that knowledge abstracted from developed market may not be directly applicable in developing market.

Furthermore, as shown in Table 1.2, due to pervasive cross holdings practice, a portion of large Malaysian firms are controlling more entities/firms

beyond their level of ownership in each firm (Khatri, Leruth and Piesse, 2002). For example Thillainathan (1998) reports that Tan Sri Halim Saad, CEO and the controlling shareholders of Renong have a personal direct stake of 23.5 percent which in turn controlled UEM with an interest of 37.1 percent. Therefore, Tan Sri Halim Saad's effective cash flow right was only 8.6 percents (0.235×0.371), but he exercises total control over UEM.

Table 1.2
Means of Enhancing Control in Selected Country (20% cut-off)

	Owns > 20% Control (%)	Pyramids with ultimate owners (%)	Cross holdings (%)	Controlling owner alone (%)	Presence in Management (%)
Australia	5	0	10	100	100
France	20	100	0	75	5
Germany	10	67	20	50	50
UK	0	0	0	0	0
US	20	0	0	100	75
Japan	20	36.4	11.6	87.2	37.2
Greece	50	0	0	70	60
Hong Kong	70	39	50	75	86
Singapore	55.4	55	15.7	37.6	69.9
Malaysia	67.2	39.3	14.9	40.4	85.0

Source: for Japan, Singapore, and Malaysia; Claessens, S., Djankov, S. and Lang, L. (2000) and for Australia, France, Germany, United States, United Kingdom, Greece, and Hong Kong; La Porta. R., .Lopez de-Silanes, F., Shleifer, A., Vishny R., (1998)

Moreover, a well-documented example of ownership cross holding or pyramiding business in Malaysia would be that of Arab-Malaysian Banking Group (Malaysia), which holds 44.5 percent of Arab-Malaysia Development Company. The pyramid also includes Arab-Malaysian Finance and Arab-Malaysian First Property Trust and six other companies listed in KLSE (Claessens, Djankov and Lang, 2000). Other pyramiding business structure

includes Berjaya Group, Sime Darby Group, Lion Group, and Hong Leong Group. It is foreseen that such tunnelling ownership structure would increase the total control capability in the hands of a few causing non-owner executives to be powerless in firms' operation and decision making.

These findings suggest evidence of ownership concentration in Malaysian corporate scenarios. Linking this finding with Haniffa and Hudaib (2006), shown in Table 1.3 that shows ownership concentration is undiluted overtime. The fact that the ownership concentration remains unchanged suggests that Malaysian corporate scenarios are dominated by undiluted family shareholding firms. Therefore, these findings would insinuate the proposition that firm's wealth remains in the hands of a few.

Table 1.3
Malaysian Bourse top 5-shareholding percentage

	1996 Mean	1997 Mean	1998 Mean	1999 Mean	2000 Mean
Top 5 Shareholders (%)	61.48	61.57	61.60	61.63	61.64

Source: Haniffa, R. and Hudaib, M., (2006).

In term of executive's remuneration, typically Malaysian executive's remuneration consists of cash, fringe benefits, and bonuses. However, over the years, there has been an increasing trend of over-paying directors and executives without justification. Eustace Gomez of Watson Wyatt (M) Sdn. Bhd. (in Nurani, Malaysian Business, August 1st – 15th, 2003) pointed out that Malaysian companies are paying fixed compensation far too high, thus driving up their total fixed costs. He added that the significant rise in compensation was due to bonus payment, while fees and salaries only rose slightly. In the

2002 Financial Year, Genting Berhad and Resorts World Berhad forked out a staggering RM86.2millions and RM47.6 millions respectively. Such lucrative compensation may be able to be justified by the net profit of both companies amounting to RM1.4billions. Nonetheless, also in 2002 Financial Year, Berjaya Group Holdings Berhad that suffers from RM651.6 millions in net loss pays a total of RM12.5 million for its director's remunerations.

The unique Malaysian corporate setting suggests a potential of conflicting interest between majority and minority shareholders as well as between agents and principals. Nonetheless, the scenario provides a good platform to study implemented tools for interest alignment mechanism.

1.2 Moral hazard and incentives

A moral hazard problem arises when the principal cannot observe agent's actions because; (1) there is a positive cost of monitoring agent's actions, and (2) he is not even able to perfectly infer agent's actions by observing the outcome because the agent's actions do not completely determine the outcome. Traditionally, the literature argues that the latter phenomenon may result from the intervention of an unexpected random exogenous occurrence that has influenced the outcome, that is to say, it would be the consequence of some kind of windfall or misfortune and not a direct consequences of the agent's actions (Shavell, 1979).

Principal therefore faces two difficulties. First, he cannot design contracts based on his observation of agent's actions because the cost of monitoring his actions is generally prohibitive. Second, the principal cannot

entirely predicate the contract on the outcome for two reasons. First, the principal is uncertain about the causality between the agent's action and the outcome. The next reason is because even if the principal would predicate the contract on his observation of the agent's actions anyway, the agent would not sign the contract because he is risk neutral. This state of affairs prevents the principal from designing complete contracts that make agent's fee contingent on either his actions or the outcome of his unobserved actions. In other words, the principal cannot contractually assign to the agent full consequences of his actions. For instance, Kotovitz (1987) finds that agency theory identifies other causes to explain the incompleteness of contracts such as costs of writing detailed contingent contracts and costs of enforcement.

Kotovitz (1987, pg. 549), defines moral hazard as “actions of economic agents in maximizing their own utility to the detriment of others, in situations where they do not bear the full consequences. Alternatively, or equivalently, do not enjoy the full benefits of their actions due to uncertainty and incomplete or restricted contracts, which prevent the assignment of full damages (benefits) to the agent responsible”. Therefore, the agent is able to engage in discretionary behaviors, that is to say, undertake actions that may undermine the utility of the principal. In other words, under such conditions, the agent may make decisions that are against the interest of the principal.

Moral-hazard problems have been identified in various kinds of contractual relationships. Therefore, it is useful to present some examples to understand the concept of moral hazard and its implications in the contractual relationship. The first example is the relationship between a physician and his patient who is the principal. In this case, the physician is the agent of the

patient. The patient expects that her doctor will correctly identify and cure her illness. However, the principal is unable to monitor agent's efforts and the relation between agent's effort and the output is random. The random character of the relation between agent's effort and output can be explained by the fact that the output can result from other factors than agent's actions. The physician may prescribe a medication for the patient that does not cure her because of the medicine manufacturing defect. Therefore, the principal's problem is how she can induce the agent to take the best action to cure her.

A second example that can illustrate the moral hazard problem proceeds from Arrow's (1971) work in the context of insurance. The insurer is the principal and the insured is the agent. The problem of moral hazard manifests itself in the fact that the "insurance policy might itself change incentives and therefore the probabilities upon which the insurance company has relied." Shavell (1979) argues that "moral hazard refers to the tendency of insurance protection to alter an individual's motive to prevent a loss." In the context of car insurance, the insurer will see his expenses increase if his client drives his car carelessly or recklessly. In the same way, if the car driver does not look after his car (for example, if he does not regularly change his brake pads or monitor tire pressure), the possibility of incurring an accident increases. A moral-hazard problem exists because the insurer cannot always keep an eye on his client and a car accident may not necessarily be the consequence of his client's negligence.

Another example is the credit relationship. One individual lends some money to another one, in return for a promise to repay that money at a future date. So long as there is a possibility of default, which can result from the

actions of the borrower, there is a moral-hazard problem since the lender cannot perfectly observe the borrower's actions. Hence, as it can be observed that there are many situations where moral-hazard problems can emerge.

Agency theory literature and, in particular, principal-agent literature, focuses in its models on the contracting process and how informational aspects of moral hazard are integrated in a contract to minimize the costs associated with moral-hazard problems. The key elements in the principal-agent literature are the structure of preferences of the parties to contract, the nature of uncertainty, and the informational structure in the environment. We consider the structure of preferences of the parties to contract as an informational aspect of the contract because the structure of preferences depends actually of the degree of risk aversion of the person themselves. And, the risk aversion is necessarily related to the fact that individuals are not evolving in a world of perfect and complete information. Traditionally, the literature assumes that the principal is risk-neutral while the agent is risk-averse. However, some models assume that the principal is also risk-averse.

The principal-agent literature shows that, to reduce moral-hazard problems and minimize costs associated with these problems, contracts must have a "carrots and sticks" format, Mirrlees (1997). As previously mentioned, the principal must induce the agent to take the most appropriate action that will maximize his expected utility. In order to do so, the principal must design a contract that balances incentives and risk sharing as well as rewards and punishments. The basic idea is to reward the agent when the desired outcome is relatively more likely due to his actions and penalize him if the

desired outcome is relatively less likely due to inappropriate action by him, Kreps (1990: 592-593)

As a general conclusion of principal-agent models regarding to moral hazard problems, it generally focuses on technical aspects regarding structure of preferences, the nature of uncertainty and the informational structure of the environment [Holmstrom (1979); Shavell (1979); Grossman & Hart (1983); and Mirrlees (1999)] and examines how these aspects are affected when variations are introduced in the models. These variations can be found in the literature by Holmstrom (1982), (1999); Lambert (1983); and Radner (1985).

Moreover, in term of management, moral hazard can occur when upper management is shields from the consequences of poor decision-making. This can occur under a number of circumstances, such as:

- When a manager has a sinecure position from which they cannot be readily remove.
- When a manager is protected by someone higher in the corporate structure, such as in cases of nepotism or pet projects.
- When funding and/or managerial status for a project is independent of the project's success.
- When the failure of the project is of minimal overall consequence to the firm, regardless of the local impact on the managed division.

(http://www.wikipedia.org/en/moral_hazard)

Some examples of the above moral hazard occurrences in management resemble the very problem faced in Malaysian corporate scenarios. Given the greater ownership concentration and major shareholders becoming directors of their firms (as shown in Table 1.1 and Table 1.2), more of the conflict are between majority and minority rather than a conflict between

agent/s and principle/s as seen in the developed markets. Consequently, ESOS adoption may not be an appropriate solution for interest alignment given the local corporate scenarios. Hence, the very idea being highlighted in this study that is ESOS adoption is a firm' management decision moral hazard rather than a tool of interest alignment.

1.3 Agency Problem and Executive's Compensations

An agency relationship defined as a contract in which one or more persons (the principal(s)) engaging another person (the agent) to take actions on behalf of the principal(s), which involves the delegation of some decision-making authority to the agent. Spence and Zeckhauser (1971) and Ross (1973) provide early formal analyses of the problems associated with structuring the agent's compensation to align his incentives with the interest of the principal.

Substantial attention has been devoted to developing a theory of agency which has resulted in two approaches, refers as the "positive theory of agency" and the "principal-agent" literatures. Although these approaches differ in many respects, nonetheless, both literatures address the contracting problem among self-interested individuals and assume that in any contracting relationship, total agency costs are minimized.

Conceptually, there are two (2) types of agency problem faced by firms around the world. The first type of the agency problem is between principals and agents and is known as type I problem, and another is between majority

and minority shareholders and is known as type II problem. As Shleifer and Vishny (1997) put it,

“... it deals with ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”

The classic owner-manager conflict (type I agency problem) as described by Berle and Means (1932) and Jensen and Meckling (1976) can be mitigated by large shareholders' greater incentives to monitor their agents. However, the type II conflict appears when large shareholders use their controlling position in the firm to extract benefits at the expense of minority shareholders. The problem becomes more acute in highly concentrated firms in which controlling shareholders at the same time are the managers who have power and ability to make decisions that will significantly affect minority shareholders.

If the large shareholder is an institution such as a bank, an investment fund, or a widely held corporation, the benefits of control are diluted among several owners. Therefore, large shareholder's incentives for expropriating minority shareholders are small and so are the incentives to monitor agents. Hence, the problem reverts to type I agency problem for those firms. However, as pointed out by Cheung, Rau and Stouraitis (2006), if the large shareholder is an individual or a family, it has greater incentives for both expropriation and monitoring, which are likely to lead to type II overshadowing type I agency problem as majority shareholders govern the firm fully through legal right as shareholders and mandate as firm' executive.

Type I agency problem, which arises when decision-making is the province of managers who are not the firm's owners (Jensen and Meckling, 1976), is typically the problem faced in the developed market. Under this condition, when both parties are utility maximizers, possibility occurs that both parties would try to maximize their own interest rather than having their interest align. Such a condition have been put forth by Beal and Means (1932) that have become a corner-stone in addressing separation of firm's ownership. However, Type II problem is more apparent in developing market, such as in Malaysia, where high ownership concentration is well documented (Claessens, Djankov & Lang, 2000; Haniffa & Hudaib, 2006; Khatri, Leruth & Piesse, 2002; and Mitton, 2002) and as shown in Table 1.1 and Table 1.2.

1.4 Problem Statement

Based on the foregoing discussion, it can be concluded that Malaysian firms in general are plagued by high ownership concentration and high occurrence of major shareholders being members of the board of directors. These features of Malaysian firms are in direct contrast with typically developed market firms with dispersed ownership and are managed by professional executives (who are not the owners of the companies). In the latter situation, the executives have incentives to pursue their own interests by maximizing their utilities instead of the firms'. Therefore, there is a pressing need for shareholders to converge the executives' interest into theirs. As a result, Executive Share Option Scheme (ESOS) is introduced to align both parties' interest by making executives become a part of firms' owner. In this

respect, ESOS is seen as a mechanism that enables executives to share the common objective of the shareholders. One example is maximizing firms' value. Hence, adopting ESOS as a solution to the interest alignment mechanism makes a lot of sense when it is introduced under the condition similar to that in the developed market.

Malaysia, with high ownership concentration and higher incidence of major shareholders being part of the management team, has a different set of agency problems all together. The main agency problem faced in Malaysia is in the form of a conflict of interest between majority and minority shareholders. When the major shareholders become members of the board, there have always been issues of whether the decisions undertaken by the board are in the best interest of minority shareholders. There is also higher likelihood that the major shareholders would incline to make decisions that favours or enriches them even if these mean at the expense of minority shareholders.

Since ESOS adoption is seen as being a solution to Type I agency problem (conflict between managers and owners), one cannot help but wonder if the same solution would work for Type II agency problem (conflict between majority and minority shareholders). Statistically, in Malaysia ESOS adoption is on the rise (as shown in Table 1.4) with a surge after the implementation of Capital Market Plan in year 2000.

Table 1.4
ESOS First Time Adoption 1989 – 2004

Adoption Year	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Total
First Time Adoption	9	9	11	9	16	3	6	12	4	2	13	41	17	28	14	20	214

Source: *Investor Digest 1990 – 2000*, respective firm' announcement in KLSE Website (www.klse.com.my)

It has been demonstrated earlier than Malaysian corporate scenario are faced with Type II agency problem and as ESOS is fast gaining popularity locally, questions remain as to if ESOS adoption really bridges the conflict of interest or is another respectful tool to strip wealth from minority shareholders. There have been instances where ESOS adoption is open to abuse. An example of that would be of YTL Corporation Berhad. In 1989, YTL' board of directors and shareholders granted its' top executives, who are also family members of YTL's majority shareholders with 70 percent of the allocated ESOS shares (see this study data, Appendix C). The problem arises when the YTL' board of directors are also its' majority shareholders. Therefore, without justification, the adoption of ESOS not only would not resolve agency problems but also could lead to expropriation of minority shareholders, (in example, another form of agency problem).

In the case of Malaysia, although ESOS has been adopted for the past two decades and has seen a rise in popularity in late 1980's and mid 1990's, there seems to be scarcity of literatures on the topic. Given the uniqueness of Malaysian corporate scenarios where shareholding concentration is relatively high and the significant presence of owner/manager in firms' management, adoption of ESOS prompts curiosity of whether it has been initiated to its

intentions. Such as the case of Renong and UEM, both are ESOS adopted firms, where UEM bails out its financial ailing parent company (Renong) through purchase of 33 percent of Renong at premium. Much of the attention are focus on Tan Sri Halim Saad personal shareholding, CEO and the controlling shareholders of Renong.

Tan Sri Halim Saad's action over the matter is atypical given Malaysian corporate scenario. However it is the action of UEM board of directors that are in questions. The incident provides two important evidence of Malaysia corporate governance, firstly, majority shareholders have the absolute uncontested power to make firm' decision to safeguard their interest at the expense on minority shareholders. And secondly, firm' non-owners executive are powerless to protect the best interest of the firm and other shareholders. As most UEM' top management team are ESOS recipient, their decision to bail out Renong causes UEM' share prices to drop and with it, their ESOS share value (Malaysian ESOS is a full right common share). Such incident suggests that most Malaysian firms attempt to emulate the developed market in the development of executive's remuneration practices without emphasizing the essence of ESOS as a tool of interest alignments.

Since there is concern that ESOS could not resolve the conflict of interest in a Type II agency problem, the importance of ESOS as an interest alignment mechanism should also be investigated, including its structure. By scrutinizing the structure especially the retention period to exercise, which is at firm' discretion, the findings could unveil the real intention of ESOS adoption and the influence of internal variables to it.

One of the reasons for issuing ESOS is to provide incentives for firms' managers or executives to improve firm's performance so that the interest of owners is well taken care of. Therefore, firm's post adoption performance is a good indicator to gauge if the interest alignment objective is met. Reviews of prior studies suggest that in general ESOS post performance in developed markets having a short-term positive accounting and financial outcomes. However, there are studies that find there is no improvement or insignificant improvement post ESOS adoption. It is therefore vital that this study be carried out to ascertain the impact of ESOS adoption onto the firms' post performance.

Since ESOS is a part of the remuneration package, it would be incomplete if this study does not cover the cash remuneration especially in light of reports that despite financial difficulties and deteriorating returns on equity (ROE), top executive' remunerations continue to grow (Hassan, Christopher, and Evans (2003) and Eustance Gomez (in Nurani, 2003).

For these reasons discussed, investigating ESOS as a tool to mitigate agency problem in a Malaysian setting is not only interesting but also a must as much of existing information on ESOP is focused on developed markets data which may reflect the specific financial trading and business ownership environment in these markets (as shown in Table 1.1 and Table 1.2).

1.5 Objectives of the Study

There have been very few empirical studies on executive's incentives in South East Asia (SEA) region. Moreover, it has been well established in the literature that ESOS adoption is used to align the interest of managers with that of the owners (Type I agency problem). However, in an environment of a Type II agency problem, ESOS adoption causes concern that it may not resolve the conflict between majority and minority shareholders but rather a tool to siphon wealth from the minority shareholders. Therefore, the main objective of this study is to provide a better understanding of a possible mismatch between adopting ESOS and solving the conflict, given the Malaysian corporate environment.

Regional study on the reason of why ESOS adoption took place can be traced to study in Singapore by Ding and Sun (2001). The study which also focuses on employee share options concludes that Singaporean investors view ESOP favourably. However, there is mixed evidence as to firms' performances. Moreover, Yeo, Chen, Ho and Lee (1999) also finds no evidence of improves performance post ESOS adoption.

The main objective is translated into the following specific objectives;

- to identify influential firm specific variables in determining decision to adopt ESOS in order to ascertain if the determinants are the same to those of western-based model,
- to examine the ownership influence on a decision to adopt ESOS, and inclusions of a retention clause (minimum holding period),
- to identify the determinants of retention clause inclusions,

- to document evidence if post ESOS adoption performance improves significantly compares to that of pre-ESOS adoption performances,
 - to study the determinants of executive' remuneration,
- and
- to examine possible remuneration discrepancies in ESOS adopting firms.

1.6 Research Question

Bearing in mind the unique Malaysian corporate scenarios plagued by type II conflict and the possible mismatch of the use of ESOS as interest alignment mechanism, this study intends to find answers to the following research questions:

1. What are the characteristic of firms adopting ESOS in Malaysia?
2. Are these characteristics differing to those identified by the western-based studies?

To address the issue of agency conflict between majority and minority shareholders, the study would also examine the following research question;

3. Does ownership structure relate to ESOS adoption?

Literatures have advocated that and certain types of ownership have higher tendency to expropriate wealth, hence inclusion of retention clause is appropriate to combat such practice. Moreover, literatures also suggest that presence of growth opportunity would also induce inclusion of retention clause in the adopted scheme. Therefore, the following research question would also be studied:

4. Does types of ownership and presence of growth opportunity influences inclusion of holding periods?

As ESOS is noted to have a positive influence on firm performance, nonetheless, given the local corporate scenarios of block-holders influencing firm's operation (as shown in Table 1.1 and Table 1.2), can ESOS overcome the obstacle? Therefore, the following research question is used to study the matter;

5. Does adoption of ESOS produce better firms' performances?

In most cases, ESOS is only a part of total remuneration package. However, not all firms are adopting the scheme. This gives the study an opportunity to document the differences in characteristics between ESOS adopters and non-adopters with regard to their remuneration. Hence, the following research question is deemed necessary to be highlighted:

6. Are remunerations between adopted and non-adopter different?

- a. What influences the determinants of executive' remunerations?

1.7 Contribution of the Study

Since there is limited studies on ESOS adoption in an environment of high ownership concentration, this study contributes to the extend literature by demonstrating the theoretical mismatch between ESOS adoption and solving the agency conflicts between majority and minority shareholders. Moreover, this study intends to provide evidence of potential (such as; adopting ESOS for the right reasons, inclusion of retention clause for interest alignment, improving post adoption performance, and executive' remuneration determinants) wealth expropriation when the usual objectives of introducing ESOS are not met.

To the best of the author knowledge, this study represents among the first study to be addressing the issue of ESOS adoption effectiveness in highly concentrated ownership.

This study's contributions are in the form of;

1. Documenting descriptive statistics on key financial ratio, and ownerships composition in all four (4) sections of sub-studies which include ESOS adoptions, structures (retention period), post-adoptions performances, and firms executives' remunerations.
2. Investigating the adoption of ESOS by Malaysian companies.
 - a. This study strives to provide answer and rationale to influential variables that lead firms to adopt ESOS.

- b. Examines and proves the possible influence of firms' ownership on adoption decisions.
3. Investigating the prevailing ESOS structure (retention periods).
 - a. Examine and document the existing ESOS structure and ratify influencing variables.
4. Investigating the post adoption performance of ESOS adopting firms.
 - a. Examine and compare ESOS adopted firms' specific key ratios over observations periods.
 - b. Examine and compare ESOS adopted firms' specific key ratios with match- paired non-adopters firms.
5. Investigating the determinants of executives' remuneration in ESOS adopting firms.
 - a. Examine the possible remuneration discrepancies in ESOS adopting firms.
 - b. Provide empirical evidence on firms' specific variables that influence executives' remuneration in ESOS adopting firms.

All of these sub-studies intend to answer the big question, if there is a mismatch between the adoption of ESOS and resolving the agency conflicts. Should ESOS be adopted for reason other than improving efficiency and solving the agency conflicts, this would indicate possible or potential wealth expropriation situation exist in Malaysia. Even if the idea is proven otherwise, this study still represent as on of the pioneering efforts to examine the usefulness of effectiveness of adopting ESOS in a highly concentrated ownership environment.

1.8 Scope and Limitation of the Study

This study focuses on all companies established in Malaysia and are listed in Malaysian Bourse (known then as KLSE). This study includes only companies that award their executive with ESOS for the first time between the periods of 1st January 1989 until 31st December 2004. Upon completing this study, several limitations have been identified. They are:

1. This research only includes first time ESOS adopters over the past 16 years due to data accessibility problem. Although this period may be adequate to generalize the impact of ESOS on Bursa Malaysia, a longer period of observation would be better.
2. Data management has been a crucial part of this study and all effort has been put forth to ensure the available data are correct. Nonetheless, relying on KLSE' publication *Investor Digest* as an initial source to identify adopting ESOS firms have proves to be inadequate. The problem aggravates when *Investor Digest* dropped ESOS announcements from companies' announcements section starting from January 1999 edition.
3. Closure of KLSE Public Library to mass public has caused grievance in collecting firms' specific hard copies data prior to 1995 period. It also causes a variable, percentage of independence directors in executive's remuneration studies, to be dropped due to inaccessibility of information.