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Is adoption of restricted stock grants related with firm performance?☆

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ABSTRACT

This study investigates whether a firm's past or future performance is related with the adoption of restricted stock grants. In addition, it also explores the relation between conditions of adopting restricted stock grants and firms' future performance.

Empirical results show that there is no significant relationship between firms' past performance and the adoption of restricted stock grants. By contrast, improved future performance is found for companies adopting this compensation policy. Further, the incentive effect of restricted stock grants could be improved by extending the vesting service period, increasing the expenses amount of restricted stock grants, and decreasing the reduction in EPS. This article contributes to the serious lack of restricted stock grants literature in Taiwan. Also, it may offer some implications to companies considering the compensation scheme of restricted stock grants.

1. Introduction

The United States developed restricted stocks as a form of compensation in the 1930s, but most companies would later adopt stock options as a method for rewarding their employees. A problem soon arose whenever the U.S. stock market became sluggish or turned downward, as the exercise prices of many stock options held by employees became much higher than the market price of the stock, and thus companies' initial intention of utilizing stock options to motivate and retain talented workers lost its value. Microsoft and other large companies therefore returned to old format of granting restricted stocks to reward employees. One example of a company using restricted stock to retain talent is Apple, which issued US$376 million worth of restricted stock in January 2011 to its CEO Tim Cook.

More than 80% of global notebook computers come from Taiwan as of 2014, with the result that domestic firms ASUS, Acer, Pegatron, Quanta, and Compal and others have all become giants in this industry. Moreover, TSMC, which is the world's largest semiconductor foundry and headquartered in Taiwan, now has a market capitalization of over US$140 billion with its shares also listed on NYSE. However, after 2008, the Taiwan government implemented its policy of expensing employee bonuses with such share dividends taxed based on the market price, Taiwan's technology elite are now a footnote in history. In fact, the country's technology industry has gradually lost its leading position to South Korea and is now facing competitive pressure from China's rapid rise, because it is unable to retain talented professionals. Therefore, legislation on "restricted stock grants" was promulgated on July 1, 2011 in accordance with the industry's suggestions.

"Restricted stock grants" simply means that before granting any stock rewards to employees, the company must first require that such employees provide the company with a determined length of service or meet certain performance requirements in order to completely receive such stock rights. The spirit of this type of stock is to reward employees for their future performance rather than for past performance. Furthermore, employees will already have in mind the award amount that will be given to them after achieving pre-determined targets, rather than achieving targets and then waiting for the reward to be determined by higher-level managers. In addition, a situation can be avoided in which an employee quits and goes to work for another company immediately after receiving huge dividends or bonuses. This type of compensation is unlike granting stock options or treasury shares to employees, for which said employees need to pay out of their own pocket. Instead, as the company can grant employees restricted stocks without such payment, the work incentive is much clearer, thus making it an

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effective employee compensation scheme. Therefore, the vital question is whether the adoption of "restricted stock grants" can solve the problem between the principal and the agent and align their interests.

This study first investigates whether a firm's past or future performance is related to the adoption of restricted stock grants. Second, I explore the relation between the conditions of the announcements of restricted stock grants and the firm's future performance. The empirical results show no correlation between a firm's past performance and the adoption of restricted stock grants. On the contrary, a significant positive correlation is found between a firm's future performance and the adoption of restricted stock grants. Lastly, extending the vesting service period, increasing the expensed amount for restricted stock grants, and decreasing the reduction in earnings per share all improve the incentive effect of restricted stock grants.

After Taiwan implemented "restricted stock grants" on July 1, 2011, only Tai (2015) has addressed this issue. Therefore, the first contribution of this study is that Taiwanese companies can utilize the findings herein as a reference for their own reward policy. As no other study in the literature has explored the conditions[1] for the announcements of adopting "restricted stock grants", another contribution is that the findings can be used as a reference for companies to design their announcements for granting restricted stocks.

Many U.S. studies, such as Irving, Landsman, and Lindsey (2011), do not find restricted stock grants have any significant benefit to a company's future performance, yet regulators in Taiwan expect restricted stock grants will benefit many listed firms. Furthermore, the issuing method of U.S. employee-restricted stocks includes the following two types: (1) "Restricted Stock Awards (RSA)", in which the company directly transfers the stock to the employee on the grant date, and the employee can acquire the entire stock rights after meeting the vesting conditions; and (2) "Restricted Stock Unit (RSU)", in which the company does not directly deliver the stock to the employee on the grant date, and the employee can only acquire stock ownership after meeting the vesting conditions. The restricted stock grants currently implemented in Taiwan are more similar to the first type, "Restricted Stock Awards (RSA)". Thus, this study's third contribution is that the empirical results can complement the existing literature.

Studying the relationship between a company's future performance and whether it has adopted restricted stock grants can determine whether such compensation is because the existing scheme is not suitable, or if the company intends to enrich managers by adopting the new scheme. Such empirical results can be used to review whether the actual effect of such a compensation scheme is consistent with the original intention of the Taiwan government when the legislation was passed. Because this study finds that company performance does significantly improve after adopting restricted stock grants, the result therefore confirms that companies employ such a scheme, because the previous one was not appropriate for them and the new one is consistent with the original intention of the government.

The organization of this paper is as follows. The first part describes the motivation of the study, the purpose, and the expected contribution. The second part introduces "restricted stock grants" in Taiwan and compares the compensation schemes in Taiwan, the United States, and mainland China. The third part presents a literature review and the development of research hypotheses. The fourth part discusses the data and methodology. The fifth part presents the empirical results, and the sixth part provides conclusions and recommendations.

2. Restricted stock grants in Taiwan

Restricted stock grants are new shares in a company that have vesting conditions, such as the length of service or performance requirements, granted to employees by public companies in accordance with the Company Law. These shares' rights are restricted until the vesting conditions are met. Such an employee compensation scheme can link employees and their future contributions to the company and can be granted free of charge or at a discount. The relevant provisions of the regime in Taiwan are summarized in Table 1, and a comparison among the schemes in Taiwan, the United States, and mainland China are presented in Table 2.

Tables 1 and 2 show that Taiwan's restricted stock grants scheme is closer to the restricted stock award (RSA) scheme in the United States and not far from the scheme used in mainland China, except that in mainland China, the vesting condition can only be performance requirements, while in Taiwan they may be either length of service or performance requirements. Compared with our existing share-based compensation scheme, restricted stock grants can be granted to specific employees, the employees can obtain stock ownership on the grant date, and restrictions are usually only placed on the disposal time. Therefore, the situation in which employees leave a company because they cannot enjoy the share interests can be avoided. Furthermore, since employees can obtain the shares only after meeting the vesting conditions set by the company, the situation in which employees leave the company immediately after receiving their shares can be avoided. Moreover, restricted stock grants may be given at a discount or free of charge, which has the advantages of certainty in employee bonus shares and the expectation of employee stock options. Therefore, Taiwanese companies have high expectations of providing restricted stock grants to enhance their future performance; however, Taiwan has no such academic study for reference. Furthermore, quite different from the view in Taiwan, most U.S. researchers do not believe that restricted stock grants significantly benefit a company's future performance (Irving et al., 2011). Therefore, this study will explore whether a firm's past performance is a determinant for companies to adopt restricted stock grants and explore whether a firm's future performance is significantly improved after adopting the restricted stock grants scheme in order to make up for the lack of academic literature in Taiwan regarding this issue, as well as serve as a reference for other Asia-Pacific countries.

3. Literature review and hypothesis developments

According to the agency theory, the design of share-based compensation schemes reduces agency costs and improves the incentive effect (Jensen & Meckling, 1976;Desai, Li, & Zhang, 2010). However, the literature found that, in practice, share-based compensation schemes do not fully comply with the agency theory (Yermack, 1995; Bryan, Hwang, & Lilien, 2000). Furthermore,

[1] The conditions in this study are: (1) granted price per share, (2) vesting condition, (3) vesting period, (4) compensation expense, (5) reduction of earnings per share after granting, and (6) dividend distribution rights. Initially this study also considered the following five conditions: (1) granting ordinary shares or preference shares, (2) conversion rights, (3) pledged rights, (4) whether the shares can be granted as a gift, and (5) voting rights. However, the numbers of the latter five conditions in all observations are the same, and so a regression model does not work. Therefore, these five conditions are removed.

[2] According to US Internal Revenue Code Section 83(a) and (b), firms and employees can decide a taxable year. Section 83(a) states that an employee can decide the vesting date of completing a contract as the taxable time, and firms can recognize the salary expense on the vesting date; Section 83(b) states that the grant date can be chosen as the taxable time because employees shoulder the risk in the contract period, and firms can recognize the salary expense on the grant date.

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