Discussion:
Stock Option Grants and Firm Value When Directors Cannot Behave Opportunistically
Balachandran et. al.(2010)

Ekta Selarka
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Research objective of the paper

- Analysis of option grants issue to executive and non-executive directors
- Option grants to NEDs removes the possibility of opportunistic behaviour of executives to manipulate the news
- Test of common practice of issuing option grants to NEDs that is apparently against CG recommendations in Australia

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Background literature

- Agency theory predicts design of incentive based compensation schemes to align interests of managers and shareholders.
- Types of executive compensation: Salary, Bonus, Equity based compensation (ownership, stock options)
- Event study analysis and discrete choice models

Background literature: Outside directors

- Existence of a market for outside directors' services
- Outside directors have incentives to develop reputations as expert in decision control.
- They use their directorship to signal to internal and external markets for decision agents that they are experts. Fama and Jensen (JLE, 1983)
- Yermack (JoF, 2004) tests and validates role of outside directors' incentives and shows that such stock and option awards are related in rational ways to firm's investment opportunities, tax status and liquidity.
- Fich and Shivadasani (JoB, 2005) finds that firms with option plans have higher market-to-book ratios and profitability metrics and there are positive CAR around the adoption of option plan.

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Main findings of the paper

- Descriptive statistics: Smaller firms with more free cash choose to grant options to NEDs. Such firms also have lower leverage ratios.
- However, when controlled for other factors, free cash is not a significant variable in explaining the choice of granting stock options to NEDs by firms.
- Market reaction to announcement of stock option grants to NEDs is positive and significant around the notice of AGM and day after the AGM.

Comments on research design

- Market reacts to the quality of outside directors
- Announcement of outside director appointments (Fich and Shivdasani, 2005)
- Anticipation of such an announcement should be considered
- Measurement of quality of outside directors (change in equity ownership, change in fees/salaries, multiple directorship)
- NEDs as Independent or Gray directors?

Some final thoughts and questions

- Board size and structure should be controlled for or at least reported across two sub-samples.
- Equity ownership of outside directors as already existing compensation scheme
- Sample selection: Other announcements such as appointment of directors, board meeting etc.
- Ownership structure matters. For instance, institutional ownership is an important explanatory variable in selection of NEDs and their compensation.
- Normative explanation of why CG recommendation discourages option grants to NEDs in the motivation would make the research richer.
- What is a typical breakup of salary and rewards for NEDs in option granting firms and vice versa?
- What proportion of board is independent?

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Thank you.