CHAPTER 2 : LITERATURE REVIEW

Studies on "shareholder ownership"

Governance is a broad concept referring to internal and external forces system; governance must be related to a particular objective. One possible objective focuses on the ownership of the firm and how decisions by the firm affect the wealth of the firm's owners – the shareholders. The governance system defines the relationship of the owners to their firm and the mechanisms through with the owners affect the institution's behaviour. Thus the governance system is concerned with the creation of wealth through the maximisation of economic efficiency of the firm and with shareholders as the residual claimant, shareholders have the greatest incentive to create wealth. The governance issue therefore is to ensure that management's interests are aligned with those of the shareholders. There is concern for the separation of ownership and control due to shareholders' loss of control over the manager of firms, who are able to pursue their own interests rather than shareholders' interests.

Since the controlling shareholders owns a proportion of the shares of the firm and has votes and claims to cash flows from the firm. The controlling shareholder can be either the founder of the firm or the founder's family (heir) where the controlling shareholder can act as manager in the case of professional management, and the controlling shareholder is active as chair of the Board of Directors. Benefits arising from a controlling position include managerial/controlling shareholder utility maximising decisions. These decisions include investment in pet projects and furthering political goals; engaging in costly investments intended to diversify the concentrated wealth of the controlling shareholder; diversion of assets to firms owned by the controlling shareholder; and salary and bonus contracts unrelated to performance. Clearly, the controlling shareholder values these benefits more than the costs associated with the reduced share price. However, there are potential costs to minority shareholders in these firms, in general it gives management an entrenched position. If decisions are made that do not benefit all shareholders and thus depress share price, the market for corporate control and the market for managers, if they exist, cannot operate to discipline poor managerial performance. While capital market will produce a lower share price to reflect poor performance, the lower price is not a signal for a takeover but is just a cost to the controlling shareholder that is insufficient to offset any benefits that arise from a controlling position !

With the competition in the equity market, the above non-value-maximsing decisions by controlling shareholders will ultimately lead to poor financial performance, financial distress and either bankruptcy, reorganisation or merger.

Ownership structure, Firms value and Performance in U.S.

Jensen and Meckling (1976) concerns with the effect of splintered ownership on managerial behaviour. In their model, management has delegated powers from the principals of the firm – the shareholders. Owing to the cost of information acquisition and the difficulty of monitoring management behaviour to ensure it is consistent with shareholders' interests, rational managers can undertake behaviour to ensure it is consistent with shareholders' interests, rational managers can undertake behaviour that shifts wealth from shareholders to themselves. The loss in market value relative to its value if no agency issues existed is called the agency cost of equity. This agency cost is also referred to as moral hazard behaviour since management undertakes unexpected behaviour not in the best interests of the principals. In the situation where managers have small equity holdings, gains from diversionary activity and shirking exceed any loss in value through a reduction in the market value of the manager's equity holding in the firm. This problem reaches its most serious manifestation in the case of widely held shares with professional management. Where managers have little or no equity holding and with widely held shares, individual shareholders will refrain from making costly investments in monitoring activity and information gathering due to the free-rider problem. Monitoring activity is of benefit to all shareholders yet only the monitoring shareholder bears the costs. In the absence of coercion, the rational decision is to eschew monitoring leaving the managers free to undertake wealth-decreasing activities. The wealth decreasing activities include shirking, accepting projects that decrease the wealth of shareholders and reduce the risk associated with managers undiversified human capital investment in the firm, and diverting corporate assets of cash flow to managers at shareholders' expense.

Demsetz and Lehn (1985) argue that the ownership structure of the firm that emerges is an endogenous outcome of competitive selection in which various cost advantages and disadvantages are balanced to arrive at an equilibrium organisation of the firm. They conclude that there is no relation between ownership structure and profitability.

R. Morck et. Al., (1988) examined the relationship between management ownership of the firm's equity and the market valuation of its tangible assets measured by Tobin's Q[1]. They find that both higher board ownership and the founding family's presence have a negative effect on Q are not evidence of an inefficiency, since they might just reflect the optimal trade-off between profits and private benefits to the management from non-value-maximising behaviour. The behaviour include investment in pet projects and furthering political goals; engaging in costly investments intended to diversify the concentrated wealth of the controlling shareholder; diversion of assets to firms owned by the controlling shareholder; and salary and bonus contracts unrelated to performance. Their evidence suggests that non-value-maximising behaviour is more prevalent in firms in which management has greater effective control, these might also be the firms in which management's private benefits of control are the greatest. The higher level of non-value-maximising behaviour in these firms then simply reflects the fact

[1] Calculated as the market value of the common stock, preferred stock and debt divided by the replacement value of assets.

that management values such behaviour more and therefore the efficient level of such behaviour is higher.

McConnell and Servaes (1990) provide further evidence on the relation between the distribution of equity ownership and corporate value. They find a strong curvilinear relation between Tobin's Q and the fraction of shares owned by corporate insiders. At low levels of insider ownership, the relation is strongly positive. At high levels of insider ownership, the relation between Q and insider ownership is negative. Q first increases, then decreases, as share ownership becomes concentrated in the hands of the managers and members of the board of directors.

Rosenstein and Wyatt (1990) provide evidence that the proportion of outside directors affects shareholder wealth by documenting a positive stock price reaction at the announcement of the appointment of an additional outside director. They find no clear evidence that outside directors of any particular occupation are more or less valuable than others.

Byrd and Hickman (1992) document that less-negative returns to shareholders are associated with board of directors in which at least half the members are independent of firm managers. They find evidence of a nonlinear relationship between the fraction of independent directors on a board and the shareholders wealth effects of tender offer bids. Although this relationship is positive over most of its range, it is negative when the fraction of independent directors is extremely high (over 60%).

Lipton and Lorsch (1992) state that the norms of behaviour in most boardrooms are dysfunctional, because directors rarely criticise the policies of top managers or hold candid discussions about corporate performance. Believing that these problems increase with the number of directors, they recommend limiting the membership of boards to ten people, with a preferred size of eight or nine.

According to McConnell and Servaes (1995), managers have both the incentive and the opportunity (i.e. excess cash flow) to undertake wasteful investment projects. This over investment problem can however, be curtailed if managers are forced to pay out excess funds to service debt. That is for firms with more internally generated funds than investment opportunities, debt financing has a positive effect on the value of the firm. They find that the significant positive relation between Q and the fraction of shares held by corporate insiders and institutional investors. They also find that the relation between Q and debt is negative for high growth firms and positive for the low growth firms.

Kole (1995) concludes that differences in firm size can account for the reported differences in empirical link between managerial ownership and firm performance. The studies generally interpret the positive relation at low levels of managerial ownership as evidence of incentive alignment, and the negative relation at high levels of managerial ownership as evidence that managers become 'entrenched' and can indulge in non-value-maximising activities without being discipline by shareholders.

Mehran (1995) provides evidence on firm performance indicate that both Tobin's Q and return on assets are positively related to the percentage of executive compensation that is equity-based, and the percentage of equity held by top managers. He finds no significant relationship between firm performance and outside directors' equity holdings. The outside directors' equity ownership in general is not significant enough to give them an incentive to monitor the firm.

Yermack (1996) find an inverse relation between firm market value, as represented by Tobin's Q and the size of the board of directors. There is consistent finding that companies achieve the highest market value when boards are small. Several measures of operating efficiency and profitability are negatively related over time to board size within firms. Smaller boards are more likely to dismiss CEOs following periods of poor performance. Some tests show that while the rate of director turnover increases following poor performance, board size remains quite stable over time with little sensitivity to performance. They find no association between the percentage of outside directors and firm performance, and firm value is significantly higher when officers and directors have greater ownership.

Holthausen and Larcker (1996) find that there is a decline in performance subsequent to the reverse Leverage Buyout (LBO) and that this is related to the change in the ownership structure. There is very strong evidence of a positive association between performance and managerial ownership and ownership by active investors (monitors).

Cotter et. Al., (1997) find that when the target's board is independent, the initial tender offer premium, the bid premium revision, and the target shareholder gains over the entire tender offer period are higher, and takeover resistance lead to greater premiums and shareholder gains. They conclude that independent outside directors enhance target shareholder gains from tender offers, and that boards with a majority of independent directors are more likely to use resistance strategies to enhance shareholder wealth.

Mikkelson et. Al., (1997) find that neither the level of performance after going public nor the change in performance from before to after going public is related systematically to various measures of ownership by officers and directors and other block holders. They conclude that the changes in equity ownership that result that result from going public do not lead to changes in incentives that affect operating performance.

Cole and Mehran (1998) examined the stock-price performance and ownership structure of thrift institutions that converted from mutual to stock ownership. They find that after conversion and the expiration of ownership-structure restrictions, firm performance improves significantly, and the portions of firm owned by managers increases. Changes in performance are positively associated with changes in ownership by managers.

Palia and Lichtenberg (1999) randomly selected a large sample of manufacturing firms that does not suffer from any survivorship or large firm size biases, to examine the ownership stake of a firm's managers as an argument in estimating the firm's productivity function. They find that managerial ownership changes are positively related to changes in productivity. They also find a higher sensitivity of changes in managerial ownership to changes in productivity for firms who experience greater than the median change in managerial ownership. They find that the stock market rewards firms with increases in firm value when these firms increase their level of productivity.

Hallock and Oyer (1999) show empirically that managers can profit by moving sales revenue among fiscal quarters. Though this may suggest that boards use short-term trends when determining rewards, they find evidence consistent with boards typing pay to recent sales growth so as to use the best information about future performance.

Ofed and Yermack (2000) investigated the impact of stock-based compensation on managerial ownership. It is found that equity compensation succeeds in increasing incentives of lower-ownership managers, but higher ownership managers negate much of its impact by selling previously owned shares. When executives exercise options to acquire stock, nearly all of the shares are sold. Results illuminate dynamic aspects of managerial ownership arising from divergent goals of boards of directors, who use equity compensation for incentives, and managers, who respond by selling shares for diversification. The findings cast doubt on the frequent and important theoretical assumption that managers cannot hedge the risks of these awards.

Managerial Ownership and Firms Performance in UK

Short and Keasey (1999) conduct a comparative analysis of the US and UK governance systems suggested that greater institutional monitoring and a lesser ability to mount takeover defenses within the UK should lead to management becoming entrenched at higher levels of ownership in the UK. The empirical results of the paper confirm that UK management become entrenched at higher levels of ownership than their US counterparts. They also confirm the general finding of US literature of a non-linear relationship between firm performance and managerial ownership.

Managerial Ownership and Firms Performance in Canada

Smith and Amoako-Adu (1999) find that when family successors are appointed, stock price decline by 3.20% during the 3 days event, whereas there is no significant decrease when either non-family insiders or outsiders are appointed. However, a cross sectional analysis indicates that the negative stock market reaction to family successors is related to their relatively young age, which may reflect a lack of management experience rather than their family connection. Investors are uncertain about the management quality of family successors who have less established reputations than more seasoned non-family insiders and outsiders. Non-family member appointments tend to follow periods of poor operating performance implying that there might be more scope for improvement when a non-family successor is appointed.

Insights on Malaysia

In Malaysia, the real impetus to the development of corporate governance was the East Asian financial crisis in 1997–98. This was the period when the economic crisis exposed the fragility of several companies. These companies came under the close scrutiny of foreign investors. It is generally perceived that a lack of good corporate governance contributed to the loss of investor confidence, because it is extremely difficult for investors to hold management accountable for their actions that adversely influence the company's performance and shareholder value. Moreover, a lack of transparent and accountable corporate governance shields corporate management against the discipline of market forces.

There is a significant concentration of equity ownership in the Malaysia (Appendix A). The ownership concentration arises through families that control a large number of companies, corporations that hold shares of other corporations as investments (cross holdings) for portfolio purposes. Concentrated ownerships a pervasive phenomenon whose existence may generate serious problems for minority shareholders due to controlling shareholder activities that either shift wealth from the minority shareholder to the controlling shareholder or maximise the controlling shareholder's utility but not the wealth of all investors. Even more broadly, concentrated holdings can have a depressing effect on economic growth.

On 24 March 1998, the Malaysia government announced the establishment of a High Level Finance Committee, comprising government and industry representatives, to formulate a framework on corporate governance and setting-up of 'best practices' for the industry. Subsequently, on 24 March 1999, the Malaysian Securities Commission (SC) officially launched the Report of the High Level Finance Committee on Corporate Governance covering about seventy (70) important recommendations. Numerous steps were also taken to formulate rules to protect minority interest and expedite measures for the timely disclosure of information to the public. Changes were made to the KLSE requirements to curb abuses by controlling shareholders in relation to related party transactions.

Conclusion

In USA and UK, there has been a lot of research published on corporate governance and related areas, many improvements had been made to develop their capital market.

Malaysia has already adopted the main outlines of the Anglo-American corporate governance model, such as independent directorships, audit committees and shareholder election of directors. Yet full adoption of this model across the corporate sector may not be possible given the concentrated ownership profile of most Malaysian listed corporations.