Managerial Ownership and Market-based Performance Indicators: Extended Agency Theory

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Abstract

Our study empirically investigates the relationship between managerial ownership and company performance of public listed companies in Malaysia. Three years panel data of 730 Malaysian public listed companies were examined. Our findings demonstrated that managerial ownership had negative and significant relationship with Tobin's Q and share price. Therefore, the involvement of management in monitoring and controlling activities fail to reduce agency conflict in the emerging economy. This study is perhaps the first that explain the extended agency theory in developing country

Keywords Managerial ownership, market-based performance

INTRODUCTION

Empirical studies have not reached a conclusive finding regarding the effect of managerial ownership on company performance. The convergent of interest hypothesis by Jensen and Meckling (1976) proposed that more equity ownership by the managers would increase corporate performance. However, Demsetz (1983) suggested the divergence of interest hypothesis where the increment of managerial ownership will reduce the corporate performance. Further study by Demsetz and Vilallonga (2003) concluded that providing the managers with shares to align their interests with the owners may not solve the agency problems or reduce agency costs and thus fails to improve company performance.

The causal relationship utilised traditional agency theory which explain that the managerial ownership consider significant determinant on company performance. This theory emphasizes the conflict between unmonitored manager and widely dispersed ownership. Majority of the previous studies are

based on developed market such as United States (US) and United Kingdom (UK) where the ownership is widely dispersed. However, recent literature questions the assumption of widely dispersed ownership and suggests a conflict between majority and minority shareholders. Unfortunately, very few studies to date investigated these issues in developing countries. It is widely accepted that concentrated ownership has the potential to limit agency problem and reduce agency cost and therefore improves the company performance (Jensen and Meckling, 1976). This is due to efficient monitoring by higher concentrations shareholders through stronger incentives and more power by appointing directorship in order to monitor manager at lower cost.

There are other researchers that focused on the issue within the agency framework to explain the ownership concentration in relation to company performance (Loderer & Martin, 1997; Claessens et al., 2000; Tam & Tan, 2007; Hu & Izumida, 2008; Ming & Gee 2008; Perrini, Rossi, & Rovetta, 2008, Mohd Abdullah & Ayoib, 2013). The management has more discretion to pursue their own objectives where there are no controlling shareholders. Hence, this study attempts to investigate the relationship between managerial ownership and company performance of public listed companies in Malaysia.

LITERATURE REVIEW

Concentrated Ownership

The research on ownership structure is interesting in Malaysia and other emerging countries since they are characterize by high ownership concentration which the shareholders are holding control in companies (Faccio and Lang, 2002). High concentration ownership and less investor protection create the conflict between the majority and the minority shareholders (Sheilfer and Vishny, 1997; La Porta *et al.,* 1999). In concentration ownership companies, the owner and the manager are usually the same person. This will significantly reduce the conflict of interest between the owner and the manager (La Porta *et al.,* 1999). Therefore, the traditional agency theory is not applicable in this scenario since the conflicts are among shareholders. Majority shareholders might involve in important decision without concern from minority shareholders.

In concentrated ownership companies, large shareholders could play an important role in monitoring the manager. The existence of large shareholders will help to monitor the managerial decisions. As a result, the agency conflict will be reduced and the company performance will be improved (Lehman and Weigand, 2000; Sheilfer and Vishny, 1986). The involvement of shareholder as a member of the board of director will increase the degree of monitoring toward the manager. The underlying assumption is to realign the ownership and corporate control in order to enhance the company performance. Lehman and Weigand (2000) stated that the incentive to monitor increase in ownership concentration as well as improving the control in companies.

The convergence-of-interest and the efficient monitoring hypothesis propose that the existence of large shareholders and concentrated ownership

influence the level of agency cost and companies performance. The important issue in agency theory is to solve the agency problem and reduce the asymmetric information between the shareholders and the manager. The nature of company ownership structure will affect the agency problem between the shareholders and the manager. Problem arises when the company ownership dispersed is different compared to a company with concentrated ownership. Dispersed ownership is typical for US, UK and Japan companies. Most of the conflicts in the companies in these countries are between managers and shareholders (Jensen and Meckling, 1976). However, in concentrated ownership especially among companies in Western Europe and the most of Asian countries, conflict arises between controlling shareholders and minority shareholders (Fan and Wong, 2002).

Ownership structure determines the nature of agency conflict as well as distribution power and control in company (Jensen and Warner 1988). Sheilfer and Vishny (1997) stated that majority shareholder as a control mechanism to solve agency conflict. This opinion supported by Kabir, Cantrijn and Jeunink (1997) where they found that more concentrated ownership provide an effective monitoring toward the manager. Controlling shareholders with large ownership concentration have incentive and power to acquire necessary information in order to supervise the manager. Higher ownership concentration is expected to reduce agency cost and to improve the company's performance as well.

Finding by Claessens, Djankov and Lan (2002) indicated that controlling of single shareholder is prevalent in more than two-third of the firm in Asian countries where separation of ownership and control is rare. Therefore, the owner has significant power to pursue their own interest with the expense of minority shareholders. Shleifer and Vishny (1997) stated that controlling shareholders might not have a convergence of interests with minority shareholders. With the effective control of company, the owner is able to determine daily operation and profit sharing among shareholders. The minority shareholders are entitle to cash flow rights of their share. However, they will face uncertainty which entrenched control owner may opportunistically deprive them of their right. This creates an 'entrenchment effect' (Morck *et al.*, 1998).

Market-Based Measures

Most of the previous studies adopted the accounting measures as indicators of firm performance and placed less attention on the market measures. According to Chakravarthy (1986) and Oswald and Jahera (1991), academics and researchers argued that accounting measures seemed to be inadequate as an indicator to evaluate the efficiency of firm performance. According to Wiwattanakantang (2001), although accounting information is useful and important in measuring company performance, not all the agency costs are reflected in the accounting measures. This limitation has led researchers to utilize information based on the market indicators of performance such as stock prices. Therefore, this study adopts two types of market measures as tools to measure the firm performance, which are Tobin's Q and share prices.

Tobin' Q is one of the market measures pioneered by James Tobin who intended to examine the causal relationship between the q value and investment. He introduced the variable of q as scaled by the ratio of the market value to replacement cost (Brainard & Tobin, 1968; Tobin, 1969, 1978). He claimed that firms have the incentives to invest if the margin q value exceeds unity, since the new capital investment value will exceed its cost (Lindenberg & Ross, 1981). In addition, Tobin's Q has been used extensively among academics, researchers and practitioners, and is claimed as one of the market measurement tools.

Furthermore, this study uses the q value, which is an approximation of the Tobin's Q that has been adopted by Chung and Pruitt (1994), Perfect and Wiles (1994), Mishra et al. (2001), Amit and Villonga (2006), and Haniffa and Hudaib (2006). Other empirical studies which also used the q value to measure the market value of the company are Morck *et al.* (1988), McConnell and Servaes (1990), Yermack (1996), and McConaught *et al.* (1998). In addition, Crongvist and Nilsson (1999), and Khanna and Palepu (1999) also adopted this similar q value measure in their studies to examine the relationship between ownership and performance in India and Sweden.

Chakravarthy (1986) and Oswald and Jahera (1991) suggested that stock prices can be a good measure and indicator of firm performance. In addition, Lindenberg and Ross (1981) stressed that stock prices have to reflect the true value of the firm where the capital market is fully developed in order to use it as a performance measure. A further study by Bacidore *et al.* (1997) stated that the financial performance measurement through the company's stock prices is appropriate in measuring the shareholders' wealth. Through stock prices, the investors are able to determine the increase of their wealth during a certain period of time based on the dividends they receive and the appreciation in share prices. Moreover, the growth revenue and returns on asset have a closer relationship with performance of stock prices that any other variable. Hence, the investors also believe that macroeconomic performance such as inflation and steady growth is highly related to strong performance.

Besides, stock returns are basically calculated by the changes in stock prices and their performance is assumed to be related to company performance (Lewellen & Huntsman, 1970; Madura, Martin, & Jessel, 1996). In addition, O'Hara, et al. (2000) found that on average financial indicators of stock prices performance such as dividends per share, cash flow per share, and earnings per share, generate higher returns than the Standard and Poor's 500 Index (S&P 500 Index).

The stock market-based performance measure is used as the performance indicator for two reasons. First, unlike accounting-based measures, market-based measures are not influenced by firm-specific reporting idiosyncrasies and potential managerial manipulation. Second, the use of stock price measure is consistent with an important principle in agency theory which is the manager should maximize the market value of the firm. Utilizing stock prices as one of the performance indicators is expected to produce more accurate results to explain the managerial ownership and performance relationship.

MANAGERIAL OWNERSHIP AND COMPANIES PERFORMANCE

Large empirical literature investigates the relationship between managerial ownership and firm's performance and provides mixed result. Jensen and Meckling (1976) argue that agency cost and managerial ownership are negatively related and have positive relationship between managerial ownership and firm's performance. The convergence of interest hypothesis suggests a positive relationship between managerial ownership and firm's performance due to lower agency cost. While a negative relationship between managerial ownership and firm's performance is suggested by entrenchment hypothesis which explain that managerial ownership above a certain threshold will have destroying effect due to conflict between large block holders. A manager owning the large fraction of the shares in the firm bears the consequences of managerial action that either create or destroy the firm performance. Therefore, managerial shareholders are likely to work hard and create better investment decision and high managerial ownership firms should perform better. This study utilized the agency theory framework and the following null hypothesis is proposed:

H01: The higher concentrated managerial ownership exhibit the higher company's Tobin's Q.

H02: The higher concentrated managerial ownership exhibit the higher company's share price.

MODEL FOR OWNERSHIP STRUCTURE AND PERFORMANCE

The econometric model developed comprises two equations. The first model utilizes Tobin's Q as performance indicator and second model utilize share price as performance indicators. These equations are tested in the current paper and are formally presented below:

$$Qit = \alpha_0 + \beta 1\text{LMAN}it + \beta 2\text{LSIZE}it + \beta 3\text{GROW}it + \beta 4\text{LEV}it + \beta 5\text{LPRO}it + \beta 6\text{AGE}it + \beta 7\text{PR}it + \beta 8\text{IP}it + \beta 9\text{CP}it + \beta 10\text{CON}it + \beta 11\text{PLAN}it + \beta 12\text{IPC}it + \beta 13\text{TECH}it + \beta 14\text{TRAD}it + \varepsilon it \quad (1)$$

Notes:

Q	Tobin's Q
α_0	Intercept/constant term.
LMAN	Log of managerial ownership
LSIZE	Log size (log of total assets)
GROW	Growth
LEV	Leverage
LPRO	Log of profitability
AGE	Company age
PR	Properties (1 for the firm operated in PR sector, otherwise 0)

IP	Industrial Product (1 for the firm operated in IP sector, otherwise 0)
CP	Consumer Products (1 for the firm operated in CP sector, otherwise 0)
CON	Construction (1 for the firm operated in CON sector, otherwise 0)
PLAN	Plantations (1 for the firm operated in PLAN sector, otherwise 0)
IPC	Infrastructure Project Companies (1 for the firm operated in IPC sector, otherwise 0)
TECH	Technology (1 for the firm operated in TECH, otherwise 0)
TRAD	Trading and services (1 for the firm operated in TRAD sector, otherwise 0)
ε	Error term
i	ith firm
t	tth period

$$SPit = \alpha_0 + \beta 1LMANit + \beta 2LSIZEit + \beta 3GROWit + \beta 4LEVit + \beta 5LPROit + \beta 6AGEit + \beta 7PRit + \beta 8IPit + \beta 9CPit + \beta 10CONit + \beta 11PLANit + \beta 12IPCit + \beta 13TECHit + \beta 14TRADit + \varepsilon it \quad (2)$$

Notes:

SP	Share price
α_0	Intercept/constant term.
LMAN	Log of managerial ownership
LSIZE	Log size (log of total assets)
GROW	Growth
LEV	Leverage
LPRO	Log of profitability
AGE	Company age
PR	Properties (1 for the firm operated in PR sector, otherwise 0)
IP	Industrial Product (1 for the firm operated in IP sector, otherwise 0)
CP	Consumer Products (1 for the firm operated in CP sector, otherwise 0)
CON	Construction (1 for the firm operated in CON sector, otherwise 0)
PLAN	Plantations (1 for the firm operated in PLAN sector, otherwise 0)
IPC	Infrastructure Project Companies (1 for the firm operated in IPC sector, otherwise 0)
TECH	Technology (1 for the firm operated in TECH, otherwise 0)
TRAD	Trading and services (1 for the firm operated in TRAD sector, otherwise 0)
ε	Error term
i	ith firm
t	tth period

DATA

Data of this study was collected from secondary sources. Ownership data was collected from the list of directors' shareholding in annual report which is downloaded from Bursa Malaysia website. After considering the incomplete information, there were 730 usable samples covering three periods from the 2007 to 2009. Therefore, the study comprises 2190 observation. However, the companies classified under the finance sector were excluded in this study

because of their unique features and business activities, as well as differences in compliance and regulatory requirement. Normality check of the data was also carried out and some of the measures were transformed into logarithm to control for skewed nature of data. As multivariate regression is used to analyze the data in this study, assumptions of multicollinearity, hemoscedasticity and linearity are also tested.

RESULT

Result of data Stationary Normality Test

The result of data stationary normality test using data mean, medium, standard deviation, skewness and kurtosis are shown in Table 1. According to Tabachnick and Fidell (2001), to use of the analysis of variance for the population or samples of observation is assumed to be normally distributed and it is important where to conduct parametric statistical techniques. Population or sample assumed normally distributed when mean of variables similar to value of medium, skewness value is zero and kurtosis value equal to 3. Skewness and kurtosis are two components in determining normality (Pallant, 2005). The diagnostic test showed that no variables have the value of mean equal to value of median. In addition the skewness value of variables are mix both positively and negatively indicating that their distributions are skewness to the right side as well as to left side of the curve. Sample assumed normally distributed if skewness value is zero. The kurtosis value of variables showed no variable with value of 3. Therefore, it indicates that the result violates the assumption of normally distribution.

Table 1 Results of normality test

	TQ	SP	LMAN	LSIZE	GRW	LEV	LPRO	AGE
Mean	0.617	1.559	1.178	5.531	1.422	0.188	4.239	15.396
Median	0.330	0.070	1.540	5.480	0.710	0.060	4.192	13.000
Maximum	38.000	45.500	1.990	7.850	14.900	16.174	6.962	50.000
Minimum	-1.350	0.010	-2.000	0.780	0.010	-0.062	1.041	0.000
Std. Dev	1.638	2.870	0.854	0.661	1.940	0.877	0.782	11.242
Skewness	12.668	7.110	-1.796	-0.324	3.014	13.292	-0.022	1.312
Kurtosis	233.686	80.235	5.584	7.998	13.876	203.880	3.868	3.984
SKtest	3932.55	2852.87	711.18	284.39	1413.49	3992.05	28.27	428.90
Probability	0.00*	0.00*	0.00*	0.00*	0.00*	0.00*	0.00*	0.00*

Notes:

1. The * denotes p-value significance at 1 percent level (P<0.01).
2. TQ = Tobin's Q ratio, SP = Share price, LMAN = Log managerial ownership, LSIZE = Log total assets, GRW = Market value of share divided by book value of share, LEV = Total debt divided by total assets, LPRO = Log profit or loss, AGE= Year of listing.

Utilizing SK test to evaluate the normality for all variables also showed it significant at 1 percent (P<0.01) and these means all the variables are failed to fulfil the normality test. Since the data distribution is not normally distributed, the estimation method of ordinary least square (OLS) to analyse the sample data would produces bias and inefficient estimators. Therefore, the generalized least square (GLS) method of estimation is more appropriate and it is expected to yield a much better result (Gujarati 2003). The issue which involves the variables of non-normal distribution is quite common in research that involves a large sized sample (Pallant, 2005). In fact, this argument is agreed by Norusis (2000) and Kleinbaum, Kupper, Muller, and Nizam (1998), who explain that variance analysis is not heavily dependent on the assumption of normality since the data is large. As a result, the assumption of normality is not seriously offended since this study covers a large sample size.

Results of Multicollinearity Test

This study must ensure that the data must be independent of one another. It means that observations or independent variables must not be influenced by other independent variables (Pallant, 2005). According to Steven (1996), it is very serious if this assumption is violated. He added that each study must ensure that all observations are independent. This study is based on Pair-wise Pearson correlation matrix for the variables and the results are provided in tables 2.

Table 2 Result of multicollinearity test using Pearson Correlation matrix

	TQ	SP	LMAN	LSIZE	GRW	LEV	LPRO	AGE
TQ	1.000							
SP	0.232*	1.000						
LMAN	-0.175*	-0.358*	1.000					
LSIZE	-0.021	0.365*	-0.274*	1.000				
GRW	0.187*	0.774*	-0.366*	0.460*	1.000			
LEV	0.255*	0.003	-0.023	-0.107*	0.003	1.000		
LPRO	0.242*	0.463*	-0.297*	0.657*	0.547*	0.025	1.000	
AGE	0.015	0.263*	-0.277*	0.322*	0.273*	0.020	0.255*	1.000

Notes:

1. The * and ** indicate correlation are significant at the 0.01 (2-tailed) and 0.005 (2-tailed) levels, respectively.
2. TQ = Tobin's Q Ratio, SP = Share price, LMAN = Log managerial ownership, LSIZE = Log total assets, GRW = Market value of share divided by book value of share, LEV = Total debt divided by total assets, LPRO = log profitability, AGE = Year of listing.

It indicates that multicollinearity is not a problem, as the correlations between all variables are relatively low. According to Gujarity (2003), multicollinearity could be a problem when the correlation exceeded 0.80. The low intercorrelation among the explanatory variables used in the regression indicates no reason to suspect serious multicollinearity.

Results of Regression Analysis

The analysis begin with the report of the regression using generalized least square (GLS) estimations technique on Tobin's Q in model 1 and share price in Model 2. The F-statistic for model 1 and model 2 are statistically significant at 1 % level. The R^2 for models 1 and model 2 indicated the value 0.29 and 0.61 respectively. The adjusted R^2 for model 1 recorded the value 0.28 and 0.60 for model 2. The regression analyses using GLS estimation technique on Tobin's Q and share price reported in table 3.

Table 3 Regression for GLS estimation

Independent variables	Hypotheses	Tobin's Q		Share Price	
Constant		1.724	0.424	0.0242	0.542
LMAN	H01 & 2	-0.086**	0.039	-2.457*	0.059
Control variables					
LSIZE		-0.429*	0.054	0.003	0.054
GROW		0.181*	0.016	0.990	0.018
LEV		0.342*	0.025	0.029	0.021
LPRO		0.151*	0.045	0.053	0.042
AGE		0.001	0.002	0.016**	0.006
R^2		0.29		0.61	
Adjusted R^2		0.28		0.60	
F-statistics		623.83*		3401.14*	
Durbin-Watson stat		1.512		Na	
Baltagi-Wu LBI (Locally best in variance)		2.390		Na	

Notes:

1. The * indicates significant at 1 percent (P<0.01), ** indicates at 5 percent (P<0.05) and *** indicates at 10 percents (p<0.1).
2. LMAN = Log Managerial ownership, LSIZE = Log total assets, GRW = market value of share divided by book value of share, LEV = total debt divided by total assets, LPRO = log profitability, AGE = year of listing.

The Effect of Managerial Ownership on Tobin's Q

Model 1 on table 3 report the managerial ownership coefficient on Tobin's Q is negative and significant at 5 percents level (P<0.05). The coefficient of LMAN recorded the value -0.086 shows that 1 percent increase in managerial ownership will lead to decrease 0.086 percent in Tobin's Q, and therefore the result reject the hypothesis H01. This is not surprising since the result may be attributed to the managerial entrenchment which results in a decrease of firm performance for increasing of managerial ownership (Ming and Gee, 2008).

The Effect of Ownership and share price

The regression utilizing GLS estimation technique reported in table 3 showed that the managerial ownership coefficient is negative and statistically significant

at 5 percents level. The coefficient of man ownership (LMAN) is -2.457 and this explained that if 1 percent increase in managerial ownership would lead to 2.457 percent decreased in share price. This is consistent with studies by Morck et al. (1988), Demsetz and Lehn (1985), Shleifer and Vishny (1997) and Himmelberg et al (1999). The result is statistically failed to support hypothesis H02. The result is consistent with entrenchment hypothesis which suggests a negative relationship between managerial ownership and firm's performance. The entrenchment theory emphasizes that the manager of the firm uses the resources for their personal benefit, and decrease the firm's performance. The finding contradicts with the agency theory which proposed that the increases of managerial ownership will increase the firm performance. Therefore, in Malaysia context, the traditional agency theory should be extending in order to explain precisely the managerial ownership and firm performance.

CONCLUSIONS

Agency theory proposed that the concentrated ownership would contribute to a more effective monitoring process. Utilizing panel data of listed companies for the year 2007-2009 covering 730 listed companies on Bursa Malaysia showed that the managerial ownership failed as a controlling and monitoring mechanism to neutralize the agency conflict. There is a negative relationship between the managerial ownership and market-based performance indicators. The findings showed that managerial ownership exhibited negative associations with Tobin's Q and share price. The finding showed that the managerial ownership is beneficial only in non-concentrated firms. The controlling owner in concentrated ownership company may use his or her position in the firm to extract private benefits at the expense of the other shareholders by appointing the managers that represent their own interests. Therefore, the managerial ownership does not influence stock returns and dividend yields among Malaysian companies. The findings suggest that greater managerial ownership can lead to greater agency problems due to an entrenchment effect. In particular, the managers with sufficient ownership have control rights, and therefore they have the ability to influence the firms to commit the self-serving transactions and thereby expropriate wealth from outside shareholders. Managerial entrenchment problem proposed that the managers who want to maximize private benefits would opportunistically withhold or manipulate information to outside investors, particularly when minority investor protection is weak. It is doubtful that even entrenched managers are totally immune from disciplinary forces such that they openly disclose details of self-serving investments or contract. Thus, the incumbent managers are likely to have incentives in hiding their efforts to expropriate wealth or secure their positions and only disclose information that is in their best interests. When the managers hold a relatively large equity stake, their concentrated control allows them to use corporate disclosures for personal interests, rather than for the best interests of outside shareholders. As a conclusion, managerial ownership

does not influence corporate performance in Malaysia and the principal agent problems cannot be solved through an increase of managerial ownership. This finding supports the view that the managerial ownership can lead to more severe agency problems.

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