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The Separation of Ownership and Control in Malaysian Domestic Companies

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Abstract. This study examines the separation of ownership and control in Malaysian domestic companies. In most businesses, if not all, there exists a separation between the person who owns a firm and the person who controls that firm. This distinction between ownership and control can be described as a scenario where the shareholders, or also known as the residual claimants, hold a low level of command on management decision making, as stated by Marks, 1999. In other words, ownership and control are seen as two separate factors of production. This is because the administration (management) makes the decisions whereas the owners (shareholders) take on the risk of profit or loss. To analyze the linkage between these two factors, one must first understand how control and ownership are defined. In corporate terms, to have control over a firm is to hold the authority to determine the strategies and course of action of that firm. On the other hand, ownership is the possession of the legal right over the use, discarding and the end product of the means of production (Loh & Zin, 2007).

Keywords: ownership, agency theory, control, shareholders, management.

1. Introduction

The most comprehensive description of the separation of ownership and control was given by Marks, (1999), for he states that it refers to the affairs related with publicly held business corporations where the shareholders, also known as the residual claimants, have indirect or very few control over management decisions. However, a more detailed definition of specific key terms like ownership and control was given by Loh and Zin, (2007). Ownership is defined as the legal right over the use of factors of production of a company whereas control is the authority over the course of action of the company. In the Malaysian context, researchers such as Ali et. al, (2008) and Claessens et al.,(1999), provided evidence on Malaysian ownership structures and the degree of separation, respectively. In discussing ownership structures, Schleifer and Vishny, (1997), explained that it is made up of ownership concentration and composition. Loh and Zin, (2007), acknowledged the two elements and explained why they were linked to corporate performance. However, Latiff and Taib, (2011), argued that ownership structure does not affect earning quality. Regarding the implications of the separation between ownership and control, Marks, (1999), contended that positive implications can be seen in terms of three factors and collaboratively, these three factors give a company superior advantage over others. As for the negative implications, he spoke of the costs that arises from having an agency relationship. The theory was supported by Nor et al., (2010). However, it was concluded that the agency analysis was not a very comprehensive approach to be used in today's business environment. This was due to the existence of outside factors that may influence control in a company. According to Ali,Salleh and Hassan (2008), the separation of ownership and control gave incentives to managers to choose and implement accounting estimates that can increase their wealth. While Warfield et.al (1995) argued that managers who own a significant amount of control has less incentive to manipulate accounting record which reduces the agency conflict. However, Morck et al. (1988) and Yeo et al. (2002) didn't agree with the reverse relationship between managerial control and agency conflict.

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2. Objective of Study

- To examine the separation of ownership and control in organizations.
- To study the positive and the negative implication of the theory of separation of ownership and control.

3. Literature Review

3.1. Ownership Structures

Ownership structure plays an important part in determining corporate performance, as agreed by many authors like Ongore,(2011). From the findings by Ali et al., (2008), it was proven that in Malaysian listed companies, the ownership structure can restrict earnings management activities. From the Malaysian context, a study conducted by Claessens et al. (1999) showed that medium-sized and small-sized firms in the country showed the most separation of ownership and control. However, these firms had much fewer shareholders in the corporation. To analyze this relationship between the two factors, the study looks at what an ownership structure consists of, and the two main elements that make up ownership structure are ownership concentration and ownership composition as mentioned by Schleifer and Vishny, (1997). It is rationalized that ownership concentration decides on how power is delegated between a firm's manager and shareholders. When shareholders are in small numbers and each of them have a relatively large cash flow at stake, these shareholders tended to have more control in their hands as indicated by Loh and Zin, (2007). As such, collaborative actions by this group would be much easier. This goal congruence between shareholders would lead to a better company performance. In contrast, when control was scattered among many shareholders, goal congruence was not achieved. This was because shareholders with a smaller stake in the company had not bothered with the monitoring of the company, since that person thought that the cost of monitoring was not worth the effort when compared to the benefits. This is also known as the free rider problem. Ownership composition describes the people who belong in the controlling group and as indicated by Loh and Zin, (2007). For instance, a family member or a whole family group who are distinctive owners of a firm would be more inclined to control benefits and profits as well. This can be compared with an institutional investor, who might only be interested in profits. This again, results in goal incongruence, should the institutional investor be only interested in the profits and did not agree with management decisions made by the board of directors example, in any expansion of the company.

4. Implications of the Separation of Ownership and Control

4.1. Positive Implications

Several benefits could be concluded from the separation of ownership and control. One such benefit would be that having a hierarchical decision making policy could be more effective than a market allocation. This is so, because both structures are involved in incurring cost and decision making, where market costs can be very high. Thus, hierarchical decision making is much more efficient. However, these are not applicable to all conditions and all types of decisions. Another benefit from separating ownership and control would be in terms of firm size. It is stated that the optimal firm size of companies that exercise high separation of ownership and control can be rather large. This is because of economies of scale in production and decision making, which is mostly associated with goal congruence of shareholders and management (Marks, 1999). Finally, when shareholders are not preoccupied with management work, they have the time to develop an optimal investment strategy where they will be able to diversify and pool. As such, this makes it possible for the owners of the company to change their allocations accordingly with the changing market environment. With the synergy from all these three factors, a large sized company that adopts hierarchical structures and diversifies its investments is likely to have transactional, informational and productive efficiencies. These criteria would then give the company a competitive edge over other corporate structures.

4.2. Negative Implications

Separating ownership and control may bring harm in the sense that the managers of companies that have a high degree of separation would experience a lack of incentives to run the company efficiently and make it more profitable, as referred from Marks, 1999. In contrast, they would rather operate the firm sub-optimally and cash in more bonuses into their “pockets”. In addition, others believe that agency problems may arise from ownership diffusion in a company an indicated by Nor et al., (2010). Basically, the dilemma with the agency problem is that although the principal (shareholder) may try to provide incentives for the agent (manager) to make them work for company profits which is beneficial to the principal, the agent still tends to deviate from the principal’s interests and mentioned by Marks, (1999). As a result, the firm would have to bear the costs resulting from this relationship. For instance, cost to monitor the agents, bonding expenditures by managers and the losses due to divergence of interest of managers are some of the common principal-agent expenditures.

4.3. Agency Problem

One of the most distinctive implications of the separation of ownership and control is the agency problem. An agency problem arises when there is a conflict of interest among creditors, shareholders, and management due to their different goals. The self interest of managers may lead them to act in a different way without protecting the interest of shareholders. Managers would put less effort in the managing process or may even transfer company’s resources into their own “pockets” and highlighted by Ritter, Silber and Udell, (1997). For example, managers might be maximizing their own salary, bonuses and benefits from the company expenses. Due to the fact that the manager (agent) has less incentive in maximizing profits than shareholders (principal), managers may act in their own interest rather than protecting shareholders’ interest. Hence, separation of ownership and control is considered as bringing along moral hazard problems to the organization.

4.4. Approaches to Deal with the Agency Problem

Monitoring the management of an organization is important to prevent the occurrence of the agent problem. However, there are some limitations in doing so. As stated by Eisendhardt (1989), a standard agency relationship such as setting a contract that specifies the responsibilities and performance standards of the contracting party (managers), could help in solving the agent problem. However, there might be under-specified elements in terms of performance standards due to the limitation in understanding the manager’s skills and knowledge by shareholders. Besides, as shareholders would not be able to observe everything that occurs in the company, the process of monitoring would be a problem to shareholders as indicated by Phan, (2000). In addition, it is difficult for the shareholders to solve the problems that have been detected as coordinating the dispersed actions of all shareholders would be time consuming and costly as indicated by Demstez and Lehn (1985).

Essentially, the agency problem is related to the way the shareholders control managers to protect their interest. Just like any other country, Malaysia had faced the same problem. To deal with the agency problem, shareholders may motivate managers by introducing incentives in order to align the goal of two parties as indicated by Lipsey and Chrytal,(2007). The first solution to align the interest of both parties (shareholders and managers) is to make sure that managers also had an interest in the value of the shares by ensuring that managers purchase some shares of company. Besides, share options could be given to managers when the value of company’s share rises above some value. As this would create wealth for the managers, managers would have more incentive to perform efficiently. For example, some companies encouraged their employees to purchase shares of the company via company savings schemes to give these employees an interest in the company’s profit. Besides, the company can give managers a shared interest in profit by turning some portion of their remuneration into company’s profit which eventually turns into an annual bonus.

5. Conclusion

In most of the public listed companies in Malaysia, the separation of ownership and control is pronounced. There are some benefits of implementing this practice such as more efficient hierarchy decision making system. However, separation of ownership and control is drawing in moral hazard to company. According to the principal-agent theory, the shareholders (principal) own the company and managers (agent) control the company. Shareholders own the residual claims of the company. However, shareholder will not have sufficient direct control over management decision making and cannot participate in the day-to-day management's activities of the company. Hence, managers would have an incentive to act in self interest rather than protecting shareholders' interest and as such could lead to agency problem. There are quite a few solutions to solve the agency conflict such as give incentives to align both parties' goal. In a conclusion, in order to generate a more efficient company, shareholders need managers' with good leadership qualities and to be ethical always in performing their duties.

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