Corporate Governance, Ownership Structure Perspective and Firm Value: Theory, and Survey of Evidence

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Abstract

The overall objective of this paper is to critically review both theoretical and empirical literature on the relationship between corporate governance, based on ownership structure and firm value. Theoretical reviews indicate that agency theory is the most dominant theory that attempt to fully explain the relationship between corporate governance, based on ownership structure and firm value. Empirical review shows that there are many studies that have been done, but there is no consensus as yet regarding the effect of corporate governance, based on ownership structure on firm value. Most studies done focus on developed economies while those on emerging markets seem to concentrate on Latin America and Asian economies. More so, these studies use varied methodologies. Studies in the African economies are scanty. Overall the studies reviewed are inconsistent in their findings. These inconsistencies clearly indicate that there are research gaps and therefore, this paper concludes that there is need to carry out further research particularly in developing countries.

Key words

Firm value, Corporate Governance, Ownership structure

1. Introduction

Corporate governance has varied definitions. According to Claessens and Yurtoglu (2013), these definitions tend to fall into two classes. The first category of definitions focuses on a set of behavioral patterns: that is, the actual behavior of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. The second category focuses on normative framework; the rules under which firms are operating. These rules originate from the legal system, the judicial system, financial markets, and labor markets. The first category is more appropriate for single country studies. It considers issues such as as how boards of directors operate, the role of executive compensation in determining firm performance, and the role of multiple shareholders. The second category of definition is applicable to cross-country studies as it focuses on the effect of differences in the normative framework on behavioral patterns of firms, investors, etc (Claessens & Yurtoglu, 2013).

According to the Organisation for Economic Co-operation and Development [OECD] (2004), corporate governance refers to the procedures and processes according to which an organisation is directed and controlled. Consequently the corporate governance structure specifies the distribution of rights and responsibilities among different firm participants ranging from the board, managers, shareholders and other stakeholders as well as laying down the rules and procedures for decision making. Turnbull (1997) defines corporate governance as all the influences affecting institutional processes including those for appointing the controllers and/or regulators, involved in organising the production and sale of goods and services. Further, Shleifer and Vishny (1997) identify two corporate governance mechanisms, that is, internal and external. Internal corporate governance which gives priority to shareholders’ interest relies on the board of directors to monitor top management. External corporate governance monitors and controls managers’ behavior through external regulations with many parties involved, such as suppliers, debtors, accountants, lawyers, providers of credit ratings and other professional institutions. Corporate governance is increasingly attracting interest from both academic scholars and practitioners across the globe. According to Claessens and Yurtoglu (2013), corporate governance has become a main centre of focus in corporate boardrooms, academic meetings, as well as policy circles around the world. Individual countries are also paying a lot of attention to issues of corporate governance. More so developing countries are increasingly recognising that corporate governance is an essential element for their prosperity and economic growth. Focusing on Africa, Kyereboah-Coleman (2008) emphasizes that the East Asian crisis and the recent corporate scandals around the world together with the seemingly poor performance of corporate Africa have given prominence and impetus to corporate governance on the continent. Due to this increased interest, corporate governance practices and principles are slowly being accepted as crucial in the determination and exercise of corporate power in the utilisation of a company’s assets and resources. Further, investors are increasingly basing their investment decisions not only on the company’s outlook but also on the firm’s reputation and corporate governance practices. This implies that if companies are to attract investors then they must adopt corporate governance principles and practices. According to Ongore and K’Obonyo (2011), the many high profile corporate failures, coupled with generally low corporate profits across the globe, has put to question the credibility of the existing corporate governance structures. Proper corporate governance structures are crucial for a progressive economic growth and social development.

Recently corporate governance challenges came into focus in the wake of the global financial crisis (OECD, 2011). There is need to put in place proper corporate governance systems and structures such as those in the United States, UK and Japan for the long run sustainability of firms. Specifically for countries in the developing world such as Africa, there is need to establish adequate corporate governance structures if they have to attract foreign investors as well as enhance sustainability and competitiveness of their institutions. There is an on-going debate specifically on the effect of corporate governance on firm value and so far there is no conclusive evidence regarding the relationship between corporate value and corporate governance (Cunat, Gine & Guadalupe, 2012; Ammann, Oesch & Schmid, 2011).
In their review of corporate governance in emerging markets Claessens and Yurtoglu (2013) underline the fact that good corporate governance practices benefit the firm through greater access to financing, lower cost of capital, better performance and more favorable treatment of all stakeholders. Firms that adopt effective corporate governance structures are best placed to provide transparent information on decision and control activities. According to Ammann et al. (2011) better corporate governance practices are reflected in statistically and economically significant higher market values. Ammann et al. are of the view that firms should understand corporate governance as an opportunity rather than an obligation and pure cost factor. This paper’s approach is to review both theoretical and empirical literature on the relationship between corporate governance based on ownership structure and firm value.

1. Statement of the Problem
The subject of corporate governance continues to draw a lot of interest in the global arena. The extent to which corporate governance contributes to firm value continues to attract a lot of debate from academicians and corporate players. However, there is no consistent evidence on the positive contributory effect of corporate governance, based on ownership structure on firm value. The overall aim of the paper is to identify gaps which can be filled by further research. Though there are many theories associated to corporate governance, no individual theory can fully explain the relationship between firm value and corporate governance. From the empirical review there is no conclusive evidence regarding the relationship between value and corporate governance, based on ownership structure. The many studies that have been done give mixed results on the exact relationship between corporate governance based on ownership structure and firm value. There is no consensus as to the effect of corporate governance, based on ownership structure on firm value. Some of the reviewed studies point to a positive relationship between corporate governance based on ownership structure and firm value while a few other studies provide evidence of a negative relationship.

Documented evidence shows that the effect of corporate governance, based on ownership structure on firm value may depend on the firm-level governance characteristics as well as the country in which the study is carried out. In addition, it is not clear if good corporate governance is related to high firm values as costs associated with implementation of stronger governance mechanisms may outweigh the benefits. Majority of the past studies done in this area have focused on the developed economies while research in developing countries is limited. Therefore, there is need to investigate and shed more light on the effect of corporate governance, based on ownership structure on a firm’s value.

2. Objectives
The following objectives are the main focus of this paper
1) To review related literature so as to identify research gaps existing in theory and empirical studies
2) To establish empirical findings on the relationship between corporate governance based on ownership structure and firm value

II. Theoretical Review

A. Agency theory
There are various theories associated with the study of corporate governance. These include agency theory, stewardship theory, stakeholders’ theory, transaction cost theory, resource dependency theory. However, it is the agency theory that explains ownership structure as a key concept of corporate governance.

The origin of this theory stems from research by economists in early 1970s who explored risk sharing among individuals (Eisenhardt, 1989). Specifically, the theory originated from the work of Stephen Ross. Ross (1973) introduced the economic theory of agency by showing that the problem is one of selecting a compensation system that will produce behaviour by the agent consistent with the principal’s preferences. In December 1972, Ross presented his paper entitled “The economic theory of agency: The principal’s problem” at the annual meeting of the American Economic Association. The paper by Ross (1973) outlined agency as a universal principle and not just a theory of the firm. Agency theory is the study of the agency relationship between two parties when one, designated as the agent, acts, for on behalf of, or as representative for the other, designated as the principal, in a particular domain of decision problems” (Ross, 1973: 134). Eisenhardt (1989) notes that the first problem in the agency relationship arises when: a) the desires or goals of the principal and agent are in conflict, and b) it is difficult or expensive to verify what the agent is doing. Therefore, the principal cannot verify that the agent has behaved inappropriately. The second problem involves risk sharing which arises when the principal and agent have different attitudes towards risk. Due to the risk preferences, the principal and the agent may prefer different actions (Eisenhardt, 1989).

Another major early contributor to the theory is Mitnick Barry M, who focused on the institutional theory of agency introducing the common logic of agency in institutional settings. In 1973 Mitnick presented a paper entitled “Fiduciary Rationality and Public Policy: The Theory of Agency and Some Consequences” at the annual meeting of the American Political Science Association. In his paper, Mitnick (1973) laid out a much more general theory of agency with possible application to numerous societal contexts. He identified the following three problems: i) The principal’s problem which revolves around motivation of the agent to act in the interests of the principal; ii) The agent’s problem which revolves around the fact that the agent may be faced with decisions to act either in the principal’s interest, his own interest, or some compromise between the two when they do not coincide; 3) Policing mechanisms and incentives. Policing mechanisms are mechanisms and incentives intended to limit the agent’s discretion while incentive systems are mechanisms that offer rewards to the agent for acting in accordance with the principal’s wishes. Policing and incentives creates costs for the principal.

In their contribution, Jensen and Meckling (1976) explained that management and shareholder interests often conflict because managers tend to try to give priority to private interests. This theory suggests a fundamental problem between shareholders who employ professional executives to act on their behalf. One of the major assumptions informing this theory is that the agents are likely to act in their own self-interest (Eisenhardt, 1989). This
implies that managers who act on shareholders behalf are likely to deviate from the shareholders’ interests forcing the principal to incur agency costs so as to minimize the agency problem. Jensen and Meckling (1976) argue that agents extract private benefits from firms that they manage if they are not shareholders, and thus neither meet the full cost of mismanagement nor share in the residual income of those firms. It has been recognised that modern firms are seen to suffer from separation of ownership and control and hence professional managers (agents) run these firms and they cannot be held accountable by dispersed shareholders (Kyebeboah-Coleman, 2008). To minimize these shortcoming various governance mechanisms aimed at aligning the interests of agents with those of principals, including equity ownership by managers, may be considered. The board of directors is put in place to safeguard the interests of principals from agents who are bent on extracting private benefits from the firm (Jensen & Meckling, 1976). According to Yusoff and Alhaji (2012b), the Board in fulfilling its governance function in the interest of shareholders, ratifies decisions made by the managers and monitors the implementation of those decisions.

According to Eisenhardt (1989: 59), “the unit of analysis is the contract governing the relationship between the principal and the agent, hence the focus of the theory is to determine the most efficient contract governing the principal–agent relationship given assumptions about people (e.g. self-interest, bounded rationality, risk aversion), organizations (e.g. goal conflict among members) and information (e.g. information asymmetry is a commodity which can be purchased)”. Despite the limitations of this theory, the assumptions have been highly influential in shaping corporate governance frameworks. Yusoff and Alhaji (2012b) note that various governance mechanisms have been discussed by agency theorists in relation to protecting the shareholder interests, minimizing agency costs and ensuring alignment of the agent-principal relationship.

A firm’s corporate governance arrangements cannot be delinked from a nation’s politics (Gourievitch, 2003). According to Roe (2003:3), “the political and social foundation that make the large firm possible and that shape its form can deeply affect which firms, which ownership structures, and which governance arrangements survive and prosper, and which do not”. Yusoff and Alhaji (2012b), insist that the political model of corporate governance can have an immense influence on governance developments. Roe (2003) emphasizes that politics can press managers to stabilize employment, to forego some profit-maximizing risks with the firm, and to use up capital in place rather than to downsize when markets no longer are aligned with the firm’s production capabilities.

III. Empirical Review

Many studies have focused on firm ownership structure as a key corporate governance attribute that has an effect on value. According to Lemmon and Lins (2003) corporate ownership structure plays an important role in determining incentives of insiders to expropriate minority shareholders during times of declining investment opportunities. In a study of 116 listed large firms in Australia, Henry (2008) found that ownership structure is significantly related to valuation outcomes. According to Klein et. al. (2005), valuation effects of governance elements differ according to a firm’s ownership structure but there is no evidence that ownership is significant when the effect of total corporate governance index is considered. In a study of 1433 listed firms from 18 emerging economies, Lins (2003) reports a positive relationship between Tobin’s Q and the level of non-management control while management group control in excess of its proportional ownership is negatively related to Tobin’s Q. The findings of Lemmon and Lins (2003) provide evidence of higher stock returns when management directly owns a large fraction of a firm’s cash flow rights.

Ongore and K’Obonyo (2011) note that studies comparing ownership concentration and firm performance show a higher rate of return in companies with concentrated ownership while other studies have shown that it is not only the amount of equity held by shareholders that matters when studying firm performance but also the identity of the shareholder. Henry (2008) found a non-linear relationship between levels of director ownership and firm value while the relationship between institutional ownership and value is positive and linear. Claessens (1997) reports that several ownership concentration measures are positively related to value and underlines that the higher the concentration the higher the share prices. Claessens (1997) found that majority ownership by outsiders was associated with higher prices. However, he also found that firms with state and foreign majority owners do not have higher prices.

Baek, Kang and Park (2004) studied 644 listed non-financial firms in Korea and found that firms with larger equity ownership by foreign investors experienced a smaller reduction in share value during the Korean financial crisis than the firms where the controlling shareholder’s voting rights exceeded his cash flow rights had significantly lower returns. In a study of 135 firms in Spain, Miguel, Pindando and De La Torre (2004) found a quadratic relationship between firm value and ownership concentration. The contribution of concentration to firm value may be explained by the more efficient monitoring provided by concentrated ownership. In a study of listed firms at the Nairobi Securities Exchange, Ongore and K’Obonyo (2011) found a significant positive relationship between foreign, insider, institutional ownership and firm performance. Further, their study’s results also indicate a significant positive relationship between managerial discretion and performance implying that managerial discretion is critical for innovation and creativity, which translate to firm performance. In a study of Swedish listed firms, Zerni, Kallunki and Nilsson (2010) found that boards with equity incentives and higher quality auditors act as effective governance mechanisms with positive valuation implications. They found that market value and dividend payout increases with board ownership of cash flow rights. Their findings imply that boards where board members have invested personal wealth in the firm, they demand more stringent auditing, thereby limiting agency problem.

Other studies found contradicting evidence on the effect of ownership structure on firm value. In a study of 2006 state-controlled listed firms in China, Leung and Cheng (2013) found that aggregate ownership of other large shareholders has different effects on firm value. Beiner et. al. (2006), found that neither presence of controlling shareholders nor block holders have significant value impact. Ongore and K’Obonyo (2011) found the relationship between ownership concentration, government ownership and firm performance was significantly negative while Mang’unyi (2011) found no significant difference between ownership type and performance.

IV. Discussion of Findings

From a theoretical review perspective, there are various theories associated with corporate governance and they focus on different
aspects of corporate governance. Agency theory is the most dominant in the corporate governance based on ownership structure-firm value debate. From this review of theories it is evident that good corporate governance practices have a positive/negative effect on firm value.

It is important to note that from this paper’s review of evidence, most of the studies on developed economies focus on the United States while those in emerging markets have specifically concentrated on Latin America and Asia. Research focusing on Africa is scanty. Specifically, there is very limited research based corporate governance literature in Africa.

On data analysis, these prior studies use varied models with some taking the basic descriptive design. However, most of the studies use Ordinary Least Squares (OLS), others Two Stage Least Squares (2SLS) as well as Third Stage Least Squares (3SLS) while there are few that have used more advanced models such as Generalised Method of Moments. On the dependent variable, TOBIN’S Q, is commonly used as a measure of firm value in corporate governance literature. TOBIN’S Q represents the ratio of total market value to total assets value. Consistently, majority of the studies have used Tobin’Q as a proxy for firm value and performance while a few other studies used other measures such as Return on Equity, Return on Assets, Dividend payout ratios, and stock returns. It has been acknowledged that there are other firm characteristics (such as size, leverage, growth prospects, age, industry) that affect firm value. Consequently many studies included control variables in their models to cater for the other firm industry characteristics that influence firm value. However, there are other studies that did not include any control variables.

**V. Conclusions**

From a theoretical perspective, there seems to be no individual theory which can explain the corporate governance, based on ownership structure and its effect on firm value. Therefore, future research should be based on a combination of various theories. From an empirical perspective, despite the many studies, their results seem mixed. This implies that there is no conclusive evidence as to the exact effect of corporate governance, based on ownership structure on firm value.

In addition, most empirical studies have anchored their research on the agency theory, which, though being a foundational theory, it does not fully explain the firm value and corporate governance, based on ownership structure relationship. Considering that there is no consensus in the past studies and the many inconsistencies note above, this paper advocates for future research to use panel data coupled with advanced regression models as this may give more valid findings compared to the reviewed past studies. These advanced models will endeavour to detect permanent variables that determine the corporate governance effect on firm value.

**References**


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