Comparative Study on Relevant Theories of the Impact of Management Shareholding on Corporation Performance

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Abstract. Management shareholding, which is an important method in solving principal-agent problem, is widely used in listed companies in our country as the progress of equity division reform. This dissertation studies the three theories related to management shareholding and corporation performance, which finds out: (1) based on human capital theory, management shareholding, in the form of stock option incentive, grants management the residual claim. Thus, a win-win situation is achieved for both managers and shareholders. (2) Based on principal-agent theory, management shareholding makes the utility function of management agree nearly with the objective function of shareholders, which effectively reduces the moral hazard of management. (3) La Porta et al. (1999) found out in the research that tracing enterprise’s ultimate property owner with ultimate property right theory will help to better understand the relationship between ownership, control rights and corporate performance.

Introduction

Modern companies win developments on the basis of continuous transformation of property relations. The core of their development is how to improve their production efficiency to enhance profitability. On this basis, people observe the incentive problems of management and staff, thereby triggering the constantly deepening of discussion and study on incentive measures. human capital theory, principal-agent theory, contract theory and ultimate property right theory not only help us to get better understanding of the incentive problems of management widely existed in modern companies, but also provide theoretical support for the study of management incentive.

1. Impact of Management Shareholding on Corporate Performance Based on Human Capital Theory

Human capital theory originates from Adam Smith’s \textit{The Wealth of Nations}. Thereafter, some economists like Say and Marshall developed the theory from various perspectives and demonstrated its dominant position in production and role in value creation. In 1960s, Schultz, Backer and other economists put forward relatively complete human capital theory system and opened up a new idea for analyzing human production capacity. Schultz, by applying the concept of human capital, studied the reasons of economic growth in developed countries after World War II and finally found out the decisive role of human capital in economic growth. Afterwards, Rome and Lucas et al. introduce human capital into economic growth model, which further highlighted the value of human capital.

The management of listed companies, as a particular human capital, is not the owner of corporation’s physical capital. But its outstanding managerial competence and capacity is an essential capital for the survival and development of modern corporations. Why incentive is made to human capital but not other capitals? This is attributable to the characteristics of property rights. Firstly, human capital belongs to an individual rather than an object. Secondly, once the property right of human capital is damaged, its property value will reduce or disappear completely. Thirdly,
human capital always seeks market for itself. The uniqueness of human capital, comparing to land, other natural resources, plants, equipment and bank loans which need no incentive, its necessity for incentive.

Management shareholding, in the form of stock option incentive, grants corporate managers the residual claim, which actually is a kind of corporation’s affirmation to the replaceable role of the human capital of managers. As a manager, to maximize the return of equity, it is necessary to maximize the corporation’s wealth. That is reflecting the increase of his personal efforts in the rising of corporation’s share price to obtain appropriate capital gains. Motivating management with stock option incentive not only realizes the value (return on equity) of the human capital of managers, but also manifests labor income (or referred to as remuneration). Thus, it brings managers’ initiative into full play and promotes the operating performance of corporation, which finally achieves mutual benefit for managers and corporation shareholders.

2. Impact of Management Shareholding on Corporate Performance Based on Principal-agent Theory

Jensen and Meckling defined principal-agent relationship as a contractual relationship and referred to a corporation as a combination of a serial of contracts [2]. They believed that the costs deviating from value maximization would decrease as the increase of shareholding ratio held by management. This means management shareholding will help to reduce agent costs, which will thus enhance corporation performance. Owing to the asymmetric information between principals and agents together with many uncertainties existed in the operation of modern corporations, during their operation of corporations, agents are likely to pursue their own benefits against the interests of principals, which exists moral risks and possibility of slack work or shirking behavior. Furthermore, the asymmetric and incomplete information, together with imperfect contracts entered into by principals and agents owing to bounded rationality of human may cause agents to adopt a program which will not maximize the benefits of principals. Therefore, principals must establish an effective check-and balance system to supervise and motivate agents and reduce agent costs. However, they asymmetric information of both parties lead to many difficulties and high cost in supervision. For this reason, an incentive system, which aligns the interests of principals with agents and makes them an interest community, is especially important. With the measure of management shareholding, besides the role of agent, a senior manager may also act as a corporate shareholder which grant him residual claim. When a manager holds some shares, as a rational economic man, his operation will move forward the corporate performance improvement to obtain more personal economic benefits. This incentive policy of management shareholding may closely link the interests of corporate shareholders to that of senior managers. As the residual claim of the management rising with the increase of their share amount, they are motivated to supervise the staff. That is because the returns for corporate shareholders and the residual returns for management will also increase with the improvement of corporate performance. This, to some extent, solves the conflicts caused by the separation of control rights and residual claims and aligns personal utility function of management with the objective function of shareholders. On this basis, the problems of moral risks and adverse selection of senior managers are mitigated.

3. Impact of Management Shareholding on Corporate Performance Based on Ultimate Ownership Theory

Berle and Means first pointed out the relationship between corporate ownership and performance [3]. They considered that the more dispersive the stock equity, the looser the ownership and control rights. Hence, the maximization of corporate profits will not be guaranteed. Moreover, a shareholder will have poorer control ability over management with less share amount. Based on the recent development of corporate ownership structure and associated theory of control mechanism, La Porta, Lopez-de-Silanes and Shleifer described the methods with which controlling shareholders sustained and expand their control rights over corporations, including superior voting rights,
cross-shareholdings and pyramid shareholding schemes etc [1]. Especially, pyramid shareholding schemes are frequently applied by controlling shareholders in modern corporations to set up a series of connections which scholars refer to as control chains. In control chains, a listed company may be controlled by another, and in turn the holding shares of the latter may, directly or indirectly, fall into the hands of an ultimate owner by means of such similar chains. Therefore, in principle, the information of direct owners of listed companies or information of intermediate owners in the chains are not enough for researchers to actually understand the ownership and control rights of these companies. This requires tracing the ultimate property owners of the company, which will help to better understand the relationship among ownership, control rights and performance in modern corporations and facilitate in-depth study the relationship between management shareholding and corporate performance.

3.1 Ultimate controllers

Regarding to the concept of ultimate controllers, it first appeared on the classical literature of La Porta et al. (1999) which mainly studied corporate ownership around the world. In the study of the features of ownership in listed companies, in order to reveal the main types and ownership distribution of major shareholders in different countries, La Porta et al. traced the ultimate controllers of controlling shareholders so as to analyze shareholders’ ownership, i.e. ultimate control rights, over the company. Moreover, they also thought about the leverage effect of control rights which were divided into control rights (i.e., voting rights) and cash flow rights (effective equity investment). In our country, the tracing of ultimate controllers in listed companies should reach the state-owned level and non-state-owned level. In the analysis of ownership nature and exercising subjects of ultimate controllers in listed companies, there are two operable judgment bases: Ownership nature and exercising subjects of ownership and their holding share ratio. Based on ownership nature, listed companies can be divided into no-government-controlled companies and government-controlled companies; based on exercising subjects of ownership and their holding share ratio, the nature of shareholding can be further distinguished, for examples, state-owned assets management agencies (e.g., SASAC, Finance Bureau), state-own corporate entities (e.g., the state-owned property rights and state-owned investment companies held by central and local state-owned enterprises), absolute shareholding and non-absolute shareholding (existing in both government control and non-government control). Different natures of exercising subjects of ownership will ultimately lead to different exercise manners which will directly result in different motivations of performance projection in listed companies.

3.2 Differentiation between ultimate controllers and actual controllers

According to Contents and Formats of Information Disclosure by Companies Offering Securities to the Public— Contents and Formats of Annual Reports, actual controllers should be disclosed to natural persons, state-owned assets managements sectors, or other agencies and natural persons which shareholders come to a agreement or arrangement. Ultimate controllers are differentiated by government and non-government. Therefore, ultimate controllers are more abstract and general than actual controllers. For example, SASAC, State-owned Assets Bureau and state-owned investment companies can be the actual controllers of listed companies, but their ultimate controllers are governments.

Conclusion and Inspiration

For studies on the relationship between management shareholding and corporate performance, there are many dissertations on the first two theories mentioned above which however can not fully explain certain situations. The third theory provides special perspectives and ideas for the study of relationship between management shareholding and corporate performance.

In our country, there are few literature references on the studies of the principle of ultimate ownership, corporate performance and management shareholding. They are mainly from Liu Shaojia, Yang Zhongcheng and Liu Menghui who mainly focused on the study of the mutual effects
of ultimate ownership and equity structure, corporate performance and value [4-6]. Liu Shaojia et al. reclassified China’s listed companies as per the standard of La Porta - classifying according to new shareholding subjects and subsequent studies by other scholars proved this to be recognized by most scholars [1,4]. Based on this standard of classification, a similar conclusion was drawn from the studies of ultimate ownership, equity structure, corporate value and performance in China’s listed companies: Equity structure will have different relationships with corporate performance and value based on different classification subjects. Based on new shareholding classification standard, the comparison of the performances from four different shareholdings, conducted by Liu Shaojia et al., revealed that equity structure was closely related to corporate performance [4]. Yang Zhongcheng, following the standards of Liu Shaojia et al., classified the listed manufacturing companies in our country into two categories, state-owned ultimate control rights and non-state-owned ultimate control rights [4,5]. The empirical results showed that the proportion of ultimate control rights presented an obvious inverted U-shape relationship with the CFOA and M/B of state-holding companies’ performance. However, there was no such relationship in non-state-holding companies. The study on the samples from China’s listed companies in China, which was conducted by Liu Menghui et al., suggested that reasonable concentration of cash flow rights and control right for majority shareholder may enhance corporate value [6]. However, if control rights surpass cash flow rights, they will deviate from each other and corporate value will decrease. However, in state-owned companies, such deviation will have no significant effect on corporate value, but it will be on the contrary in family-owned companies. Therefore, corporate performance and value will vary with the nature of corporate control rights.

Appendix

This paper provides phasic research results for scientific research subjects of Yunnan Department of Education. The project manager is Wei WENG. Corresponding Authors: Mei-Ying JIANG, Fei LI and Wei WENG.

References


