Ownership Structure, Corporate Governance, and Company Performance

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[Abstract] This study explores the intricate relationships between ownership structure, corporate governance, and company performance in the modern corporate landscape. Utilizing data from the China Stock Market & Accounting Research Database (CSMAR) covering 2010 to 2018, the study investigates various corporate governance mechanisms, including ownership structure and board composition, and their impacts on company performance measured by return on assets (ROA), stock return, net income, and market-to-book ratio. The analysis employs both linear and monotonic methods to capture the complex, nonlinear relationships inherent in these variables.

Key findings indicate that ownership concentration and insider equity holding positively influence ROA and net income but have mixed effects on stock returns. Larger board sizes for both boards of directors (BODs) and boards of supervisors (BOSs) are negatively associated with ROA and stock return, suggesting that overly large boards may impede company performance. Conversely, the dual role of the BOD chair as CEO, often criticized as management entrenchment, is shown to enhance income growth and ROA. Independent BOD members, typically considered beneficial for corporate governance, have a mixed impact, improving long-term stock returns while potentially hindering company growth and ROA.

These findings underscore the need for a balanced approach to corporate governance and ownership structure. While ownership concentration can boost earnings and stock returns, excessive insider ownership may detract from stock performance. Additionally, while stock-based compensation can incentivize earnings, it should be implemented judiciously to avoid negative impacts on stock returns. The study provides practical implications for companies seeking to optimize their governance mechanisms and ownership structures to enhance overall performance.

[Keywords] company performance, corporate governance

Introduction

In the modern corporate landscape, the interplay between ownership structure, corporate governance, and company performance forms a cornerstone of business studies and practices. These three elements are interlinked and collectively shape the operational and strategic outcomes of firms. According to agency theory, there is often a misalignment between the interests of management and shareholders. Corporate governance measures are implemented to reduce agency costs and align these interests. A concentrated ownership structure can serve as an effective corporate governance measure. Concentrated ownership often leads to more direct control and oversight, potentially reducing agency problems where management interests diverge from those of shareholders. However, it can also lead to entrenchment and expropriation risks if the controlling shareholders prioritize their interests over those of minority shareholders. This study examines various corporate governance mechanisms, including ownership structure, aiming to identify a balanced approach that enhances corporate earnings and market value.

Ownership structure encompasses institutional ownership, private ownership, state ownership, as well as ownership by executives and the board of directors. These structures can serve as corporate governance measures (Elyasiani, Wen, & Zhang, 2017). Beyond ownership structure, corporate governance includes elements such as the Board of Directors (BODs), the Board of Supervisors (BOSs), independent BODs, the duality of the CEO and BODs Chairperson roles, and the use of external auditors, among other factors. In mainland China, BOSs primarily oversee the activities of the CEO and BODs and monitor financial affairs.

Company Performance is a measure of how well a company achieves its objectives and goals. It is typically assessed through various financial metrics such as profitability, return on assets, and shareholder value, as well as non-financial indicators like customer satisfaction and employee engagement. This study uses return on assets (ROA), stock return, net income, net income growth, and the market-to-book ratio as measures of company performance.

This paper will proceed with a review of the literature, a discussion of the methodology and a presentation of the results, followed by the conclusion.

Literature Review

Corporate governance comprises a very robust body of literature, and there has been growth in research specifically addressing corporate governance of international companies, including multinationals. Buckley and Strange (2010) posit that the literature on international business, specifically that centered on corporate governance issues, has keyed on distribution/production, from the perspective of internalization theory. Kogut and Zander (1993) looked at foreign direct investment in multinationals as a mechanism to appropriate rents through various exploitation mechanisms. Foreign direct investment tends to reduce costs incurred across borders, compared to other types of market exchanges. This issue has been addressed in the literature, including analyzing specific advantages that firms may have as a result of foreign production in developed economies. Some of the factors identified by Dunning and Lundan (2008) include experience, differentiation, proprietary assets, and size. However, other studies have noted that such strategies related to international operations can have substantial risks, especially when faced with legal environments that may not be well developed.

Agency theory would suggest that such decisions related to foreign direct investment tend to impound risk tolerance preferences (Carpenter & Fredrickson, 2001). In a global business environment, an international presence may be required for growth (Carpenter & Fredrickson, 2001). Such a presence can provide new market opportunities as well as opening new markets for key resources (Zahra et al., 2000). We can learn from the agency theory literature that firm managers may seek international expansion as a method to facilitate the acquisition of private benefits, in excess of their costs (Baker et al., 1988), in spite of any reduction in shareholder value. Given that a firm's degree of internationalization is an important determinant of the complexity it faces (Sanders & Carpenter, 1998), foreign direct investment strategy will depend on management's ability to manage asymmetrical information and agency conflicts. Such foreign direct investment decisions are information intensive but occur infrequently thus exacerbating agency problems (Michael & Pearce, 2004).

Classic agency theory research has looked at various ways to combat the sub-optimal behaviors of managers, through such means as strict oversight by boards of directors (Fama & Jenson, 1983), as well as the effect of large outside shareholders (Demsetz & Lehn, 1985). Shleifer and Vishny (1997) noted that various external factors, including takeover threats and competition may serve to constrain such managerial behavior, and lastly, Jensen and Murphy (1990) posited

that goal congruence between principal/agent may be improved through the use of equity incentives for managers, while noting that high levels of such can lead to entrenchment behaviors.

Ownership concentration as a characteristic of corporate governance, particularly large ownership groups, has been widely studied. Research by Claessens et al. (2000) addressed such in emergent economies. A review of the literature by Connelly et al. (2010) indicates that those with significant ownership have motivations to exert oversight and influence on the executive's beneficial activities. A common factor in developing economies is that of family (or other) groups occupying a governance position and affecting decision-making, both tactical and strategic (Douma et al., 2006). A study by Filatotchev et al., (2001) found that institutional investor shareholders, in both developing and developed countries, can impact both governance quality as well as strategy decisions. Some performance strategies may be impacted by disparate owners. Hoskisson et al. (2002) addressed internationalization, and Douma et al. (2006) addressed performance. In a study of publicly listed and family-controlled firms in Taiwan, Filatotchev et al. (2005) found that informal networks of controlling families had significant influence over the behaviors of domestic institutions.

Filatotchev and Wright (2011, pp. 476-477) concluded that "foreign institutional investors with globally diversified portfolios and superior monitoring abilities are more likely to encourage high-risk, high-commitment FDI decisions by firms in emerging economies, whereas domestic institutions are more likely to form a coalition with risk-averse family block- holders and insiders in the parent company, supporting a low commitment entry mode". Insider equity holding can work as corporate governance measures as well. Noting limitations in the current literature related to predictions surrounding links between rent extraction and tax avoidance, Armstrong et. al. (2015) addresses these issues found in Desai and Dharmapala (2006), specifically, that a reduction in tax planning may reduce diversion by managers, due to internal control structures in place in the firm. Armstrong et. al. (2015) concludes that risk-taking equity incentives by managers have a positive effect on tax avoidance. They further conclude that the financial sophistication of the board has a positive effect on tax avoidance.

Hoskisson et al. (2002) looked at corporate governance and various innovation strategies and found that rather than having a unified voice, various constituencies differed in their strategy preferences. In addition, they found that the board of directors' composition also had an impact. Inside directors preferred internal innovation while external was preferred by outside directors. Hoskisson et. Al. (2002) concluded that differing mechanisms of corporate governance are preferred by different constituencies and may result in conflicting strategies by executives.

In an interesting study addressing the relationship between CEO turnover and earnings management, Hazarika et. al. (2012) found that forced, but not voluntary turnover has a positive relation with earnings management within the firm. Hazarika et. al. (2012) found that CEO ouster is followed by a reduction in earnings management, indicating that the CEO is responsible for the earnings management, rather than any failings in the control environment of the firm.

In addition, various academic studies over the years have suggested that earnings management may be a positive factor due to the enhancement of the information value of earnings. Studies going back to 1986 have posited that utilizing discretion in the presentation of earnings allows for the communication of private information to the market. If this contention is in fact true, such earnings management may be found to not be harmful. Subramanyam (1996) found evidence that a manager's discretion may improve the ability of earnings to reflect fundamental value. However, when managers' and shareholders' incentives are not congruent, managers may

choose to use the flexibility provided by the Generally Accepted Accounting Principles (GAAP) to manage income and create distortions of earnings (Healy & Palepu, 1993).

Methodology

Our data is from the China Stock Market & Accounting Research Database (CSMAR). The data covers the period from 2010 to 2018.

Ownership Structure

Ownership structure is a crucial element of corporate governance (Gillan & Starks, 2003; Li, 2010; Sueyoshi, Goto & Omi, 2010). In our analysis, we examine the top ten shareholders, private individual investor ownership among the top ten investors, and the ownership stakes of the state, executives, BODs, and BOSs. Chinese publicly listed companies are mandated to have both a BODs and a BOSs. The BOSs is responsible for duties such as auditing the company's financial affairs, overseeing directors and managers, and initiating actions against them if necessary. This study analyzes how different types of ownership impact company performance.

Traditional Corporate Governance Measures

Board size, a high proportion of outsiders on the BODs, and management entrenchment are among the most extensively researched corporate governance measures (Wang & Campbell, 2012; Beasley, 1996; Lanis & Richardson, 2011; Musteen, Datta, & Kemmerer, 2010). This study examines the relationship of each of these elements with company performance.

Linear and Monotonic Analysis

Besides linear analysis, this study employs monotonic analysis to capture nonlinear relationships of corporate governance measures and company performance. It examines both short-term and long-term company performance, with long-term performance measured using a five-year average. The aim is to identify an optimal corporate governance structure that promotes company growth in both the short and long term.

Results

Table 1

Linear Analysis of Ownership Structure and Company Performance

Pearson correlation	Net Income	Income Growth	Market to Book Ratio	ROA	Stock Return (including dividend)
TopTenShareholderOnwership%	0.1226	0.0144	-0.0158	0.0786	-0.0294
P value	<0.0001	0.0788	0.0487	<0.0001	0.0002
BODOwnership%	-0.1002	-0.0020	0.0101	0.0496	-0.0726
	<0.0001	0.8147	0.2225	<0.0001	<0.0001
BOSOwnership%	-0.0331	-0.0007	0.0031	0.0268	-0.0345
	<0.0001	0.9325	0.7064	0.0008	<0.0001
ExecutivesOwnership%	-0.0794	-0.0019	0.0108	0.0442	-0.0582
	<0.0001	0.8260	0.1928	<0.0001	<0.0001
PrivateIndividualOwnership%	-0.1154	-0.0020	0.0144	0.0435	-0.0737
	<0.0001	0.8065	0.0725	<0.0001	<0.0001
StateOwnership%	0.0456	-0.0023	-0.0163	0.0008	-0.0053
	<0.0001	0.7896	0.0484	0.9181	0.5216
Pearson correlation (5-year average)	Average Net Income	Average Income Growth	Average Market to Book Ratio	Average ROA	Average Stock Return (including dividend)
TopTenShareholderOnwership%	0.1920	0.0403	-0.0364	0.1324	0.0464
P value	<0.0001	0.0016	0.0065	<0.0001	0.0005
BODOwnership%	-0.0932	-0.0009	0.0141	0.1350	-0.1033
	<0.0001	0.9474	0.3208	<0.0001	<0.0001
BOSOwnership%	-0.0259	-0.0008	0.0025	0.0703	-0.0421
	0.0415	0.9506	0.8616	<0.0001	0.0029
ExecutivesOwnership%	-0.0702	-0.0010	0.0103	0.1006	-0.0375
	<0.0001	0.9412	0.4658	<0.0001	0.0080
PrivateIndividualOwnership%	-0.1154	-0.0027	0.0190	0.1113	-0.0950
	<0.0001	0.8352	0.1553	<0.0001	<0.0001
StateOwnership%	-0.0014	-0.0046	-0.0223	-0.0583	0.0611
	0.9155	0.7351	0.1153	<0.0001	<0.0001

PrivateIndividualOwnership% represents the ownership percentage held by the top ten shareholders, excluding institutional owners.

As illustrated in Table 1, ownership concentration and insider ownership exhibit a significant positive linear relationship with net income and ROA. However, when the ownership percentage of major private individual investors increases, net income decreases while ROA increases. We speculate that these conflicting results may be due to companies with a higher presence of private individuals among their top ten shareholders being smaller, resulting in lower net income despite a higher ROA. State ownership is correlated with higher net income but not with higher ROA, possibly because companies with greater state ownership are larger, yielding higher net income even though their ROA is not higher. Stock return is negatively associated with ownership concentration and insider equity holding.

Analysis using five-year average data confirms these results, except that, in the long run, ownership concentration is positively associated with stock return rather than negatively. In summary, concentrated private ownership and insider ownership have a significant positive linear relationship with ROA but a significant negative linear relationship with stock return. In the long run, ownership concentration has a significant positive relationship with both ROA and stock return.

Table 2

Linear Analysis of Corporate Governance and Company Performance

Pearson correlation	Net Income	Income Growth	Market to Book Ratio	ROA	Stock Return (including dividend)
Duality of BODChair&CEO	-0.0522	0.0138	0.0100	0.0304	-0.0059
	<0.0001	0.0911	0.2121	<0.0001	0.4574
BOD Size	0.0864	-0.0035	-0.0507	-0.0003	0.0059
	<0.0001	0.6766	<0.0001	0.9681	0.4731
BOS Size	0.0917	-0.0057	-0.0264	-0.0202	0.0239
	<0.0001	0.4980	0.0014	0.0122	0.0038
BOD Size scaled by ln(Sales)	-0.0457	-0.0076	-0.0065	0.0036	0.0023
	<0.0001	0.3707	0.4331	0.6555	0.7786
BOS Size scaled by ln(Sales)	-0.0000	-0.0083	0.0068	-0.0211	0.0227
	0.9990	0.3252	0.4095	0.0087	0.0061
IndependentBODMembers%	0.0589	-0.0003	0.0185	0.0015	0.0111
	<0.0001	0.9756	0.0252	0.8522	0.1782
Pearson correlation (5-year average)	Average Net Income	Average Income Growth	Average Market to Book Ratio	Average ROA	Average Stock Return (including dividend)
Duality of BODChair&CEO	-0.0431	0.0248	0.0033	0.0454	0.0357
	0.0003	0.0510	0.8028	0.0002	0.0075

BOD Size	0.0643	-0.0062	-0.0771	-0.0049	-0.0427
	<0.0001	0.6475	<0.0001	0.7025	0.0025
BOS Size	0.0958	-0.0101	-0.0356	-0.0253	0.0027
	<0.0001	0.4527	0.0118	0.0481	0.8499
BOD Size scaled by ln(Sales)	-0.0630	-0.0145	-0.0449	-0.0553	-0.0313
	<0.0001	0.2808	0.0015	<0.0001	0.0268
BOS Size scaled by ln(Sales)	0.0061	-0.0154	-0.0170	-0.0564	0.0135
	0.6299	0.2527	0.2307	<0.0001	0.3389
IndependentBODMembers%	0.0741	-0.0005	0.0189	-0.0037	0.0314
	<0.0001	0.9729	0.1822	0.7749	0.0264

As illustrated in Table 2, the relationship between company performance and corporate governance becomes more pronounced in the long run. The dual role of the BODs chair as CEO improves both ROA and stock return. However, larger board sizes, both for the board of directors (BODs) and the board of supervisors (BOSs), are negatively associated with ROA. Additionally, a larger BOD size is negatively associated with stock return. In the long run, a higher percentage of independent BOD members enhances stock return. In summary, the dual role of BODs chair and CEO boosts ROA and stock return, whereas larger BOD size has the opposite effect. Including more independent BOD members on the board can help mitigate this negative impact.

Table 3
Monotonic Analysis of Ownership Structure and Company Performance

Spearman's rank correlation	Net Income	Income Growth	Market to Book Ratio	ROA	Stock Return (including dividend)
TopTenShareholderOnwership%	0.1719	0.0662	0.1020	0.3058	-0.0065
P value	<0.0001	<0.0001	<0.0001	<0.0001	0.4160
BODOwnership%	-0.1106	0.0684	0.3134	0.2512	-0.0966
	<0.0001	<0.0001	<0.0001	<0.0001	<0.0001
BOSOwnership%	-0.0224	0.0456	0.1237	0.1480	-0.0574
	0.0054	<0.0001	<0.0001	<0.0001	<0.0001
ExecutivesOwnership%	-0.0889	0.0694	0.3023	0.2465	-0.0877
	<0.0001	<0.0001	<0.0001	<0.0001	<0.0001
PrivateIndividualOwnership%	-0.3181	-0.0027	0.3623	0.1403	-0.0932
	<0.0001	0.7426	<0.0001	<0.0001	<0.0001

StateOwnership%	0.1229	0.0353	-0.1310	-0.0360	0.0199
	<0.0001	<0.0001	<0.0001	<0.0001	0.0159
Spearman's rank correlation (5-year average)	Average Net Income	Average Income Growth	Average Market to Book Ratio	Average ROA	Average Stock Return (including dividend)
TopTenShareholderOnwership%	0.2690	0.0950	-0.0463	0.1811	0.0389
P value	<0.0001	<0.0001	0.0005	<0.0001	0.0036
BODOwnership%	-0.0363	0.1345	0.3725	0.2726	-0.1386
	0.0042	<0.0001	<0.0001	<0.0001	<0.0001
BOSOwnership%	0.0793	0.0865	0.1128	0.1831	-0.1116
	<0.0001	<0.0001	<0.0001	<0.0001	<0.0001
ExecutivesOwnership%	-0.0073	0.1233	0.3491	0.2669	-0.1164
	0.5634	<0.0001	<0.0001	<0.0001	<0.0001
PrivateIndividualOwnership%	-0.2937	0.0329	0.4239	0.1075	-0.1176
	<0.0001	0.0098	<0.0001	<0.0001	<0.0001
StateOwnership%	0.0620	0.0729	-0.1575	-0.0822	0.0770
	<0.0001	<0.0001	<0.0001	<0.0001	<0.0001

As shown in Table 3, ownership concentration significantly boosts company income growth, ROA, and long-term stock return. Insider shareholdings and a larger presence of private investors also significantly enhance company income growth and ROA but have a significantly negative impact on stock returns. The monotonic analysis aligns with our linear analysis, showing even more pronounced results.

Table 4
Monotonic Analysis of Corporate Governance and Company Performance

Spearman's rank correlation	Net Income	Income Growth	Market to Book Ratio	ROA	Stock Return (including dividend)
Duality of BODChair&CEO	-0.1247	0.0142	0.2018	0.0935	-0.0077
	<0.0001	0.0820	<0.0001	<0.0001	0.3361
BOD Size	0.1849	0.0076	-0.2116	-0.0174	0.0196
	<0.0001	0.3705	<0.0001	0.0308	0.0179
BOS Size	0.1539	-0.0131	-0.2402	-0.0981	0.0452
	<0.0001	0.1228	<0.0001	<0.0001	<0.0001
BOD Size scaled by ln(Sales)	-0.1068	-0.0649	0.0225	-0.0244	0.0056
	<0.0001	<0.0001	0.0064	0.0024	0.4949
BOS Size scaled by ln(Sales)	-0.2828	-0.1166	0.1162	-0.0872	0.0193
	<0.0001	<0.0001	<0.0001	<0.0001	0.0195
IndependentBODMembers%	-0.0320	-0.0144	0.0627	-0.0145	0.0018
	<0.0001	0.0894	<0.0001	0.0710	0.8276
Spearman's rank correlation (5-year average)	Average Net Income	Average Income Growth	Average Market to Book Ratio	Average ROA	Average Stock Return (including dividend)
Duality of BODChair&CEO	-0.0929	0.0275	0.1658	0.0635	0.0229
	<0.0001	0.0306	<0.0001	<0.0001	0.0873
BOD Size	0.1660	0.1533	-0.2093	0.0033	-0.0364
	<0.0001	<0.0001	<0.0001	0.7995	0.0100
BOS Size	0.0308	-0.0140	-0.2687	-0.0637	0.0271
	0.0223	0.2982	<0.0001	<0.0001	0.0554
BOD Size scaled by ln(Sales)	-0.0854	-0.0502	0.0034	-0.0511	-0.0416
	<0.0001	0.0002	0.8094	<0.0001	0.0033
BOS Size scaled by ln(Sales)	-0.2376	-0.1248	0.0712	-0.1376	0.0198
	<0.0001	<0.0001	<0.0001	<0.0001	0.1616
IndependentBODMembers%	-0.0323	-0.0603	0.0270	-0.0336	0.0155
	0.0109	<0.0001	0.0561	0.0086	0.2719

Our monotonic analysis reveals that the dual role of the BODs chair as CEO enhances income growth and ROA but does not improve stock returns. A relatively larger BODs size is negatively associated with both ROA and stock return, while a larger BOSs size is also negatively associated with ROA. Additionally, a higher percentage of independent BODs members is negatively associated with ROA. These findings are consistent with our linear analysis. The implications suggest that although larger board sizes and a higher percentage of independent BODs members are often considered indicators of improved corporate governance, their negative impact on company earnings and growth may outweigh the benefits.

Conclusion

Our results indicate that while a larger board size, particularly for BODs, is typically seen as enhancing corporate governance, it actually restricts company growth and negatively impacts ROA and stock return. Conversely, the dual role of the BODs chair as CEO, often viewed as management entrenchment, improves income growth and ROA. Independent BODs members have a mixed effect on company performance: they may enhance long-term stock returns but can negatively affect company growth and ROA. Ownership concentration, an effective corporate governance mechanism, boosts income growth, ROA, and long-term stock return. Insider equity holding benefits company growth and ROA but significantly reduces stock return.

Our results have practical implications. Companies need a balanced governance mechanism and ownership structure. A larger BODs size can hinder both company growth and stock return; however, this negative impact on stock return can be mitigated by increasing the number of independent BODs members. Ownership concentration can positively influence both company earnings and stock return, though a high concentration of insider ownership can negatively affect stock returns. Stock-based compensation is an effective incentive for improving company earnings but should be used cautiously to minimize its adverse effects on stock return.

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