The Game of Powers between Major Shareholders and Management in China

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Abstract

As the differentiation of the two contract major-owner and manager, there are two different types of agency costs-the agency cost of management to shareholders and the principal-agent problem of major shareholders to small shareholders. As the different forms and different levels of counterbalance and conspiracy between major shareholders and managements, the companies form the final result - corporate behavior and performance. That is, the value of the company is the external expression of the game between major shareholders and managements. This paper analyzes the two types of agency costs in a studies framework and discusses how to game between the major shareholders and managements and how to impact on the performance of listed companies with the study samples of China listed companies.

Keyword: agency cost, counterbalance, conspiracy, game

1. Introduction

In recent years, researchers gradually realized that, in the countries during economic structural transformation, one company's agency cost is not simply agency issues of professional managers or occupation issue of controlling shareholder, but a combination of both. China is in this period of gradual transition with some significant institutional characteristics, such as state-owned nature of listed companies, small market size and non-tradable shares. Within the progress of China's enterprises reform, the power of the management grows. It may open up possibilities to abuse of authority or decide their own compensation. Also, a major shareholder is motivated and capable to transfer resources of listed companies. In this context, the agency cost of China listed companies has the characteristics of "double high". On one hand, under the environment of weak market and legal, the problem of major shareholders’ occupation is very serious, especially in those companies with concentric ownership structure. On the other hand, the management is at the center of the company's contract, and the management agency cost of "insider-control" is high, which should be included in the framework of corporate governance analysis.

This article analyzes two types of agency costs in one framework to discuss how the majors shareholders and management of China listed companies game and how influences the performance of the companies. This article focuses on the counterbalance and conspiracy between major shareholders and management, and discusses three interconnected questions: 1, what effects does the ownership structure of major shareholders have on management authority (occupation issue).2, what effects does the management’s authority structure has on the power of major shareholders (tunneling issue).3, what effects does the game of power between major shareholders and management have on the performance of listed companies.

2. Literature Review

Research on the power of major shareholders and tunneling issue: La Porta, Lopez-de-Silanes and Shleifer (1999) found that many large listed companies were not highly fragmented as Berle and Means(1932) forecasted, instead, they concentrated more on one holding shareholder, who controlled the whole company, appointed and supervised the manager and expropriated the interest of other shareholders and creditors. Johnson, Boone, Breach and Friedman (2000) and Baeketc (2004) support La Porta (1999)'s view with South Korea's empirical evidence during the Asian financial crisis. Claessen (2000), Bergstron and Rydqvist (1990), Barelay and Holderness (1989), Zin-gales(1994), Bertrand (2002), Bae (2002) and Atanasov (2005) support La Porta (1999)'s view with empirical evidence from nine Asian countries, Sweden, the United States, Italy, India, South Korea and Bulgaria.

Research on the power of management and occupation issue: Crystal (1991) believed that management holds the most bargaining power to get highly-paid. Academics have since focused on the impact of management power on their interests. Borokhovichect (1997) found that management could influence compensation committees to set up anti-takeover terms, and those management tended to receive higher salaries, more options and more likely to get "golden parachutes". Core etc. (1999) found that when the board was large and many external directors were appointed by the CEO, the CEO got higher paid, but the performance of the company was worse. Cheng (2005) further analyzed companies with management benefit trench, and indicated that those management compensation was unsymmetrical with the performance: Compensation is more sensitive to earnings but less sensitive to loss.

Research on the interaction between shareholders and management: Some academics believed that the major shareholders were beneficial to the supervision of management. Hambrick and Finkelstein (1995) found that the compensation of CEO in the company controlled by the owner was generally lower than those controlled by management. Gravey and Milbourn (2004) further found that management who was protected by the terms of the takeover offer got more rewards for good luck, but less punishment for bad luck. Other academics believed that major shareholder had the incentive to conspire with management to seize the interests of listed companies. E.g. By establishing a game model, Burkart analyzed that major shareholder had to conspire with management to gain private interest. He discussed the issue of sharing private interest between major shareholder and management. Some other studies (e.g. Mike、Burkart、Fausto and Panunzi (2006)) showed that in the case of conspiring with management, major shareholders were more active in the supervision of management, that is, conspiracy enhanced the supervision of management by major shareholders.

3. Hypotheses

3.1 Power of major shareholders and theoccupation issue of management

In different ownership structure, the supervision of management by large shareholders is not always tried and effective. With the change of ownership structure, major shareholders in listed companies may conspire with management to share the private gain. When ownership concentration is low, management dominates while major shareholders have no obvious control over the company. Therefore, major shareholders are more inclined to restrict the power of management to protect their own interests. When ownership concentration is medium, major shareholders enhance the control of listed companies, their self-interest behavior leads to different attitude towards management, causing two results: One is that major shareholders will execute more supervision over management due to enhanced control. Another is that major shareholders will allow the opportunistic behavior of management to share the benefits. Therefore, in this stage, the degree of restriction of major shareholders to management is uncertain. When ownership concentration is high, major shareholders have been dominant in listed companies, with more control over the appointment and compensation of management. They could earn extra return without conspiracy with management. Major shareholders in this stage also have more restriction on management. Based on the above analysis, this article proposes the following hypothesis:

H1a: when the ownership concentration is low, the greater the power of the first majority shareholder of listed company, the lower the management compensation is.
H1b: when the ownership concentration is medium, the influence of the first majority shareholder's power of listed company on management compensation is uncertain.
H1c: when the ownership concentration is high, the greater the power of the first majority shareholder of listed company, the lower the management compensation is.

3.2 Power of management and tunneling of major shareholders

In different ownership structure, management will take different approaches to deal with the tunneling behavior of major shareholders. When the ownership concentration is low, management is in the leading position while major shareholders are not dominant. Management can restrict the opportunistic behavior of major shareholders. When the ownership concentration is medium, major shareholders enhance the control of listed companies, so management has to consider more about the impact on its own interests when restricts the major shareholders. It leads to two results: one is continuing to impose some degree of restriction to major shareholders, the other is condoning the opportunistic behavior of major shareholders to share the benefits. Therefore, the management of this stage will continue to restrict the major shareholders, but the extent will be reduced. When ownership concentration is high, major shareholders have been dominant in listed companies, and management has to condone the tunneling of major shareholders, even directly represent the interest of major shareholders to occupy the interests of minority shareholders. Based on the above analysis, this article proposes the following hypothesis:

H2a: when the ownership concentration is low, the greater the power of the management in listed companies, the more restriction on the opportunistic behavior of the major shareholders.
H2b: when the ownership concentration is medium, the greater the power of the management in listed companies, the more restriction on the opportunistic behavior of the major shareholders.
H1c: when the ownership concentration is high, the greater the power of the management in listed companies, the less restriction on the opportunistic behavior of the major shareholders.

3.3 The game between major shareholders and management and the performance of listed companies

In different ownership structure, the power of major shareholders and the management is constantly changing, so is the impact of their gaming on the performance of the companies. Specifically, when ownership concentration is low, major shareholders could neither carry out effective control over the companies nor easily transfer resources. So they tend to restrict the power of management to protect their interests, which helps improving company performance. At the same time, when the management is in a dominant position, they could easily occupy interests of the companies and hurt the performance, even though with restriction. So this article proposes the following hypothesis:

H3a: when the ownership concentration is low, the performance of listed companies is positively correlated with the power of major shareholder and negatively correlated with management power.
When the ownership concentration is medium, the major shareholders enhance the control of the companies.Their motivation and ability of tunneling is getting stronger. They conspire with the management to gain extra profitsby both sides and hurt the performance of companies. For the management, they can obtain personal gain by conspire with major shareholders. But as the major shareholders are not in full control of listed companies, the counterbalance will of management will rise and improve company performance. So this article proposes the following hypothesis:

H3b: When the ownership concentration is medium, the performance of listed companies is negatively correlated with the power of major shareholder and positively correlated with management power.
When the ownership concentration is high, the major shareholders could completely take control of the listed company. They are able to control the management and transfer the interest of the company through various means, which leads the impact on the performance of listed company uncertain. At the same time, the management has basically lost control of the company. It may supervise the major shareholders, but also tend to be consistent with the interest of major shareholders. Therefore, the influence on the performance of the company is uncertain. So this article proposes the following hypothesis:
H3c: when the ownership concentration is high, the performance of listed company is not related to the power of major shareholders or the management.

4. Empirical Study Design

4.1 Data sources and sample selection

This article selects Chinese A-shares listed companies in Shanghai and Shenzhen Exchanges from 2003 to 2010 as samples. The financial data are mainly from CSMAR database and RESSET database. And the governance data is taken from the Guotaian database. The final sample of the study was 8,832.

4.2Variable

The power of management is directly manifested as occupying the interests of listed companies, while the occupation is directly manifested as controlling their own compensation. Therefore, this article takes management's monetary compensation as an alternative to its "occupation". This article takes the shareholding ratio of the largest shareholder as the measurement of the power of major shareholders.

In inside dealing, when the major shareholders take advantage of higher the supply prices and lower the purchase price to occupy interest of the listed companies, they may increase the main business cost of listed companies. So this article takes gross margin of main business as an alternative to major shareholders' tunneling, and takes "the chairman of the board serve concurrently as the general manager" as representatives of management power.
Other variables are shown below:

Table 1 :Variable Declaration

Sign	Description
CeoPay	Logarithm of the average compensation of the top three executives
Top1	Shareholding ratio of the largest shareholder
Gro_Mar	Profit of main business/Revenue of main business
Apart	Dummy variable. When the chairman of the board serves concurrently as the general manager then takes 1; or takes 0.
Tobin Q	Measure the market performance of listed companies
ROE	Net Profit/Net Assets
Size	Logarithm of total assets at the end of year
State	Dummy variable. If the company is state-owned then takes 1; or takes 0.
AvgPay	Payment to employees in cash/the number of employees
Lev	Total liability at the end of year/total assets at the end of year
Top2_5	Shareholding ratio of the second to fifth largest shareholders
Ind_i	Virtual variables of industry
$Year_i$	Virtual variables of year

5. Empirical Analysis

5.1Power of major shareholders and the occupation issue of management

International accounting standards indicate that the shareholding ratio of 20 per cent is a measure of important influence on the company. When the largest shareholder own more than 20 per cent of company, it will have a significant impact on the company's behavior; when the largest shareholder own more than 50 per cent of company, it will have absolute control over the company. Therefore, this article divides the ownership concentration by the above criteria.

To investigate the influence of the major shareholders' power to the occupation of management, this article builds model and results as follows:

$$\text{CeoPay} = \beta_0 + \beta_1\text{Top1} + \beta_2 ROE + \beta_3\text{Size} + \beta_4\text{State} + \beta_5\text{AvgPay} + \sum a_i Ind_i + \sum c_i Year_i + \varepsilon$$

Table 2 Subsection Research of the relationship betweenthe power of major shareholders and the compensation of management

Variable	CeoPay		
	Low Ownership Concentration	**Medium Ownership Concentration**	**High Ownership Concentration**
Constant terms	1.423^{**} (2.117)	3.615^{***} (13.214)	5.008^{***} (15.311)
Top1 (%)	-0.22^{***} (-2.61)	-0.001 (-1.132)	-0.04^{*} (-1.73)
ROE (%)	0.004^{***} (4.252)	0.006^{***} (8.65)	0.009^{***} (4.841)
Size	0.362^{***} (15.23)	0.223^{***} (21.01)	0.201^{***} (12.49)
State	0.038 (0.943)	-0.065^{***} (-3.23)	-0.246^{***} (-4.56)
AvgPay	0.25^{***} (9.095)	0.184^{***} (14.992)	0.223^{***} (10.976)
Ind_i	Control	Control	Control
$Year_i$	Control	Control	Control
Sample N	1204	5523	2105
Adj_R^2	0.331	0.368	0.56
F	28.392	74.91	46.52

***、**、* indicates that it is significant at 1%、5% and 10% level and the number in ( ) is T value (two-tailed test)

The results of the subsection regression indicate:

In the sample companies with low ownership concentration, the regression coefficient of the largest shareholder's shareholding ratio is -0.22, and the t-statistics is -2.61, which is significant at 1%(p=0.006). It shows that when the ownership concentration is low, the shareholding ratio of major shareholder has a significant negative effect on the compensation of management, and H1a is verified.

In the sample companies with medium ownership concentration, the regression coefficient of the largest shareholder's shareholding ratio are -0.001, and the t-statistics is -1.132, which does not pass the significance test. It shows that when the ownership concentration is medium, the shareholding ratio of major shareholder has no significant effect on the compensation of management, and H1b is verified.

In the sample companies with high ownership concentration, the regression coefficient of the largest shareholder's shareholding ratio is -0.04, and the t-statistics is -1.73, which is significant at 10%(p=0.062). It shows that when the ownership concentration is high, the shareholding ratio of major shareholder has a significant negative effect on the compensation of management. Also, the regression coefficient value (-0.04) is lower than that with low shareholding concentration (-0.22), as well as the negative influence. H1c is verified.

5.2 Power of management and the tunneling of major shareholders

To investigate the influence of the management's power of to the "tunneling" of major shareholders, this article builds the model and results as follows:

$$\text{Gro\_Mar} = \beta_0 + \beta_1\text{Apart} + \beta_2 ROE + \beta_3\text{Size} + \beta_4\text{State} + \beta_5\text{Lev} + \beta_6\text{Top 1} + \beta_7\text{Top2\_5} + \sum a_i Ind_i + \sum c_i Year_i + \varepsilon$$

Table 3：Subsection Research of the relationship betweenthe power of management and gross margin of main business

Variable	Gro_Mar		
	Low Ownership Concentration	Medium Ownership Concentration	High Ownership Concentration
Constant terms	32.431*** (4.09)	59.419*** (11.143)	30.006*** (5.95)
Apart	2.452* (1.699)	1.507** (2.205)	-0.23 (-1.22)
ROE (%)	0.089** (2.45)	0.203*** (10.113)	0.297*** (9.55)
Size	-1.21** (-2.389)	-1.19*** (-5.12)	-0.63 (-1.675)
State	-3.052*** (-2.842)	-2.861*** (-5.33)	-2.75*** (-2.68)
Lev (%)	-0.028** (-2.22)	-0.073*** (-10.64)	-0.215*** (-10.279)
Top 1(%)	0.124 (1.477)	-0.019 (-1.267)	0.084* (1.623)
Top2_5 (%)	0.26*** (4.623)	0.167*** (6.584)	0.027 (1.206)
Ind_i	control	control	control
$Year_i$	control	control	control
Sample N	1201	5472	2098
Adj_R^2	0.265	0.258	0.397
F	13.563	49.692	35.449

***、**、* indicates that it is significant at 1%、5% and 10% level and the number in ( ) is T value (two-tailed test)

The results of the subsection regression indicate:

In the sample companies with low ownership concentration, the regression coefficient of “Apart” is 2.452, and the t-statistics is 1.699, which is significant at 10 %(p=0.079). It shows that when the ownership concentration is low, the management power has a significant positive effect on the gross margin of main business, which also restricts the opportunism behavior of major shareholder. H2a is verified.

In the sample companies with medium ownership concentration, the regression coefficient of “Apart” is 1.507(which is lower than that with low ownership concentration), and the t-statistics is 2.205, which is significant at 5 %(p=0.022). It shows that when the ownership concentration is medium, the management power has a significant positive effect on the gross margin of main business. It restricts the opportunism behavior of major shareholder to a less extent. H2b is verified.

In the sample companies with high ownership concentration, the regression coefficient of “Apart” is -0.23, and the t-statistics is -1.22, which does not pass the significance test. It shows that when the ownership concentration is high, the management power has no significant effect on the gross margin of main business. H2c is not verified, but the negative value of regression coefficient indicates the conniving effect of management power on the behavior of major shareholders.

5.3The game between major shareholders and management and the performance of the listed companies

To investigate the influence of the game between the major shareholders and the management to the companies' performance, this article builds the model and results as follows

$$\text{Tobin Q} = \beta_0 + \beta_1\text{Apart} + \beta_2\text{Top1} + \beta_3\text{Top2\_5} + \beta_4\text{Size} + \beta_5\text{State} + \beta_6\text{Lev} + \sum a_i Ind_i + \sum c_i Year_i + \varepsilon$$

Table 4 : Subsection Research of major shareholders' power andmanagement's power and performance of listed companies.

Variable	Tobin Q		
	Low Ownership Concentration	Medium Ownership Concentration	High Ownership Concentration
Constant terms	10.058*** (12.95)	8.991*** (27.602)	6.404*** (10.11)
Apart	-0.089* (-1.826)	0.069* (1.768)	-0.11 (-1.502)
Top1 (%)	0.029*** (2.581)	-0.05*** (-3.664)	-0.003*** (-2.702)
Top2_5 (%)	-0.002 (-0.408)	0.005 (1.521)	-0.018 (-1.416)
Size	-0.832*** (-10.237)	-0.299*** (-26.64)	-0.203*** (-9.002)
State	-0.123 (-1.42)	-0.059 (-1.117)	0.064 (0.93)
Lev (%)	0.011*** (4.176)	-0.004*** (-4.421)	-0.003** (-2.295)
Ind_i	control	control	control
$Year_i$	control	control	control
Sample N	1183	5467	2069
Adj_R^2	0.411	0.328	0.296
F	26.523	64.88	20.384

***、**、* indicates that it is significant at 1%、5% and 10% level and the number in ( ) is T value (two-tailed test)

The results of the subsection regression indicate:

In the sample companies with low ownership concentration, the regression coefficient of “Apart” is-0.089, and the t-statistics is -1.826, which is significant at 10%(p=0.078). The regression coefficient of shareholding ratio by the largest shareholder is0.029, and the t-statistics is 2.581, which is significant at 1%(p=0.000).It shows that when the ownership concentration is low, the management power has a significant negative effect on the performance of listed companies, while the power of major shareholder as a significant positive effect on the performance of listed companies. H3a is verified.

In the sample companies with medium ownership concentration, the regression coefficient of "Apart" is 0.069, and the t-statistics is 1.768, which is significant at 10 %(p=0.091). The regression coefficient of shareholding ratio by the largest shareholder is-0.05, and the t-statistics is -3.664, which is significant at 1%(p=0.000).It shows that when the ownership concentration is medium, the management power has a significant positive effect on performance of listed companies, while the power of major shareholder has a significant negative effect on the performance. H3b is verified.

In the sample companies with high ownership concentration, the regression coefficient of "Apart" is -0.11, and the t-statistics is -1.502, which does not pass the significance test. The regression coefficient of shareholding ratio by the largest shareholder is-0.003, and the t-statistics is -2.702, which is significant at 1%(p=0.002).It shows that when the ownership concentration is high, the management power has no significant effect on the performance of listed companies, while the power of major shareholder as a significant negative effect on the performance. H3c is partly verified.

6. Conclusions

Since the establishment of China's securities market, all the government, investors, scholars and the community have paid close attention to the establishment and improvement of the governance mechanism of listed companies. The agency cost of management to shareholders and the principal-agent problem of major shareholders to small shareholders have been core issues since. This article shows that the management and major shareholders will conspire in a competitive way to maximizing their own interests. When the interests from counterbalance are larger than that from conspiracy, they tend to restrict each other to monopolize the resources as much as possible. In the other hand, when the interests from conspiracy are larger, they tend to conspire to share the resources. The empirical research in this article shows that, when the ownership concentration increases, the major shareholders' power sequentially has "negative-uncertain-negative" effect on the occupation of management. The management's power has sequentially "negative-positive" effect on the tunneling of the major shareholders. The major shareholders' powers have sequentially "positive-negative-uncertain" effect on the performance of listed companies. The management has sequentially" negative- positive- uncertain "effect on the performance of listed companies.

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