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Assessment of Salient Problems Associated with the Separation of Ownership and Control of Modern Corporations: Evaluation of Solutions and Their Effectiveness

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Abstract: This paper examines the salient problems related to the separation of ownership and control of modern corporations, as discussed in the books 'The Wealth of Nations' and 'The Modern Corporation and Private Property'. It qualitatively analyzes past empirical studies and evaluates the effectiveness of various solutions aimed at alleviating the separation between ownership and control. The analysis reveals that the agency relationship between shareholders and organizational managers underpins the phenomenon of ownership and control separation in modern companies. This separation offers several benefits, including ensuring business sustainability through professional management, efficient decision-making, and maximizing physical capital. Additionally, numerous mechanisms have proven effective in managing these issues. The paper explores management ownership and incentives, independent ownership, and institutional ownership as solutions that they have been found to reduce institutional problems and manage risk avoidance.

Keywords: separation, cause of separation, salient problem, empirical finding, effectiveness analysis

1. Introduction

The separation of ownership and control in corporate entities, along with the associated problems, can be traced back to the works of Adam Smith [1]. In his renowned book 'The Wealth of Nations' (1776), Adam Smith highlighted the agency relationship between owners (equity holders) and managers. Smith (1776) argued that as managers handle the wealth of others, they might not exercise the same level of vigilance in protecting shareholders' interests as partners in a private copartnery. However, the modern interest in this phenomenon has been largely influenced by Berle and Means [2]. In their book 'The Modern Corporation and Private Property', Berle and Means [2] documented the rise of modern corporations in the USA. Marks [3] emphasizes that while separating ownership and control of firms offers certain advantages, it also leads to significant problems, including the principal-agent problem and slower decision-making.

Based on these considerations, this report aims to analyze the salient problems associated with the separation of ownership and control in modern corporations, the solutions in use, and assess the

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effectiveness of these solutions. The report begins with a literature review covering the problems related to the separation of ownership and control, the solutions employed, and their effectiveness. The second part of the report presents a qualitative analysis of past empirical studies, focusing on the effectiveness of various solutions used to mitigate the challenges arising from the separation of ownership and control.

2. Literature Review

2.1. Separation of Ownership and Control

Kostyuk et al. [4] expound that over the past few decades, the separation of ownership and control in publicly listed enterprises has garnered increased attention from researchers and academic professionals. However, this interest can be traced back to the publication of Berle and Means's [2] book titled 'The Modern Corporation and Private Property'. Berle and Means recognized the rise of modern corporations in the United States. They described modern corporations as organized into two structures: the board of directors and the equity holders. Berle and Means [2] were among the first authors to assess and document the evolution of ownership structures in modern corporations. They highlighted the divergent interests of the board of directors compared to the firm's shareholders. The firm's directors, acting as the owners' agents and managing the wealth of others, are expected to exhibit a different level of vigilance in overseeing this wealth than partners in a privately held business. Consequently, Chua and Ab Razak [5] contend that negligence and profusion are more likely to be prevalent in the management of such organizations.

Before delving into the salient problems that exist in the separation of ownership and control of a firm, it is crucial to understand the concept of ownership and control of an entity. Marks [3] explicates that the separation of ownership and control of a corporation can be explained in the context of an owner-managed entity. In such entities, the firm's owner or manager possesses two key characteristics. Firstly, the owner/manager of the entity makes all the management decisions of the organization. Secondly, the owner/manager has claims of the firm's earnings [6]. These earnings are regarded as residual claims and reflect when the costs and fixed claims of the firm have been accounted for.

However, in the context of large publicly listed corporations, equity holders only possess one of these aspects, which is the right to a residual claim of the assets and earnings of the firm. Nevertheless, shareholders do not have control over the day-to-day management of the corporation's affairs [7]. In contrast, the firm's management holds control over organizational decision-making while having little or no residual claims over the firm's assets.

2.2. Causes of Separation of Ownership and Control

According to Berle and Means [2], the separation of ownership and control in modern corporations is caused by several factors. Firstly, the lack of control on the part of equity holders can be attributed to the free-rider problem. The free-rider problem arises when individuals have little incentive to contribute or participate in managing collective resources when they are aware that they can still benefit even without actively contributing. Shareholders may exhibit a free-riding attitude, knowing that they will still receive consistent dividends and see an increase in share price even without direct intervention in the firm's management. Furthermore, with the growth of large corporations, there has been increased ownership of the firm's shares, resulting in no single equity holder owning a controlling stake in the organization. This dispersion of ownership leads to collective action problems, as the lack of collective action among shareholders hinders their ability to effectively exercise control over the firm's affairs [8]. Additionally, for any shareholder to attempt to remove the current management of the organization, they would face significant costs and challenges.

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2.3. Causes of Separation of Ownership and Control

However, the separation of ownership and control gives rise to several significant problems for an entity. The most salient problem elicited by this separation is the agency problem. Adam Smith, in his book "The Wealth of Nations," argued that separating ownership and control of an entity would create a problem, as the management of the firm needs more incentives to undertake their duties with the same degree of vigilance and enthusiasm as owner-managers [9]. This problem is commonly known as the 'agency problem,' as described by Jensen and Meckling [10]. In the agency relationship between shareholders and management, shareholders are the principals, and the management acts as agents. An agency problem arises when the interests and utility functions of the management differ from those of the principals.

Additionally, the agency problem is exacerbated by information asymmetry and incompleteness between the principals and agents. While the equity holders and the board of directors expect the management to make decisions that maximize shareholders' wealth [11], the firm's shareholders may have different insights into the firm's affairs. Due to the managers' superior access to information, the shareholders and board of directors may require assistance in effectively monitoring the management's actions [12]. This information asymmetry creates an incentive for the management to act in a way that maximizes their own utilities at the expense of the capital owners' interests.

Another aspect of the agency problem is managerial risk aversion. As mentioned by Chod and Lyandres [13], the risk preferences of management can diverge from those of the shareholders. Shareholders, who can diversify their investments across multiple firms, are generally considered risk-neutral concerning an individual firm's actions. However, the management's employment security and income are closely tied to the entity's performance and fate. This situation leads to a high level of risk aversion among the management to safeguard their wealth. Consequently, risk-averse management may be less inclined to pursue highly uncertain ventures that could potentially result in business failure, thereby impacting the firm's growth and development.

Furthermore, the separation of ownership and control can lead to slowed decision-making. As explained by Guiso and Paiella [14], various checks and balances are implemented in an organization, such as the board's committees. While these measures contribute to better corporate governance, they can also create bureaucratic processes that impede the management's ability to respond quickly to market changes, such as the implementation of new technologies. This stands in contrast to situations where owner-managers control the organization's affairs and can make investment decisions more expeditiously without numerous consultations.

In response to these salient problems of separating ownership and control in modern corporations, various empiricists and governance practitioners have proposed several solutions. These solutions include the establishment of a market for corporate control, corporate governance oversight, direct managerial incentives, and shareholder empowerment. The analysis section of this paper will provide a critical evaluation of the effectiveness of these solutions in addressing the challenges posed by the separation of ownership and control.

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3. Analytical Review

3.1. Empirical Findings on the Market for Corporate Control

Mechanism	Author (s)	Title of dissertation	Empirical finding
Market for corporate control	Agrawal and Knoeber (1996)	Firm performance and mechanisms to control agency problems between managers and shareholders	Significant relationship between the impacts of debt and corporate control on reduction of agency costs
	Trong and Nguyen (2020)	Firm performance: The moderation impact of debt and dividend policies on overinvestment'	Debt and dividend policies of the selected firms had a negative and significant impact on overinvestment in the entity
	Harvey et al. (2004)	The effect of capital structure when expected agency costs are extreme	High levels of debt reduces the overinvestment and lowers managerial agency costs

Figure 1: Empirical findings on the market for corporate control's effect on salient problems of separation of ownership and control.

(Source: Developed by the Author, 2022)

An empirical study conducted by Agrawal and Knoeber [15] used OLS regression to demonstrate a significant relationship between the impacts of debt and corporate control on the performance of many listed firms in the USA. In another study, Trong and Nguyen [16] analyzed 669 non-financial firms listed on the Ho Chi Minh and Hanoi stock markets from 2008 to 2018 using the dynamic model to assess the relationship between overinvestment, debt, and dividend policies. The study found that the debt and dividend policies of the selected firms had a negative and significant impact on overinvestment. These results were corroborated by Abor and Biekpe's [17] study in the South African SME sector, which focused on SMEs listed on the Johannesburg Stock Market from 1998 to 2004. Their regression analysis revealed that capital structure significantly influenced agency problems in the entities, suggesting that effective monitoring through a higher debt ratio could increase shareholders' value. Conversely, a study by Harvey et al. [18] in the USA found evidence supporting the reconstructing hypothesis. The results suggested incremental benefits when debt was concentrated in entities with high managerial agency costs.

3.2. Analysis of the Effectiveness of the Market for Corporate Control

Based on the empirical findings above, it is evident that the market for corporate control plays a significant role in eliminating moral hazard and adverse selection issues within an organization. The market for corporate control operates in two primary variants. Despite the potential negative tax consequences, the payment of steady dividends to shareholders serves as a signal to the market that the entity manages its free cash flows prudently. Conversely, some scholars, such as Mao [19] and Ganiyu et al. [20] have emphasized that capital structure can also be an effective signaling tool for management. Particularly, a capital structure dominated by debt obligations imposes a responsibility on the firm's management to meet interest and principal repayments to debt holders. Consequently, organizations can strategically use their debt and dividend policies to limit the availability of excessive free cash flow that management might otherwise misuse. In alignment with these findings, Harvey et al. [18] contend that high levels of debt are often concentrated in entities with high managerial agency costs. From the perspective of the board of directors of these firms, the elevated

debt levels act as a deterrent against managers exhibiting opportunistic behavior and misallocating the firm's free cash flows. Consequently, the debt policy of an organization plays a critical role in reducing managerial agency costs and monitoring expenses, thereby addressing the salient problem of agency conflicts between managers and shareholders.

3.3. Empirical Findings on Corporate Governance Structure and Oversight

Corporate Governance structure and oversight	**Huu Nguyen et al. (2020)**	**Corporate governance and agency cost: Empirical evidence from Vietnam**	**Board independence has a negative and significant effect on agency cost; Board size and managerial ownership exacerbated the agency costs**
	Rashid (2016)	Managerial ownership and agency cost: Evidence from Bangladesh	Managerial ownership reduces agency costs
	Mustapha and Che Ahmad (2011)	Agency theory and managerial ownership: evidence from Malaysia	Managerial ownership has an inverse relationship with an entity's total monitoring costs
	Allam (2018)	The impact of board characteristics and ownership identity on agency costs and firm performance: UK evidence'	Board size and board independence were effective measures in lowering agency conflicts
	Wardhana and Tandelilin (2011)	Institutional ownership and agency conflict controlling mechanism	higher the ownership level of institutional investors in a listed firm, the lower the agency conflict and monitoring costs
	Ajay and Madhumathi (2015)	Institutional ownership and earnings management in India	institutional ownership was found a negative relationship with earnings management
	Zajac and Westphal (1994)	The costs and benefits of managerial incentives and monitoring in large US corporations: When is more not better	managerial incentives were not effective in monitoring the activities of the management
	Schäuble (2018)	The impact of external and internal corporate governance mechanisms on agency costs	managerial incentives and ownership had a negative effect on the agency costs
	Allessandri et al. (2018)	Managerial incentives, myopic loss aversion, and firm risk: A comparison of family and non-family firms'	managerial ownership results in decline in myopic risk aversion greater bonus pay for the managers results a decline opportunistic behaviour of management

Figure 2: Empirical findings on corporate governance structure and oversight effect on salient problems of separation of ownership and control.

(Source: Developed by the Author, 2022)

To start with, Huu Nguyen et al. [21] investigated the relationship between corporate governance and agency costs, drawing from empirical evidence in Vietnam. The study assessed managerial, government, and foreign ownership, while agency costs were assessed using the asset utilization ratio. For data collection, the study drew data from 281 listed entities in the Ho Chi Minh stock market in

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2013-2018. Leveraging the OLS, FEM and random effect model, the study made several findings. Firstly, board independence was found to negatively and significantly affect agency costs.

Nonetheless, managerial and government ownership were found to positively and significantly affect agency costs. However, Huu Nguyen et al. [21] result on managerial ownership and agency cost relationship seem to contrast with the majority of findings of other empiricists. For instance, Rashid's [22] study in the Bangladeshi context selects 67 listed firms and finds that managerial ownership reduces agency costs. These findings collaborate with Mustapha and Che Ahmad's [23] study in the Malaysian context. The study draws data from 235 listed companies in the Bursa stock exchange and uses questionnaires and annual reports for data collection. The result of the study shows that managerial ownership has an inverse relationship with an entity's total monitoring costs.

On the other hand, Allam's [24] study in the UK context concurs with Huu Nguyen et al. [21] on the effects of board characteristics on agency costs. The study utilized the panel data regression method on all non-financial entities listed in the FTSE all share index in 2005-2011. The result of the study shows that board size and board independence were effective measures in lowering agency conflicts in these entities and resulting in higher firm performance.

Institutional ownership has also been found to reduce agency costs significantly. Wardhana and Tandelilin [25] investigate the effectiveness of institutional ownership as an agency conflict resolution mechanism in the Indonesian stock market. The study focuses on the listed non-financial firms from 2000-2007. The regression analysis results espouse that the higher the ownership level of institutional investors in a listed firm, the lower the agency conflict and monitoring costs. The study also espouses that the entities' debt and dividend policy also reduced agency conflict in the listed non-financial entities.

Meanwhile, Ajay and Madhumathi [26] assess the relationship between the presence of institutional investors and earnings management. Drawing on panel data methodology and firms listed in the CNX 500 of the Indian stock market, the study finds that firms with higher institutional ownership had higher reported earnings quality. In this case, earnings quality was measured using discretionary accounting accruals. Overall, institutional ownership was found to have a negative relationship with earnings management. Ajay and Madhumathi [26] collaborated on Burns and Lipson's [27] study in the USA. The study utilised data on 448 firms that made accounting restatements in 1997-2002. The study results showed that concentrated institutional ownership harmed incidences of financial misreporting. In the same regard, concentrated institutional ownership was found to improve the effectiveness of monitoring the management of the firms.

Managerial incentives have also been highlighted as practical solutions for the problems that emanate from the separation of ownership and control. Nonetheless, the research findings in this regard have been mixed. For instance, Zajac and Westphal's [28] study of large corporations in the US found that managerial incentives could have been more effective in monitoring the activities of the management. The study leveraged longitudinal data drawn from 400 large US-listed entities. These results are collaborated by Schäuble's [29] study in the German context. The study utilizes data from German firms listed on the Frankfurt Stock Exchange in 2006-2011. Using scholastic frontier analysis to estimate the agency costs and regression analysis to test for the relationship, the study found that managerial incentives and ownership had a negative effect on the agency costs in the listed entities and managerial risk aversion. Alessandro et al. [30] compare the effectiveness of managerial incentives as an effective mechanism for mitigating agency problems and myopic risk aversion. Using data drawn from 1500 S&P 500 firms in 2003-2006, the study found that managerial ownership results in a decline in myopic risk aversion for managers in family and non-family firms. Moreover, the study shows that more fantastic bonus pay for managers results in a decline in risk preferences and opportunistic behavior of management.

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3.4. Analysis of the Effectiveness of Corporate Governance Structure and Oversight

The empirical evidence above demonstrates that corporate governance structure and oversight are highly effective in addressing salient problems such as agency costs, lowering monitoring costs, and mitigating managerial risk aversion. Notably, Huu Nguyen et al. [21] and Allam [24] found that the size of the board has a positive and significant effect on agency costs, implying that larger boards can lead to increased agency costs due to coordination and communication expenses. On the other hand, the presence of independent directors decreases agency and monitoring costs; based on the findings of Huu Nguyen et al. [21] and Allam [24], having independent directors on the board enhances corporate governance oversight in an entity and reduces the agency and monitoring costs borne by shareholders. Independent directors are viewed as effective in providing reassurance to equity holders that the entity is being run professionally and ethically. Moreover, their presence helps neutralize the influence of influential insiders' tendencies toward opportunistic behavior. In many ways, independent directors act as a bridge between equity holders and the firm's management.

Meanwhile, institutional ownership also proves to be effective in reducing agency costs. The results from Wardhana and Tandelilin [25], Ajay and Madhumathi [26], and Burns, and Lipson [27] studies indicate that a concentration of ownership helps reduce agency conflicts and information asymmetry between shareholders and the firm's management. Importantly, the concentration of ownership among institutional investors addresses the problem of ownership dispersion caused by the presence of a large number of shareholders. Additionally, institutional investors can directly influence the firm's management by holding seats on the board of directors, which further reduces monitoring costs and the risk of financial misreporting since these directors actively contribute to setting internal control systems and formulating part of the audit committee.

Furthermore, providing managerial incentives in the form of ownership and financial rewards proves to be effective in aligning the interests of management with those of the shareholders. Schäuble's [29] and Alessandro et al. [30] studies demonstrate that offering incentives to management reduces agency costs for the entity. Moreover, providing bonus pay to the management motivates them to maximize shareholders' wealth and discourages them from engaging in opportunistic behavior, as the interests of management and shareholders converge.

Overall, corporate governance structure and oversight, when implemented effectively, play a crucial role in addressing the challenges posed by the separation of ownership and control in modern corporations. These mechanisms enhance transparency, accountability, and alignment of interests, ultimately benefiting both shareholders and the firm's overall performance.

4. Conclusion

Based on the above analysis, the separation of ownership and control in modern corporations can be explicated by the agency relationship between shareholders and organizational managers. While shareholders own the corporation through their equity stakes, they do not have control over the day-to-day operations of the corporation. Control is limited to aspects such as voting for directors in elections, and the firm's management acts as the shareholders' agent in running the affairs of the corporation. The separation of ownership and control can be observed in various aspects, including the free-rider problem of shareholders and the dispersion of ownership in corporations. However, this separation also gives rise to several significant problems, such as agency conflicts, managerial risk aversion, and slowed decision-making.

The analytical review presented above has highlighted several effective mechanisms for managing these salient problems. These include the strategic use of debt policy and dividend pay-out policy as monitoring measures to address management activities in an organization. Additionally, corporate governance structure and oversight measures play a crucial role in mitigating these challenges.

Notably, managerial ownership and incentives, independent ownership, and institutional ownership have been found to be effective in reducing agency problems and managerial risk aversion. These mechanisms help align the interests of managers with those of shareholders, fostering better decision-making and overall organizational performance.

In conclusion, understanding and addressing the separation of ownership and control are vital for modern corporations to thrive and succeed in a competitive business environment. By implementing effective solutions to manage the salient problems associated with this separation, organizations can enhance their governance, minimize conflicts, and ensure sustainable growth and success in the long run. Further research and ongoing efforts in this area are essential to continuously improve corporate governance practices and maximize the value for all stakeholders involved.

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