Control of Shareholders' Wealth Maximization in Nigeria

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Abstract

This research focuses on who controls shareholder's wealth maximization and how does this affect firm's performance in publicly quoted non-financial companies in Nigeria. The shareholder fund was the dependent while explanatory variables were firm size (proxied by log of turnover), retained earning (representing management control) and dividend payment (representing measure of shareholders control). The data used for this study were obtained from the Nigerian Stock Exchange [NSE] fact book and the annual reports of the six sampled companies from Food/ Beverages and tobacco sub-sector for twenty years (1986-2005) to constitute pooled data of 120 observations. Using auto-regression technique for correcting serial auto-correlation in time series data, the results converge at ten iterations. Results showed that all the independent variables provide good explanation for the model. It was observed that firm size (log of turnover) and retained earnings had positive relationships and statistically significant impacts on the shareholders fund while dividend payment had negative relationship. The results show that turnover and retained earnings are of more significance in the control of shareholders wealth than the dividend payment. Thus, we can conclude that the management of the organizations under the present study is in major control of shareholders wealth maximization objective and impact on the firm performance. Implication is that selecting high quality management for the organizations would help in achieving shareholders wealth maximization objective in organizations.

Keywords

Shareholders wealth, shareholders fund, turnover, total earnings, dividend payment, and retained earnings

1. Introduction

The fundamental and traditional objective of business organizations is maximization of shareholders' wealth. All activities of the organizations are geared towards achieving this objective. One major attribute of public limited liability companies is the separation of ownership from control. Ownership of these companies is usually in the hands of shareholders while the control of the day to day activities is in the hand of management appointed by the Board of Directors. This separation of ownership from control is strength in the sense that it allows division of responsibilities based on specialization. This structure creates principal-agent relationships between the shareholders and managers where the shareholders are the principals and managers are the agents.

Basically, managers as agents of the shareholders are expected to act in the best interest of shareholders, which is to maximize their wealth (that is, the net-worth of the organisations). However, in practice, there is possibility of managers pursuing their own personal objectives (Pandey, 2005; Koutsoyannis, 1979; and

Okafor, 1988). Thus, agency relationship arising from separation of shareholding from control may become weakness where management is tempted to over invest or over-emphasized growth or market shares and would want to maximize its own wealth (which are in form of high salaries and perks) at the expense of maximising wealth of shareholders. Management may avoid taking investment and financial risks that may otherwise be needed to maximize wealth of shareholders. This, however, poses conflict of interest between the shareholders and management. This is what is usually termed as the agency problem.

The gains accrued to shareholders in form of dividends and capital appreciation in the values of the stocks held by them. The stock price appreciation and dividends received constitute the total returns to shareholders. Dividends are payable out of distributable profits and management is not under any obligation to pay dividend (Sections 379-382 of CAMA, 2004). Management is charged with the responsibility of deciding whether to distribute all its earnings (profits attributable to ordinary shareholders) to shareholders in form of dividends or retain part of the earnings to finance future growth. The objective of the study is to determine who controls the wealth that accrues to shareholders, whether it is the management or the shareholders and the effect of such control on the firm's performance.

2. Review of Literature

Historically, the decision-making power of a company lies in the assembly of the shareholders during the general meeting. However, it is only possible if the company is small with few shareholders who often function as the directors, but with big companies, it is impracticable and sometimes impossible for so many shareholders to operate and manage the various functions of companies. Therefore, the shareholders entrust decision making process of the company to a cream of professional and skilled managers. These two groups have divergent interests. The shareholders want to maximize their wealth while the management wants to maximize their gains in terms of salaries and other perquisites. This has led to conflicts of interests between shareholders and managers.

The agency conflict, which arises from the incongruence of the interests of equity owners and managers, has been examined by many researchers (Ahmadu, Aminu and Turkur. 2005; Loderer and Martin, 1997). There is lack of consensus how to deal with such agency conflicts. This has resulted to suggestions of a variety of mechanisms on how to promote the alignment of interests of shareholders and managers.

McConnel and Servaes (1990) found a significant curvilinear relationship between insider ownership and firm performance while Loderer and Martin (1997) found no significant curvilinear relationship. The composition of board members was also proposed to help reduce agency problem. Weisbach (1991) found a positive relationship between firm performance and the proportion of outside directors sitting on the board. Unlike inside directors, outside directors are better able to challenge the Chief Executive Officers. Board size is another mechanism that has been proposed to deal with agency problem.

Yermack (1996) argues in favour of small board size believing that large board rooms tends to be slow in making decisions and hence large size can be an obstacle to change. He examines the relationship between board size and firm performance and concludes that the smaller the board size the better the performance. He proposes an optimal board size of ten or fewer. Ownership concentration in term of the proportion of a firm's shares owned by a given number of the largest shareholders was one of the mechanisms examined. A high concentration of shares tends to create more pressure on managers to behave in ways that are value maximizing. At a low level of ownership concentration, an increase in concentration will be associated with an increase in firm's value but beyond a certain level of concentration the relationship might be negative. The fifth mechanism examined is debt owned; they argued that large creditors such as banks are also believed to be a useful tool for reducing the agency problem.

Jensen and Meckling (2001) argue that the existence of debt reduces the amount of equity and enables higher levels of insider ownership. They also argued that the existence of debt in the firm's capital structure acts as a bonding for company managers, by issuing debt rather than paying dividends, managers contractually bind themselves to pay out future cash flows in a way unachievable through dividend. It can deter management from non-value adding diversification strategies.

Adenikinju and Ajinade (2001) examine the extent to which insider shareholding may be related to firm financial performance. They examine the relationship between internal governance mechanism and financial performance. The results show the need for a reasonable number of directors of corporate bodies with more than a typical share of equity of the firm as this will encourage them to undertake the monitoring process.

Gerald and Useam (2001) reviewed the agency theory and researched on the relations among top managers, company directors, investors and external contenders for corporate control. The study focuses on the major questions raised in most recent work such as who are the top managers and corporate directors? How is management organized? What does the board do? How do shareholders influence corporation? Etc.

Mcolgan (2003) attempts to provide an overview of the major literature which has been developed in the area of agency theory and corporate governance since Jensen and Mecklings (1996) ground breaking article on theory of the firm. It was observed that corporate financial policy structure of a company has strong implication on agency controls. Ahmadu, Aminu and Turkur (2005) observe that the use of insider shareholding has been proposed to resolve the agency conflict and this had produced varying conflicting results.

Jorg, Loderer, and Roth (2005) examine whether managers of corporations pursue shareholders value maximization. A three pronged experiment was conducted: managers' target were analyzed, they studied their valuation metrics and asked whether share-price performance was better when they pursue shareholders' value maximization and use appropriate metrics. The first part of the analyses focuses on whether the managers pursue shareholders' value maximization. It was discovered that greater percentage of the managers does not pursue that particular target. On shareholders value maximization, they first focused on the full sample of firm. A sizeable fraction (81%) wants to maximize shareholders value unconditionally. Another question was asked if managers pursue multiple targets. It was observed that 95% of the firms pursue at least two targets (see Cyert and March, 1992). It was discovered that unlisted firms' managers even profess to maximize both shareholders value and at the same time uncover evidence that the identification of shareholders increases when stock price fall. Accordingly, the reason why managers are willing to state that they do not maximize shareholders value is that the control mechanism to prevent them from the capital market behaves otherwise, particularly in the case of unlisted firms. The threat of takeover is the main mechanism outside the firm that keeps firms from diverging too much from a policy of shareholders value maximization.

In the course of the study the following hypotheses were tested.

1. Companies with high dividend payout ratio are controlled by shareholders while those with high retention ratio are controlled by the management.
2. Companies with high retention ratio experience higher profit and performance than those with high dividend payout ratio. There is understanding that shareholders would prefer income revenue to capital gains. They would prefer dividend payments to retained earnings.

3. Research Methodology

3.1 Method of Data Collection

The data used for this study were collected from the financial statements of companies in the Food/ Beverages and Tobacco sub-sector listed in the Nigeria Stock Exchange between 1986 and 2005. A total of 159 companies were all together quoted on the Nigeria Stock Exchange at that date. Of these, 13 companies were in the Food/ Beverages and Tobacco sub-sector. Out of these 13 companies 6 companies which had complete data on the variables needed for the study were selected using purposeful sampling technique. Some of the companies in this sub-sector were not in existence as at 1980 while some do not have complete data required. The problem of keeping adequate data by

Nigeria Stock Exchange is a major challenge as many companies listed on Nigeria Stock Exchange have no adequate information published on them. Access to individual companies to obtain their past financial statements was not encouraging as most often refer one to the Nigeria Stock Exchange. In all we have 120 data sets pooled from 6 companies over 20 –year period.

3.2. Method of Data Analysis

The data collected were initially analysed using the Ordinary Least Square (OLS) regression technique on the pooled data collected under the assumption of the homogeneity of data. Due to the incidence of a first order serial auto-correlation problem we decided to use auto-regression technique in order to eliminate this problem of first order serial auto-correlation.

3.3 Theoretical Framework

Specifically shareholders wealth control has a significant impact on the performance of a firm. This study suggests a model which seeks to establish the relationship between performance variables of a firm and the shareholders wealth control. The study however takes shareholder fund (sharefund) as the dependent variable while the explanatory variables include firm size (FS) measured as log of turnover, retained earnings (RE) , dividend payment(DP), and total earnings (TE). Log of turnover is the natural log of the total amount realized from sales in a particular period of time. Retained earnings are undistributed profit of the firm in particular period of time representing management control. Dividend payment is the amount of a firm's profit paid to proprietors of the firm representing shareholders control. Total earnings refer to all revenues attributable to a business for a particular period of time after all related expenses have been properly taken care of.

3.4 Model Specification

The model for this study is specified as follows:

$$SHF = b_o + b_1FS + b_2RE + b_3DP + b_4TE + e$$

where:

SHF = Shareholders Fund

Fs = Firm Size (measurable as log of Turnover)

RE = Retained Earnings

DP = Dividend payment

TE = Total Earnings (which is the Profit After Tax, earnings attributable to ordinary shareholders)

$b_o - b_4$ = Coefficients of regression estimators.

e = Stochastic error-term.

4. Data Analysis and Interpretation of Results

The final results of the analysis using the Statistical Package for Social Sciences (SPSS) version 16 are represented below. The regression equation using auto-regression technique, which converges after 10 iterations, is presented as follows:

$$SHF = 42.036 + 0.179FS + 0.119TE - 0.695DP + 1090RE$$

t- values (0.175) (14.292) (0.949) (-3.414) (3.272)

Beta values (0.869) (0.62) (-0.234) (0.177)

R2 = 0.787, Adjusted R2= 0.777, F-stat (4, 114) = 105.01, DW statistic = 1.996.

A close examination of the results presented in the equation above indicates that the R^2 value of 0.79 indicates that about 79% of the total systematic variations in the shareholder's fund (dependent variable) were due to the variations in firm size (log of turnover), total earnings, dividend payment and retained earnings (independent variables). This means that only about 21% of the systematic variations in the shareholders fund are left unexplained hence captured by the stochastic error term in the estimate model. Also, the adjusted R-square of 0.777 shows that after adjusting for the degree of freedom the entire variables taken together could still explain about 78% of the systematic variations in shareholders fund. This implies that the regression line has a very good fit and thus a high forecasting power of the model.

The results showed that the overall model was statistically significant since the observed F-value of 2.45 is smaller than the computer F-value of 105.01. This means that firm size (log of turnover), total earnings, dividend payment and retained earnings (independent variables) taken together have significant impacts on shareholders fund at 5% level of significance. The DW-statistics of 1.996 (~ 2.0) means the absence of auto-correlation in the model. On the basis of the individual statistic, total earnings failed the test of statistics at 5% level of significance under the two-tailed test, since the observed t-value of 0.344 is less than the critical t-value of 1.96. This implies that total earnings are not a major determinant of shareholders fund. The other variables such as firm size (log of turnover), dividend payment and retained earnings passed the test of significance since their observed t-values of 14.292, -3.414 and 3.272 respectively are greater than the critical t-value of 1.96. This implies that firm size (log of turnover), dividend payment and retained earnings are major determinants of shareholders fund.

Furthermore, it was observed that firm size (log of turnover) had a co-efficient of 0.869, which means that an increase in the companies turnover by 10%, would lead to an increase in the shareholders fund by 86.9%. This indicates a strong significant positive relationship between firm size (log of turnover) and shareholders fund. Total earnings with co-efficient of 0.62 shows that increase in the total earnings of company by 10% would lead to an increase in shareholders' fund by 62%, which is not significant at 5% confidence level. Dividend payment with co-efficient of -0.234 shows that 10% increase in the payment of the dividends would lead to 23.4% decrease in shareholders fund. This implies that there is an inverse relationship between dividend payment and shareholders' fund. Retained earnings with a beta co-efficient of 0.177 shows that 10% increase in retained earnings would lead to about 18% increase in shareholders fund, which indicates a positive relationship between retained earnings and shareholders fund.

From the foregoing we can revisit our research question, which is who controls the shareholders wealth maximisation in Nigerian organizations? We observe that turnover has the largest contribution to shareholders fund (with the beta value of 0.8690). This is followed by retained earnings (with the beta value of 0.177) and the least is dividend payment (with the beta value of -0.234). Since, management is in control of generating turnover and would ordinary want to retain earnings for financing future growth while the shareholders are assumed would prefer dividend payment, we can conclude that management of the organizations in Nigeria have major control over the maximization of shareholders' funds.

5. Summary, Policy Implications and Conclusion

The objective of this study is to empirically establish who controls shareholders' wealth and the impact of such control on firm's performance. Results revealed that firm size (log of turnover), dividend payment and retained earnings have significant relationships and impacts on shareholders fund but total earnings does not have a significant relationship and impact on shareholders' fund. It was observed that dividend payment had an inverse relationship on shareholders fund. The firm size (log of turnover) and retained earnings are the major determinants of shareholders fund and have positive relationship and where there is an increase in shareholders' fund it will also increase or boost firm performance. It was discovered also that all the regressors taken together have a good linear relationship with shareholders' fund.

In conclusion as companies grow, there is a tendency for the ownership and management of the business to separate. Due to this separation, there is always a conflict of interest between the management who is interested in ensuring high market shares and could maximize their own wealth (in form of high salary and pecks) at the cost of shareholders who are interested in high dividend payment and returns in their investment. The results showed that dividend payment, which represents shareholders' control in our study, reduces propensity for shareholders wealth maximisation. Furthermore, it was observed that the firm size (log of turnover) and retained earnings representing management control are the major determinants of shareholders wealth maximization. Thus, we can conclude that the management of the organizations under the present study is in major control of shareholders wealth maximization objective and impact on the firm performance. Implication is that selecting high quality management for the organizations would help in achieving shareholders wealth maximization objective in organizations.

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