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Ownership Concentration and its impact on Firm Performance

Usman Mahmood

Department of Management Sciences, the Islamia University Bahawalpur

**Corresponding author email:* Usman@gmail.com

Abstract

The study shows the effect of ownership concentration on the firm's performance – profitability, growth in assets and growth in sales.This thesis studies the influence of ownership concentration on the performance of business or firm. This topic has been a commonly discussed issue among scholars. The results of thesis show that the firm which is closely held by owner managers performs well as compare to the business controlled by hired managers. Owner managers tries to maximize the value of business, make suitable decisions with the intentions of long term benefits. Closely held governance is an effective tool to remove the agency issues. It ensures that all activities are properly managed and decisions are effectively made by managers to enhance the performance of the firm. It also reduces the conflict between the principal and agent as it aligns the interests of principal and agents. In this study firm performance is defined as the profitability, growth, risk and value of the firm. In Pakistan and in other developing countries, almost half of the businesses are closely held by owners so determining the influence of concentrated ownership on the performance of the business is a vital contribution for the betterment of corporate sector.

This research has been conducted in business sector of Bahawalpur and its nearby areas. The financial data of 20 different businesses has been taken for the analysis. The data has been used to analyze the firm's performance. Performance has been measured in three aspects: a) Profitability b) Growth in Assets c) Growth in sales.Their results have been analyzed to find the effect of ownership concentration on firm performance.

Keywords: Ownership Concentration, Profitability, Growth in assets, Growth in Sales

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Introduction

All the businesses have hierarchy of goals. However, the main purpose of any business is to earn profit, with this object business is incorporated. Profit maximization is most generally quoted business goal. Investor invests in businesses to earn profit so; investor attraction is linked with business financial health. Good financial health is favorable for investor. Business chases the separate entity principle. According to this principle owner and business are separate. Shareholders are owners of business.(Hennesay, 2005) They appoint managers and directors to run the operations and daily activities of company in their best interest. So control is hand over to the managers and directors. This relationship between shareholder and managers is known as agency relation - The relation of trust. The conflicts in this relation arises when managers prefer their own interest and maximize their own effectiveness instead of working in the best interest of shareholders, in this situation the value of firm is effected badly. To resolve these problems and to make management's operations effective in business, closely owned ownership structure or concentrated ownership is required.

The relationship between the closely owned ownership structure or corporate governance and firm performances are very important issue in the corporate governance study. In firms' viewpoint, structure of ownership decides profitability of the firms which is shared by all shareholders. [Zeckhouser and Pound (1990)] Ownership structure is an important tool for minimizing the agency costs linked with the separation of ownership and management. Many businesses owned by separate shareholders and managed by hired managers are not doing its best. Firms, as a result, whose owners are isolated from the management activity of the business and have a small portion of total shares, be likely to underperform as studded by Berle and Means (1932). Latter, this abstract relation between ownership structure of firm and its performance is empirically studied by Jensen and Meckling (1976) and Shlefier and Vishny (1986).

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It is oblivious from various studies that only owner-managers have real passion and motivation to run the firm in the best interest. Hired managers cannot have such passion. Closely owned firms are more likely to have better performance because owner-managers try their best to increase the profitability of the firm. They try to reduce the agency cost and make the daily operation of the firm more effective. They use the resources and assets of the firm more efficiently so that they can grow the sales of the firm. In closely owned firm manager do not scarifies long term benefits for current temporary benefits.

In Pakistan and other developing markets most of the business and large firms have concentrated ownership structure. Owners of that firm normally deal with operational activities of the firm. Hired manager's decisions significantly impact the value of organization. Their decisions have two -fold effect. It can result in maximizing the value of firm if these decisions are in interest of shareholders or it might result in poor organizational performance if these are in the self-interest of managers. Researchers have different views about managerial stake in organization. Managers having more stock in organization might enforce them take decisions that are in their best interest to increase their wealth, job tenure and enhancing their value and reputation. A situation of conflict is arises in result of these decisions. To resolve these issues closely held corporate governance is needed to ensure that all activities are properly managed and decisions are effectively made by managers to enhance the value of shareholder wealth and the value of firm. One of the important mechanisms of corporate finance to deal with above issue is board of directors that are hired to monitor the decisions of management and to ensure these are in the best interest of shareholders. This job performed by BOD increases the firm value (Hennesay, 2005). Managers perform those activities that are concerned with fulfillment of their own goals on the investment of shareholders.

Large shareholders do their best for value maximization. They have relatively more authority and intention for value maximization [Jensen and Meckling (1976); Zeckhouser

and Pound (1990); Burkart (1997)]. The practical study about ownership structure says that concentrated ownership has better power and control over hired manager as compare to dispersed ownership. Claessen, Djankov and Pohl (1996 and 1999) said that there is a positive relation between firm performance and shareholding concentration Kocenda and Svejnar (2002) only partly confirmed that study.

Some studies stated that concentrated ownership sometime is the result of weak legal system in the country. The countries that have weak legal atmosphere, the original owners try to hold large positions in their business that has outcome in concentration of ownership. "La Porta, Lopez-de-Silanes, Shleifer" and "Vishny ". In under-developed markets due to weak legal enforcement reasons and under-developed situation of finance oriented markets which permit limited right to use to external financing, results come out in large number of closely owned firms [La Porta, et al. (1997, 1998); Pistor, Raiser, and Gelfer (2000)]. In Pakistan, most of the big firms and large group of industries are hold by the family manager.[Cheema, Bari, and Saddique (2003)]. Moreover, this thesis has broadly discussed the issues of owners and managers about the performance of the business.

Research objectives

The general purpose of this study is to investigate relationship between concentration of ownership and firm performance.

The specific purpose of this study is to examine the effect of closely owned firm structure on firm profitability, growth in assets and growth in sales in Bahawalpur business sector.

Literature Review

Concentrated ownership structure has been believed to affect the efficiency and performance of the firm for many decades. For example, Adam Smith (1776) said that the joint stock companies are relatively less efficient as compare to private companies because hired managers and the directors may be not watch over other people's money

with the same anxious vigilance as their own. Sometime managers are promoting their own financial concerns at the cost of the shareholders, [Hassen (1983),Berle and Mean] claim. Sometime they misuse the assets of firm that declines the worth of the firm. In separately owned ownership hired managers are not monitor closely therefore their operational activities sometime may not recover the financial cost of the business—financial risk. In this situation shareholders have to pay an active attention in electing and nominating managers which influence the selection of the managers who run the business. While Jensen and Meckling (1976) argue that offering of management's share in equity may minimize these agency issues thus make parallel the interest of shareholders and managers. They said that when ownership and management are separated and the hired managers play a part in such actions that may not improve firm value for the best of owners, firm value could be minimized as a result.

When owners are too lazy to watch over the hired manager's work, the manager could use the assets of the firm for their own benefit rather than for maximizing owner's wealth. There is solution suggested by many scholars of this problem that gives the managers stake in equity. This will align managerial interest with of owners and resolve the moral problem.

Himmelberg, Hubbard, and Palia (1999).Stulz (1988) stated that sufficiently high managerial ownership can low firm's value. There are wide-ranging studies on concentrated ownership or closely owned structure that have a significant impact on the performance of the business. Owners and big investors have power over the firm which results in strict managerial control that creates strong incentive for executive managers to take such actions and decisions that could maximize the value of the firm. Gedajlovic and Shapiro (2002) are also says that closely held ownerships well to be found to look after the performance of manager of the firm within their system. The firm performance varies substantially for different types of owners. Pakistan where large share holdings are common [La Porta, et al. (1999); Cheema, et al. (2003)], it seems more interesting to explore the link between concentration of ownership and its performance.

It is claimed that as regards the impacts of concentrated ownership on firm performance, the observed higher efficiency of closely owned business because they are excessively concentrated in large productive sectors [Griffith (1999) and Oulton (2000)]. They monitor actively, balance the inadequate or inefficient monitoring of business Choi and Yoo (2005). There resources are not only financing but also control-enabling property rights and scarce monitoring skills in emerging markets [Khanna and Palepu (1999)].

The agency issues are also a big problem in separately owned business. This study also focuses on principal agent theory and agency issue.The following section gives a review on corporate governance theory with focus on Principal-agent theory and agency problems.

2.2) Corporate Governance Theory (CGT)

2.2. A) Principal agent theory

Williamson (1963) stated the principal agent theory in his expense preference model. According to this model, managerial optional spending can be categorized in two major forms:

1) Utility expenses that has no productivity
2) Profit maximization expense.

Profit maximization is the preference of the principal, on other hand agent's preference is utility maximization. This difference between the preferences of principal and agent may raise the conflicts. Owner wants to cut down unnecessary and unproductive expenses and want to increase the productivity of the firm. However on the other side, when hired managers have a preference of expense for unnecessary staff expenditures, as assumed by Williamson, in this situation owner's preference of profit maximization will encounter with the preference of the utility maximization of management. When the management has the preference of utility maximization they will surely spend more on

need of staff instead of spending on some productive project to increase the value for the firms. These conflicts are the results of separate owned ownership structure that makes owner unable to check operational activities of business done by managers. According to Jensen &Meckling (1976) and Furubotn& Richter (2005), the principal agent relationship is a contract based relationship in which the principal assign specific duties for the agent against some charges.

Agency Problems

Many corporations face a rigorous new difficulty called the agency problem: there is a likelihood that the professional managers who governs the daily activities of the business would go against the shareholder's best interests. These agency problems arise from the separation of ownership and control in the business (Berle and Means, 1932; Jensen and Meckling, 1976; Famaand Jensen 1983).

The result is there should be close monitoring system or any type of contract that aligns the manager's interests and actions with the welfare and wealth of the owners or stockholders. The presence of agency troubles weakens the central theory that modern open-ownership companies are more efficient. It is feasible that in some firms the costs of monitoring and bonding the manager would be too much. It is also probable that in some cases the advantages of large-scale operations and professional management would be minor and insufficient to overshadow the expected agency costs.

Ownership Concentration

Ownership concentration refers to the amount of shares owned by investors. A higher level of ownership concentration or more shareholders suggest a stronger monitoring power from investors over a firm's managerial decisions because of the incentives from these owners to proactively safeguard their investment. [Faccio and Lang (2001)]. Owners with significant amount of shares may take aggressive actions, either directly or indirectly, over firm decisions such as the election of board members and replacement

of CEO or poor management with their voting power. As such, ownership concentration can be an internal governance mechanism that helps reduce the likelihood of managerial opportunism because managers and boards of directors are more likely to take into accounts the preferences and interests of large shareholders [Doidge, Karolyi, Lins and Stulz (2005)].

Monitoring is important because it may encourage managers not to over diversify the company's portfolio of products and/or businesses. Weak monitoring may result in diversification beyond the preferences of shareholders. High or strong levels of monitoring may encourage managers to avoid excessive levels of diversification. Another result of monitoring is that it also may hold down the level of top management compensation (as a result of limiting diversification and, in turn, limiting the size of the company). Research indicates that ownership concentration is associated with lower levels of company diversification.

The ownership definition in this thesis depends on cash flow rights of equity stakes instead of on voting rights. The variable of ownership is ownership concentration. For the sake of deep and clear study, the variable “concentration of ownership” is precisely described into three distinctive groups of owners that are

1) Individual-owners
2) Partner-owners
3) Family-owners

Individual-owners

Individual owner can b e defined as the sole person who owns a personal business. It is also called sole proprietorship. Sole proprietorship, as it is clear from its name, is a one person business. This type of ownership is easy to do because one does not need to fill any kind of special papers or legal file as is being done in corporation business. There is no need to register with the government like private limited or public limited companies.

According to the law, a sole proprietorship or individual ownership is not separable from its owner because the owner and the business are one and the same. This means the income of the business is the income of the person and similarly the loss of the business is the loss of the person. The liability of such type of business is unlimited. If business is unable to recover the loss then the owner will liable to pay all the loss from his or her personal property. Individual owner has significant effect on firm performance. Individual owner works in the best interest of the company to increase the value of the firm. His or her intention is to enhance the growth of the company in terms of sales and assets. He or she make such decisions that rise the profitability ratio of the company.

Partner-owners

In partner owner, there are two or more owners. This type of ownership comes into exits when two or more than two people put together their capital and start a business. They share loss and profit according to predetermine ratio. To register partnership, partners have to fill some paperwork. After the paper work partnership begins as soon as you start a business with another person. Sole proprietorships and partnerships make sense in a business where personal liability isn't a big worry -- for example, a small service business in which you are unlikely to be sued and for which you won't be borrowing much money for inventory or other costs.

Family-owners

The family ownership is defined in this study as the portion of shares which isin custody of husband, wife, daughter, and son and other family members, in general words any persons whose surname are identical. That person may be the family member by birth of by marriage.

Family ownership is very common worldwide. According to La Porta et al. (1999) and La Porta et al. (2000), family owned firms are the most common type of economic organization among the listed companies in 27 countries around the world. Anderson &Reeb (2003) found that more than one third of the S&P 500 companies are family

firms. Family ownership structure has significant effect on the performance to the firm. In this type of ownership, family members act as the controlling managers. This reduces the conflicts between principal and agent and also reduced the agency issue. All the owner-managers try as a family to increase the value of the firm in long run. They do their best for the growth of the firm and make efficient decision.

Firm Performance

Performance is a very general term which can be defined as the completion of a job or task given by someone measured against predetermined standards like speed, accuracy, cost, and completeness. In law terminology, performance is defined as the fulfillment of a responsibilities or obligation in such way that releases the performer from all liabilities which is due under the law. Firm or organizational performance can be measured in term of the actual output or results which a firm gives over specific time period against its predicted or intended outputs —objectives and goals. Richard et al. (2009) said that firm performance includes three specific aspects of firm.

(a) Financial performance of the firm—profits
(b) Product market performance—sales
(c) Growth performance—assets

Other aspects of the firm – operations, strategic plans, legal, and organizational development – also affect the performance of the firm.

So the firm performance is important for the investor. Performance of the firm is influenced by ownership structure or the concentrated ownership style. The firm which is closely held by owners is more likely to perform well as compare to the firm which separately owned as this kind of firm may face agency cost or principle-agent problem.
To narrow down the study for the better result, firm performance is further divided into firm profitability, growth in assets and growth in sales.

Variables of Firm Performance

Firm Profitability

This research focuses that the firm that has owner managers will enjoy high profitability. There are many studies which have stated that the firm that has concentrated ownership will have high profitability ratio as compare to those firms which ownership is separate from management activities of the firm and the firm is controlled by hired managers. The reason is that hired managers do not have fruitful attention as the owner managers have. Profit of the firm has different aspects and concentrated ownership has significant effect of profit of the firm. Profit can be defined in economic terminology as it is the difference between a firm's total revenue and cost. Owner managers try to enhance the revenue of the firm to increase the profit margin. Profitability in term of accounting can be defined as it is the measure of the difference between the purchase price and the costs of bringing to market. Means it is the revenue a company receives from its operational activities less all explicit costs. Accounting profit does not include the opportunity cost of activity. While, economic profit includes the opportunity cost of activity. Firm profitability has positive relationship with ownership structure. The firm which is closely held will has high profitability. Profitability can be sub divided into two main heading. Market related profitability and accounting profitability according to data resources.

Market related profitability measures the growth in stock value with the passage of specific time. In this it is assumed that dividends earned form stocks are reinvested. In short these are the profit earned through capital gains and dividends. On the other side there are some accounting tools to measure accounting profit.

Manager generally uses Return on assets (ROA)and Return on equity (ROE) to measures accounting profitability. The ROE tell about the ratio of return on the equity investment of owners and ROA gives estimation of the return of both equity holders and debt holders. However, ROE is a more sensitive measure in the ownership

research,[Chaganti & Damanpour (1991)]. Thus, ROE is more frequently used to measure the relationship between equity ownership and firm performance .According to characters, the income of the any firm can be classified into two types. The first type of the income is earned from usual operating activity of the firm – the selling of the firm's main product. This income is generated on usual basis and this is normal income also called ordinary income. The second type of income is from non-operating activities. This includes the rents of non-operating assets and the return on non-operating financial assets. This type of income is unusual. If the firm has the owner managers then there will high profit and income.

B) Growth in Assets

A firm which is developing at a fast pace contrasted with its associates or to the wide economy could be called growing firm. Growth in asset measures the change of the total assets, which is the gain/loss of investor (debt holder and equity holder). In other words, it is the increase in assets with the passage of time. In closely owned firm, growth in assets to increase the volume of the firm is the priority of owner managers. It is also called business growth. There are some specific rules that define the growth of the assets. A firm that has one time growth will not be considered as a growing firm, rather, it should show a consistent growth over a number of years. Growth of the assets is an important factor to measure the performance of the any firm. Growing business generates significant positive cash flows or earnings, which increase at significantly faster rates than the overall economy. A growth company tends to have very profitable reinvestment opportunities for its own retained earnings.

Firm growth is important element for the attention of investor. A remarkable growth will attract the investor. Owners try to increase the growth rate of firm. So such ownership which is closely owned will has greater effect on growth of the firm. Hired managers may not work well for the growth.

Growth in Sales

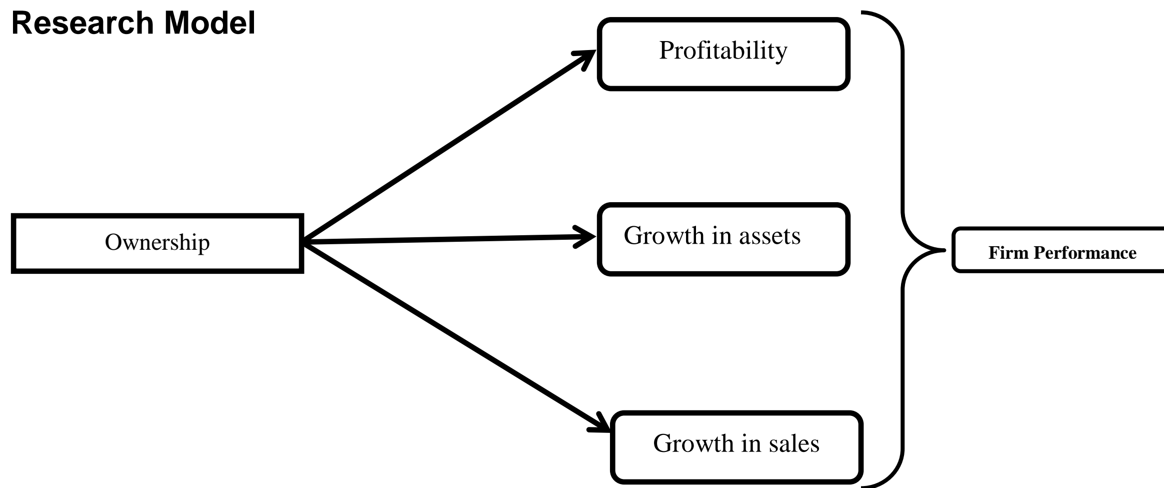
Growth in sales is the growth rate at which sales of the business is increasing over the period (Bracker et al 1988). Growth in sales is an important tool to measure the performance of the business. Concentrated ownership aligns the interest of managers and owners which results in growth of sales. A growing firm normally has the competence to expand yearly incomes over long time period.[Zikmund, (1997)].Owner managers try to enhance the production line of the firm. They go in other markets and expand its area of operations. They target new customers and offer new products with different features by doing expansion in business.

Owner managers will have more enthusiasm to increase the growth rate of the firm so we can say that there is the positive relationship between ownership structure and growth in sales.

Hypothesis

H1: Ownership Concentration has positive impact on profitability.
H2: Ownership Concentration has positive impact on growth in assets.
H3: Ownership Concentration has positive impact on growth in sales.

Research Model



Research Methodology

According to the nature this research falls in the category of Descriptive Research. It can be explained as describing something, some idea, some phenomenon or any particular situation. Descriptive researches are the researches which describe the prevailing situation instead of interpreting and making judgments (Creswell, 1994). The verification of the developed hypotheses that reflect the current situation is the main purpose of the descriptive research. Along with that this sort of research also provides information about the current study scenario and focus on past or present.

Sample Data

In order to collect the data for understanding the situation about Ownership concentration and its impact on the performance of the firm, the financial reports of 20 different businesses has been collected form Bahawalpur and its nearby areas. Financial reports include the income statement/profit & loss account and Balance sheet. Cash flow statement also has been to support the data.

Instrument and Measures

This research is based on secondary data. Accounting tools and statistical methods have been used as instrument to analyze the result to understand the relationship between ownership concentration and its impact on firm performance.

The data includes the financial statements of the companies and businesses. The purpose to analyze the financial statement was to study the variables. These variables include ownership concentration, profitability, growth in assets and growth in sales.

The calculation of the study has been self-solved. The first variable ownership concentration, this variable is independent. And other three are profitability, growth in assets and growth in sales. These were dependent.

Procedure

To understand the relationship between ownership concentration and business performance, the financial statements of 20 different businesses have been collected from Bahawalpur and its nearby areas. The statements were then analyzed with the help of accounting and statistical tools. ROA & ROE were calculated to analyze the profitability of the business. To analyze the growth in assets and in sales, percentage increase in sales and assets over the period was calculated.

Result and analysis

Concentrated Ownership Business

Sr #	Term	Years		Term	Years	
		2012 (%)	2013 (%)		2012 (%)	2013 (%)
1	ROA	6.51	6.45	ROE	18.10	20.80
2	ROA	24.20	33.05	ROE	20.73	27.63
3	ROA	3.85	12.12	ROE	46.01	41.99
4	ROA	24.20	28.54	ROE	20.73	28.05
5	ROA	10.13	5.28	ROE	14.13	10.72
6	ROA	42.91	41.08	ROE	47.90	43.10
7	ROA	18.95	27.25	ROE	49.08	48.01
8	ROA	6.51	6.36	ROE	18.10	19.12
9	ROA	9.90	9.93	ROE	12.80	12.84
10	ROA	1.73	1.83	ROE	11.76	11.89

Separately Owned Business

Sr #	Term	Years		Term	Years	
		2012 (%)	2013 (%)		2012 (%)	2013 (%)
1	ROA	34.65	36.01	ROE	35.67	36.91
2	ROA	6.98	8.29	ROE	19.21	24.49
3	ROA	2.62	3.13	ROE	34.12	37.07
4	ROA	16.72	18.32	ROE	20.14	22.47
5	ROA	2.35	3.07	ROE	1.83	3.48
6	ROA	0.99	1.84	ROE	4.39	12.48
7	ROA	26.47	31.27	ROE	23.36	27.59
8	ROA	1.51	2.99	ROE	6.70	7.29
9	ROA	5.97	11.27	ROE	22.70	23.55
10	ROA	3.40	5.47	ROE	9.10	8.55

Growth in Assets

Sr #	Concentrated ownership business (%)	Separately owned business (%)
1	8.02	-43.90
2	7.25	-4.79
3	15.67	-18.36
4	7.19	-7.35
5	6.45	-14.77
6	22.49	-4.39
7	17.59	-7.69
8	8.73	49.90
9	6.15	5.71
10	39.72	3.25

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Growth in Sales

Sr #	Concentrated ownership business (%)	Separately owned business (%)
1	5.19	-14.41
2	9.1	49.41
3	31.02	-2.64
4	8.03	39.41
5	12.15	-14.29
6	15.77	-7.08
7	38.84	-9.43
8	12.87	-14.42
9	0.57	-2.71
10	12.64	3.64

4.3) Results of data

4.3. A) Ownership concentration and Profitability

Concentrated Ownership business

Terms	Years	
	2012	2013
ROA	14.8890 %	17.1890 %
ROE	25.9340 %	26.415 %

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Separately Owned business

Terms	Years	
	2012	**2013**
ROA	10.1660 %	12.1660 %
ROE	21.7220 %	25.2880 %

According to outcomes of study, the variable ownership concentration has a significant positive relationship with firm profitability. It means ownership concentration affects positively firm profitability. Thus the results validate **H1**.

4.3. B) Ownership concentration and Growth in Assets

Term	Concentrated ownership business	Separately owned business
Growth in Assets (%)	13.99	-4.24

While considering the relationship between ownership concentration and firm growth, the results of current study shows a positive and significant relationship between these two variables. Thus, according to results we accept **H2** and concluded that the study found a positive and significant relationship of ownership concentration and growth in assets.

Ownership concentration and Growth in Sales

Term	Concentrated ownership business	Separately owned business
Growth in Sales (%)	14.62	2.75

Analysis of the Ownership concentration and its impact on firm performance model shows that there is a positive relationship between ownership concentration and growth in sales. The results suggest that if the level of ownership concentration increases growth in sales will also increases. Hence, the results support **H3.**

Conclusion

This thesis shows the effect of ownership concentration on the performance of firm or business. This study has been conducted by analyzing the financial reports. 20 different businesses was chosen from Bahawalpur and its nearby areas to collect the required data. And the result shows that in Bahawalpur, the concentration of ownership seems to have positive effect on firms' performance measures.

Ownership concentration describe the level of the shares that investor hold. If the investor has more shares of the firm or business he will has better control over managerial activities. The investor can closely examine the operational activities of the business. The business which is closely held by owners will remain save from agency issues and other conflicts which is normally raised by hired managers. The interests of owners and managers will be parallel. Such business will grow with faster rate as owners try to find opportunities in market with more passion as compare to hired managers. Owner managers make the decision to increase the value of business for long time period therefore such business is solid, healthy and has very economical friendly financial statements. Owner- managers try to cut down the unnecessary cost and use the resources more efficiently to get high returns – increase profitability measure of the firm.

The results also indicate that there is a positive relationship between concentration of ownership and growth in sales. The firm which is closely held by owner will has less business and financial risk. The findings reveal that owner-managers do their best to increase growth in assets and in revenue. They increase the size of the firm to avail opportunities available in markets.

Since, there is always a space for improvement. There are some limitations in this research. This study gives the view of the business persons in Bahawalpur and its nearby areas. Further research can be done all over the Pakistan. The research conducted over just 20 businesses therefore this shows the results of small community.

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