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## The Separation of Ownership from Control and Firm Performance Evidence from UAE

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### INTRODUCTION

Since Berle and Means (1932) first proposed the hypothesis that the "modern corporation" was characterized by "ownership of wealth without appreciable control and control of wealth without appreciable ownership", a substantial line of research has appeared that addresses the effect of separation of ownership from control on firm performance.<sup>1</sup> There are at least two main versions of the theory of the firm that can explain the effect of the separation of ownership from control on firm performance; the first theory is "the managerial theory of the firm" by Williamson (1963 and 1964), and Mosen and Downs (1965) among others and the second one is "the agency theory" by Jensen and Meckling (1976) and Fama and Jensen (1983b, 1985)<sup>2</sup>. Both two theories expect negative effect on the firm performance due to the separation of ownership from control. Many empirical studies did examine these two theories; however the results are not conclusive. To my knowledge, not one study has been conducted which empirically examines the effect of separation of ownership from control on the performance of UAE firms. This study provides the first insight regarding this issue. The rest of the paper is organized as follows. The next section reviews the literature of the effect of separation between ownership and control on firm performance. Data, hypothesis, and methodology are presented in the third section and finally, the empirical results and some concluding remarks are presented in the last section.

### LITERATURE REVIEW

The theory and empirical research on the relation between ownership and firm performance can be considered as being initiated with the book published by Berle and Means in 1932 on the specialization between ownership and control among large American corporations. Berle and Means argued that the non owner professional managers of the new corporations try to maximize their interests at the expense of the owners and hence they predicted negative effect on the corporate profits due to the separation of ownership from control. The scholars of the managerial theory of the firm such as Williamson (1963 and 1964), and Mosen and Downs (1965) among others expanded on the work of Berle and Means and criticized the traditional economic theory which considers the firm as a black box aiming at profit maximization. The managerialists differentiate between the managers (decision makers) and stockholders (owners) of the firms, especially the large ones, and expect managerial discretion that leads to the expense-preference-behavior by the managers to maximize their pecuniary and non-pecuniary lifetime income. Williamson (1963, 1964) introduced elements of managerial discretion into a theory of the firm in an attempt to examine whether the opportunity for discretion (by managers) has a systematic effect on resource-allocation decisions. Williamson suggested that certain managerial motives (e.g., salary, security, power, prestige, and professional excellence) can result in managerial "expense preferences" for certain types of items. "In particular, staff expense, expenditures for emoluments, and funds available for discretionary investment have value additional to that which derives from their productivity" (Williamson, 1963, P.1034). The implication is that managers may use stockholder resources to maximize their own utility rather than that of the owners.

In the development of their theory of "large managerial firms," Mosen and Downs (1965) offered two central hypotheses: (1) Owners desire to have each firm managed so that it provides a steady income from dividends and gradual appreciation of the market price of the stock and (2) Managers act so as to maximize their own lifetime incomes (Mosen and Downs, 1965, P.225). In discussing these hypotheses, the authors suggested that the behavior of large managerial firms (i.e., firms with diffuse ownership) deviates from profit maximization due to size effects and the separation of ownership and management. Recently, the effect of conflicting interests of owners and managers has been investigated by Jensen and Meckling (1976) under the heading of "agency theory" which views the firm as a nexus of contracts between owners who hold decision rights over the resources combined in the firm and the managers as agents for the owners. Jensen and Meckling argued that the agency problem arises whenever the manager of a firm owns less than 100 percent of the firm's common stock. If the firm is managed by its owner, the owner-manager will presumably operate so as to maximize his or her own welfare, with welfare measured in the form of increased personal wealth, more leisure, or perquisites. However, if the owner-manager sells some of the stock to outsiders, a potential conflict of interests immediately arises. Now the owner-manager may decide to lead a more relaxed lifestyle and to work less strenuously to maximize shareholder wealth, because less of this wealth will accrue to him or her. Also, the owner-manager may decide to consume more perquisites, because some of these costs will be borne by the outside shareholders. The agency theory expects negative effect on the firm performance caused by the separation of ownership and control and calls it "the agency cost". Jensen and Meckling argued that the agency cost consists of: on-the-job consumption, the monitoring costs, the bonding costs and the residual loss. Later, Fama and Jensen (1983b, 1985) defined it as the cost of writing and enforcing contracts between owners and managers, and considered it as a key factor to the success and continuity of different forms of organizations. Jensen and Meckling (1976) and Fama and Jensen (1983b, 1985) among others argued that the large firms with dispersed share ownership will face the conflicting interests of shareholders and managers by introducing control mechanisms that lower agency costs, but these will also have their own implementation costs. Fama and Jensen (1983a) suggest that such control mechanisms most often imply the allocation of some steps of the decision process to owners and some to managers. Alternatively, the agency costs may be avoided by allocating all the steps in the decision processes to the same agents and, at the same time, making those agents the residual claimants of the firm. It is worth mentioning that recently, many researchers have treated this issue through the theme of corporate governance which is concerned with the system by which corporations are directed and controlled (e.g., Shleifer and Vishny, 1997). In this setting some scholars admit the hypothesis of the negative effect on performance due to the separation between ownership and control but meanwhile they think that through incentives and/or one or more disciplining mechanisms (e.g., stock market, takeover market, and labor market) managers are effectively constrained from taking actions that are not in the best interests of the owners.

### **Empirical Evidence**

Table 1 shows examples of some recent empirical findings. As pointed out earlier both of the managerial theory of the firm and the agency theory generally predict that the separation between ownership and control results in poor profitability and returns for the owners. Substantial body of empirical work has subsequently been undertaken in order to test the hypothesis formulated from the theoretical analysis, with mixed results. By far, the most common method used by researchers to partition samples into desired groupings was to define OC and MC firms on the basis of some percentage stock ownership and the voting rights inherent in them. This methodology was applied to large corporations traded in the efficient western stock market. However, some studies have used another methodology such as family companies (represent the OC firms) versus the non family companies (which represent the MC firms). That methodology had been applied to both the traded and non traded firms and applied also to large and small firms.

**Table 1** Examples of Recent Empirical Studies <sup>a</sup>

Study	Data	Measurement of Performance	Results <sup>b</sup>
JacQuemin & Ghellinck (1980)	French (1970-1974)	Cash flow/equity	No
Levin & Levin (1982)	American (1967-76)	Market Return	Yes
Maddin (1982)	American (1968-1973)	Market Return	No
Demsetz & Lehn (1985)	American (1976-1980)	Accounting & market Return	No
FizRay & Kraft (1986)	Germany (1977,1979)	Cash flow/assets	Yes
Murali & Welch (1989)	American (1977-1981)	-Market return - ROE and ROA	No
McConnel & Servaes (1990)	American (1976, 1986)	Topin's Q	No
Leech & Leahy (1991)	British (1983-1985)	ROE & the largest salary	Yes
Prowse (1992)	Japanese (1979-1984)	Return on equity	No
Gorritz & Fumas (1996)	Spanish (1990-1991)	Efficiency (value added) Return	Yes/No
Ang, Cole & Lin (2000)	Small American Firms (1992)	The expense ratio The asset utilization ratio	Yes
Fosberg & Rosenberg (2003)	American (1990-1996)	The expense ratio The asset utilization ratio Dual leadership structure	Yes
Barontini & Caprio (2004)	675 firms from 11 European countries (1999-2001)	-Tobin's Q -ROA	Yes

a- This table has benefited from and completed on the one of Hunt (1986, P. 102-104).

b-The answer yes indicates that the results support the expectation of the managerial theory of the firm and the agency theory which predict that the OC firms will outperform the MC ones.

## DATA AND METHODOLOGY

### Objective and Data

To my knowledge, not a single study has been conducted which empirically examines the effect of separation of ownership from control on the performance of the UAE firms. Therefore, it is hoped that this study will provide some evidence regarding this issue. The study aims at examining empirically the effect of the separation of ownership from control on the firm performance through the comparison between the performances of two categories of the UAE firms: owner-control (OC) versus manager-control (MC).<sup>3</sup>

The first category which consists of 24 owner-control (OC) firms that takes the legal form of sole proprietorships or partnerships. They are not listed in the organized stock market nor traded in the OTC, small size in terms of total assets (average AED 28,447,534) and sales (average AED 34,433,943) and more importantly are managed by the owners who are mostly from one family or close friends.<sup>4</sup>

The second category consists of 25 manager-control (MC) firms that take the legal form of corporations. Most of them are listed in the organized stock market, large size in terms of total assets (average AED 2,061,940,112) and sales (average AED 720,320,564) and more importantly are managed by the non owner managers most of them are foreigners. However, those firms have high level of ownership concentration ratio and large shareholders either in the shape of individuals, or institutions or government.<sup>5</sup>

The empirical study uses the accounting data of 49 non financial UAE firms covering many economic activities in only three sectors: manufacturing, commercial and services. The study did not include any firms from the agricultural sector. The choice of the firms included in the empirical

study was based on the availability of data in addition to the control-type. The dependent variable and the explanatory variables are measured as averages of the data of the five years (2002-1998).<sup>6</sup>

### **Hypothesis and Model**

The paper tests the following null hypothesis "There is no significant impact of the control-type upon the performance of the UAE firms". Cross-sectional multiple regression model is employed to test the hypothesis:

$$Y = a + b_1 CT + b_2 SIZE + b_3 LEV + b_4 RISK + b_5 MANU + b_6 SERV + b_7 COMM + e$$

Where:

Y is the dependent variable which represents the firm performance measured by three variables as follows: (1) the return on equity (net profit/equity), (2) the asset utilization (Sales/total assets) and operating expenses ratio (operating expenses/sales). The first variable (ROE) measures the managerial efforts to realize profit for owners and used in many previous studies such as JacQuemion and Ghellinck (1980). The last two are proposed by Ang, Cole, and Lin (2000) as measures for the agency costs and recently have been used by Fosberg and Rosenberg (2003).

CT is an independent variable representing the control-type and is measured by a dummy variable takes the value (1) if the firm is MC, or it assumes (0) value if the firm is OC. The expected sign is negative as hypothesized by both, the managerial theory of the firm and the agency theory.

SIZE is a control variable representing the firm size and was used in many previous empirical studies as shown in table one because it has direct effect on the firm performance. The study measured firm size by the natural logarithm of the firm's net sales. No expected sign because the results of previous studies were mixed. (e.g., Kumar, 1996)

LEV is a control variable representing the financial leverage and has a deep effect on firm performance as concluded by a lot of empirical studies such as Gorriz and Fumas (1996) among others. The study measured the leverage by the total debt as a percentage of the total assets. No expected sign because leverage has, studies indicate, mixed effect on firm performance (e.g., Ross, Westerfield and Jaffe, 2002, P. 390 – 452)

RISK is a control variable used by several studies based on the expectation of the managerial theory of the firm that the MC firms have less return and less risk comparing to the OC ones as predicted by Monsen and Down (1965). The study measured the risk by the coefficient of variation for the ROE

MANU, SERV and COMM are three control variables representing the industry effect as used by several studies such as McKean and Kania (1978). The three variables stand for manufacturing, services and commercial respectively and are measured by three dummy variables (1, 0).

Table 2 shows the mean, standard deviation, minimum and maximum values of all the variables for both of the OC and MC firms.

**Table 2** Descriptive Statistics for All Variables

<b>Panel A: Owner-Controlled Firms</b>					
Variable	N	Mean	StDev	Minimum	Maximum
EXPR	24	0.2336	0.2366	0.0378	0.8301
ASSU	24	1.3560	0.8780	0.0787	3.3100
ROE	24	0.2112	0.1210	0.0200	0.4600
CONT	24	0.0000	0.0000	0.0000	0.0000
MANU	24	0.2500	0.4423	0.0000	1.0000
COMM	24	0.4170	0.5040	0.0000	1.0000
SERV	24	0.3333	0.4815	0.0000	1.0000
LEV1	24	0.4799	0.2447	0.0096	0.8815
SIZE	24	6.9930	0.8260	5.1770	8.5010
RISK	24	0.7900	0.6390	0.0982	2.8970
<b>Panel B: Manager- Controlled Firms</b>					
Variable	N	Mean	StDev	Minimum	Maximum
EXPR	25	0.3625	0.3220	0.0393	1.1140
ASSU	25	0.3615	0.2496	0.0638	0.8446
ROE	25	0.0852	0.0817	-0.0500	0.2800
CONT	25	1.0000	0.0000	1.0000	1.0000
MANU	25	0.5600	0.5070	0.0000	1.0000
COMM	25	0.0800	0.2769	0.0000	1.0000
SERV	25	0.3600	0.4899	0.0000	1.0000
LEV1	25	0.2833	0.2007	0.0182	0.7516
SIZE	25	8.3050	0.6380	7.2630	9.8290
RISK	25	0.6600	1.5410	-3.236	6.0080

Table 3 shows the correlation matrix of the explanatory variables. As shown in the table the highest correlation coefficient is 0.673 between the size and control type and all the correlation coefficients are less than (0.80) which means that there is no multicollinearity problem Gujarati (1995, P. 335 – 339).

**Table 3** The Correlation Matrix for the Variables

	EXPR	ASSU	ROE	CONT	MANU	COMM	SERV	LEV1	SIZE
ASSU	-0.347								
ROE	-0.099	0.614							
CONT	0.226	-0.622	-0.530						
MANU	-0.124	-0.301	-0.426	0.315					
COMM	-0.336	0.392	0.286	-0.391	-0.473				
SERV	0.431	-0.043	0.181	0.028	-0.605	-0.415			
LEV1	-0.178	0.358	0.417	-0.410	-0.414	0.256	0.196		
SIZE	0.055	-0.297	-0.126	0.673	0.069	-0.078	-0.000	0.029	
RISK	-0.173	0.023	-0.093	-0.056	0.003	0.031	-0.031	0.077	-0.037

**RESULTS**

**Empirical Results**

From the regression results as shown in table 4, it can be concluded that the first two models of return on equity (ROE) and asset utilization (ASSU) are highly significant in terms of both of the p-value and the F statistic. However, the third model of operating expense ratio is not strong as the first two models in the level of the p-value and F statistic.

**Table 4** The Regression Results

	ROE	ASSU	EXPR
Intercept	- 0.0748 (-0.53) <sup>a</sup>	+0.3680 (+0.38)	+0.6409 (+1.67)
Control Type	- 0.1724 (-3.5)	- 1.0287 (-3.06)	0.0803 (0.60)
Manufacturing	- 0.06045 (-1.80)	-0.0479 (-0.21)	-0.2614 (-2.86)
Commerce	-0.02584 (-0.67)	0.2345 (0.89)	-2.959 (-2.81)
Leverage	0.01938 (0.26)	0.1564 (0.31)	-0.2153 (-1.08)
Size	0.04466 (2.04)	0.1195 (0.80)	-0.0127 (-0.21)
Risk	0.01217 (-1.03)	-0.0101 (-0.13)	-0.0335 (-1.05)
F	5.63	5.31	2.87
P	0.0000	0.0000	0.019
R-Sq(adj)	36.7%	35.0%	19%

<sup>a</sup> Values between parentheses are the (t) statistics

#### Analyzing the results in details reveals the following conclusions

- The first two models of return on equity (ROE) and asset utilization (ASSU) are robust where the p-value is zero and the actual F statistics (5.63 for ROE model and 5.31 for ASSU model) are greater than the tabulated ones (approximately 2.74) at  $\alpha = 5\%$  with degrees of freedom (6 and 42). So, there is a strong evidence to accept the alternative hypothesis which states that there is a significant difference between the performance of the MC firms and the OC firms measured by both the return on equity and asset utilization. On the other hand, even though the third model of the operating expenses ratio is accepted where the p-value is (0.019) which is not low enough and the actual F statistic (2.87) is slightly greater than the tabulated one (approximately 2.74).
- The main conclusion of the study is that the control-type (MC firms) has a significant negative effect on firm performance measured by both of ROE and asset utilization, but week positive effect if measured by operating expense ratio. As Monsen, Chiu and Cooley (1968, P.440) the return on equity measures the effects of management's efforts to provide a return on the owners' investment, so the professional managers of MC firms provide poor efforts for the owners. In addition, Ang, Cole and Lin (2000, P. 86) state that a firm whose sales-to-asset ratio is lower than the base case firm experiences positive agency cost which arises because the manager acts in some or all of the following ways: makes poor investment decisions, exerts insufficient effort, resulting in lower revenues; consume executive perquisites, so that the firm purchases unproductive assets, such as excessively fancy office space, office furnishing, automobiles, and resort properties.
- Overall those results support the expectations of the managerial theory of the firm and the agency theory. In addition the results are consistent with the results of several previous studies such as Levin and Levin (1982), FizRay and Kraft (1986), Leech and Leahy (1991) Ang, Cole and Lin (2000), Fosberg and Rosenberg (2003) and Barontini and Caprio (2004) but inconsistent with some other studies such as JacQuemin and Ghellinck (1980), Maddin (1982), Demsetz and Lehn (1985), Murali and Welch (1989), McConnel and Servaes (1990) and Prowse (1992).
- The R-sq (adj) of the two models is some what low (36.7% for the model of ROE and 35% for the model of asset utilization) which means that there may be missing control variables such as: The market structure, the compensation package for the managers, the dividends, the systematic

risk (beta), the unsystematic risk, managerial ownership, employee ownership, institutional ownership, diversification and the age of the firm.

- The results reveal that the sector (industry)–type has little effect on firm performance, where the dummy variables of both of manufacturing and services have negative significant effect on the operating expenses ratio. We have to interpret this result with reservations because we do not have the same classification of the industry type as in USA or western countries (two, three or four – digit SIC code) as measured in details in the literature by Sorensen (1974) and Kania and Mckean (1976) among others.
- The firm size has positive significant impact on ROE indicating that the large firms outperform the small ones in terms of the return on equity. On the other hand, the firm size has no significant effect on both of asset utilization and operating expense ratio. This result supports the managerial theory of the firm which assumes that the firm size is an endogenous variable. (JacQuemin and Ghellinck, 1980, P. 83)
- The financial leverage has no significant effect on firm performance in the three models. This result may be interpreted as a result of the trade-off between the debt advantages such as the interest tax shield and the disadvantages such as the bankruptcy and agency costs. However, this result may motivate researchers to study the interactive effect of the ownership structure and the using debt on firm performance from the following two view points: the free cash flow hypothesis and the monitoring by banks as creditors.
- The risk measured by the coefficient of variation of the ROE shows negative but insignificant effect on the performance. This result does not support the expectation of the managerial theory of the firm that the MC firms have less return and less risk as compared to the OC ones as predicted by Mosen and Down (1965). However, this result may be attributed to the low number of observations used to calculate the risk (only five years).

## CONCLUSION

This paper provides the first empirical evidence regarding the effect of separation between ownership and control on the performance of UAE firms through testing whether there is a significant difference between the performances of 24 owner-controlled (OC) firms versus 25 manager-controlled (MC) firms using the averages of the accounting data over the five years 2002–1998.

The results show that the owner–controlled UAE firms significantly outperform the management–controlled ones when the performance is measured by the return on equity and the asset utilization. The overall results support the expectations of the managerial theory of the firm and the agency theory. We may justify the results by either the moral hazard problem (the condition under which the owners cannot be sure if the managers have put forth maximal efforts or act in the best interest of the owners) and/or the adverse selection problem (the condition under which the owners cannot ascertain if the managers accurately represent their ability to do the work for which they are being paid) in the manager-controlled UAE firms.

Future research may enhance our knowledge about the relation between ownership and performance in UAE firms by investigating the effect of different ownership patterns of the MC firms (e.g., institutional, managerial, non manager employees and government ownership) and testing the impact of some related variables such as the management choices of the accounting policies and methods.<sup>7</sup> Future research may also improve on the sampling procedure and the statistical and methodological approaches, for example, testing the performance of the family firms versus the non family ones, using other measures of performance such as the market return and using the data of larger samples and for longer time periods.

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## NOTES

1. The interest of the subject has been dated to much longer when Adam Smith in 1776 argued that "The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company" as quoted in Jensen and Meckling (1976, p. 305).
  2. The stakeholders' theory is a new version of the theory of the firm has got a great recognition in recent years (e.g., Donaldson and Preston, 1995).
  3. There is a common belief that the UAE economy is dominated by family companies and hence it could be better to test the effect of the separation between ownership and control through comparing the performance of the family companies versus the non-family ones, unfortunately I could not get the statistics that can confirm or deny that belief and I could not get the ownership data to distinguish between family and non family firms.
  4. Even though the federal law 8/1984 regarding the commercial companies are not allow the foreigners to own more than 49% of any UAE firm, some researchers believe that most of the UAE sole proprietorships and some of the partnerships are effectively owned and managed by foreigners but cosmetically owned by the national UAE people in return for getting an annual predetermined reward (Al Shamsi, 2001, P.144-145).
  5. The board of directors of most of those firms are composed from the large shareholders, so I excluded the firm if its key manager, chief executive manager or general manager, is on its board of directors to make sure that all the firms in this category are MC firms.
  6. Due to the restrictions imposed by the unavailability of the data and the weak financial disclosure in UAE, I have used the data of the five years (1999-2003) or (1997- 2001) for few firms out of the total 49 firms.
  7. Considerable research has been aimed at determining the motivations behind the management choices of accounting methods such as: income smoothing or earning management, depreciation methods, information misrepresentation, inventory methods such as LIFO and FIFO and reporting the investment tax credit (Hunt, 1986, P.113- 119). This issue is very important and recently has been treated as an essential part of the topic of the corporate governance especially after the systematic news about the accounting fraud and its contribution in the recent financial scandals such as Enron, Worldcom, and Adelphia in the late 1980s and early 1990s.
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