

Internal Corporate Governance Mechanisms and Agency Cost: Evidence from Large KSE Listed Firms

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Abstract

The purpose of the study is to analyze various corporate governance mechanisms that reduce agency cost. For the period 2003-2010 we have selected 120 firms on the basis of market capitalization listed on the “Karachi Stock Exchange”. We used two proxies’ asset utilisation and asset liquidity ratios to measure agency cost. A higher asset utilization ratio means lower agency cost whereas a higher asset liquidity ratio means higher agency costs. Board and committee activities, board size, CEO/Chair duality, CEO tenure, %Block ownership, %largest investor and debt financing are used as independent variables. The result shows that variables board and audit committee activities and asset utilisation ratio has strong positive correlation. However block ownership, board size, duality and asset utilization ratio appears to have negative correlation. When we use asset liquidity ratio as the dependent variable agency cost is reduced with frequent board meetings. The variables board size and CEO tenure has positive correlation with asset liquidity ratio. Block ownership and asset liquidity ratio has negative association. Furthermore variables duality, debt financing and largest investor has insignificant relation with asset liquidity ratio.

Keywords: Asset Utilization Ratio, Asset Liquidity Ratio, Corporate Governance.

1. Introduction

Corporate governance can be defined in many different ways, for example Investors are the suppliers of finance to a corporation therefore corporate governance deals with investor protection in regards to their investment Shleifer and Vishny (1997). According to Organization for Economic Co-operation and Development (OECD) corporate governance is a set of relationships between a firm’s shareholders, its board and other stockholders. According to Allen and Gale, (2001) the focus in corporate governance is on corporate control through affective corporate governance mechanisms to force managers to pursue principles interests. In the view of Jensen and Meckling (1976) agency relationship is a contract in which the principle (shareholders) hire an agent (manager) to act on his behalf. The agent has a responsibility to fulfill certain obligations for the shareholder, which include maximization of the wealth of shareholders. However according to Jensen and meckling these agents sometimes overindulge in personal pursuit at the expense of maximising shareholders wealth. Managers are responsible for the daily operations of the firm because they are the agents of the shareholders they have inside information which they can use for private benefits. Thus a conflict exists between the two parties because their interests are not completely aligned. According to Jensen and meckling (1976) the agency problem give rise to the agency cost which is a sum of the monitoring cost, bonding cost and residual loss.

In previous corporate governance literature various mechanisms have been suggested to prevent the agency problem and to mitigate the agency costs. These mechanisms include hiring of high quality external auditors, foreign listing, small size boards, debt financing, splitting the CEO and chairman position and monitoring through financial institutions. According to Gul et al, (2012) previous studies which focus on CG and agency

cost association include, a study on US non-listed firms by Ang et al. (2000), similarly using a large sample of US listed firms Doukas, Kim and Pantzalis (2000) and Singh and Davidson (2003) investigated the same issue, Darren Henry (2004) and Fleming et al. (2005) explored the influence of CG on agency cost in Australia, Florackis and Ozkan (2004) and Doukas et al. (2005) during the period 1999 to 2003 investigated the issue in the context of UK.

Most of the work done so far on the issue covers only developed countries, and there is lack of research in developing countries, thus to fill this gap we are trying to explore whether results obtained from developed countries also applied to developing countries. The aim of the paper is to analyze different CG mechanisms and to study their influence on agency cost in Pakistan for a large sample of listed firms. For this purpose we have studied different CG and ownership structure variables suggested in prior literature that reduce agency cost arising from the agency problem. The remainder of this paper is organized as follows. Section 2 discusses the previous literature and hypothesis. Section 3 consists of methodological issues. Finally, Section 4 presents the empirical results and section 5 concludes.

2. Literature Review

2.1 Board and Committees Activities

We have used two variables number of board meetings and number of audit committee meetings during the year to measure board and committees' activities. Previous literature on the association between CG and agency cost predicts that more frequent meetings by board and audit committee members should be related to lower agency costs because management performance will enhance with increased activities by board and committee members which will result in the reduction of agency cost Kanagaretnam et al. (2007). Furthermore they find an inverse association between activities and bid-ask spread a measure of agency cost. Thus we predict that agency cost will be reduced with increased board and committee meetings because increased number of meetings is an indication of active board.

H1: agency cost will be lower with increased number of board and committees meetings.

2.2 Block Ownership

According to Shleifer and Vishny (1997) and Florackis and Ozkan (2008) large shareholders with significant stakes in a firm can more efficiently monitor management because of their greater incentives. More over companies with concentrated ownership where there are few large shareholders can enhance their long run performance by minimizing agency cost because in such ownership structure family owners are the managers of the firm thus firms with large shareholders are more capable to reduce agency cost Campbell and Frye (2006); Kini and Main (1995); Pawlina and Renneboog (2005). In contrast according to O'Neill and Swisher (2003) and Fehle (2004) higher ownership by financial institutions is linked with a lower degree of informed trading, and not all types of institutions can cause reduction in asymmetric information. Large shareholders will pursue their own self interests at the expense of minority shareholders, and in order to increase their earnings and dividends large shareholders continuously forces firm's management towards unacceptable practices Clarck (2007). There are two variables used in this article as a proxy for block ownership, % block ownership (BLOCKOWN) which is measured as the fraction of outstanding shares owned by family members, and financial institutions, and % largest investor (LARGINV) is defined as the fraction of outstanding shares owned by the largest block-holder.

H2: There is a positive relationship between the ratio of block ownership and agency cost.

2.3 Board Size

Yermack (1996) argues that small boards are related to better firm performance. As compare to small boards large boards are associated with increased problem of communication and coordination, and decreased ability to control management. When board size increases conflict of interests rises and it is difficult for CEO to control larger boards. According to Pearce and Zahra (1991) boards that are small in size are more effective and organizationally functional Gul et al. (2012). In a study Singh and Davidson III (2003), finds that firms with higher utilization ratio are associated with minimum agency cost. However on the opposite side for a sample of UK listed firms for the period 1999-2003 Florackis and Ozkan (2004) uses asset turnover ratio as a proxy for agency cost and explored that board size and turnover ratio are negatively correlated, indicating greater agency costs for larger boards. Similar to Florackis and Ozkan (2004); Beiner et al. (2004) and Eisenberg et al. (1998) found the same results.

H3: Smaller boards have lower agency costs.

2.4 CEO Tenure

Prior literature on the link between CEOTEN and agency cost predicts that CEO becomes more powerful and entrenched once his tenure increases and thus he values his own interests as compare to shareholders interests.

The reason is that CEO reduces monitoring capability of the board because he is in a position to control the make-up of the board Jensen (1993) and Hermalin and Weisbach (1998).

H4: agency costs will increase with increasing the tenure of CEO.

2.5 CEO/Chair Duality

Duality is included as a dummy variable which is given a value of 1 if the CEO is also the chairperson of the board of directors and 0 otherwise. Fama and Jensen (1983a) states that agency problem can be reduced by splitting the position of CEO and chairman which means separating monitoring of decisions from implementation of decisions. To run meetings of the board is the responsibility of the chairman, in addition to monitor the process of hiring, firing and compensating the CEO. Therefore if dual roles are performed by same person, it will be very hard for the board to achieve its main objective i.e., to evaluate management performance. Therefore the presence of an independent chairman is important in board decision making. Thus the two roles must be split otherwise the dominance of a single person on board decision making will increase which will lead to higher agency costs and poor firm performance. However in contrast McKnight and Mira (2003) and Florackis and Ozkan (2004) found that duality do not appear to have any influence on agency cost.

H5: Agency costs will be lower by splitting the CEO/chair position.

2.6 Debt Financing

According to Jensen and Meckling (1976) leverage plays a significant role in reducing agency cost. Previous literature about debt and agency cost association suggests that high leverage firms are more closely monitored by lenders which prevent managers from non-value maximizing activities, which results in lowering agency costs because when firms pays interest payments less earnings retained inside the firm, thus managers cannot use the funds for private benefits which is consistent with the free cash-flow hypothesis. Lenders have the ability to exercise control therefore debt play a significant part in minimizing agency problem Shleifer and Vishny (1997). However on the other hand, manager's in order to cover interest payments may utilize the funds in unprofitable projects once leverage increases McConnell and Servaes (1990). In order to monitor the firm and to implement correct investment choices John and Kedia (2003) stated that the bank acquires private information about the borrowing firm.

H6: agency cost and debt financing are negatively correlated.

3. Methodological Approach

We have selected 120 non-financial firms on the basis of market capitalization listed on the "Karachi Stock Exchange" for the period 2003-2010. Secondary data are collected from firm's financial statements, Karachi Stock Exchange, State Bank of Pakistan publications, and company's websites. Board and committee activities, board size, CEO/Chair duality, CEO tenure, %Block ownership, %largest investor and debt financing are used as independent variables. To investigate the link between corporate governance mechanisms and agency cost we have employed fixed effect regression.

3.1 Dependent Variable

We have used the proxies' asset utilization and asset liquidity ratios to measure agency cost i.e., dependent variable.

3.1.1 Agency Cost

(a) *Asset Utilization Ratio*: we have used this ratio as a proxy of agency cost following Ang et al, (2000) and Singh and Davidson (2003). Agency cost will be higher the lower the asset utilization ratio because the firm is not making productive use of its resources and firms management has failed to make best use of its assets. Asset utilisation ratio is obtained by dividing total revenues by total assets.

(b) *Asset Liquidity Ratio*: The second agency cost proxy used to measure agency cost is the asset liquidity ratio. There will be higher management discretion to utilize their funds when they have greater amount of liquid assets in their total assets, due to which the chance of investing some or all of these funds in unproductive assets will be high. Therefore it is clear that companies will be exposed to higher agency costs when they have higher liquidity ratios. Following Prowse (1990) we define it as:

$$\text{Asset liquidity ratio} = \frac{\text{sum of cash and marketable securities}}{\text{total assets}}$$

4. Model

In this research article we have employed fixed-effect regression model because of the panal nature of the data. We can write the general fixed-effects model as:

$$Y_{it} = \alpha_i + \sum_{j=1}^7 \beta_j X_{ijt} + u_{it}$$

Where,

Y_{it} stands for the dependent variable which is agency cost (asset utilization and asset liquidity ratio), i represent the number of sample firms and t represent time period of the study, u_{it} is the error term. The constant α_i represents unobservable individual firm-specific effects which differ between firms and are time invariant. X_{ijt} represent independent variables:

X_{1t} = CEO tenure

X_{2t} = Board meetings

X_{3t} = Audit committee meetings

X_{4t} = Board size

X_{5t} = Duality

X_{6t} = Debt financing

X_{7t} = Block ownership

5. Analysis and Results

5.1 Asset utilisation ratio as dependent variable

In table, where the dependent variable is asset utilization ratio the R-square value is 51%. The result shows that variables board and audit committee activities and asset utilization ratio has strong positive correlation. Kanagaretnam et al. (2007) argue that boards and audit committees which meet commonly should be more efficient monitors of management thus agency cost should be smaller for companies whose board and committees meet more frequently. However block ownership, board size; duality and asset utilization ratio have negative correlation. In relation to block ownership, a higher number of institutional investors are associated with a lower degree of informed trading, and not all types of institutions can cause decreases in adverse selection costs as a measure of asymmetric information. When ownership becomes more concentrated large shareholders will pursue their own self interest rather than shareholders interests according to entrenchment hypothesis due to which agency cost will increase. We have found that same person performing dual roles will result in lower asset utilization ratio and as a result higher agency costs. Fama and Jensen (1983a) states that agency problem can be reduced by splitting the position of CEO and chairman. Thus the two roles must be split otherwise the dominance of a single person on board decision making will increase which will lead to higher agency costs. The result is inconsistent with the findings of McKnight and Mira (2003), Florackis and Ozkan (2004). The reason for inverse relation between size of the board and utilization ratio may be that large boards have increased problem of communication and coordination which increases agency cost because larger boards are hard for the CEO to control. Ibrahim and Abdul Samad (2006) also found similar result. However the result is against the findings of Pearce and Zahra (1991) and Florackis and Ozkan (2004).

The variable debt and agency cost has negative association because high leverage firms managers have fewer opportunities to pursue non-value maximizing activities due to increased monitoring from creditors.

5.2 Asset liquidity ratio as the dependent variable

In table 2, The R-square value is 0.46, meaning that 46% of the variability is explained in the dependent variable. Agency cost is reduced with board and audit committee activities, however audit committee meetings and asset liquidity ratio has insignificant association. CEO tenure and asset liquidity are significantly positively correlated, which is in line with the view that larger CEO tenure will increase agency cost. The variable larger board increases asset liquidity ratio, which means larger boards have higher agency costs. In contrast to the result found in Table 1, block ownership and asset liquidity ratio has negative association. Thus agency costs will be lower the higher the block ownership. The reason is that shareholders with substantial stakes have more incentives to supervise management and can do so more effectively (Shleifer and Vishny, 1997; Florackis and Ozkan, 2008). Campbell and Frye (2006) argue that large shareholders are able to reduce agency costs and improve long-run performance. The variables duality, debt financing and large investor has insignificant relation with asset liquidity ratio.

Table 1

The result of fixed effect regression, the dependent variable is the asset utilization ratio.

Variables	coefficient	t-statistic	p-value
Intercept	0.214	3.84*	0.0000
BM	0.124	3.41*	0.0006
ACM	0.120	2.91*	0.0079
CEOTEN	1.021	0.74	0.0137
Board size	0.012	3.08*	0.0058
Duality	0.142	0.19	0.8530
BlockOwn	-0.104	-3.66*	0.0001
LargOwn	-0.090	-2.49**	0.0189
Debt	0.145	2.17**	0.0323
R-square	0.514		
F-statistic	7.102		
Fixed effect significance	51.425		

*Significant at 1% level

**Significant at 5% level

Table 2

The result of fixed effect regression, the dependent variable is the asset liquidity ratio.

Variables	coefficient	t-statistic	p-value
Intercept	0.2718	4.45*	0.0000
BM	-0.017	-2.05**	0.0440
ACM	-0.143	-1.23	0.2189
CEOTEN	0.152	2.02**	0.0460
Board size	0.043	4.46*	0.0000
Duality	0.077	0.19	0.8530
BlockOwn	-0.163	-2.01**	0.0480
LargOwn	0.009	1.41	0.1591
Debt	-0.011	-0.645	0.5205
R-square	0.46		
F-statistic	8.36		
Fixed effect significance	49.112		

*Significant at 1% level

**Significant at 5% level

5.3 Conclusion

The purpose of the study is to analyze various corporate governance mechanisms that reduce agency cost. For the period 2003-2010 we have selected 120 firms on the basis of market capitalization listed on the "Karachi Stock Exchange". We used two proxies' asset utilisation and asset liquidity ratios to measure agency cost. A

higher asset utilization ratio means lower agency cost whereas a higher asset liquidity ratio means higher agency costs. Board and committee activities, board size, CEO/Chair duality, CEO tenure, %Block ownership, %largest investor and debt financing are used as independent variables. The result shows that variables board and audit committee activities and asset utilisation ratio has strong positive correlation. However block ownership, board size, duality and asset utilization ratio appears to have negative correlation. When we use asset liquidity ratio as the dependent variable agency cost is reduced with frequent board meetings. The variables board size and CEO tenure has positive correlation with asset liquidity ratio. Block ownership and asset liquidity ratio has negative association. Furthermore variables duality, debt financing and largest investor has insignificant relation with asset liquidity ratio.

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