Agency costs, ownership structure and corporate governance compliance: A private contracting perspective

Darren Henry*  
School of Economics and Finance La Trobe University, Australia

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ABSTRACT

This paper examines whether the adoption of specific corporate governance practices, and, in particular, adherence to an overall code of governance practice, is associated with agency cost benefits for companies listed on the Australian Securities Exchange (ASX). Using a private and voluntary contracting setting, the adoption of individual corporate governance attributes is found to have no influence on firm-level agency costs, whereas greater compliance with an overall governance index variable representative of the ASX Corporate Governance Council requirements now in force results in significantly lower agency costs. The beneficial influence of voluntary governance compliance on agency costs is also found to be independent of firm ownership structure, with these findings having a range of implications for firms both in Australia and globally.

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1. Introduction

There is a growing body of international evidence supporting the existence of a correlation between corporate governance structure and firm performance and valuation outcomes. What is less clear from this evidence, however, is the channel through which governance mechanisms derive their impact. Prior studies have suggested a number of potential channels for corporate governance effects, such as resulting from stronger shareholder rights and legal protection mechanisms which lower investor capital costs (La Porta, Lopez-de-Silanes et al., 1998, 2000; Beck et al., 2003), or incentive effects associated with takeover vulnerability (Gompers et al., 2003; Bebchuk et al., 2004; Cremers and Nair, 2005).

Other suggested channels included greater coverage and reporting by ratings agencies (Klapper and Love, 2004; Linden and Matolcsy, 2004; Brown and Caylor, 2006), improved management structure and
oversight through voluntary or legislative enforcement of codes of governance practice (Black, 2001; Black et al., 2005, 2006; Henry, 2008), and enhanced disclosure informativeness (Beeckes and Brown, 2006).

Furthermore, there is other work intimating that it may, in fact, be prior or contemporaneous performance or valuation outcomes that are driving changes in the corporate governance structure of firms (such as Himmelberg et al., 1999; Hermalin and Weisbach, 2003; Wintoki et al., 2007). This introduces the issue of governance and performance endogeneity (in the form of reverse causality and/or dynamic dependence) and doubt as to the underlying importance of corporate governance structures and codes of corporate governance practice.

Another potential channel through which governance initiatives may impact on firm performance is by minimising firm-level agency conflicts and resulting agency costs. Little attention to date, however, has been accorded to agency cost reduction as an outcome of the corporate governance reform process, and particularly in the context of publicly-traded firms. Ang, Cole and Lin (2000) found that agency cost levels of non-listed US small businesses are negatively related to the manager's ownership interest and the degree of external bank monitoring and positively related to the number of shareholders and the existence of an outside (non-owner) manager. Fleming, Heaney and Mccosker (2005) identified similar results for non-listed Australian firms.

Core, Holthausen and Larcker (1999) found higher agency problems in listed US firms with weaker governance mechanisms, Kim and Lee (2003) identified that ownership and organisational (chaebol and non-chaebol) structure influence the extent of agency problems experienced by Korean firms, and Basu, Hwang, Mitsudome and Weintrop (2007) concluded that main bank monitoring and keiretsu affiliation reduced agency problems (proxied by excessive compensation) in Japanese firms. Singh and Davidson (2003) found that larger managerial ownership and smaller-sized boards both enhanced asset utilisation ratios for large listed US companies. Gao and Kling (2007) found greater outside board representation and board ownership to reduce asset appropriation in Chinese firms and Doukas, Kim and Pantzalis (2000) identified analyst following to be an effective agency-mitigating mechanism. Doukas, Mc Knight and Pantzalis (2005), however, concluded that greater analyst following only reduced agency cost levels for small UK firms, and McKnight and Weir (2009) found minimal evidence that adoption of individual governance attributes consistent with the UK Combined Code recommendations reduced agency costs.

The contributions of this paper are addressing the corporate governance and agency cost relation from a private contracting viewpoint, in association with the consideration of an overall code of governance practice, rather than the adoption of specific individual corporate governance practices, as an agency control mechanism. Focus is placed on determining the expected impact of the Principles of Good Corporate Governance and Best Practice Recommendations introduced by the ASX Corporate Governance Council in 2003 on measures of agency costs for ASX-listed companies. This is achieved by creating a ‘structural’ governance index based on components of this now-applicable code of practice during the pre-adoption period from 1992 to 2002. This will be the first attempt to evaluate the impact of a combined corporate governance ‘code of practice’ as a specific agency-mitigating device. Listed companies on the Australian Securities Exchange (ASX) also provide a novel sample for analysis, as market and institutional characteristics suggest the potential for substantial agency problems.

Relating agency cost levels with the voluntary adoption of corporate governance frameworks by firms allows for an objective and unbiased assessment of the likely influence of the corporate governance reform process in Australia. Focusing on the pre-adoption period removes potential bias associated with firms adopting a box-ticking approach to compliance with the best practice recommendations, which could lead to spurious relationships being identified. This concern is particularly relevant given the focus on agency cost variables representative of managerial decision-making and outcomes from the separation of ownership and control.

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1 The term ‘structural’ is emphasised here to distinguish between measurable governance attributes, such as board composition or board sub-committee existence, and governance requirements based on the disclosure or provision of information. Many of the best-practice recommendations proposed by the ASX Corporate Governance Council relate to the disclosure of specific information or approvals or developments of various codes of conduct, both of which cannot be directly evaluated on an ‘ex ante’ basis. Section 2 and Appendix A outline, in detail, the content of the Principles of Good Corporate Governance and Best Practice Recommendations document, and other developments in corporate governance practice in Australia.
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