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Agency costs, ownership structure and corporate governance mechanisms

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Abstract

In this paper, we extend the work of Ang et al. [J. Finance 55 (1999) 81] to large firms. We find that managerial ownership is positively related to asset utilization but does not serve as a significant deterrent to excessive discretionary expenses. Outside block ownership may only have a limited effect on reducing agency costs. Furthermore, smaller boards serve the same role, but independent outsiders on a board do not appear to protect the firm from agency costs. Thus, this paper reports complementary evidence to Ang, Cole and Lin. In large publicly traded corporations, managerial ownership significantly alleviates principal–agent conflicts even in the presence of other agency deterrent mechanisms.

JEL classification: G-3
Keywords: Management ownership; Agency costs; Corporate governance; Board of directors

1. Introduction

Ang et al. (1999) (henceforth ACL), provide evidence on corporate ownership structure and agency costs measured in terms of asset utilization and operating expenses. Their analysis of the Federal Reserve Board's National Survey of Small Business Finances (NSSBF) data on small businesses, relating absolute and relative measures of agency costs suggests that agency costs for outsider managed firms

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are higher relative to firms that are owner managed. In addition, they show that asset utilization efficiency and operating expenses for small businesses are, respectively, positively and negatively related to the managerial ownership stake in the firm.

In this paper, we extend ACL's analysis of the relationship between corporate ownership structure and agency costs to large publicly traded corporations, and we provide evidence complementing their findings. Given that exchange listed large firms are subject to continuous security market monitoring, the role of ownership structure in influencing agency costs may significantly differ from that in the small corporations in ACL's investigation. While ACL focus on managerial ownership and the number of non-manager owners, we investigate, in addition to managerial ownership, the role of outside block ownership in terms of their proportion of equity ownership. Since corporations may use alternate governance mechanism as substitutes (Agrawal and Knoeber, 1996), we control for the influence of the size and composition of the board of directors on the level of agency costs. Examining block ownership and controlling for board of director variables, not considered by ACL, are appropriate for our sample since it contains large publicly traded firms. In addition to analyzing the role of the board of directors in controlling agency related costs, this analysis provides an opportunity to understand if corporate ownership has a significant influence on the agency behavior of management in large corporate units after controlling for corporate governance mechanisms. Finally, we use two time-series observations in non-consecutive years per cross-section unit, to reduce the possibility of the results being time period specific.

There are some important differences between our analytic design and the ACL approach. Since we are dealing with large publicly traded corporations, we do not have a zero-agency-cost base case where a firm is fully owner managed. We, therefore, relate absolute levels of asset utilization efficiencies and operating expenses to firm ownership while controlling for governance characteristics. Further, we utilize a slightly different definition of operating expenses. As we aim to capture agency induced managerial expense as a measure of agency cost, we focus on a firm's selling, general, and administrative (SG&A) expenses instead of total operating expenses used by ACL. SG&A expense, representing the costs related to the management function and to the sale of products, includes managerial salaries, rents, insurance, utilities, supplies, and advertising costs. Higher levels of SG&A expenses are a close approximation of managerial pay and perquisite consumption in terms of higher salaries, large office complexes, and other organizational support facilities. These costs, to a large extent, reflect managerial discretionary expenses and may be a closer proxy for agency costs. Given that large corporations have greater access to the public debt market, they should rely less on bank financing and be less subject to bank monitoring than the small businesses in ACL. Therefore, we analyze the role of corporate leverage, rather than banking relationship in influencing the agency costs in large corporations.

Our findings provide support for ACL's findings, in that, higher managerial ownership significantly and positively influences the corporate asset utilization efficiency, and we find some limited evidence that it acts as a significant deterrent to excessive discretionary expenses. We find that in the case of large publicly traded firms, outside