The Quarterly Review of Economics and Finance
49 (2009) 139–158

The QUARTERLY REVIEW of ECONOMICS And FINANCE

www.elsevier.com/locate/qref

Agency costs, corporate governance mechanisms and ownership structure in large UK publicly quoted companies: A panel data analysis

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Received 2 August 2006; received in revised form 2 September 2007; accepted 25 September 2007
Available online 1 February 2008

Abstract

This paper examines the impact of governance and ownership variables on agency costs for a panel of large UK quoted companies. We use three measures of agency costs: the ratio of sales-to-total assets, the interaction of free cash flows and growth prospects and the number of acquisitions. We employ a range of techniques to analyse the data: fixed-effects, instrumental variables, and Tobit regressions. We find that the changes in board structures that have occurred in the post-Cadbury period have not, generally, affected agency costs. This suggests a range of mechanisms is consistent with firm value maximisation. We also find that having a nomination committee increases agency costs, which indicates that there are costs associated with certain governance mechanisms. Increasing board ownership also helps to reduce agency costs. We also find that debt reduces agency costs. Our results raise questions about the usefulness of the information sent to shareholders when firms adopt a recommended governance framework.
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JEL classification: G30; G34

Keywords: Agency costs; Governance mechanisms; Codes of best practice

1. Introduction

Agency costs arise from the misalignment of the interests of the owners and managers of firms when the separation of ownership and control occurs (Jensen, 1986). The agency model identifies

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doi:10.1016/j.qref.2007.09.008

a number of governance mechanisms which realign the interests of agents and principals and so reduce agency costs. Recent changes in the UK, for example through the Cadbury and Hampel Committees, have stressed the importance of corporate governance mechanisms that take specific forms. In the UK, firms are expected to adopt board structures consistent with a Combined Code of best practice.

In contrast Coles, Lemmon, and Mescke (2005), Coles, Daniel, and Naveen (2008) and Boone, Field, Karpoff, and Raheja (2007) argued that companies adopt a range of governance mechanisms, each of which is consistent with maximising firm value. Therefore, they, question the usefulness of moving towards governance systems that identify preferred mechanisms. Such a system may force a firm to move away from a value maximising structure and to adopt a non-optimal structure.

The paper makes a number of contributions to the agency costs debate. First, we present a UK analysis of the theory that firms choose value-maximising governance structures. There is evidence of that UK firms have increasingly adopted the Combined Code. Does this change therefore represent a move away from existing value-maximising governance mechanisms to another combination of maximising mechanisms? Alternatively, does the adoption of recommended governance structures cause firms to end up with inappropriate governance structures?

Second, the few studies that have attempted to directly measure agency costs have analysed the US context. Ang, Cole, and Lin (2000) looked at small unquoted US companies and Singh and Davidson (2003) analysed quoted US companies. We undertake the first direct study of agency costs in large quoted UK companies.

Third, we present the first UK study of agency costs that uses panel data, a technique which enables us to isolate both cross section and time series effects. Our analysis also explicitly differentiates between fixed and random effects models. In contrast, Singh and Davidson (2003) did not distinguish between these effects but merely reported results for both approaches. This is important because their results differ between fixed and random effects. Fourth, we investigate the endogeneity issue through the use of instrumental variables. Singh and Davidson (2003) do not address this issue.

We find that there has been an increasing adoption of the key board structural recommendations of the Combined Code. In UK quoted companies, nomination committees are becoming more common, duality is rare, and becoming rarer. The percentage of non-executive directors has been increasing and now constitutes around 50% of boards.

Using a range of agency cost measures, we find that the changes to board governance mechanisms brought about by adopting the Combined Code's recommendations have had little effect on agency costs. Consistent with Coles et al. (2005, 2008) this suggests that UK firms have been able to move costlessly to new governance structures consistent with value-maximisation. However, we find that the nomination committee, and its structure, has had an unexpectedly negative impact on agency costs. This shows that setting up such a committee creates an ineffective mechanism and is not a component of the value maximising alternatives.

This paper is structured as follows. The following section discusses the literature relating to agency costs and optimal board structures within the context of the UK Combined Code of best practice. It also discusses ownership and debt issues in relation to agency costs. Section 2 provides a discussion of the methodology and variable definition. Section 3 discusses the results of the study and in Section 4 some conclusions are drawn.

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