CORPORATE GOVERNANCE AND AGENCY THEORY HOW TO CONTROL AGENCY COSTS

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Abstract:
Agency theory is considered as the main theory in business word separating ownership from management, which makes conflicts called "agency problems" as a result of interest conflicts between managers and shareholders. These problems are costs on a company to encourage high performance of managers, need to be monitored and minimized to protect the company from bankruptcy. Agency theory grants to manager a huge margin allowing them to use free cash and getting more benefits returned to their own behalf. This relationship is needed to be discussed highlighting on the possibility of controlling and avoiding such as issues can lead the company to unpleasant situation and force managers to lose their positions.

Key words: agency theory, agency costs, corporate governance, managerial incentives

JEL classification: G38, Q 56

1. Introduction

Starting with last century management thinking has been developed massively. Organizations required important changes of theories; strategic management has shared its duties with board of directors presenting the main attention of massive developing. That could be happened with significant developing of financial and operating managements with showing slightly some changes in board of director's roles. However, twenty century concerned on management developments among huge concerning on corporate governance started with twenty first century to be highlighted in academic researches attracting attentions of international institutions and organizations pushing them to update and develop corporate governance theories and principles. Economic growth enacted to improve

the framework of corporate governance theoretically and practically facing economic challenges to reach mature level of what corporate governance is now.

Economic entities have been thirsty for revolution in corporate governance to solve the issues between board of directors and other members of a company. That creates relationships with others; internal / external members of a company, which need to be managed by corporate governance. The different between management and corporate governance is that management runs company's activities and governance ensures these activities are managed and done well and correctly. For that directors gain this title from directing and supervising the activities of their companies.

Governance as an idea is from past, but the phrase of corporate governance is started in 1980s to be adopted widely in business world. The agency theory has brought significant challenges in modern regulations of enterprise nowadays.

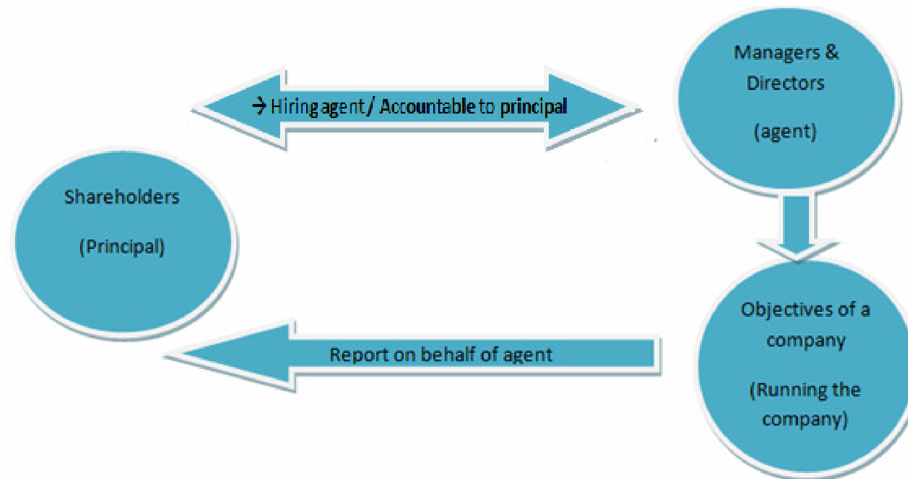
Middle ages of Europe each trading were standards and regulations for participants, which was formulated by guild charters meeting states' regulations nowadays. The charters consisted of trade masters. Three century back the competition between European empires was culmination and companies were created by states or king leaded by charters. Queen Elizabeth named a charter in 1600 for *East India Company* to handle all trades between England and Asia to join stock market and elected board of government directors. In 1602 Western part of India was controlled by Dutch East India managing trades between Asia and Netherlands. In this period there were not real and special expectations leading theses companies to be defrauded and collapsed leading to financial crisis similar with current financial crisis. In nineteenth century Limited Liability Company Law has taken place encouraging people to engage in business those days asked people to be attentive to achieve a great economic growth to create first Incorporation Company. Incorporation - Limited Liability Company was firstly created in France with a condition that directors disclosed the debts of their companies among English law, which was not limited on directors to include all shareholders even if they are not part of the management. The concept considered the company as an independent entity separated from owners introduction first tries of agency theory. That mean debts' responsibilities are transferred from shareholders properties to be limited on company's properties even though shareholders are the main power since board of directors are elected by them owing duties of reporting and stewardship. Till nowadays shareholders' rights are main part of any law even of their difficulties. The experience of limited liabilities companies were limited on small and medium sizes to be large and more complicated by twentieth century appointing the advantages of industrial revolution

especially in United Kingdom and United States of America making shareholders widely internationally. That requests to separate between ownership and operations of a company. All public companies have started to be listed in stock market pushing step by step to give an agency theory its own role in running companies (Means and Berlet 1932), and previously dialogue can be dropped on corporate governance. Board of directors duties has transferred to challenged level to make important decisions mostly presented as an advice's resource for the chairman of the company in case of resigning because of bad performance. All academic literatures handle the function of board of directors classically covering three significant points: (1) strategies, objectives and policies of board of directors, (2) putting intelligent questions, (3) and choosing the chairman.

2. What are the agency costs?

Ownership has been separated from management since agency theory is applied making conflicts based on interests between different parties of contracts (Jensen & Meckling 1976).These parties are presented by shareholders, managers and debtors as the main business drivers according to classic approach. Researchers have passed huge progress to explain means and natures of these conflicts to determine the possibilities of solving these conflicts. Agency relationship is described as that contract between principal giving agent the right to make decisions and take the responsibilities of these decisions (Jesen & Meckling 1976). Classic view of owner-manager problem proposes that managers presume the essential role of agent of acting on behalf of shareholders. The basic problem is shown up as result of the separating between decision making and residual risk carried by shareholders. The agency problem is related to difficulties confronted by moneymen in assuring there is no expropriating or wasting for their money (Shleifer & Vishny 1997). That mean shareholders are expecting to obtain financial benefits of holding financial equity. Agency problem can costly controlled due to impossibility of perfect performance of agent in decision-making to affect both agent and principal benefits (Brennan 1995). There is an argument that incomplete contracts between principal and agent is feasible; shareholders must apportion residual monitoring rights to managers of a company (Shleifer & Vishny 1997), caused of that managers monitor the company and have the ability to determine individual benefits of monitoring, which are inaccessible to shareholders. The inefficiency of managers are reduces with increasing managerial bonuses to maximize decision-value. Agency cost has been suggested by academic writers to attract managers to act according to maximum benefits of shareholders through providing certain benefits to managers. Like other cost agency cost is recognized in share price of a company. The researchers have categorized

agency cost to two different types: First type leaded by Jensen and Meckling (1976).



Monitoring cost: Monitoring and understanding of management actions are behind agency cost, judging managers' performance is based on maximizing wealth of shareholders. Monitoring costs are these expenditures paid for controlling, rewarding and measuring managers' behaviors. There is possibility to add auditing cost, hiring and training costs for top-management. At the beginning these costs are paid by shareholders, but at the end are covered by managers since their recompense is based to cover these costs (Jensen & Fama 1983). As well these costs are affected by regulations and governance codes; Combine code (2008) in United Kingdom requests from companies to provide abidance statements as a result of Cadbury code, Hampel code and Higgs code. Governance codes ensure monitoring function of control systems used to reduce conflicts of interests between principal and agent and in meanwhile excluded behaviors of abidance statements must be explicated and disclosed, which are considered as part of control system. That present the possibility of strict monitoring for certain groups as feature of effective control system (Denis & Sarin 1997), and that request expert monitors have necessary skills and financial knowledge to control and threat believably managers to provide a credible report of control system and management performance. Strict view on monitoring has been presented to restrain management behavior and to sustain company's activities to reduce judging margin for managers. That mean external shareholders do not have human capital to determine opportunities confronting the company making monitoring cost high (Gromb, Panunzi and Burkart 1997). There was an important discussion on

publishing governance codes in United Kingdom leads to increase monitoring cost with providing credible presentation of company's activities and management's performance (Hull, Short, Wright and Keasey 1999). Therefore, best level of monitoring can be concentrating on contracting environment of a company (Hubbard, Himmelberg and Palia 1999).

Bonding costs: Holding monitoring cost by managers pushes them to construct their acts upon to shareholders' interests otherwise they are going to pay for it. The cost of setting up and working according to monitoring system is called bonding cost (Meckling & Jensen 1976). Bonding cost is generated by managers with having possibility of financial and non-financial such as guarantee offering from agent, wearing a uniform and maintain good reputation. Also attempts of providing information to external shareholders accurately and timely. Managers can limit carrying bonding cost through managerial balancing; decreasing in monitoring cost is equal to increasing in bonding cost. Solving conflict of interests between shareholders and managers can be solved through contracts bonding managers to act exactly according to shareholders' interests in any circumstance facing the company (Denis 2001).

Residual loss: Contempt of monitoring cost and bonding cost. The difficulty of gathering interests of shareholders and managers will continue existing to be added to other differences between managers' decisions and decision maximizing benefits of shareholders. That generates agency loss gets up from conflicts of interests, which is known as residual loss. This loss is not assessed upon to shareholders' expectations, or to high-level of managers' performance. Hence maximizing managers' role will attempt to minimize agency costs (monitoring cost, bonding cost, residual loss) to promote an idea of giving bonuses for managers to sign contracts appropriating imposing costs (monitoring cost and bonding cost) making differential cost equal to differential benefits to cut down residual loss.

3. What are the agency conflicts?

Different interests of principal and agent are behind agency conflicts. The natures of these interests are limitless pushing academic researches and professional institutions to study the reasons of these differences. In 1976 Jensen and Meckling define these reasons by: moral-hazard, earning retention, time-horizon and managerial risk aversion.

- Moral-hazard conflicts**:** The first proposal to explain agency conflicts. Jensen and Meckling (theory of the firm, 1976) assumed that a manager owns the company to develop a specific model by motivations instead of investing in Net-Present-Value of projects of that company to increase manager's stake in descent of a company. That can be easily applied when the structure of ownership is various and the majority of shares are not controlled by managers, which is not matching with British companies' situation for an example. That can be instead of not investing, because managers are toward investments, which match their skills. Some investments of managers may increase the value of a certain manager with increasing the cost of substituting. That allows managers to obtain more bonuses from their companies (Shleifer & Vishny 1989). The possibility for moral hazard issues of having superior power and influences are high in multinational companies (Jensen 1993). In these companies external auditing and complexity of contract blow up exponentially leading to increase agency costs. The solution of moral-hazard has been related to present the need of pay-performance sensitivities for Chief of Executive Manager CEO (Murphy & Canyon 2000). Moreover, in large size companies the problems of cash flow highlight produced difficulties by moral-hazard (Jensen 1986). High free-cash in large companies makes hard to know where cash are utilized by managers. Managerial exertion is also related to moral-hazard since managerial exertion lack might lead to management problems with difficult evaluating fiddled responsibilities by managers. The share price of the company is positively related to meeting between managers and board of directors proofing that company value is affected by managerial exertion (Wyatt & Rosenstein 1994).

- Earning retention conflicts: oversimplifies agency problems as an effort of antipathy (Brennan b 1995). Grandiose imaginations of management with distributing cash on shareholders can be over attention than declining investments and providing luxury offers to certain employees. The structure of compensation has a role on

management's rewards affecting size function of a company (Jensen & Murphy 1990 and Conyon & Murphy 2000) pushing management to concentrate on growth size instead of concentrating on growth returns on shareholders. That explain why management tends toward retain earning among trending of shareholders to distributing cash particularly when possibility of positive invest inside the company is low (Jensen 1986). Managers obtain high benefits from retain earning giving greater cachet and image with high bonuses in front of board of directors (Jensen 1986, 1993). That cuts down a specific risk inside the company imposing for strengthening security of executive jobs. Nevertheless, finance theory prescribes that diversified portfolios must be hold by investors to reduce risks by investing in variety of assets, which leads to block any cooperating of diversification by managers since that is not meeting their individual interests. That is proofed by empirical studies ensuring this strategy of managers is harming shareholders' wealth strongly to reduce company's value (Stulz & Lang 1994). Retain earning reduces the need for external financing in case that it is used in investing projects by managers. Nevertheless, the cost of increasing capital from financial market leads to a practicable controlling function on unnecessary managerial investments (Easterbrook 1984). In this case managers will try to reduce retain earning escaping from this external controlling function.

- Time Horizon conflicts: cash flow timing creates an agency problem between managers and shareholders. The time of cash flow is demanded by shareholders significantly as part of future definition of a company. Nevertheless, managers' concerns on cash flow may be related to their individual interests generating negative influences in short-term on the company to give birth to top-executive approach concentrating on leave-payment of managers with proofing that research and development expenses reduce these negative influences of top-executive approach in short-term (Sloan & Dechow 1991). There is possibility that management uses certain accounting tactic to use retain earning before they leave their positions to maximize their leave-payments (Healy 1985). In 1988 Weisbach proofed that retain earning is higher in previous year of leaving managers and chief executive officers to give them a role in manipulating cash flow problems.

- Managerial risk aversion conflicts: managerial income raises this agency conflict. Financial investors hope to spread their control by

shareholders with minimum cost among managers who hope to increase their individual control. The majority human resource directors are connected strongly to their companies depending upon companies' performance leading to reduce risk of their companies in financial market (Denis 2001). Thus, these directors may reduce risk by encouraging diversifying investments and invalidate investing decision making investing risk high (Jensen 1986). The risk of investing decision might increase the possibility of bankruptcy, even the reputation of managers is harmed, but it is still hard to replace them (Lehn & Demsetz 1985). That means this agency problem has its impacts on financial policy of the company since debt increasing considered as a solution to reduce managerial risk aversion (Jensen 1986) and to increase tax shields (Sendbet & Haugen 1986). Nevertheless, there is an argument that risk may enforce managers to choose financing by equity instead of financing by debts avoiding bankruptcy and failure possibilities (Brenna 1995b).

4. How to control problems of agency theory?

In spite of pervious discussion of agency problems, interests' conflicts are continuing to increase in modern companies between external investors and managers (Jensen 1993). That can be assigned strongly to developments in monitoring process internally and externally serving at managing agency problems. Companies incline to alternate different mechanisms based on economic features of contractual environment (Himmelberg et al 1999). Subsequently, contracting link has been changed dramatically from a company to another without ignoring an assumption that it is optimum for a company but not necessary to others. Accordingly, a certain mechanism is employed to a little degree in a certain company it can be employed more in another company generating same good performances in these different companies (Knoeber & Agrawal 1996). There conditions are requested to achieve an efficient mechanism of corporate governance (Denis 2001); first condition is that device works to reduce the conflict area between managers and shareholders' interests; second condition is that selected mechanism has an important effect on value and performance of a company. In 2001 Denis pointed out that if governance mechanisms are respected there is no significant link between individual mechanism of mangers and their companies' performance.

First option: Managerial labor market

Managers will adjust their behaviors accordingly to market evaluation for the goodness of their acts toward shareholders' interests. Those depend on pervious performance reports of their companies (Fama

1980). Labor market practices external monitoring with demanding conditions:

I. Talents and excellence of managers must be seeable through pervious performance reports of their companies. These talents and excellence of managers should be changed from report to other. The main issue is moral-hazard problem of agency theory were analyzed by Meckling and Jensen in 1976. Nevertheless, simply analysis has been done by Fama 1980 treating agency problems assuring other agency problems; earning retention, time horizon and risk aversion problems.
II. Efficient process of information by labor market into evaluating management performance. The cost of gathering information will be presented through having different information by various parties.
III. The process of revising salary must be enough to solve managerial incentives' problems in a perfect market where managers' acts serve the achievement of shareholders' interests (Fama 1980). That means labor market is practicing external monitoring through several punishment on poor managerial performance (Murphy & Jensen 1990).

Solving agency problems and reducing agency cost can be done through managerial labor market. And to solve the problem of ownership separation must be an effective factor enforces managers to act toward shareholders' interests through providing stimulus to encourage managers.

This factor is presented in managerial labor market according to researchers in corporate governance; poor managerial performance leads to managerial replacement. That is happened only in a real poor performance of manager sustained in long-term (Warmer et al 1988 & Weisbach 1988). Managerial labor market uses pervious performance reports of managers to determine opportunities of a company and bonuses for its manager (Gilson 1989). Managerial labor market can be maximize a role of managers in shareholders' value, but in real that is limited only to reduce poor managerial performance (Murphy & Jensen 1990, Kaplan & Relishes 1990).

Second option: Corporate boards

Theoretically shareholders elect the members of board of directors during annual meeting, which means simply directors must maximize the value of shareholders. Board of directors has cooperated with market to solve agency problems inside a company (Weisbach & Hermalin 2001).

Effectual board of directors in a certain company can affect strongly other independent directors to hold a well position in management of other

company, and to differentiate between management decision problems and control decision problems (Jensen & Fama 1983). There is possibility that managers and chief of executive officer can control board of directors, but that will be difficult to dominate managerial and control decisions, because that does not serve shareholders' value and leads to disaster situation to whole the company subsequently. External directors have the ability of controlling decisions with separating from managerial decision, which can be supported by incentives provided by shareholders. Board of directors must involve effectively in monitoring management performance, and solve agency problems even it requests to replace management. Greenbury report (UK, 1995) recommends that remuneration should be high for board of directors to encourage professional behave of them toward management.

Good corporate governance requests from board of directors to check all information offered from management and to behave professionally with all information offered from financial market. External directors in respect the separation between tasks have a positive role to eliminate poor performance of managers (Weisbach 1988), and to reduce the ability of top-management corruption (Cotter et al 1997 & Mehran 1995). Sustainable poor managerial performance contributes top-management to have short incumbency (Wruck & Watts 1987). That important role of board of directors and external directors particularly; is active with governance mechanism affecting positively on value of a company turning to increase shareholders' value (Knoeber & Agrawal 1996), but that is request other monitoring mechanism on external boards according to US companies' report, even there are researchers deny this relationship between external boards and shareholders' value (Weisbach & Hermalin 1991). Highlighting this important role has been done by Denis in 2001 focusing on positive role of board during crisis time with mentioning on the difficulty of running business daily is caused of agency problems.

Moreover, this important role is reflected in stock market through changes in share price of a company (Wyatt & Rosenstein 1990, Villalonga & Demsetz 2001, Weisbach & Hermalin 2001).

That presents the issue of board size and the argument that chief of executive officers would like to control board of directors attracting to individual interests (Mace 1986). The size of board of directors can lead to inefficient decisions caused by losing ability to determining and controlling their operations (Jensen 1993). That was proofed through empirical studies done by Eisenberg and Yermack in 1996, and Wells and Sundgren in 1998 through connecting between the company-value and the size of board of director. In United Kingdom, studies distinguished between external and internal members of board of directors; Lasfer and Faccio in 1999 argued in

their study that there is no significant connection between company-value and size of board of directors among Jensen (1993) argument that mini board of directors has more ability to make effective and quick decisions.

External directors are effective in certain decisions such as reducing poor performance of chief of executive officer, and they can be less effective for unobservable tasks to econometricians (Black & Bhagat 1999).

Thus, performances of external directors are worse than mixed board between external and internal directors. The previous performances of independent directors of a company board and chief of executive officer with balancing their power are not less important than other factors affect on decision-making quality (Weisbach & Hermalin 2001).

Third option: Corporate financial policy

Agency problem control is affected by financial policy of a company since free cash is handled by managers, which has direct implications on financial structure. Increasing company's debt increases internal ownership level with cutting down equity's amount (Meckling & Jensen 1976). These debts in financial structure of a certain company present a monitoring mechanism on managers; managers are forced to pay back the debts contractually in away from cutting down dividends (Jensen 1986). That pushes managers to improve their financial performance and to adopt effective strategy with bonding maximization of personal interests in order to escape from bankruptcy (Easterbrook 1984). This mechanism is important to a company in order to increase cash flow with reducing growth of a company that is also proofed by a reverse relation between leverage and growth percentages of Low Tobin's Q done by Stulz, Ofek and Lang in 1996. That study said poor performances of managers and poor invest opportunities pointed that debts act as an important function to discipline company's performance. Therefore, there is a positive relationship between high levels of debts and decision of liquidation (Brennan 1995b), that is related to high value of a company (Raviv & Harris 1991). That mean leverage increases related risks of having debts leading to increase agency cost (Raviv & Harris 1991). In optimal capital, there must be equality between managerial costs and benefits of having debt in order to maximize the value of the company (Myers 1984). That means debts in optimal structure of the company capital increase the risk of agency cost and reduce the value of the company (Stulz 1990). Also using dividends reduces agency cost of using free cash by managers caused of obligatory level of dividends among debts (Jensen 1986). Over all, an inefficient using of free cash by managers creates a problem in financing investments and increases the need of having debts (Raviv & Harris 1991).

Forth option: Block holders and institutional investors

The idea is that atomistic shareholders have the smallest part of the whole shares of a certain company meaning that they cannot monitor all managers' performance, which is not really considered as a high priority for a part of them among others who gain benefits from practicing this right.

Therefore, block holders might troubleshoot this issue by requesting high financial skills and time to solve this issue and to monitor managers' performance. Block holders can join board of directors after being elected by shareholders. That encourages chief of executive officer to share more effective information to reduce the cost of monitoring managers' performance. Board of directors considered as part of governance mechanism works affectively under the pressure of external controls of financial market meaning that external shareholders – block holders push governance mechanism to operate expeditiously leading to effective monitoring on managers' performance (Sarin & Denis 1997). That means block holders reduce none value strategies of management, which is using free cash of a company to reduce invest risk of external shareholders.

Fifth option: The market for corporate control

Breaking down internal monitoring system of a company can be behind interests' conflict between managers and shareholders with contributing of availability of free cash and useless policies wastes company's resources (Jensen 1986). In short run, corporate control by market can be switched from monitoring company's assets to monitor managers' performance efficiently. The mechanism is shown when managers use free cash in wealthy investments protecting themselves from being fire, which is active strongly after failure period (Titman & Safieddine 1999). The motivations behind this mechanism are to reduce and control poor performance of managers and to achieve gains enabling a company to keep an average position in the market comparing with similar companies (McConnell & Martin 1991). The mechanism of market for corporate control is just active in recession period encouraging managers to act professionally to keep their positions (Partch & Mikkelson 1997). This option is not common and used only in a real poor performance of managers because of high cost of applying (Ruback & Jensen 1983, and Kruse & Denis 2000).

Sixth option: Managerial remuneration

The contracts between shareholders and managers return positively on managers such as salaries, bonuses and percentage of profit, which encourage them to act in high level of professionalism increasing the company value (Meckling & Jensen 1976).

Salaries are determined by worker force market with taking in considerations other important factors such as experience and academic level. That depends also on the size of the company and the need for certain skills. Labor market has a significant role in avoiding high salaries for poor performance of managers (Murphy & Jensen 1990). Salaries' mechanism is ineffective when managers receive high salaries to increase the value of their companies (the value increased by a certain amount of money e.g. 100 Pounds leads to small changes in managers' salaries e.g. 1 cents).

Bonuses present an effective mechanism to encourage professional acts of managers to increase the value of their companies (Potter & Lee 1996). Thus, bonuses are considered as expenses in short-term, but as investments in managers in long-term which have a positive relationship with a company's value (Healy 1985, and Murphy & Jensen 1990).

Giving shares to managers is one of workable methods to bring managers and shareholders to same area and to have common interests reducing interests' conflicts to minimum level. Managers become real partners to shareholders leading to increase a company's value dramatically through investing free cash in profitable investments instead of serving individual interests of managers (Mandelker & Agrawal 1987). This mechanism of giving shares leads to repurchase shares in high level by shareholders (Liang & Fenn 2000). Operating performances in a certain company are increased significantly after including managers in ownership by limit level (Kaplan 1989). Expanding management-ownership leads to a negative relationship between with financial market acts on equity shares (Mazachek & Hull 2001). Management-ownership must be controlled before managers enable to control their whole companies not just as managers but as owners as well. That avoids external shareholders, which is a tool of monitoring managers' performance (Stulz 1988).

5. Conclusion

Historically, Agency theory – separating between ownership and management has been created to protect shareholders' interest, but that has interrupted with individual interests of managers. Interests' conflicts have been developed to generate cost affecting on a company, which can threat shareholders' rights and benefits leading to bankruptcy and close their company. That creates the need of control these agency problems presented in different possibilities to encourage managers to move toward shareholders' interests and to avoid poor performance. These solutions are based on materialism through providing incentives, which are affectively in different levels based on the size of the company and managerial skills.

Recently, two active methods of controlling agency costs to meet financial crisis are managerial-ownership and external shareholders. These

two methods are adopted widely in such as countries suffer from economic crisis such as Cyprus, where banks allow external shareholders and manager to be part of ownership structure leading to transfer clients to be shareholders presenting an effective way to control top-management performance. The main issue of current financial crisis is that managers are using free cash of their company to serve their own interest instead of using it in profitable investments reducing the value of the company. All options of controlling agency cost must be applied with a good governance system, where ethics codes are active with well understanding of a new consumption called stakeholders.

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