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MODERATING EFFECT OF AGENCY COST ON THE RELATIONSHIP BETWEEN CAPITAL STRUCTURE, DIVIDEND POLICY AND ORGANIZATION PERFORMANCE: A BRIEF LITERATURE REVIEW

The conflicts of interest among shareholders, management and debtholders are known as agency problems (agency cost) since it is a kind of internal cost. There are two sorts of conduct of agency cost; one is conflict of interest between shareholders and management (equity cost); the second one is conflict of interest between management and debtholders (debt cost). Agency cost impacts on organization performance as well since it is the outcome of the conflicts of interest between debtholder and equity holders. There are some important issues (e.g., substitution effect underinvestment and free cash flow) which generate agency cost and impact the performance.

Keywords: *agency cost, dividend policy, capital structure, performance, free cash flow.*

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ВПЛИВ АГЕНТСЬКИХ ВИТРАТ НА ВЗАЄМОЗВ'ЯЗОК МІЖ СТРУКТУРОЮ КАПІТАЛУ, ДИВІДЕНДНОЮ ПОЛІТИКОЮ ТА ЕФЕКТИВНІСТЮ ДІЯЛЬНОСТІ: ОГЛЯД ДОСЛІДЖЕНЬ

У статті розглянуто конфлікт інтересів між акціонерами, менеджментом і кредиторами, відомий як "агентська проблема" (агентські витрати), оскільки він є свого роду внутрішньою витратою. Їх існує два види: перший – конфлікт інтересів між акціонерами та менеджментом, другий – конфлікт інтересів між менеджментом і кредиторами. Агентські витрати впливають на ефективність діяльності, оскільки вони є результатом конфлікту інтересів між кредиторами та акціонерами. На агентські витрати впливають кілька факторів (наприклад, ефект заміщення активів, недофінансування, вільні грошові потоки), які генерують агентську вартість, що позначається на продуктивності.

Ключові слова: *агентські витрати, дивідендна політика, структура капіталу, продуктивність, вільні кошти.*

Рис. 1. Літ. 33.

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ВЛИЯНИЕ АГЕНТСКИХ ИЗДЕРЖЕК НА ВЗАИМОСВЯЗЬ МЕЖДУ СТРУКТУРОЙ КАПИТАЛА, ДИВИДЕНДНОЙ ПОЛИТИКОЙ И ЭФФЕКТИВНОСТЬЮ ДЕЯТЕЛЬНОСТИ: ОБЗОР ИССЛЕДОВАНИЙ

В статье рассмотрен конфликт интересов между акционерами, менеджментом и кредиторами, известный как "агентская проблема" (агентские издержки), поскольку он является своего рода внутренней издержкой. Их существует два вида: первый – конфликт интересов между акционерами и менеджментом, второй – конфликт интересов между менеджментом и кредиторами. Агентские издержки влияют и на эффективность деятельности, так как они является результатом конфликта интересов между кредиторами и акционерами. На агентские издержки влияют несколько факторов (например, эффект замещения активов, недофинансирование, свободные

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денежные потоки), которое генерируют агентские издержки, что сказывается на производительности.
Ключевые слова: *агентские издержки, дивидендная политика, структура капитала, производительность, свободные средства.*

1. Introduction.

Agency cost is a kind of internal cost which arises due to acting of an agent on behalf of a principal, and it should be paid to agent. Interest conflicts between management (agent) and shareholder (principal) are the basic reasons behind agency costs. Interest of shareholder is to run a company in a way to maximize the value for shareholder. However, interest of management to increase the value and growth of company in that ways which leads to increase their incentive and powers. Increase in wealth and power of management is not included in the interests of shareholders, so agency cost arises (Jensen & Meckling, 1976; Jensen, Solberg & Zorn, 1992). However, there are two types of agency cost present in an organization: first, arising due to conflicts between shareholder and management (Myers, 1997) and the other one – due to conflicts between shareholders and debtholders (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1999). In addition, free cash flow (FCF) is also a form of agency cost which increase agency costs as managers use this for their own compensations and benefits or use in some low returns projects (Yermack, 2006; Zhang, 2009). Subsequently, agency costs have significant impact on organizational decisions (e.g., capital structure decisions, dividend policy decisions) and performance of organization. Therefore, many researchers claim that the relationship between agency costs and capital structure decision, dividend policy as well as performance exists in corporations (Byrd, 2010; Stephan et al., 2011). However, for better understating of agency cost, it is necessary to understand the agency cost theory, FCF hypothesis and the factors involved in agency costs.

Agency Problems of Capital Structure

Agency theory belongs to financial economics, which explains the conflicts of interest between agent (management) and principal (shareholders). If interest of management is different from shareholder interest, then shareholder bears the costs for monitoring the activities of management (Jensen & Meckling, 1976; Jensen, Solberg & Zorn, 1992). There are some types of issues of agency costs but conflicts of interest between shareholder and debtholders are very critical (Money-Terms, 2012). However, there are some kinds of agency issues (substitution effect underinvestment and free cash flow), which indicates the relevancy (impact) of agency costs with capital structure decisions (Wiki, 2012). Substitutions effect occurs when the debt/equity ratio increases in capital structure. Management invests in some risky projects and shareholders will gain all the benefits on the success of that project. On the other hand, debtholder will bear all the costs in case of failure of that project (Wiki, 2012). Underinvestment issues arise when debt is very risky since benefits from a project will belong to debtholders instead of shareholders. In this case, management rejects the positive NPV (net present value) projects, even if these projects can increase the growth, value and performance of organization (Wiki, 2012). The agency problems of free cash flow happen when free cash flow is available to management and not distributed among investors. Management sometimes destroys the growth and perform-

ance of organization by investing available profits into unfruitful purposes (personal usage, constructing buildings, parks etc).

Agency theory of Dividend

There are no conflicts between shareholder and management; this is the one of M&M assumptions related to the perfect capital market. Nevertheless, in the real market this assumption does not hold because of separate interests of shareholders and management. Managers are not perfect agents of principal (shareholders) because the interests of both are not always the same. Managers can take such actions that are costly for shareholders and to avoid such actions shareholders start monitoring the activities of managers. As a result, shareholders are going to bear some costs and this cost is known as agency cost. According to Rozeff (1982), dividend payment might play important role in aligning the interests and alleviate agency problems of shareholders and managers through decreasing the available free cash. However, dividend payout can provide the basis to another agency cost which is interest of conflicts between shareholders and bondholders. Because it is considered that bondholder becomes principal after providing funds and shareholders become agents. In this situation, increase in dividend to shareholder probably assumed as confiscating profit from bondholders (Jensen and Meckling, 1976). Nevertheless, it is accepted that increase in dividend would reduce the free cash available to manager and build a pressure on managers to acquire funds from market. It means that shareholders are willing to bear risk of debt and ready to pay more personal taxes on dividend. Simply it is the trade-off between costs and benefits of increasing dividends.

Agency Costs and Free Cash Flow (FCF) Hypothesis

Agency cost theory essentially involves in such costs, which arises to settle the conflicts of interest of agent and principal. Therefore, it means that the agency costs theory is a very academic term. Therefore, in the perfect capital market there is no interest conflict between management (agent) and shareholder (principal), which is the one of assumptions of Modigliani and Miller (1958 & 1961) theory. Nevertheless, in reality this assumption is disputed because shareholders are separate from company management. This scenario predicts that manager is always a flawed agent of principal (shareholders). The reason behind this is that it is not compulsory the interest of managers always similar to shareholder's interest and managers could take such actions that are costly and not in the interest of shareholders (consuming excessive perquisites or overinvesting in managerially rewarding but unprofitable activities). Then shareholder starts monitoring the behavior of managers and acquires agency costs and because of conflict between shareholders and managers, these costs are an implied cost (Easterbrook, 1984). Unrestricted cash is available to managers and this cash paying as a dividend might play a vital role in align the conflicts and agency cost problems between shareholder and managers (Rozeff, 1982). Jensen and Meckling (1976) explained that the problems of agency costs which might be prejudiced by dividend payment is the conflict of interest between bondholders fund and shareholders is another source of agency costs. Bondholder for securing their claim on profit put constraint on dividend policy because shareholders although have limited liability but they have access to cash flow of company before bondholders (Ang, 1987). However, the idea of increasing dividend will reduce cash available to managers is acceptable because it forces managers to acquire funds from market. It means owners must show

willingness to pay high personal tax rates as dividend and endure the risk and burden of more debt. Simply, tradeoff between benefits of acquiring more dividend and costs is the choice of owners.

As agency problems are very important in today's economic world, they have great impact on organizational performance. However, empirical studies on agency costs are relatively insufficient (Tsuji, 2011). Similarly, the agency cost of debt and the agency cost of free cash flow have been widely discussed but effects of free cash flow cost on organizational performance have been ignored (Al-Taleb, 2012). Management has excess free cash flow and it can be used in paying more dividends or investing in some profitable projects. In addition, they can use free cash for their own incentives or invest it into some unprofitable projects. As Gul et al. (2012) explained there is a number of studies measuring the agency cost indirectly but only few studies exist, that measure the agency cost directly. Agency cost impacts capital structure as well as the dividend policy. Therefore, it has impact on the relationship between capital structure, dividend policy and organization performance. However, the intend of this study is to provide a review of literature on agency cost and try to explain the impact of agency cost on the relationship between capital structure, dividend policy and organizational performance by exploring the viewpoints and the results of prior studies. Moreover, this study also explains different types of agency cost as well, which can affect the capital structure and dividend policy decisions.

2. Literature Review.

Generally, agency cost is explained as the loss of principal (shareholder) for monitoring the agency behavior. Controlling the agency behavior and some uncontrollable costs are also the loss of shareholder. Jensen and Meckling (1976) stated that agency costs are of two types, one is the agency cost of equity and the other is agency cost of debt. When a company sold their shares to outsider (outside investors) and that outsider pays less than share price because he expect the performance of the company will change after his buying. Therefore, agency cost of equity arises because at the end of issuing equity shares decrease the market value of company assets. In this situation company relays on debt for covering the value of assets and it increases the pressure on managers to perform efficiently but debt also bring some costs. Debtholders put some restrictions on company through creating bond agreements because they secure their interest by using agreements that are costly and cannot be negotiated. In limited liability corporations, due to separation of management and shareholder agency costs arise. In corporations, shareholders (theoretical owners) have prominent control over manager's activities although other stakeholder (stagg, customers, creditors etc.) have little influence. Lease et al. (2000) stated that prominent control of shareholders on management than other stakeholders is because this disparity agency costs exist.

In the existence of agency cost there are many factors that enhance the agency problems, and electoral systems or electoral power is critical here. This electoral system means the political system that lies within the company as explained by Agrawal & Knoeber (1996), La Porta et al. (2000) and Choy, Gul & Yao, (2011). Agrawal & Knoeber (1996) wrote that electoral system is a system in which shareholders have right to vote and select management. They explained that this system increases the agency problems as it is not compulsory the interest of management should align with

shareholder interest, both work for their own benefits. According to La Porta et al. (2000), agency costs are high in those countries where shareholders have less protection. They further explained that electoral system decreases the efficiency of company by increasing agency costs. Beside this, Choy, Gul & Yao (2011) showed that electoral system can affect the efficiency of the company because it enhances the agency problems. They found that this system increases the power of shareholders and forces management to work in the interests of shareholders.

Various factors could play a vital role in decreasing agency costs along with such factors that enhance agency costs. According to Rozeff (1982), management has to create a balance between cost of transaction and agency cost. The balance can be easily done by distributing extra cash to avoid agency problems and keep in hand enough cash to meet necessities. Sometimes agency cost can arise by investing in less profitable projects or investing more than the capability of the firm. As Litzenberger and Lang (1989) stated, in overinvesting company's higher risk of agency cost exists. They suggested that in this situation most companies pay their income as dividend to evade agency costs. Hall (1998) and Ang, Cole & Lin (2000) documented that if agency costs are existent in significant numbers, it means that managers or directors still have to do work on such activities like capital budgeting and financing decisions to improve wealth. Firm can use performance bounces or share scheme as a method to avoid agency problems. Yermack (2006) and Zhang (2009) investigated the agency cost of free cash flow. They explained that FCF increase agency costs as managers use this for their own compensations and benefits or use in some low returns projects. They suggested that agency cost of FCF could be reduced by giving incentives or by increasing debt in capital structure. On the other hand, Al-Hunnayan (2011) explained that window dressing, uncertainty resolution and free cash flow are the examples of agency costs. He suggested that for avoiding agency costs compensations and performance bounces are used as tools.

Although agency cost upshot the interest of shareholder and management but it also has great impact on capital structure decisions, dividend policy decisions as well as performance of the company. However, some researchers are against the effect of agency costs on capital structure decisions, dividend policy decisions and company performance. Lasfer (1999), Jong & Dijk (2002) and Bell (2012) documented that agency costs exist in large corporations at minimal level but not in small business. They found that agency costs have no impact on debt/equity proportion in capital structure and dividend policy is free of its influence. Although agency cost has minimal relation with debt but not at significant level or no direct relation exists. They further explained that agency cost does not entirely determine the capital structure but it does have small (can be ignorable) impact on financial choices of the company.

Many researchers have claimed that the relationship between agency costs and capital structure decision, dividend policy as well as performance exists in corporations. The relation may be positive or negative as Byrd (2010) indicated that financial leverage (debt) can increase or decrease agency costs of the company, which put impact on performance and profitability of the company. He found inverse relationship between agency costs and leverage. An additional study by Stephan et al., (2011) show that agency costs, liquidity and taxes are very important for company performance. Agency costs arise due to the conflict of interest of management and owners so

its importance related to performance is more critical. They found negative relationship between agency costs and leverage.

Numerous researchers have argued in favor of positive relationship between capital structures decisions (debt) and agency costs. In the light of trade-off theory increase in debt leads to the increase in agency costs and bankruptcy, hence performance and value of the company decrease. In large corporations a relationship between agency costs and company performance exists. Further relationship between agency costs and leverage (debt) is positive (Jaggi & Gul, 1999). In addition, Berger and Di-Patti (2006) recognized that small increase in leverage reduced the agency costs of outside equity but leverage in big amount increases agency costs. This is because higher borrowing means higher expected bankruptcy and financial distress costs which leads to agency problems. Therefore, they found a positive relationship between agency costs and leverage (debt). Similarly, Utami & Inanga (2011) showed that the agency costs of FCF have positive significant relation with leverage. Companies that borrow small amount of funds for short period may decrease agency costs but borrowing of larger debt for long period increases agency costs. Moreover, Al-Taleb (2012) examined the relationship between risk, leverage, agency costs of free cash flow and company growth. He found that the agency cost of FCF increased as leverage increased which means positive significant relation exists between them.

Agency costs of FCF have positive relation with leverage but inverse relation with dividend policy. Previous studies (McKnight & Weir, 2009; Zhang 2009; Utami & Inanga, 2011; Khan, Kaleem & Nazir, 2012) provided evidence to confirm the inverse relation of agency costs of FCF and dividend policy. These results are also consistent with free cash flow theory by Jensen (1986) which argued the increase in debt reduces available free cash flow to company. This reduction in FCF leads to a decrease in agency costs. McKnight & Weir (2009) analyzed the relation between agency costs of FCF and debt. They found inverse relationship, which is consistent with the free cash flow theory. Similarly, Zhang (2009) inspected importance of capital structure decisions in scheming agency problems of FCF. He documented that agency problems of FCF are high in low growth and mature companies. He also found inverse relation of agency costs with debt; companies used high debt for reducing FCF costs. Moreover, Utami & Inanga (2011) inspected the relationship between agency cost FCF and dividend policy. They concluded that negative insignificant relation exists between FCF and dividend policy. It means that companies pay more dividends for reducing agency cost, which leads to a decrease in agency costs. Alongside Al-Taleb (2012) clarified the link between FCF agency costs and dividend policy. He concluded that agency costs of FCF are present in companies, which may affect company performance but negative and significant relation is found between FCF costs and dividend policy. Another study of Khan, Kaleem & Nazir (2012) exposed that debt plays a vital role in reducing FCF agency cost by decreasing FCF available to management. FCF is under the control of management which can be used in low profit projects or management incentive; this increases agency problems in company. They confirmed the negative relation between FCF agency cost and dividend policy; this result is steady with the theory of FCF.

There are many other agency costs present in corporations, which can affect company performance, beside FCF agency costs. As Ang, Cole & Lin (2000) found,

managers' ownership shares and performance of the company inversely related to agency costs. They explained that managers' ownership shares are a type of dividend payout policy for increasing company performance. Simply by offering share to management, company performance can be increased because in this way managers' interest could be aligned with shareholder interest. They further confirmed that ownership share and agency costs are inversely related. Similarly, Cohen & Yagil (2006) worked on company performance, growth, dividend and agency costs. They concluded that dividend changes provide changes in agency costs. They also explained the relationship between company performance and agency costs existing in corporations. Another study of Kraus (2006) provides results in favor of the relationship between agency cost and company performance. He used ROA, ROE, and Tobin Q as a measure of company performance. He concluded that a relation exists between performance and agency costs as well as a negative relationship between agency costs and dividend policy. In the same context, Brockman & Unlu (2009) showed that performance affected by agency costs and inverse relation is found between agency costs and dividend policy. They also documented that in dividend policies agency costs of debt play crucial role. Further Caelers (2010) demonstrated that performance and agency cost are related to each other but depend upon a company's situations. He clarified that agency costs are inversely related to dividend, which means that it is also inversely related to performance of the company.

Framework and Model

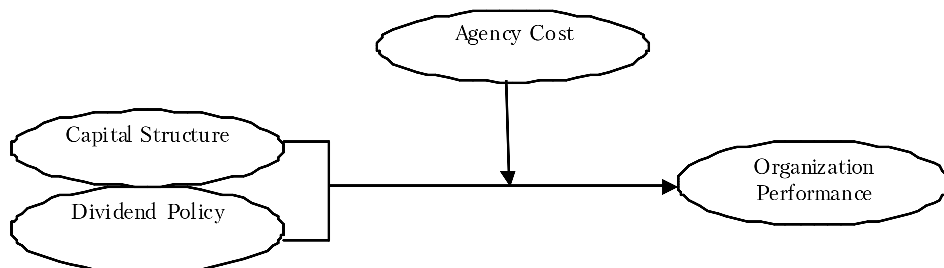

Figure 1

3. Conclusion.

Based on prior studies and theories, this study concludes that the relationship between company performance and agency cost exists. All the studies that have gone through in this study support the existence of a relation between agency costs and organizational performance. The second proposition based on the previous literature is that there is a negative relationship between agency costs and dividend policy, as all prior studies confirm this relationship. Previous studies on the relationship between agency costs and capital structure decision (debt/equity) have different propositions. A small number of studies conclude there is no relationship between capital structure and agency costs in small business but is minimal in large corporations. On the other hand, few studies concluded that a relationship exists between agency cost and capital structure but inversed in nature. Beside this, many studies also confirm the relationship between agency cost and capital structure

(debt) but are positive in nature. In addition, it is confirmed from the prior studies and the agency theory that agency cost have impact on the relationship between capital structure, dividend policy and performance of organization. Based on these studies, developing and testing a hypothesis on the relationship between agency costs and capital structure, dividend policy, organization performance will be our next work.

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