Capital Structure, Corporate Governance, and Agency Costs

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Abstract: The purpose of this empirical research is to examine the impact of capital structure and good corporate governance on agency cost. This research used 104 manufacturing companies which were listed on the Indonesia Stock Exchange from 2014-2016 as sample. This research used fixed effect models from Eviews 9 as the program. The statistical method used to test the hypothesis is multiple linear regression. General administrative expense ratio is used as a proxy to measure agency cost. Capital structure is measured by debt to asset ratio and long term debt to asset ratio. Corporate governance mechanism is measured by managerial ownership and board of director. The results showed that debt to asset ratio has a significant effect on agency cost. The long term debt to asset ratio, managerial ownership, and board size do not have a significant effect on agency cost.

1 INTRODUCTION

Agency costs are costs that are related to supervision from shareholders to the board of directors with the intention to optimize directors’ performance. According to Yegon et al., (2014), agency costs occur due to non-optimal performance of directors. These behaviors include excessive corporate consumption, ineffective investment decisions, wrong asset management, and fraudulent actions on company assets. Supervision costs are useful to reduce the risks and losses that must be borne by shareholders.

Many factors can influence agency costs, including capital structure and corporate governance mechanism. According to Truong (2006) and Zheng (2013), the capital structure shows the proportion of debt to finance the investment. Managers should know the balance between the risks and the rate of return on their investment. An optimal capital structure can control the amount of agency costs incurred because managers will tend to prioritize payment of debt costs. Managers are also afraid of the possibility of financial distress if debt obligations are not met, so managers will prioritize payment of debt obligations before using company assets for their own purposes.

Another factor that can affect the agency costs is good mechanism regarding corporate governance. Good corporate governance can work as a tool to achieve organizational goals and regulate relationships between stakeholders including the board of directors and shareholders. The agency problem and the agency cost will automatically decrease if there is good corporate governance mechanism. This study aims to investigate the relationship between corporate governance and capital structure with agency problems leading to increased agency costs among manufacturing companies in Indonesia that went public.

2 THEORY AND HYPOTHESIS

According to agency theory of Jensen and Meckling (1976), agency problems are characterized by conflict of interests and information differences between the company owner (principal) and the agent (manager). One of the ways to minimize the conflict and differences is to spend agency costs. Agency costs are difficult to measure, so this research will choose the ratio of general and administrative expense to sales as represented by agency costs (Ang et al., 2000). This ratio can show if there is excessive consumption by the manager.

2.1 Capital Structure

Agency costs can be reduced by debt. This can be explained by the Free Cash Flow Hypothesis.
According to Ross et al., (2008), the free cash flow hypothesis explains that managers have the authority in the consumption of cash flows and often waste the cash flow for the situation that will benefit themselves. Jensen (1986) also said that high free cash flow can make managers overconsume on expenditure for the company. However, with the existence of debt, it is believed that the waste of free cash flow can be reduced, because the company must pay interest on the debt. According to Gitman and Zutter (2012), capital structure can be optimal if there is a balance between benefits and costs of debt. Several studies have shown that debt can reduce agency costs, one of which is the research by Zheng (2013) which shows that debt has an impact on the decrease in agency cost. Debt can also be used to control excessive use of free cash flow by the management, thereby reducing worthless investments. With increasing debt, the company has an obligation to return the loan and pay interest periodically. This condition causes managers to work hard to increase profits so that they can meet the obligations of using debt. Capital structure is measured by debt to asset ratio (Ha1) and long term debt to asset ratio (Ha2) in this research.

2.2 Corporate Governance

Agency costs can also be reduced by the presence of good corporate governance. According to Sutedi (2012), good corporate governance leads to a system which regulates the relationship of the board of directors and company executive staff with all stakeholders and is responsible for improving organizational performance and achieving company goals. According to the National Committee on Governance Policy (2012), the main principles of Good Corporate Governance consist of transparency, accountability, and independence. The GCG used as a variable in this study are managerial ownership and composition of the board of directors.

Managerial ownership is a condition where the manager has a share in the ownership of the company. Managerial ownership is believed to be one way to overcome agency problems. Managers who own shares in the company are expected to have interests that are aligned with the shareholders. Managerial ownership is measured by the proportion of shares held by the company's directors at the end of the year which are then expressed in percentages (Yegon et al., 2014). Companies that have a large number of shareholdings usually experience low agency problems and low agency costs (Zheng, 2013). Ghasemipur (2014) also proved that the larger number of shareholders can lower agency costs.

The board of directors which consists of many people is considered to not able to work effectively because the larger number of directors, the more opinions in decision making there are. This can affect agency costs. Ineffective decision making can harm the company and increase agency costs (Yegon et al., 2014). Florackis (2004) said that a corporation must have a good proportion of board of directors so the decision making will be effective. Corporate governance mechanism is measured by managerial ownership (Ha3) and board of directors (Ha4).

2.3 Hypotheses

The hypotheses of this research are as follows:
Ha1: Debt to asset ratio has a significant negative effect on agency cost
Ha2: Long term debt to asset ratio has a significant negative effect on agency cost
Ha3: Managerial ownership has a significant negative effect on agency cost
Ha4: Board of directors has a significant negative effect on agency cost

Research Model:

3 RESEARCH DESIGN

Subjects in this study were manufacturing companies listed on the Indonesia Stock Exchange in the 2014-2016 period. The total sample selected was 104 companies with the company's requirements as follows: (1) The manufacturing companies were listed on the Indonesia Stock Exchange in the year 2014 -2016 (2) The manufacturing companies presented financial
statements during the period 2014 - 2016 (3) The manufacturing companies presented financial statements on December 31 (4) The manufacturing companies used Indonesian Rupiah in their financial reporting.

Operational variables in this study consist of capital structure and good corporate governance as independent variables and agency costs as the dependent variable. The operational definitions of each of the research variables are as follows:

Dependent variable is a variable that is influenced by independent variable (X) and denoted by symbol (Y). The dependent variable in this study is the agency cost which is proxied by general and administrative expenses (AC). This measurement is in accordance with the research used by Zheng (2013) and Yegon et al., (2014):

\[
Y = 0.040736 + 0.177828 X1 + 0.030228 X2 - 0.377242 X3 - 0.079430 X4 + e
\]

R-square value in Table 3 was used to determine the influence of the independent variables (X) to the dependent variable (Y). The adjusted R-square value was 0.338313 which means 33.83% of general variables and administrative expenses can be explained by debt to asset ratio, long term debt to asset ratio, managerial ownership and board size. Whereas 66.17% was affected by other factors not discussed in this study.

To find out whether the independent variables together have a significant effect on the dependent variable, the test was carried out together (F test). The F test results can be seen in table 3. The prob value was less than 0.05 which means that all the independent variables can affect the dependent variable. The result shows the Debt-Asset Ratio, Long Term Debt-Asset Ratio, Managerial Ownership and Board of Director Size together have an influence on the Agency cost proxied by the General and Administrative Expense Ratio.

**4 RESULTS AND DISCUSSION**

This research used Eview 9 to test the hypotheses. The statistics is shown on table 2 below:

<table>
<thead>
<tr>
<th>No</th>
<th>Variable</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Agency cost (Y)</td>
<td>General&amp;administrative expenses/sales</td>
</tr>
<tr>
<td>2</td>
<td>Debt to asset ratio (X1)</td>
<td>Total Debt / total asset</td>
</tr>
<tr>
<td>3</td>
<td>Long term debt to asset ratio (X2)</td>
<td>Total long term debt / total asset</td>
</tr>
<tr>
<td>4</td>
<td>Managerial ownership (X3)</td>
<td>Managerial ownership /shares outstanding</td>
</tr>
<tr>
<td>5</td>
<td>Board of directors (X4)</td>
<td>Ln (number of directors on the board)</td>
</tr>
</tbody>
</table>

Mean value of X1 means 49.4% asset is financed by debt. Mean value of X2 means 19.2% asset is financed by long term debt. Mean value of X3 means managerial has 1.6% ownership of the company. Mean value of X4 means there are, on average, 1.4 persons on the board of directors in the company. Mean value of Y means agency cost is 7.9% of general and administrative expense to sales.

Before testing the hypotheses, the first step was to determine which model of test was used. The Likelihood Test was conducted to determine the panel data research model that was better compared to Pooled Least Square or Fixed Effect. Results showed that fixed effects were better in this study. The Hausman test was also conducted to determine the panel data research model and test results also show fixed effects were better. The results of multiple regression analysis using fixed effect model was:

\[
Y = 0.040736 + 0.177828 X1 + 0.030228 X2 - 0.377242 X3 - 0.079430 X4 + e
\]

The results of the t test indicate that the debt to asset ratio (DAR) has a probability value of 0.0350 with a significance value <\( \alpha = 0.05 \). This shows that
there is a significant positive effect between the debt to asset ratio and the agency cost with a coefficient of 0.1778. The long term debt to asset ratio, managerial ownership, and board size do not have a significant effect to agency cost with a probability value of more than 0.05.

The result of the first hypothesis (Ha1) was supported by Hastori et al., (2015) but was not supported by Zheng (2013). The test result showed a positive relationship and indicates that debt can increase agency costs. This positive relationship can be caused by the use of high debt in manufacturing companies in Indonesia which can be seen from the percentage of average debt (49.40%). This high debt can cause a threat of bankruptcy to the owner because of the possibility of financial distress. This will encourage shareholders to spend more to prevent defaults and can increase monitoring costs. Additionally, it will increase agency costs.

The result of the second hypothesis (Ha2) did not show any significant influence of long term debt to asset ratio on Agency costs. This is in line with the research conducted by Zheng (2013). Low average debt ratio with a percentage of 19% indicates that the company does not use a lot of long-term debt to finance their assets, so there will be no significant increase of agency cost.

The result of the third hypothesis (Ha3) indicates that there is no significant effect of managerial ownership on agency costs. This is in line with the research conducted by Putri and Nasir (2006) and Singh and Davidson (2003), but not in line with Yegon, Sang, and Kirui (2004). The absence of a significant effect can be caused by the low number of managerial ownership in the Indonesia Stock Exchange. The average managerial ownership in the Indonesia Stock Exchange is only 1.65%.

The result of the fourth hypothesis (Ha4) was that the board size variable shows no significant effect on agency costs. The result of this study was in accordance with the research proposed by Singh and Davidson (2003), Kung’u and Munyua (2016), and Flemming (2003). In its decision making both in large and small sizes, the board of directors will continue to experience conflicts of interest in order to prosper themselves because of their position as agents in the agency theory, so the board size cannot have an impact in reducing agency costs.

5 CONCLUSION

From the results of this study, it can be concluded that the debt of the company can prevent any wasteful behavior by the manager for his personal interests. Cash flow generated from the company's business activities must be prioritized to pay interest expense and company debt. Therefore, proper debt and capital proportions are needed so that the agency costs incurred by shareholders can be minimal.

Limitations in this study include: (1) the population of data only includes companies engaged in manufacturing industries listed on the Indonesia Stock Exchange in the 2014-2016 period, (2) agency costs is very difficult to measure so this study uses a proxy ratio of general and administrative expense as a proxy.

Based on the results and limitations that have been explained, the suggestions that can be given to further researchers are: (1) to add sectors other than manufacturing companies as sample data and (2) to use another measurement as a proxy of agency cost.

REFERENCES


