Corporate Governance, Ownership Structure and Agency Costs: Evidence from Sri Lanka

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ABSTRACT

This paper aims to examine the link between corporate governance, ownership structure, and agency cost in Sri Lanka. The present study uses the regression model to analyze data for a sample of 150 firms listed in the Colombo Stock Exchange (CSE) for the financial years 2014 to 2018. The empirical results show statistically significant and positive associations between board size, CEO duality, managerial ownership, and agency cost proxies (i.e., asset turnover and expense ratio). The results also show a positive and significant relationship between the independent directors and asset turnover (though statistically insignificant with expense ratio), suggesting that entrenched independent directors employ lower conflict of interest to reduce the agency cost. Nonetheless, ownership concentration was statistically insignificantly associated with agency costs, and this paper provides support for such a view in the Sri Lankan context. This study contributes to the literature on the association between corporate governance, ownership structure, and agency costs. The findings may be useful for financial managers, investors, financial management consultants, and other stakeholders.

Keywords: agency costs, corporate governance, ownership structure

JEL Classification: G3
INTRODUCTION

Corporate governance is primarily concerned with finding a solution to the principal-agent problem. The Corporate Governance Committee (1997, pp.1) asserts that: "...directors are entitled to govern the firm and to supervise and monitor the firm's management in order to promote effective management and ensure prudent accountability to the shareholders". Corporate governance as a way in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer & Vishny, 1997). Corporate governance’s importance arises in a firm due to the separation between those who control and those who own the residual claims (Epps & Cereola, 2008). McCullers and Schroeder (1982) argue that the agency theory assumes an opportunistic behavior: individuals want to maximize their expected interests and are resourceful in doing so. There will be a conflict of interest between managers and stakeholders (Macus, 2008). Agency theory suggests corporate governance as a mechanism to reduce these conflicts by monitoring managers' performance and aligning management's goals with those of the stakeholders (Brickley & James, 1987).

Moreover, the agency theory (Jensen & Meckling, 1976), under dispersed ownership structure, the separation between ownership of resources and control and management of those resources creates agency conflict between the agent (i.e., one that manages and controls resources) and the principal (i.e., one that owns the resources), whereby the self-interest agent expropriates the resources for the benefit of him/herself while detriment the principal. As a consequence of the conflict, agency costs arise as reflected in the decrease of firm value. Ang et al. (2000), Singh and Davidson (2003), and Fleming et al. (2005) investigate the empirical determinants of agency costs and focus on the role of debt and ownership structure in mitigating agency problems. In line with previous research findings, they provide evidence that managerial ownership aligns managers' and shareholders' interests and reduces agency costs. Ang et al. (2000) point out that debt has an alleviating role, whereas it aggravates Singh and Davidson (2003).

Additionally, existing studies do not provide sufficient evidence on the association between corporate governance, ownership structure, and agency costs. The empirical findings of studies regarding developed markets have limited applicability in emerging markets (Guest, 2008). The mixed outcomes in the extant literature and a dearth of emerging country
studies suggest a significant gap in understanding corporate governance, ownership structure, and agency costs. The present study extends these studies using data from Sri Lankan firms. This study adds empirical substance to existing literature. Thus, the results might be generalized to an emerging context. Sri Lanka has an emerging economy it is still considered less developed and has received much attention in the financial literature during recent years. Especially after the conclusion of the domestic ethnic wars from 1970 to 2009, Sri Lanka has entered a post-war recovery phase where reform of the financial system has become pivotal in accelerating economic growth. Sri Lanka has recently started adopting several economic reforms, namely, infrastructure development, deregulation processes, and fostering international integration. As a result, long term investment has increased significantly. This study would hopefully benefit academics, researchers, policy-makers, and practitioners of Sri Lanka and other similar countries by exploring the impact of corporate governance, ownership structure, agency costs, and pursuing strategies to improve its current status. Section 2 presents the literature review; Section 3 describes the research methods; Section 4 presents findings and discussions, and Section 5 concludes the paper.

REVIEW OF LITERATURE

Corporate governance mechanisms are market, institution and legal settings that protect outside investors from opportunistic behavior of managers or controlling shareholders. In the absence of such protection, asymmetries of information and difficulties of monitoring suffered by outside investors enable managers to misallocate and expropriate corporate resources, often at the expense of minority investors and the long-term firm performance (Mollah, AlFarooque, & Karim, 2012).

The corporate form of firms is based on the separation of ownership and control, where the ownership is with the firm's shareholders, while the control is maintained by the firm management (Kumar, 2010). The Chartered Accountants of Sri Lanka has been at the forefront of issuing corporate governance codes in Sri Lanka. The code of best practice on matters related to financial aspects of corporate governance was issued in 1997. After that, in 2003, 2008, 2013, and 2017 the codes were reviewed and revised through a consultative process (CA Sri Lanka, 2017). This section reviews the empirical foundations for the association between
corporate governance, ownership structure, and agency cost. Board size is the number of directors present on a firm’s board, including independent directors and executive directors (Malik & Makhdoom, 2016). The literature of corporate governance studies such as the famous works of Yermack (1996) and Eisenberg, Sundgren, and Wells (1998) deduce that a large number of directors on the board of a firm may decline firm performance. Large boards may draw on various perspectives on corporate strategy and may reduce domination by the CEO (Forbes & Milliken, 1999; Goodstein, Gautam, & Boeker, 1994). On the other hand, the board-size effect: increased problems of communication and coordination as group size increases, and decreased ability of the board to control management, thereby leading to agency problems stemming from the separation of management and control (Yermack, 1996). According to the CSE (2013) listing guidelines, independent board members should not relate to a key employee, are independent of management, and have never worked at the firm or its subsidiaries, or for its consultants or major stakeholders. The Malaysian Code on Corporate Governance (2000) recommends balancing on the board of directors, with at least a third of the board directors' independent directors. It is consistent with corporate governance rules as required by section 7.10 of the listing rules of the Colombo Stock Exchange (CSE). Similarly, resource dependence theory argues that independent directors are likely to bring useful resources from other organizations. It is argued that outside directors will contribute to value-maximizing decisions by providing better monitoring and expert knowledge (Borokhovich, Parrino, & Trapani, 1996). On the other hand, the institutional theory argues that appointing independent members to the board may merely represent firms' attempts to comply with institutional pressures: the presence of more internal directors reduces agency costs, as they have more insider information at their disposal. Hermalin and Weisbach (1991) did not find any statistically significant relationship between external and independent directors and agency costs. Duality offers a clear direction on a single leader relationship concomitantly faster response to an external event. It would be anticipated that the separation of the chairman and CEO roles leads to gran eater prevents managerial behavior and leads to better performance. From an agency perspective, the roles of CEO and chair of the board should be separated. The stewardship theory argues that authoritative decision-making under the leadership of a single individual (as both chairman and CEO) leads to higher firm
performance. It is also argued that the CEO and COB's separated roles can lead to better board performance and fewer agency conflicts. The boards of director COB's separated roles were deemed an important corporate governance mechanism. The Sri Lankan best practices on corporate governance (2017) in recent times suggest that board meetings should be held at least once in every quarter of the financial year. Lipton and Lorsch (1992) suggest that meetings' greater frequency is likely to result in superior performance. Conversely, Jensen (1993) is that routine meetings engage much of time and limit the opportunities for independent directors to exercise meaningful control over management. Literature advises that there are various aspects of board meetings such as quality, the chairman's role, and how the decisions that need to be considered in terms of the impact on the firm's endeavors (Van den the Berghe & Levrau, 2004). Jensen and Meckling (1976) suggest that managerial ownership can help alleviate agency conflicts between managers and owners. That is because a manager who owns a large portion of the firm shares has more incentives to maximize job performance to ensure better company performance. Empirical evidence regarding the relationship between managerial ownership and agency cost is, however, mixed. While Agrawal and Knoeber (1996) found results consistent with agency prediction. The agency view is based on the idea that in modern corporations, separation of ownership (principal) and management (agent) leads to costs associated with resolving the conflict between the principals and the agents. In firms with high-ownership concentration, boards' monitoring function may become less relevant as ownership concentration minimizes agency problems. However, boards' managers are untrustworthy and opportunistic, and boards' responsibilities go beyond monitoring them. Prior literature has questioned new conflicts of interests between majority and minority shareholders. Similarly, Shleifer and Vishny (1997) believed that the real conflict worldwide is the conflict between large shareholders and minority shareholders. Research into the relationship between corporate governance, ownership structure, and agency cost has also been frequently conducted in previous years. The studies conducted in this area have been inconclusive (i.e., mixed results). The mixed outcomes of that research suggest that a significant gap exists in understanding the nature, intensity, and direction of the relationship between corporate governance, ownership structure, and agency cost.
RESEARCH METHODS

This research utilized a positivist theoretical perspective with deductive reasoning applying quantitative method techniques. Given this study’s focus on measurable and observable events concerning corporate governance, ownership structure, and agency costs, a positivist approach seems well suited to its research objectives. Moreover, seeking to understand the relationship between corporate governance, ownership structure, and agency costs, positivism provides a suitable paradigm to seek facts and causes of social phenomena where the researcher is independent of the research being conducted. This study’s population of interest is the two hundred and eighty-nine listed firms on the Colombo Stock Exchange (CSE) as of September 2018. The study excludes the financial, investment, and securities sector firms due to their financial characteristics, non-comparability of applicable regulations concerning share ownership concentration, and because their use of leverage is substantially different from other industries. After elimination, the population size is 150 Sri Lankan listed firms. Secondary data for the computation of independent and dependent proxies were obtained from the relevant firms’ annual reports, the CSE database, measured in five years from 2014 to 2018. Regression analysis was performed to examine the relationship between corporate governance, ownership structure, and agency cost. Corporate governance was proxied by board size, independent directors, CEO duality, board meetings. While ownership structure is represented by managerial ownership and ownership concentration. Agency cost was measured by asset turnover and selling, general and administrative expenses to sales.

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Agency\ cost\ (\text{asset \ turnover}) = \alpha_0 + \alpha_1 BS_j + \alpha_2 ID_j + \alpha_3 DU + \alpha_4 BM + \alpha_5 MO + \alpha_6 OC + \alpha_7 FA + \alpha_8 Lev+ + \epsilon
\]

\[
Agency\ cost\ (\text{expense \ ratio}) = \alpha_0 + \alpha_1 BS_j + \alpha_2 ID_j + \alpha_3 DU + \alpha_4 BM + \alpha_5 MO + \alpha_6 OC + \alpha_7 FA + \alpha_8 Lev+ + \epsilon
\]
Table 01. Variable measurement

| Corporate governance | Description | Source |
|----------------------|-------------|--------|
| Board Size (BS)      | The total number of directors on the board | Abor & Biekpe (2007); Florackis (2008); Li, Wang, Deng (2008) |
| Independent directors (ID) | The ratio of the number of independent directors to the number of total directors on the board | Abor & Biekpe (2007); Florackis (2008); Li, Wang, Deng (2008) |
| CEO duality (DU)     | A dummy variable that takes the value of 1 when the roles of CEO and CEO are not separated and 0 otherwise | Abor & Biekpe (2007); Florackis (2008); Li, Wang, Deng (2008) |
| Board meetings (BM)  | Frequency of annual meetings | Abor & Biekpe (2007); Florackis (2008); Li, Wang, Deng (2008) |

| Ownership structure | Description | Source |
|---------------------|-------------|--------|
| Managerial ownership (MO) | The percentage of equity ownership held by directors | Florackis (2008); Li, Wang, Deng (2008) |
| Ownership concentration (OC) | The sum of the stakes of the firm’s shareholders with equity ownership greater than 3 percent | Florackis (2008); Li, Wang, Deng (2008) |

| Agency cost | Description | Source |
|-------------|-------------|--------|
| Asset turnover | The ratio of annual sales to total assets | Ibrahim & Abdul Samad, (2011); Sajid, Muhammad, Nasir, Farman (2012) |
| Selling, general and administrative expenses to sales | The ratio of selling, general and administrative expenses to total sales | Ibrahim & Abdul Samad, (2011); Sajid, Muhammad, Nasir, Farman (2012) |

| Control variables | Description | Source |
|------------------|-------------|--------|
| Firm age (FA)    | Present year – incorporation year | Abor & Biekpe (2007) |
| Leverage (Lev)   | Borrowings/total assets | Abor & Biekpe (2007) |

RESULTS AND ANALYSIS

Descriptive Analysis

Table 02 provides the descriptive statistics embodying the overall mean, standard deviation, minimum and maximum values of both the dependable and the control variables. The board’s average size in the sample is 7.15, with a standard deviation of 2.031, while the maximum board size is 12. This result is consistent with the extant literature. Board size varies depending on the size and requirement of a firm. The ideal size is often recommended to be between seven, eight (Jensen, 1993), or ten. Although 20.6 percent of firms have minimum independent directors on board, an average of 77.77 percent of directors are independent positions on the boards. It suggests that independent directors have a larger influence on
the board, similar to existing studies. Boards with a majority of independent directors are more effective in monitoring management, more likely to replace poorly performing CEOs, and have lesser fraud instances than the board with lesser independent directors. CEO duality records 0.50, indicating that some boards have the CEO and the board chair as the same person. This result is consistent with recent studies. It is argued that there is a conflict of interest and higher agency costs when the CEO is also the board chairman, and it is suggested that two different persons should occupy the two positions. Another argument is that when the CEO doubles as board chair, it allows the CEO to carry out decisions without any undue influence of bureaucratic structures. Board meeting varies from one to five with an average of 2.66, which suggest that they are more severe and active in monitoring the management. When boards of directors meet frequently, they are likely to enhance firm performance and perform their duties following shareholders' interests.

About ownership structures, the average managerial ownership is 6.51, which varies between 0 and 74.39. Ownership concentration is examined as the proportion of the three biggest shareholders' shares over the total shares, and an average value of 13.34. The agency theory that explains the conflict of interest between the shareholders suggests that ownership patterns can be a solution to the agents suggest them and improve the firm's value. The firm age mean is 1.31, and leverage is 0.221, showing that sample firms depend more on equity than debt.

### Table 02. Descriptive analysis

| Variable                  | Mean | SD   | Minimum | Maximum |
|---------------------------|------|------|---------|---------|
| Board size                | 7.15 | 2.031| 4       | 12      |
| Independent directors     | 77.77| 14.256| 20.60  | 88.60 |
| CEO duality               | 0.50 | 0.392| 0       | 1       |
| Board meetings            | 2.66 | 1.95 | 1       | 5       |
| Managerial ownership      | 6.51 | 14.22| 0       | 74.39 |
| Ownership concentration   | 13.34| 25.92| 0       | 98.96 |
| Firm age                  | 1.31 | 0.167| 0.678   | 1.818  |
| Leverage                  | 0.221| 1.612| 0.033   | 57.912 |

### REGRESSION ANALYSIS

The model adjusted $R^2$ value of the agency cost proxies (i.e., asset turnover ratio and expense ratio) indicate that the corporate governance and ownership structure can explain 20.1 -17.3 percent of the observed variability in agency cost. The F-statistics and significance levels (Table 3) show that both asset turnover ratio and expense ratio models generate...
statistically significant outcomes that firms need good corporate governance and ownership structure to reduce agency costs and provide extra insurance for investors against any expropriation of shareholders' wealth. Board size is significant and positive at the 5 percent level of significance on the agency costs proxy: asset turnover and the expense ratio, which indicates that firms with larger boards have a higher asset turnover and expense, which leads to lower agency costs. Similarly, resource dependence theory suggests that larger boards may better form environmental links and secure critical resources. It is expected that larger boards will provide more effective oversight of management. The independent directors on the board had a positive and significant impact on the asset turnover and insignificant coefficients on expense the to. This result is consistent with the previous studies that included Haslindar and Fazilah (2009), who revealed that the number of independent directors on the board increase, the asset turnover ratio also increases, hence mitigating agency costs. These results indicated that independent directors would contribute to value-maximizing decisions by providing better monitoring and expert knowledge, which leads to minimizing the conflicts between shareholders and managers. The duality role positively and significantly impacted agency cost measures: asset turnover and expense ratio. Firms with duality practice could increase an asset turnover/expense ratio, which generates many sales that create shareholder value, thus having less agency conflict than those with lower asset turnover. This result was consistent with the previous findings of Singh and Davidson (2003). The annual number of board meetings is insignificantly related to agency cost measures. This result indicated that when the board of directors meets frequently, they are more likely to discuss the concerned issues and monitor the management more effectively, thereby performing their duties with better coordination and in harmony with shareholders' interests, which mitigating agency costs. From the regression results, managerial ownership is significantly and positively related to agency cost measures. Whereas ownership concentration is not significantly related to agency cost measures. It suggests that managerial ownership may reduce agency costs, but ownership concentration does not protect the firm from agency costs. The result also indicates that firm age is an insignificant determinant of agency costs within the sample firms. Leverage had a significant impact on asset turnover but not significant to expense ratio. The results suggest
that firms with higher leverage are more likely to get into mitigating agency costs

**Table 03. Regression analysis**

|                          | Model asset turnover | Model expense ratio |
|--------------------------|----------------------|---------------------|
| Constant                 | 3.131                | 3.701               |
|                          | (0.002)              | (0.000)             |
| Board size               | 2.528                | 2.430               |
|                          | (0.013)              | (0.032)             |
| Independent directors    | 2.485                | 1.449               |
|                          | (0.014)              | (0.061)             |
| CEO duality              | 2.389                | 3.323               |
|                          | (0.019)              | (0.000)             |
| Board meetings           | 1.808                | 1.884               |
|                          | (1.121)              | (0.147)             |
| Managerial ownership     | 2.641                | 2.462               |
|                          | (0.031)              | (0.016)             |
| Ownership concentration  | 1.194                | 1.064               |
|                          | (0.236)              | (0.290)             |
| Firm age                 | 1.074                | 1.516               |
|                          | (0.286)              | (1.26)              |
| Leverage                 | 2.109                | 1.203               |
|                          | (0.038)              | (0.112)             |
| R                        | 0.449                | 0.416               |
| R Square                 | 0.201                | 0.173               |
| F                        | 2.834                | 2.361               |
| Sig                      | 0.007                | 0.024               |

**CONCLUSION**

This study examines whether agency cost is influenced by corporate governance and ownership structure measures for Sri Lankan listed firms for 2014-2018. In the developed regression model, agency cost measures are used as dependent variables (e.g., asset turnover and expense cost). In contrast, corporate governance measures (e.g., the board size, independent directors, CEO duality, and board meetings) and ownership structure (e.g., managerial ownership and ownership concentration) are considered independent variables study. Two other control variables (e.g., firm age and leverage) are included in the regression model. The main findings in this study are: first, the results show that board size is significantly related to agency cost measures. Second, the board’s independent directors are significantly associated with asset turnover but not significant to expense ratio. Third, there is a significant association between CEO duality and agency cost measures. Forth, the annual number of board meetings is insignificantly related to agency cost measures. Fifth, managerial ownership is significantly and positively related to agency cost measures, and also, ownership concentration is not found to be related to agency cost.
measures. An increase in board size leads to mitigating agency costs only when it adds diversity to the board; therefore, the study supports Cadbury's (2002) suggestion that people with different backgrounds, knowledge, and skills should be appointed as independent directors. Even so, if the role of duality is separated on the board, it could mitigate agency costs.

Moreover, a board meeting is an important source for improving the board's effectiveness and, thus, better decision-making and mitigating agency costs. Managerial ownership enhances mitigating agency costs, whereas the presence of ownership concentration does not do so. The limitation is the difficulties inherent in discovering and adjusting variations in the agency cost, business scope, and/or financing portfolio across firms. Mainly, the agency cost may be influenced by variables other than those considered in this study. Future research should consider including many countries across the emerging to developed continuum to support more generalized conclusions. In addition to this, a longitudinal study might be more able to validate findings.

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