INFLUENCE OF THE MANAGERIAL BEHAVIOUR OF AGENCY COST ON THE PERFORMANCE OF LISTED FIRMS ON NSE

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ABSTRACT

Agency conflicts between managers and shareholders are characterized by whether the implementation of incentive compensation schemes mitigates the manager-shareholder conflict. This study investigates the relationship between some determinants of managerial behavior and agency cost from one hand, and the impact of this relationship on firm performance from the other. Within the framework of shareholders' and management's behaviors, that the role of management represented by being delegated by shareholders to manage available financial resources of the company and negotiate with all concerned parties on their behalf, must be in such a way that achieves positive outputs exceeding the opportunity cost in which those resources could be utilized and shareholders' wealth maximized. The Kenyan Capital Market Authority issued guidelines on corporate governance practices for publicly listed companies in 2002. The study used descriptive research design. The target population was listed firms in the Nairobi Stock Exchange (NSE). The study found out that non-conforming information is a source of the problems of agency conflicts that the organization's good performance depends on the importance of knowledge possessed by a decision maker and that information would never be fully revealed on the part of the managers due to agency problems.

Key Words: Agency Cost, Firm Performance, Information asymmetry and Managerial Ownership

Introduction

The end of the 1990s and the beginning of 21st century have witnessed a series of corporate accounting scandals across the United States and Europe. Examples include Enron, HealthSouth, Parmalat, Tyco, WorldCom and Xerox. At the core of these scandals was usually the phenomenon of earnings management (Agrawal & Knoeber (2006). Earnings management has been a great and consistent concern among practitioners and regulators and has received
considerable attention in the accounting literature. It has been argued that earnings management masks the true financial results and position of businesses and obscures facts that stakeholders ought to know (Loomis, 1999).

The accounting numbers are deemed value relevant if they have significant association with equity market value (Barth et al., 2001). Previous studies use equity market value as the valuation benchmark to assess the effect of accounting numbers on information used by investors and they suggest that shareholders use accounting earnings to estimate future returns (Anderson, R.C., Mansi, S.A., & Reeb, (2004). Reported earnings are considered by shareholders to be value relevant and useful in estimating future returns and thus earnings and share returns are expected to be related. A long line of empirical research has demonstrated that accounting earnings are related to share returns (Easton and Harris, 1991; Das and Lev, 1994; Liu & Thomas, 2000).

**Statement of the Problem**

According to (KPMG, 2012) Kenya has only 56 listed companies with a market capitalization that constitute 34% of GDP (RoK, 2012). According to World Bank (WB). This is relatively small when compared to South Africa which has 668 listed companies with a market capitalization that constitute 132% of GDP (WB, 2012). Reports from KPMG show that Malaysia that got independence in the same time with Kenya has over 1000 listed companies (KPMG, 2012). The Kenyan Capital Market Authority (CMA) issued guidelines on corporate governance practices for publicly listed companies in 2002. This statistics show that Nairobi Securities Exchange is still an emerging market. Globally for instance in America, The Enron scandal reveal that Shareholders lost nearly $11 billion when Enron's stock price, which hit a high of US$90 per share in mid-2000, plummeted to less than $1 by the end of November 2001 (Benston, George, 2003).

In the year 2006 Uchumi Supermarket was put under receivership (RoK, 2007). Uchumi Limited’s closure as a result of management’s incompetence, has been described as "one of the greatest corporate disasters in independent Kenya history" revealing agency conflict (CMA, 2011). Uchumi posted a loss of Ksh690 Million ($9.3 million) in June 2004 after two years of poor performance (PWC, 2011). According to information obtained from capital markets authority shows that Nyaga Stockbrokers Ltd was under statutory management due to conflict of interest by management of the company (CMA, (2012). The boardroom wars at listed motor dealer CMC has brought to the fore the caliber of management board members who run many public and private listed institutions in Kenya (CMA, (2012). Therefore the study sought to determine the managerial behaviour of agency cost and its influential extent on the performance of listed firms on Nairobi securities exchange. Local studies done include, Maina (2000) carried out a study to establish whether there exists a
relationship between dividend and investment decisions since both compete for internally sourced funds and given that funds obtained by debt are very expensive and not available to all firms. Karanja (1987) studied dividend practices of publicly quoted companies and found out that there are many reasons why firms pay dividends. This study seeks to analyze the influence of the managerial behaviour of agency cost on the performance of companies quoted at Nairobi Securities Exchange.

Objectives of the Study

1. To find out the influence of Agency cost on the performance of listed firms on Nairobi securities exchange
2. To evaluate the influence of managerial ownership on the performance of listed firms on Nairobi securities Exchange
3. To find out the influence of information asymmetry on the performance of listed firms on Nairobi securities Exchange
4. To find out the influence of debt ratio on the performance of listed firms on Nairobi securities Exchange
5. To explore the effect of Board Composition as the moderating variable for performance a case of listed firms on Nairobi securities Exchange

Literature Review

Pinteris (2002) conducted a study entitled:"Agency Costs, Ownership Structure and Performance in Argentine Banking". This study empirically investigates two main objectives: first is related to the reality of banking sectors in Argentine. Such objective proves the agency problems existence between stakeholders and management, from one hand, the stakeholders and government represented by banking institutions, from other hand. Second objective is represented by providing evidences related to the impact of bank ownership concentration on both agency cost and performance using available information related to banks in the period 1997-1999. The study reveals an inverse relationship between ownership concentration and performance. The study also concludes that the banks having high ownership concentration should have high risk on bank's loan portfolio; at the same time it does have a high agency cost as compared to other banks which have low ownership concentration. The results of this study also showed a strong conflict between stockholders and the management of banks because of the asymmetric information and the stockholders’ attempt to push the bank's managers towards investment on the account of deposits and reserves ratios.

It was measured using the same way done by Ang et al (2002) by using two alternative measurements: the expense ratio and the asset utilization ratio. The first ratio includes using the excessive expenses used by managers to get fancy things related to office, such as fancy
furniture, resort properties, and automobiles. In this study, the researchers will depend on using the first ratio because it is related to the excessive expenses, which are more common type of agency cost in NSE companies. For agency cost of ownership for the selected sample, it has been identified based on the difference between the averages of operating expenses ratio.

Mustafa (2006) conducted a study which provided a new measurement for agency cost of ownership represented by irregular risk related to the company. It supposed a model to interpret agency cost of ownership through two groups of determinants: First one is represented by causes behind agency cost arising between shareholders and managers, and the second determinant lies in the impact of financial policies on agency cost. Furthermore, this study used other two variables: company size and the field of company's activity.

This study was applied in sample of 40 Egyptian companies. Multiple regression analysis was employed to explore the accounting and market information for the period 2000-2004. The results support the integrity of the model, and the study also reveals the importance of information asymmetry and debt financing to increase agency cost of ownership.

The comparative analysis shows that the current study is similar to the previous studies regarding to examining the relationship between agency cost of ownership and some other factors associated with managerial behavior such as the percentage of managerial ownership, information asymmetry, and debt contracts. Nevertheless, in the researchers' knowledge, the current study offers a new contribution of investigating the impact of performance on such relation between these variables.

**Research Methodology**

The study adopted descriptive research design. The study was implemented at Nairobi Securities Exchange (NSE). The target populations for this study were companies that have floated shares on the NSE. There are 59 listed firms in Kenya (NSE, 2011). The target populations for this study were all the 59 listed firms. Due to the large number of listed companies, the study took a sample size of 31 listed firms and the respondents were 1 financial manager from each firm who is best placed to reveal the desired financial information required by the study.

Data collected was analyzed using descriptive statistics. The descriptive statistical tools help in describing the data and determining the respondents’ degree of agreement with the various statements under each factor. Data analysis was done using SPSS and Microsoft excels to generate quantitative reports, which were presented in the form of tabulations, percentages, mean and standard deviation.
The model that was used to investigate the influence of managerial behavior of agency cost on the performance of listed firms on Nairobi securities exchange was based on the models of (Hameed & Lim, 1998). A multiple regression analysis between performance and four determining variables was performed by estimating a linear regression as indicated by the regression equation below:

\[ Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \varepsilon \]

- **Y** = Dependent variable (Performance)
- **\( \alpha \)** = Constant (The intercept of the model)
- **\( \beta \)** = Coefficient of the X variables (independent variables)
- **X_1** = Agency cost
- **X_2** = Information Asymmetry
- **X_3** = Debt Ratio
- **X_4** = Managerial Ownership
- **X_5** = Board composition
- **\( \varepsilon \)** = Error Term

The moderating variable was Board composition. A moderator variable is one which alters the relationship between other variables. Suppose that we are using regression analysis to test the model that continuous variable Y is a linear function of continuous variable X, but the slope for the regression of Y on X varies across levels of a moderator variable, M. Put another way, we think that there is an interaction between X and M with respect to their effect on Y.

If the moderating variable is categorical, we can conduct a “Potthoff analysis” to determine if the regression of Y on X differs across levels of the categorical moderator. T-test was used to ascertain the significant of the predictor variable.

In addition, the researcher conducted a linear multiple regression analysis so as to test the relationship among variables (independent and dependent variables.)
Research Results

Table 1: Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.690a</td>
<td>.477</td>
<td>.367</td>
<td>.1643</td>
</tr>
</tbody>
</table>

The four independent variables that were studied, explain only 47.7% of the factors that affect Performance of listed firms on NSE represented by the R2. This therefore means that other factors not studied in this research contribute 52.3% of the factors that affect Performance of listed firms on NSE.

The researcher conducted a multiple regression analysis on the role of intellectual capital on the performance of commercial banks in Kenya. The following multiple regression equation was used.

\[ Y = 0.718 + 0.643 + 0.447X_2 + 0.450X_3 + 0.234X_4 + \epsilon \]

Where Y is the dependent variable (Performance of commercial banks), \( X_1 \) is the innovation capital variable, \( X_2 \) is human capital, \( X_3 \) is structural capital, and \( X_4 \) is the customer capital.

As shown in table 4.9 above, the most significant variable at predicting financial performance of the organization was agency Cost as shown by a p-value of 0.0017; followed by Information Symmetry (p-value=0.0026), managerial ownership with p-value of 0.0029, Board size (p-value= 0.0036) and finally debt ratio with a p value of 0.0047. The significance value is .000 which is less that 0.05 thus the model is statistically significant in predicting (Agency Cost, Managerial Ownership, Information Symmetry and Debt ratio).

The researcher also sought to establish the moderating effect of board composition on the relationship between each independent variable and the dependent variable.

As revealed by the inferential statistics in table 4.10 above, the moderating variable has a strong moderating effect on each relationship. This was shown by the increase in the beta coefficients to 1.988, 1.643, 1.233, 1.222, and 1.000 for managerial Ownership, agency Cost, information Symmetry, and debt ratio and board size respectively after using operationalizing the moderating variable.
Conclusions and Recommendations

The study was to explore the influence of the managerial behaviour of agency cost on the performance of listed firms on NSE. Based on previous studies, the components of Agency cost were expected to have positive relation with performance of listed firms on NSE. The output given from the findings indicate that there is a significant positive relationship between the components of agency cost namely managerial ownership, information asymmetry, debt ratio, and board composition on the performance of listed firms on NSE. The findings revealed that respondents agreed that high-equity ownership on the part of managers and board members affects firms performance to a great extent, that CEOs should typically be the only insiders on the board, that CEOs should seldom be the chairman of the board and that Small boards of directors, typically consisting of not more than eight people work better. The findings revealed that majority of the CEOs who are related to the controlling family receive a lower total compensation compared to outside CEOs. The study also found out that the separation of ownership and control, and the resulting conflict of interests between owners (principals) and manager (agents); that Large shareholder does have a strong incentive to monitor managers and can play a beneficial role in remedying agency problems and increase firm value; that the ownership and identity of the shareholder should be examined with the most control rights.

Findings from the study showed that non-conforming information is another source of the problems of agency conflicts that the organization's good performance depends on the importance of knowledge possessed by a decision maker. Information would never be fully revealed on the part of the managers due to agency problems to a great extent. The study findings also revealed that managers utilize this information to achieve performance and decisions leading to achieve their own interests and create negative impacts on shareholders' interest to a moderate extent. It was also observed that debt servicing obligations help reduce agency problems; that making debt contracts leads to increasing company's financial risk, which may lead to motivate managers to reduce agency cost to keep on the financial ability of the company to meet debt and burdens on time. Findings further revealed that agency problems within a firm are usually related to free cash-flow and asymmetric information problems; that bank debt and short-term debt are expected to constitute important corporate governance; and that bank lenders have a comparative advantage in minimizing information costs and getting access to information not otherwise publicly available.

The study finally found out that making the internal corporate governance mechanisms (such as shareholder participation and the role of the board) work better affects firms performance to a great extent; that enhancing the standards of accounting, audit and disclosure; and a standard deviation of reducing ownership concentration. The separation of ownership and control; ensure the firm has a large shareholder base as large shareholder have a strong incentive to monitor managers and plays a beneficial role in remedying agency problems and increase firm value.
References


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