RESEARCH PAPER | Economics | Volume : 4 | Issue : 5 | May 2014 | ISSN - 2249-555X

Corporate Governance and Agency Cost

KEYWORDS: Corporate Governance, Agency Cost, Shareholders, Managers.

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ABSTRACT *Corporate governance is the wide term that explains the processes, customs, policies, laws, and institutions that directs the organisations and corporations in the way they act, administer and control their operations. Corporate governance is assisting in increasing the performance of firm and raises the long term value of shareholder by making managers more accountable. It also reduces the conflict of ownership and control by separately define the interest of shareholders and managers. This paper intends to present the concept of corporate governance and agency cost. This paper also highlights that the principal-agent problem can be reduced due to effective corporate governance mechanisms in the corporations.*

INRODUCTION :
Corporate governance is the system by which corporations are directed and controlled. The governance structure specifies the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators and other stakeholders) and specifies the rules and procedures for making decisions in corporate affairs. Governance provides the structure through which corporations set and pursue their objectives, while reflecting the context of the social, regulatory and market environment. Governance is a mechanism for monitoring the actions, policies, and decisions of corporations. Corporate governance involves the alignment of interest among the stakeholders. If there is a divergence of interest between owners and managers due to separation of ownership from control, it results in agency costs. So good corporate governance is fundamental to the economies with extensive business background and also facilitates the success for entrepreneurship. Fine corporate governance is an essential standard for establishing the striking investment environment which is needed by competitive companies to gain strong position in efficient financial market.

CORPORATE GOVERNANCE-
Importance of corporate governance arises in modern organisations due to separation of management and ownership control in the corporations. The interest of owners is misaligned with the interest of managers. The principal-agent problem is depicted in the management and direction related problems due to the distinguished interests of firm's stakeholders. There is not a single definition of corporate governance rather it might be viewed from different angles. Corporate governance has been defined as "a system of law and sound approaches by which corporations are directed and controlled focusing on the internal and external corporate structure with the intention of monitoring the actions of management and directors and thereby mitigating agency risks which may stem from the misdeeds of corporate affairs". Shleifer and Vishny (1997) define corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (p.737)". Oman (2001) defined corporate governance as a term refer to the private and public institutions that include laws, regulations and the business practices which governs the relationship between the corporate managers and the stakeholders. OECD in 1999 defined corporate governance as "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporations, such as, board, managers, shareholders, and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance". India's SEBI Committee on Corporate Governance defines corporate governance as the "acceptance by management of the alienable rights of shareholders as the true owners of the corporations and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of company.

AGENCY COST-
Agency costs arise from the misalignment of the interest of the owners and managers of firms when the separation of ownership and control occurs (Jensen 1986). Agency theory is concerned with contractual relationship between two or more persons. Jensen and Meckling (1976 p .308) define agency relationship as a "contract under which one or more persons (the principals) engage another person (the agent) to perform some services on their behalf which involves delegating some decision making authority to the agent". Under this agency relationship, both the agents and the principals are assumed to be motivated solely by self-interest. As a result, when principal delegates some decision making responsibility to the agents, agents often use their power to promote their well being by choosing some actions which may or may not in the best interests of principal (Barnea, Haugen and Senbet 1985; Bromwich,1992; Chowdhury, 2004).The agency relationships are common everywhere in economic and business life and are an element of the more general problem of contacting between entities in the economy (Bomwich1992). For example, in context of public corporation, there are contractual relationships between the shareholders and Board of Directors and the executives and their subordinates. In the above mentioned relationships, the former can be called the principal(s) and the latter can be called the agent(s).The main reason behind the relationships, as prior literature suggests and Bromwich(1992) indentifies include

a) To exploit any asset specific advantage.
b) To take advantages of economies of scale and scope.
c) To provide an ability to improve on the contracts other-

Volume : 4 | Issue : 5 | May 2014 | ISSN - 2249-555X

wise available.
d) To allow the advantage of transaction cost avoidance and
e) To maintain authority relationship including vertical integration.

The problem in the agency relationship occurs as the agent and the principal may be at variance with each other, and nature of agency contract (due to uncertainty and asymmetric information) cannot fully prevent the participants in the agency relationships from pursuing their self-interest at the expense of other participants. Agency costs can be seen as the value loss to shareholders, arising from divergences of interests between shareholders and corporate managers. Jensen and Meckling (1976) defined agency costs as the sum of monitoring costs, bonding costs, and residual loss.

A-Monitoring Costs-
Monitoring costs are the costs incurred by the owners to monitor the actions of the actions of the manager. Examples are the costs incurred for the appointment of the auditors, appointment of board of directors, installation of formal control systems, budget restrictions, etc.

B-Bonding Costs-
Bonding costs are costs incurred by the managers to assure the owners that they will act in the interest of the later.

C- Residual Loss-
Residual loss is the reduction in welfare experienced by the principal because of such divergence of interest between the owners and the managers, Jensen and Meckling (1976).

CONCLUSION-
There is question which needs to be asked why we should worry about corporate governance in the first place, since product market competition should provide incentives for firms to adopt the most efficient corporate governance mechanisms. Firms that do not adopt cost-minimizing governance mechanisms would presumably be less efficient and in the long run would be replaced, i.e. competition should take care of governance. While there are likely to be important interactions between product markets and corporate governance systems, market competition alone cannot solve the market failures arising from asymmetric information, hold up, and principal-agent problems that are at the heart of the corporate governance problem. However, we should keep in mind that the effectiveness and form of different corporate governance systems may be influenced by a number of factors, including product market competition, the structure of capital and labour markets, and regulatory and legal environments.

An effective corporate governance framework can minimize the agency costs and hold-up problems associated with the separation of ownership and control. There are broadly three types of mechanisms that can be used to align the interests and objectives of managers with those of shareholders and overcome problems of management entrenchment and monitoring:

- One method attempts to induce managers to carry out efficient management by directly aligning managers interests with those of shareholders e.g. executives compensations plans, stock options, direct monitoring by boards, etc.
- Another method involves the strengthening of shareholder's rights so shareholders have both a greater incentive and ability to monitor management. This approach enhances the rights of investors through legal protection from expropriation by managers e.g. protection and enforcement of shareholders rights, prohibitions against insider-dealing, etc.
- Another method is to use indirect means of corporate control such as that provided by capital markets, managerial labour markets, and markets for corporate control e.g. takeovers.

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