AGENCY COSTS AND FIRM PERFORMANCE: LITERATURE REVIEW AND PROPOSED MODEL

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Abstract: ***The relationship between agency costs and corporate performance constitutes a significant area of research, garnering substantial interest from scholars globally, including those in Vietnam. In the context of an increasingly competitive business environment, the effective minimization of agency costs is crucial for the success and sustainable development of enterprises. This paper conducts a comprehensive review of previous studies, elucidating the various factors influencing agency costs. Furthermore, the paper proposes a quantitative model to analyze the impact of agency costs on corporate performance. This model not only provides a robust theoretical foundation but also offers practical applications for corporate management, enhancing transparency and facilitating the design of more effective corporate governance mechanisms.***

• Keywords: *agency theory, agency costs, firm performance.*

Date of receipt: 14th March, 2024
Date of delivery revision: 28th March, 2024
Date of receipt revision: 10th April, 2024
Date of approval: 05th July, 2024

1. Introduction

Modern companies are the integration of team power with a number of living individuals, including managers, employees, shareholders, creditors, and so on. For a long time, economists chronically assume and think that these parties have a common goal and orientation, but actually there is a conflict of interests among economic individuals. And companies have been trying to reconcile these contradictions. Therefore, it has always been the focus of scholars in the field of corporate finance and capital markets.

The theory of agency costs was initially articulated by Jensen and Meckling (1976), who posited that the divergence of interests between principals and agents necessitates mechanisms to align the incentives of managers with those of shareholders. Despite the theoretical foundation laid decades ago, the real-world implications of agency costs on firm performance remain a vibrant and contentious area of research (e.g., Ang et al., 2000; Singh & Davidson, 2004; McKnight & Weir, 2009; Belghitar & Clark, 2015; and Rossi et al., 2018). Agency costs arise from the conflicts of interest between shareholders (principals) and managers (agents). These costs can significantly affect firm performance by influencing managerial behavior and decision-making processes.

The study of the relationship between agency costs and corporate performance has become a profound research area in recent times, attracting the attention of researchers and economic experts. Recent studies have indicated that managing agency costs plays a crucial role in the operation and management of corporate activities (Ang et al., 2000; Khidmat and Rehman, 2014; Chen and Jia, 2015; Rossi et al., 2019; Mazlan et al., 2019; Hoang et al.,2019; Khuyen, 2021). Researchers have indicated that optimizing agency costs not only helps improve operational efficiency and increase profitability but also enhances the trust of investors and shareholders in the enterprise.

However, managing agency costs also poses numerous challenges. These risks may include the complexity in managing and monitoring costs, as well as the potential for conflicts of interest and a lack of transparency in corporate activities (Lee, 2010; Li et al., 2021). Particularly, in an increasingly competitive business environment, effectively minimizing agency costs can play a decisive role in the success and sustainability of an enterprise (Chen and Jia,2015; Rossi et al., 2019; Mazlan et al., 2019).

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This paper provides an extensive review of prior research, clarifying the different factors that affect agency costs. Additionally, it introduces a quantitative model to examine the effects of agency costs on corporate performance. This model offers a solid theoretical base and practical applications for corporate management, improving transparency and aiding in the creation of more effective corporate governance mechanisms.

The structure of this paper is outlined as follows: Section 2 covers theoretical foundation for the research and the effects of agency costs on firm performance. Section 3 develops a research model for the impact of agency costs on firm performance and Section 4 offers concluding remarks.

2. Theoretical foundation for the research

2.1. Agency cost

Agency cost theory, a fundamental concept in corporate governance and financial economics, refers to the costs associated with resolving conflicts between managers (agents) and shareholders (principals). These conflicts arise due to different objectives, information asymmetry, and risk preferences between managers and shareholders.

Agency theory stems from the separation between ownership and control. This separation is becoming more and more popular as the scale of businesses becomes larger, the owner is not be able to participate in running the business but tends to hire people to run the business. According to Jensen and Meckling (1976), agency theory suggests that when there is a separation between ownership and management rights, conflicts will arise between owners and managers. Managers do not always make decisions in the best interests of shareholders.

Jensen (1986) argues that managers want to retain more profits, while shareholders want to pay cash dividends. When retained profits are large, the scale of the company's operations is expanded and therefore the power of the manager is greater and his position is strengthened. Therefore, the dividend decions are made for the interest of managers instead of the benefits of shareholders.

The misalignment between principals and agents can lead to various costs. Monitoring costs are one kind of agency costs incurred by principals to oversee the actions of agents. Denis and Timothy (2000) argue that most of the intelligence of the manager is devoted to the company, their income will depend on the performance of the company. Managers tend to invest in projects that suit their skills and interests, not always based on the interests of the owners, thereby increasing their position and earning. The problem of moral hazard is often more evident in large-scale companies with complex ownership structures. Therefore, monitoring costs will be considerable. Monitoring activities require additional costs and this cost is the agency cost paid by the owner, which is mentioned by Fama and Jensen (1983). Eisenhardt (1985) argues that a fixed income can be an excuse for managers to avoid work, because the amount of money the manager receives will not change regardless of the quality of work. Research by Alchian and Demsetz (1972) shows that replacing a fixed salary with an income based on the added value of corporate profits is more effective.

The owner (principal) - manager (agent) relationship is like a contract in which one party (principal) hires another party (agent) to do some work on its behalf and delegates some decision-making authority to the agent. If both parties are benefit maximizers, the managers may not always act in the best interests of the owners. Owners can limit this regime of inconsistency by providing incentives to the managers and incurring additional control costs to limit unfavorable actions of the managers. This cost is called agency cost. According to research by Bendickson et al. (2016), agency costs were first mentioned by two authors Berle and Means in 1932. Afterwards, many studies tried to understand the agency problem in corporate governance by developing frameworks theories to analyze agency costs such as Jensen and Meckling (1976), Jensen (1986), Lowe and Rohling (1993), Bernanke et al. (1994), Lang et al. (1995).

According to Jensen (1986), measuring agency costs of a business should be based on the relationship between free cash flow and growth prospects. He believes that agency costs will be high when the company has a large amount of free cash flow associated with low growth opportunities because it means arbitrariness in operating decisions. In the view of Ang et al. (2000), there are two important criteria to evaluate agency costs: asset utilization efficiency and the ratio of corporate management costs to total revenue. In fact, the asset utilization ratio evaluates the level of asset utilization efficiency

compared to revenue and thus has an inverse relationship with agency costs. Studies by Singh and Davidson (2004) and Lee (2010) show that if the ratio of revenue to total assets is high, it means low agency costs. On the contrary, if this index is low, it shows that the manager is implementing poor investment policies and ineffective asset management and use. As for the coefficient of business management costs on total revenue, it shows how effective the company's management is in controlling business operating costs. A higher index means higher agency costs. On the contrary, if this index is low, it shows that the business manages spending effectively.

In order to reduce agency costs, the law can play an important role. For example, the disclosure requirement for agents can be enhanced and also the principal can enable legal actions being taken towards dishonest or negligent agents (Rossi *et al.*, 2018). Furthermore, foreign investors, who are usually minority shareholders, are induced to drive investment of unrelated businesses in the group in order to reduce agency costs. In emerging countries, it is not unusual that many businesses have unrelated diversification due to political, cultural and economic conditions. Usually, both principals and agents are interested to reduce agency costs in any business transaction. Therefore, an effective corporate governance structure has to be established to ensure that creditors and shareholders are effectively protected and also to ensure their investment returns. In addition, it also enables to promote the conducive environment to the sustainable growth and efficiency of the corporate sector.

2.2. Firm performance

Firm performance refers to the overall effectiveness with which a business or company achieves its objectives and goals over a period of time. It is a comprehensive measure of how well a firm uses its resources to generate profits and create value for its stakeholders, including shareholders, employees, customers, and the community.

In previous studies, firm performance can be approached from the following aspects:

Financial performance: Financial performance indicators assess how well a firm manages its resources to generate revenues and profits. Research by Altman (1968) on the development and application of financial ratios like Return on Assets (ROA) and Return on Equity (ROE) to assess firm profitability. Studies by Beaver (1966) and subsequent scholars that examine the relationship between profit margins and firm performance, demonstrating how profitability metrics reflect operational effectiveness and revenue generation capabilities.

Market-based performance: Market-based performance refers to the evaluation of a firm's financial health and success based on its stock market performance and investor perceptions. Unlike traditional financial metrics that focus on internal operational efficiencies and profitability, market-based performance measures how well a company is valued by the market and how its stock performs relative to peers and broader market indices (Ramaswami *et al.,* 2009; Zahoor *et al.,* 2023,). This focuses on the firm's market value such as Tobin's Q and M/B ratio provide indicators of market perception and valuation, reflecting firm performance relative to its assets and equity (Lindenberg & Stephen, 1981).

2.3. The relationship between agency costs and firm performance

In large businesses, separation of ownership and management is inevitable. Most public listed companies have hundreds of shareholders and it makes it impossible for all shareholders to be involved in the management of the company. Hence, the separation of ownership and management allows shareholders to appoint the management to act on behalf of them to manage the company. However, if managers' objectives are different from shareholders' objectives, it will create agency problems. These problems come with an associated cost, generally referred to as agency costs.

The agency theory offers two options to avoid agency problems. The first option is to develop a structure of governance where the contract based on the agent's behavior to generate agency costs aimed to monitor and assess the act of the agent Singh and Davison (2004), Bendickson *et al.* (2016). These studies found that stewardship structures are advantageous for family-owned companies because they increase the steward-like behavior of family employees. Notwithstanding, these structures are damaging because they increase the agent behavior of nonfamily employees. This shows that agency structures based on the agent's behavior are essential, but that stewardship structures can only be useful when a large number of family employees are employed. The second option is to develop a governance structure that can facilitate supervision

and appraisal of agent behavior, which typically comprises reporting procedure, the inclusion of the main board of directors or management personnel Bendickson *et al.* (2016).

Several ratios can indirectly gauge the agency costs of a firm, including the utilization ratio and expense ratio. The total assets turnover serves as a proxy for the utilization ratio, which measures the agency cost of a company by assessing management's efficiency in utilizing its assets. According to Singh and Davison (2004), a higher utilization ratio indicates more productive use of assets, thereby creating greater shareholder value. On the other hand, the expense ratio, another proxy for agency costs, reflects discretionary management expenses using company resources, where higher management expenses lead to increased agency costs.

Higher agency cost indicates poor management of operational cost, which leads to low operating income and is possibly due to fraudulent management of the operating costs. It can increase agency costs and adversely affects the company's profitability (Ang et al., 2000; Rossi et al., 2019; Mazlan et al., 2019).

2.4. Empirical studies on the impact of agency costs on firm performance

Regarding empirical studies related to how agency costs affect firm performance of enterprises, Jabbary *et al.* (2013) used a data set of 73 listed companies between 2006 and 2010 to evaluate the impact of agency costs on the performance of companies listed on the Tehran Stock Exchange. In this study, the authors proposed 01 main hypothesis and 06 secondary hypotheses to test with the selection of criteria affecting firm performance. In this empirical study, three criteria are used including: operating expenses to sales ratio, asset turnover ratio to sales and Tobin-Q ratio to measure agency costs. In addition, two criteria return on assets (ROA) and return on equity (ROE) were used as dependent variables to measure the firm performance. The statistical analysis results from this study have shown a significant relationship between agency costs and performance of companies listed in the Tehran Stock Exchange.

From a different perspective, Khidmat and Rahman (2014), when studying 113 companies listed on the Karachi stock exchange in Pakistan from 2003 to 2009, showed a significant negative impact of agency costs on firm performance except for total asset turnover ratio (TATO) which has a positive impact. In Pakistani context, minority shareholders are exploited by majority shareholders and management. This research results have provided suggestions for corporate governance rules in which agency costs can be controlled. Investors are also advised to be able to manage their investment portfolio effectively while considering the impact of agency costs and the company's free cash flow.

Yao and Wu (2014) conducted a pivotal study examining the impact of agency costs on firm performance within the context of Chinese listed companies. Utilizing a comprehensive dataset from the China Stock Market and Accounting Research (CSMAR) database, they employed econometric techniques to analyze the relationship between ownership structure, governance mechanisms, and firm performance. Their findings revealed a significant negative correlation between agency costs and firm performance, indicating that higher agency costs detract from corporate efficiency and profitability. Moreover, the study highlighted the role of ownership concentration and board independence in mitigating these costs. Specifically, firms with concentrated ownership and independent boards exhibited better performance, suggesting that effective governance structures are crucial in reducing agency conflicts. Yao and Wu's research contributes to the broader literature by providing empirical evidence from an emerging market, emphasizing the importance of tailored corporate governance practices to enhance firm performance in different economic contexts. The study underscores the necessity for policymakers and corporate managers to focus on reducing agency costs through improved governance frameworks to foster sustainable business growth.

Another study by Hoang *et al.* (2019) used data sets on 736 companies listed on the Vietnamese stock market in the period from 2010 to 2015. To handle defects in the research model, the authors used the model Generalized Method of moment Model (GMM). Research results have shown that agency costs have a negative impact on the performance of listed companies in Vietnam. Thus, this result is similar to the study of Yao and Wu (2014) on empirical evidence of the negative impact of agency costs on the performance of insurance companies in China. In addition, this

study also shows that debt instruments can be a useful tool to reduce the negative impact of agency costs on company performance in Vietnam.

Similar to the research of Yao and Wu (2014) when studying a specific group of industries listed on the stock market, Khuyen (2021) also used a panel data regression model with a data set of 34 food and beverage companies listed on the Vietnam stock market in the period from 2010 to 2020 to analyze the impact of agency costs on firm performance. Research results also show that agency costs have a significant impact on firm performance of food and beverage companies in Vietnam. However, the difference in the study of Khuyen (2021) compared to the study by Hoang *et al.* (2019) is that among the three variables representing agency costs, the total asset turnover criterion has a positive impact on firm performance. On the contrary, the criteria of short-term debt ratio and total administrative expenses and selling expenses on total revenue have a negative impact on firm performance.

3. Developing a research model for the impact of agency costs on firm performance

3.1. Research hypotheses

Based on previous studies, we develop two research hypotheses regarding the impact of agency costs on firm performance as follows:

Hypothesis 1: An increase in agency costs can adversely affect firm performance.

The ratio of general & administration expenses and sales expenses to total revenue has a negative impact on the operational performance of the enterprise.

Agency costs arise from conflicts of interest between managers and shareholders, often manifesting through inefficient resource allocation and unnecessary expenditures. These costs can be indirectly measured by the ratio of general and administrative expenses and sales expenses to total revenue.

Jensen and Meckling (1976) introduced the concept of agency costs, highlighting how managerial actions that do not align with shareholders' interests lead to inefficiencies. High G&A and sales expenses can indicate such misalignments, where managers might engage in excessive spending that benefits themselves rather than the firm's overall performance.

Empirical studies support this view, Ang et al. (2000) found that higher agency costs, as reflected by increased administrative expenses, correlate with lower firm performance. Similarly, Hall and Weiss (1967) demonstrated that firms with higher operational costs tend to have reduced profitability, underscoring the impact of inefficient management practices.

Hypothesis 2: The total asset turnover has a positive impact on the firm performance.

Total asset turnover, a key efficiency metric, measures how effectively a firm utilizes its assets to generate revenue. Research indicates a positive correlation between total asset turnover and operational performance, suggesting that higher turnover rates typically reflect better resource management and higher productivity.

Smith *et al.* (2003) highlight that firms with higher asset turnover ratios tend to exhibit superior performance, as they efficiently convert their asset base into revenue. This efficiency minimizes waste and maximizes output, aligning closely with agency theory, which posits that reduced agency costs - reflected in better asset utilization - lead to improved firm performance.

Further empirical studies, such as those by Penman (2010), underscore that efficient asset management, indicated by higher asset turnover, correlates with higher profitability and operational success. This relationship holds particularly true in asset-intensive industries like manufacturing and real estate, where effective asset utilization is crucial for sustaining competitive advantage.

Moreover, Ghosh and Revilla (2007) argue that high asset turnover is indicative of streamlined operations and effective management strategies, which directly contribute to enhanced operational performance. This is consistent with the findings of Anderson et al. (2003), who assert that firms achieving higher turnover rates generally manage their resources more efficiently, thus driving better financial outcomes.

3.2. Research model

Measure the dependent variable: According to Lang *et al.* (1995), Jabbary *et al.* (2013), Hoang *et al.* (2019), Mazlan *et al.* (2019) and many other authors, ROA, ROE and Tobin's Q are the most frequently used financial ratios to ascertain the firm performance. ROA indicates how well a firm's management is utilizing the assets to create income. ROE is a profitability ratio that shows the amount of net income a company records as a percentage of the owner's equity. Meanwhile, Tobin's Q is

measured by comparing the total market value of a firm with the total book value of its capital and debt.

Measure independent variables in the model: We also inherited the measurement of independent variables from many previous studies. The calculation of independent variable values is performed in Table 1.

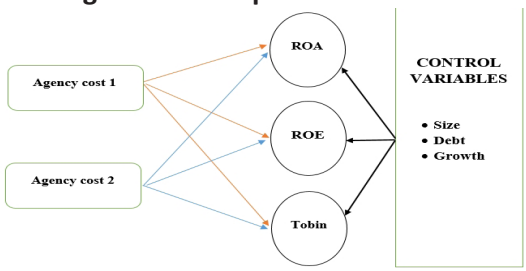
Table 1: Variable and measured scale description

No.	Variables	Scales	Source
1.	*ASTR*	Ratio expenses$_{i,t}$ = Total administrative expenses and selling expenses $_{i,t}$/Total revenue $_{i,t}$	Ang et al. (2000), Jabbary et al. (2013), Hoang et al. (2019), Mazlan et al. (2019), Khuyen (2021),...
2.	*TATO*	Total Asset Turnover $_{i,t}$ = Net sales $_{i,t}$/ Average total assets $_{i,t}$	Smith et al. (2003), Jabbary et al. (2013), Rossi et al. (2018), Hoang et al. (2019), Mazlan et al. (2019),...
3.	*SIZE*	Firm size$_{i,t}$ = Logarith(Total Assets$_{i,t}$)	Khidmat and Rahman (2014), Mazlan et al. (2019), Khuyen (2021),...
4.	*DEBT*	Debt ratio$_{i,t}$ = Total debt $_{i,t}$/ Total assets$_{i,t}$	Khidmat and Rahman (2014), Hoang et al. (2019), Mazlan et al. (2019), Khuyen (2021),...
5.	*GROWTH*	Firm's growth$_{i,t}$ = (Total revenue $_{i,t}$ - Total revenue $_{i,t-1}$)/ Total revenue $_{i,t-1}$	Yao and Wu (2014), Mazlan et al. (2019),

Source: Compilation by authors

The research model is shown in the diagram below:

Figure 1. Conceptual framework



Source: Compilation by authors

4. Conclusion

Based on previous studies, the linear regression model can be accepted. Therefore, the estimated models can be written as below:

$$ROA_{it} = \beta_1 + \beta_2 ASTR_{it} + \beta_3 TATO_{it} + \beta_4 SIZE_{it} + \beta_5 DEBT_{it} \beta_5 + GROWTH_{it} + \varepsilon_{it} \quad (1)$$

$$ROE_{it} = \beta_1 + \beta_2 ASTR_{it} + \beta_3 TATO_{it} + \beta_4 SIZE_{it} + \beta_5 DEBT_{it} + GROWTH_{it} + \varepsilon_{it} \quad (2)$$

$$TOBINQ_{it} = \beta_1 + \beta_2 ASTR_{it} + \beta_3 TATO_{it} + \beta_4 SIZE_{it} + \beta_5 DEBT_{it} + GROWTH_{it} + \varepsilon_{it} \quad (3)$$

Where the subscript i, t represent the i-th observation at time t; ε_{it} *is a random error.*

Agency costs are a crucial aspect of corporate governance, with various perspectives and measurement methods existing. Recent studies have shown that managing agency costs plays an important role in operating and managing business operations. Accordingly, optimizing agency costs not only helps improve firm performance and enhance profits but also increases the trust of investors and shareholders in the enterprise.

Our next research direction is to collect sufficient data on industry groups listed on the Vietnamese stock market to test this model. Hopefully, the experimental results will be consistent with the hypotheses we have proposed. This will be the basis for us to propose solutions to improve firm performance for companies listed on the Vietnamese stock market according to each specific industry group.

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