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Does Debts have any Impact on Governance Bundle and Agency Costs? Over-Governance Hypothesis

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Abstract. The purpose of this article is to extend the bundles of corporate governance theory and propose the role of corporate debt in determining the governance structure of a company. This research intended to answer some questions have been put forward by scholars to explain the inter-relationship between debt, corporate governance, and agency costs: (i) what exactly is the disciplinary role of debts? (ii) how is governance structure influenced by the debt level? and (iii) are extremely high debt ratios required? Previous works have looked at interrelations between debt, corporate governance, and agency costs in isolation result in inclusive findings. However, we argue that debt level is a key determinant of the effective governance structure that maintains agency costs at the optimal level. Based on the governance bundle theory, we contribute to the literature by introducing a new model (over-governance model) that suggests financial leverage as a critical contingency linking governance bundle and agency costs. Also, it provides a clear picture on the different type of agency costs. Our paper provides a theoretical framework to guide further studies and provide important implications for the board, corporate management, and regulators.

Keywords. Corporate Governance, Governance Bundle, Agency Costs, Debt, Capital Structure

1. Introduction

The initial debate of the capital structure has started by Modigliani and Miller (1958) who argued that the structure of capital within firms are not related to their valuations. In reality, however, the perfect market does not excite due to agency problems, information asymmetric, and taxes, which make the capital structure relevant to firm performance (Vijayakumaran and Vijayakumaran 2019). Afterward, a significant number of empirical research have been carried out and several theories have been introduced to this topic. Yet, there is a good deal of uncertainty as to whether or under which governance condition debt can enhance the performance of corporations.

Theoretically, however, the conventional belief about capital structure is for companies to use more debts finance so that the agent -principal conflict can be reduced because of the disciplinary role of debt as suggested by free cash flow theory. The usage of leverage signals

the managers inclination to be also monitored by debtholders (Jensen 1986; Beiner et al. 2006; Ha 2019; Vijayakumaran and Vijayakumaran 2019). Berger et al. (1997) maintain that in corporations where the CEOs encounter less pressure from active monitoring, debt levels are lower. Also, Alves et al. (2015) maintain that more boardroom independence leads to higher financial leverage rather than retained earnings. Nevertheless, regardless the governance structure of firms, several recent studies emphasize on the detrimental impact of financial leverage (i.e., Coleman, Esho and Wong, 2006; Kharabsheh, AL-Gharaibeh and Zurigat, 2017; Le and Phan, 2017; Ciftci *et al.*, 2019). This incompatibility necessitates the need to answer several questions introduced by Lambrecht and Myers (2008); What exactly is the disciplinary role of debts? How is governance structure influenced by the debt level? Are extremely high debt ratios required?

To answer these questions, one must consider the agency costs associated with financial decisions and governance structure of corporations since the capital structure is significantly influenced by disciplinary mechanisms and agency costs (Lasfer 1995; González 2013). There is large number of empirical evidence suggesting that agency costs have a significant impact on financial decisions (Florackis, 2008). However, prior researches have looked at the interrelation between debt, agency costs, and corporate governance in isolation and thus have produced mixed results in both developed and developing markets (Lasfer 1995 [UK]; Lasfer and Centre 2002 [UK]; Mcknight and Weir 2009 [UK]; Florackis 2008 [UK]; Henry 2010 [Australasia]; Rashid 2016 [Bangladesh]; Grashuis 2019 [USA]; Schäuble 2019 [Germany]). Moreover, Henry (2010) has found that the agency costs are substantially reduced by the overall governance index, whereas the implementation of individual disciplinary mechanisms has no influence on the agency costs. Also, Mcknight and Weir (2009) have suggested that several type of costs are also associated with different monitoring structure, and these costs increase in the presence of nomination committees, while increasing boards ownership help to reduce agency cost. Therefore, this study adopts the governance bundle theory in building our model which simultaneously links the overall governance structure, debt level, and agency costs. According to governance bundle theory, the mechanisms of corporate governance are best to be seen as a bundle of mechanisms and the effective selection of overall governance bundle should be based on cost–benefit tradeoff (Ward et al. 2009).

Despite the fact that conceptual articles are much less common compared to empirical article (Cuomo, Mallin, & Zattoni, 2016), those studies have concentrated on the advantage and disadvantage of the monitoring mechanisms used to solve the agency problems (Cuomo et al. 2016). Similarly, Li et al. (2020) have found that the majority of prior works have focus on the outcomes rather than the antecedents of corporate governance characteristics. However, this article contributes to the literature in two ways: first, it provides a clear picture on the different type of agency costs; second, propose our over-governance model where debts act as a key contingency in determining the governance bundle of a corporation and reduce the over-governance costs (monitoring costs) and activities. As Lambrecht and Myers said,

"Raising debt to the optimal level creates value that they can appropriate, so they adopt the optimal capital structure (and accept discipline) voluntarily..... the critical level of investor protection such that firms below (above) this level move to a high (low) debt level. Firms with weak investor protection need debt as a commitment device and therefore rely more heavily on debt." (Lambrecht & Myers, 2008).

We suggest that debt, as an external and relatively cheap source of monitoring function, is a critical element in determining the governance structure and balancing the agency costs of a firm. The corporate borrowing activities are mainly determined by the agency costs (M. A. Lasfer, 1995). For instance, it helps to mitigate the over-governance costs and practices on top management from the directors or/and hiring extra directors on the boardroom. As the internal monitoring activities of a boardroom can be effectively complemented by external monitoring mechanisms (Ward et al. 2009). Additionally, our model considers the integration of agency and capital structure theories as suggested by several scholars for future work to understand the interrelationship among firm performance, capital structure, and the disciplinary mechanisms. Hence, this preliminary paper will open up a new direction towards working capital, governance, and performance literature.

2. Literature Review

2.1 Theoretical Conflict

Pecking order and trade-off theories are the most theoretical perspectives in corporate finance literature. According to the pecking order theory, due to information asymmetry, the costs of internal financing is relatively lower than that of external financing costs, corporates would, therefore, prefer internal generated fund over issuing debt or equity (Myers and Majluf 1984). Block (2011) offer supporting evidence to this hypothesis that a corporate is much more interested in using debt rather the equity market to a balanced capital structure. However, this theory does not count for the concept of balancing the structure of capital (Block 2011). In fact, The founder of this theory criticized it for its simplicity as it is “*grossly oversimplified and underqualified*” (Myers, 1984). Therefore, this theory still has some limitations in demonstrating the capital mix of corporations.

In contrast, trade-off theory suggests that the firm can maximize its value by targeting the optimal structure of capital (Myers 1984). This theory clearly states that a company compromises the benefits and costs of the debt to enhance its valuation by “rationalizes borrowing” activities. Thus, it does not explicitly predict a positive association between borrowing activities and performance for all corporates and all industries. Indeed, it is common across similar firms to have debt ratios that vary widely (Myers 1984). In this spirit, Matjaž and Mramor (2009) found that leverage of firms in manufacturing sector is lower than those in other industries like construction, trade, transport and communication.

Capital structure decision is a quite complex process and although there are several theories existing provide a high-order explanation. Yet, only limited aspects of the diversity and complexity of financial decisions can at best explained by those theories (Margaritis & Psillaki, 2010). Several factors should be taken into considerations when determining the optimal structure of capital including the governance practices of a firm and its consequent agency costs. The legal system enforcement and the protection of the shareholders’ rights are key determinants of relationship direction (negative/positive) between debt and firm performance (González, 2013). Also, Lasfer (1995) suggests that the agency cost in a firm is the key determinant of the borrowing behaviour. Several scholars also stress the advantageous role of debt in minimizing both agency cost and agency conflict (Fosu, 2013; Lee-Kuen et al., 2017).

2.2 Corporate Governance and Debt

The concept of corporate governance appears to be more closely related to financial aspects of a firm as it is associated with the means in which investors ensure that their investment gains are achieved (Shleifer & Vishny, 1997), promoting the transparency, trust and accountability environment of a firm. Indeed, the corporate governance association with capital structure is

well established in the literature (see, Jensen, 1986; Liao, Mukherjee and Wang, 2015; Kyriazopoulos, 2017; Khatib *et al.*, 2020).

At least in theory, the financial debt is essential monitoring mechanism in ensuring that management does not misuse the excess cash flow at the expenses of stockholders. Agency conflict is the main concern of free cash flow assumption, where this conflict emerges due to the ownership separation of corporates (Jensen & Meckling, 1976). Executives are reluctant to distribute dividends or to take more debts as they do not want to go under threat of bankruptcy. Here emerges the essential disciplinary role of leverage that has been suggested by Jensen (1986). Corporate might utilize more debts to reduce agency costs by constraining executives from undertaking inefficient investments (Hoang *et al.*, 2019; Ji, Mauer, & Zhang, 2019; Jiraporn, Kim, Kim, & Kitsabunnarat, 2012). Moreover, it enables executives to signal their inclination to be also monitored by debtholders (Beiner *et al.*, 2006; Ha, 2019; S. Vijayakumaran & Vijayakumaran, 2019). Thus, mitigating the monitoring costs of, for example, having more directors on the boardroom or/and increasing the remuneration of board members. Jiraporn *et al.* (2012) showed that a firm can mitigate agency conflicts by using debts to substitutes several governance mechanisms as it encourages executives to devote most of their effort to maximize the shareholders' value. Whereas, Brown *et al.* (2011) showed that corporate governance roles are often in combination with financial policies in mitigating agency costs. Finally, a firm with better protection frameworks has a more ability to increase its external funds with better terms, higher performance, and the capital costs is lower (Shleifer & Vishny, 1997). Supporting this argument Okiro and Aduda (2015) suggest that corporates with better monitoring quality provide transparent reporting; therefore, they have more ability to obtain capital with better conditions.

There are significant number researches investigating the corporate governance and capital structure association, these researches mostly focused on testing the relationship between the cited variables because of the main function of each one in dealing with the agency problem (i.e., Elmagrhi *et al.*, 2018 [the UK]; Germain, Galy, & Lee, 2014 [Malaysia]; González, 2013; Hussainey & Aljifri, 2012 [UAE]; Sheikh & Wang, 2012; Wen *et al.*, 2002 [China]). Yet, the empirical evidence is still inconclusive (Khatib *et al.*, 2020). In contrast, Liao *et al.* (2015) found out that a better quality of the governance structure is linked with more debts finance. In their part, also, Berger *et al.* (1997) maintained that if CEO does not face active monitoring from the board, the debt levels are lower. Ullah *et al.* (2019) provides supporting evidence to this view. On the other hand, other researchers conclude an inverse association among leverage and governance quality (Jiraporn *et al.*, 2012). Similarly, Wen *et al.* (2002) maintain that companies with stronger disciplinary practices from the boardroom, executives more likely to seek lower financial leverage. Whereas, other studies failed to identify the link between debt and the disciplinary mechanisms (Safiullah, 2016; S. Vijayakumaran & Vijayakumaran, 2019). Several reasons were identified in the literature behind this incompatibility such as the determinants of capital structure decisions are still unknown and different theories framework used in deferent studies and/or different quantitative regression models (Hussainey & Aljifri, 2012; Khatib *et al.*, 2020; Nicholson & Kiel, 2007).

However, Ward *et al.* (2009) suggest that the disciplinary mechanisms are best to be viewed in combination (governance bundle theory). Also, Rediker and Seth (1995) argue that aligning the interest of management and owners, a firm has considerable flexibility to design the effective combination of the governance structure. Furthermore, a study conducted by Henry (2010) finds that firm-level agency cost is not influenced by the implementation of a single governance attribute but the overall governance structure results in significantly lower agency

costs. However, most of the previous studies investigate this issue individually, which might be an important reason for the contradiction findings.

2.3 Debt and Agency Costs

The agency cost and its determinants have received less attention from scholars (Panda & Leepsa, 2017). Agency cost emerge from the interest misalignment among the executives and owners and they are considered as one of the internal costs. It is also argued that a company should design its capital structure so as to ease possible conflict of interest between management, stockholders and debtholders. There is, however, limited knowledge on the different types of agency costs impact on firm and its association with corporate governance and debt. These costs incurred by shareholder or management and can be classified into monitoring costs, residual loss, and bonding expenditure (R. Vijayakumaran, 2019). We shall explain how debt influence each type of these costs. First, monitoring cost that incurred from the owners to control the manager's practices in managing and monitoring the firm such as remunerations, fees of the audit firm, and training of directors (Chamidah and Asandimitra 2017; Panda and Leepsa 2017). The influence of debt on this type is by providing an external source of monitoring body (lenders). For instance, having more members on the boardroom would increase the monitoring costs. Instead, a firm might consider increasing the overall monitoring efficiency by increasing the debt level. Jiraporn *et al.* (2012) demonstrate that a firm can mitigate agency conflicts by using financial debt as a substitute for disciplinary mechanisms. Thus, the usage of debt signal management inclination to be also monitored by debtholders (Jensen 1986; Beiner *et al.* 2006; Ha 2019; Vijayakumaran and Vijayakumaran 2019). Second, bonding cost that is provided to the agents to insure that they will not take any action that might be harmful to the stockholders. This is well reported in the literature that debt can enhance a company's valuation as it forces executives to take value-maximizing actions to keep their salaries, jobs, and perquisites (González, 2013). It consequently reduces the free cash flow problem (Chamidah & Asandimitra, 2017; Hastori, Siregar, Sembel, & Ahmad Maulana, 2015; Kadioglu & Yilmaz, 2017). It should be noted that bonding cost and monitoring costs have a reverse association, where the monitoring costs rise with the decrease in bonding cost (Panda & Leepsa, 2017). Third, residual loss is the opportunity cost or even the thing that would have been earned by each of the parties not to contract with the other. For example: the bad allocation of resources. Thus, the over-governance activities of the board or/and owners on the management might lead to a substantial increase in monitoring costs or/and residual loss.

Indeed, García-Castro *et al.* (2013) showed that corporates might be less likely to undertake an over-governance activities with the availability of potential alternative alignment mechanisms as it is likely to impair company performance as a result of the cost of governance (Arcot & Bruno, 2011). Some firms may rely less on board monitoring due to the high expenses of board monitoring to controlling top management behaviour (Zajac & Westphal, 1994), and use complementary external monitoring of firms. Thus, a firm may reinforce the internal monitoring provided by the board through external monitoring as it can be an effective complementary (Ward *et al.*, 2009). Apart from the benefit of the free cash flow reduction, debt can also help mitigates the potential "over-governance" costs and activities of controlling top management behaviour from a board of directors.

To this end, we argue that debt has a double edge impact on disciplinary mechanisms and performance of firms, in which the rational used debt, apart from the tax deduction advantages, and free cash flow reduction, it would rationalize the monitoring activities on the top management and consequently reduce the over-governance costs. In addition, as discussed in an earlier section that governance mechanisms are best viewed in combination, we build a

model based on governance bundle theory that simultaneously links governance structure, debt, and agency cost. Panda and Leepsa (2017) suggest more works is needed on disciplinary mechanisms and agency cost linking them to the debt finance. Brown et al. (2011) and Vijayakumaran (2019) argue that the effectiveness of disciplinary mechanisms in mitigating agency costs is often in combination with financial policies.

3. The Model

Following the governance bundle (GB) theory of Ward et al. (2009), the indifference curve analysis is employed in our model to evaluate the complementarity role of debt to disciplinary mechanisms that influence the agency cost and eventually influence the performance of a company by looking at the dynamics of this combination. Given that some firms might face a high cost related to the boardroom monitoring practices and thus likely to rely less on the boardroom monitoring to control top management behaviour (Zajac & Westphal, 1994). Therefore, firms use external source of monitoring (debts) to minimize the actual monitoring costs and reduce the monitoring activities that might lead to a residual loss, in which debt raises the executives' equity ownership (Harris & Rivav, 1991), thus, reducing the governance activities of the board in over-governed firms, or increase the governance efficiencies in poorly governed firms.

However, Ward et al. (2009) utilized the boundaries of the disciplinary mechanisms' ability to control agency costs to define maximum and minimum standards of governance efficiency. Financial leverage is, therefore, a crucial contingency that manipulates the agency costs and consequently firm performance. Thus, we evaluate how debt dictates the choice that boardrooms may make in selecting governance bundles of a firm as well as the subsequent lever of agency costs.

3.1 Over- Governance Assumptions

Since our argument is to extend the governance bundle theory of Ward et al. (2009), we, therefore, are adopting the same assumption of their theory as a fundamental assumption of our model. However, we include more assumptions that are in contrast to the one in agency theory. For example, one assumption of the agency theory is all taxes are zero. However, in reality, most firms use debt due to the tax advantage of financial leverage as it is the heart of trade-off theory by Myers (1984). Thus, the first assumption is the non-zero tax, where the firm can trade-off between the monitoring advantage of debt as an external monitoring mechanism and the internal governance mechanisms balancing the agency costs. Second, the governance bundle curve itself (defines a point on Figure 1) represents a combination of different internal governance mechanisms, while debt represents external governance mechanisms. Third, a movement along the governance bundle curve between level of debt and agency costs represents substitutability between external and internal disciplinary mechanisms, thus, a company would shift in between governance bundle and debt level to an establish efficient governance structure with optimal agency costs, for example, a small number of members on the boardroom followed by an increase in the debt level because of the monitoring advantages of debt. The usage of debt signals managers' inclination to be also monitored by debtholders (Jensen 1986; Beiner et al. 2006; Ha 2019; Vijayakumaran and Vijayakumaran 2019). Indeed, Ward et al. (2009) said, "The redressing of governance mechanisms within a bundle may be prompted by a change in the relative costs of the two mechanisms that has the effect of tilting the cost- constraint line." Fourth, a point below the curve represents less efficient combination of external and internal governance attributes as it represents less of either or both of internal and external (debt) governance mechanisms. Fifth, a points above a curve represent more

effective combination of external and internal governance attributes as it represents more of either or both of external and internal disciplinary mechanisms. Sixth, selecting the optimal structure of corporate governance is based on maintaining the optimal agency costs (bonding and monitoring costs) as all possible combinations of governance structures can be compared and ranked by boards and use the external mechanisms in case to reduce the overall costs. Seventh, the indifference curve is not a straight line but an asymptotic curve.

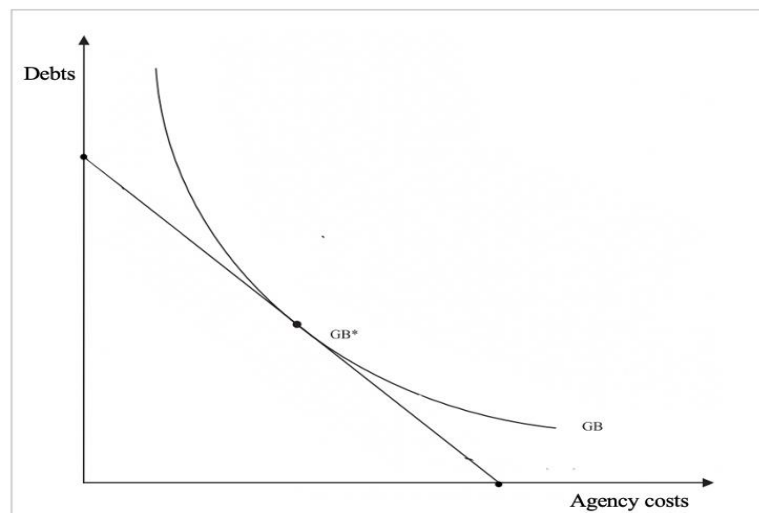


Figure 1. Governance bundle model

3.2 Firms under Condition of Different Debt Level

For firms with optimal internal governance structure, there is little need for external governance sources. Chang et al. (2014) found that when using debt as a takeover defence tool, the benefits of the disciplinary role of debt is less than its costs and hence companies with weak disciplinary mechanisms are under levered. Such companies tend to adjust slowly to the optimal capital structure. The governance mechanisms are freely replaceable at each point on the curve, subject to the relative costs of providing each mechanism (Ward et al. 2009). Thus, in the scenarios shown in Figure 2, as the debt level increase from D to D.2 the governance bundle shift from A to B results in a reduction in the overall agency costs. As the executive's equity ownership increases, it causes the payoffs of manager to be more responsive to corporation activities, and, since debt is nonvoting, it concentrates the voting power (Harris & Rivav, 1991), and consequently minimizes the residual loss. On the other hand, reduction in the debt level would minimize the governance effectiveness from A to C and result in an increase in the overall agency costs to AC.1. The cost trade-offs Maintains the combination near to the curve apex (Ward et al. 2009).

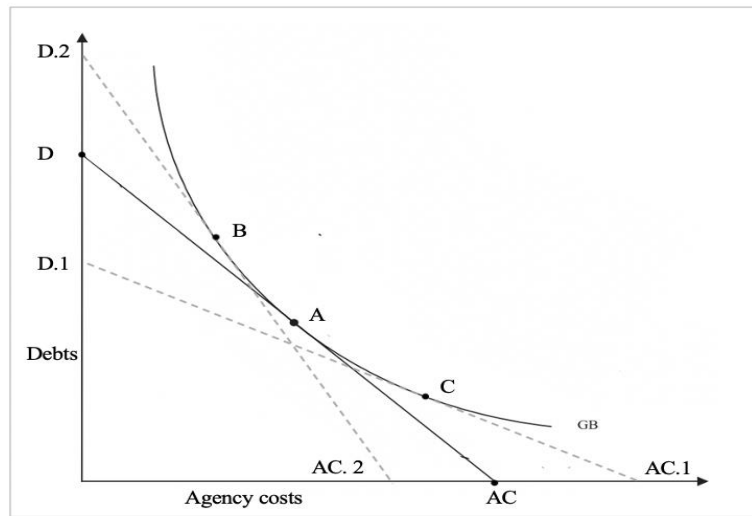


Figure 2. Governance bundle under debt and agency costs conditions

In the over-governance scenario shown in Figure 3, where governance bundle of a firm consists of proportionately more monitoring mechanisms, the governance effectiveness would move toward the maximum from A to B and thus increase the agency costs (monitoring costs such as remunerations, fees of the audit firm, training of new directors) from AC to AC.1. In addition, it would increase the residual loss in which Excessive mechanisms of governance, specifically monitoring, can harm firms when managers lose motivation under excessive control (Ward et al. 2009). The latter scenario is also in line with the stewardship theory of (Davis, Schoorman, & Donaldson, 2018) in which the managers are naturally driven to make choices that are compatible with organizational objectives. In other words, they are inherently motivated to make decisions compatible with corporate's objectives as they are more aware of the firms' operations and environment than shareholders. Therefore, as suggested by Frey (1997), an excessive control (over-governance) of owners can undermine agents' motivation. This argument is in line with the findings of Adams and Ferreira (2009) that female members on boardrooms are more tougher monitors "over-monitoring" and thus it could decrease value of a firm.

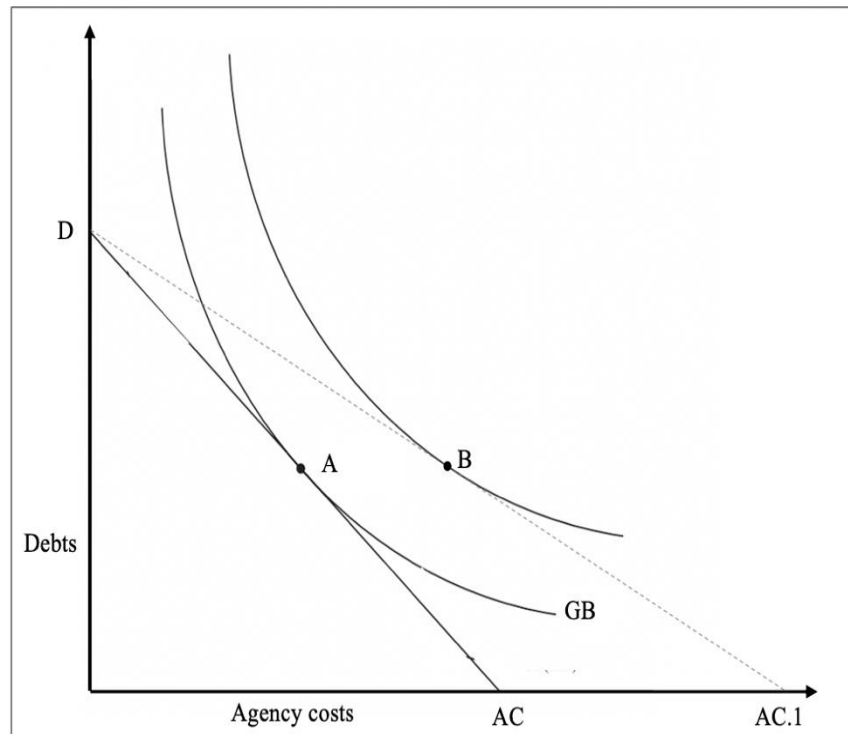


Figure 3. Over-governance

4. Discussion

The disciplinary role of debt is well documented in the literature. However, the questions introduced by Lambrecht and Myers (2008) as: what exactly is the disciplinary role of debts? How is governance structure influenced by the debt level? Are extremely high debt ratios required? remain unanswered. Based on our model we argue that debt has a double edge agency costs and corporate governance structure in which the rational used debt, apart from the tax deduction advantages (trade-off theory), and free cash flow reduction (free cash flow theory), would rationalize the monitoring activities practices from the owners upon the top management as it increases equity ownership share of managers and it concentrates on voting power as debt is non-voting. Consequently, it minimizes the residual loss. This perspective is in line with the stewardship theory of Davis et al. (1997) in which managers are more aware of the firms operations and environment than shareholders. Thus, they are motivated to act in ways to achieve corporation objectives. Therefore, an excessive control “over-governance” can undermine this motivation. Similar to the residual loss reduction, debt as an external source of monitoring body (lenders) helps to minimize the monitoring costs of a board. For example, having more members on the boardroom would increase the monitoring costs (remuneration, training of directors, etc.). Instead, a firm might consider increasing the monitoring efficiency by increasing the debt level and consequently keeping the agency costs at a minimum level. Brown et al. (2011) emphasize the function of corporate governance, often in combination with financial policies in mitigating agency costs. Similarly, Jiraporn et al. (2012) suggest that a firm can mitigate agency conflicts by using financial leverage as a substitute for governance mechanisms.

5. Implications

This paper provides essential implications for the board, management and regulators to improve understanding the different roles of debt. It also has an impact on the governance bundle as well as the different agency costs. For boards and owners, this article shows how external monitoring of a firm might be an efficient governance attribute that reduces the overall governance practices upon management and consequently manipulating the different agency costs to keep them at the minimum level. Another main implication of this article for managers and policymakers is how debt became a key contingency in determining the governance bundle and simultaneously keeping the agency costs on the optimal level. This is particularly important for over-governed firms, as it gives more flexibility to manager/owner to restructure the capital of corporates in a way that reinforces the governance mechanisms and maintains the minimum agency costs level.

6. Conclusion

In this paper, we provide a clear picture on the different sort of agency costs; that are subsequent to agency conflict (monitoring costs, residual loss, and bonding costs). We show that its disciplinary role is to mitigate the over-governance activities of the board or/and owners on the management and consequently reduce the residual loss. Furthermore, we illustrate the influence of debt level on the governance structure by showing that debts can also reduce the monitoring costs (over-governance costs), while keeping an efficient overall governance structure. Additionally, we propose that debts are a key contingency in determining the governance bundle and simultaneously keeping the agency costs on the optimal level. We, therefore, by extending governance bundle assumptions, built our conceptual model that provides a link between corporate governance, financial debt, and agency costs. Future studies may utilize our theoretical framework to examine the interrelationship between debt, monitoring mechanisms, and agency costs. We encourage future researchers to differentiate between the sorts of agency costs to provide a better understanding of this matter. Also, future research could empirically test our model based on the interrelationship between monitoring mechanisms, debt, and agency costs.

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