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The impact of agency cost on firm performance

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Abstract

This study aimed to determine the effect of agency cost on the performance of firms listed in the Kompas100 index on the Indonesia stock exchange for the 2016-2021 period. In determining the sample, this research applied the purposive sampling method. This study used a sample of 46 companies and managed a total of 248 observations. The findings indicated a negative and significant impact of agency cost on firm performance. Companies with a high agency cost tend to reduce the performance. Mitigating these adverse effects requires the implementation of robust internal controls, transparent reporting mechanisms, and effective corporate governance practices.

JEL classifications: *C23, G10, L25*

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1. Introduction

The establishment of a company is typically driven by specific objectives, such as achieving maximum profitability, enhancing the wealth of owners or shareholders and maximizing overall corporate value. These objectives prompt companies to continually strive for improved performance. Strong company performance holds significant meaning for stakeholders, who fundamentally support the company. Evaluating company performance involves using methods, such as financial ratios and the market value of the company (Karen & Susanti, 2019; Maysuri & Dalimunthe, 2018).

The evaluation of firm performance is crucial as it provides insights into efficiency, productivity and financial health. This assessment aids in identifying areas for improvement, making strategic decisions and ensuring long-term sustainability. Moreover, it plays a pivotal role in attracting investors, maintaining stakeholder trust and fostering competitive advantages in the market. Regularly assessing company performance enables adaptability to market changes, optimal resource allocation, and overall business operation enhancement, leading to sustained growth and success.

Effective and efficient management serves as the cornerstone of a firm's performance, playing a pivotal role in its success or failure. Competent management enhances overall company performance, instills stakeholder confidence and sends positive signals to investors (Andreou et al., 2017; Fernando et al., 2020; Ting et al., 2021). This can have a favorable impact on company performance while reducing information asymmetry (Ambrosini & Altintas, 2019; Curi & Lozano-Vivas, 2020). Conversely, poor management can lead to inefficient decision-making (Ting et al., 2021), resulting in inefficiencies and missed opportunities that ultimately weaken competitiveness and long-term sustainability.

Within publicly traded firms, ownership and managerial control are distinctly segregated, with professional managers overseeing the firm to ensure the company's ongoing viability and progress. Establishing an optimal balance structure becomes imperative, aiming for equitable interest distribution and mitigating conflicts among various interest groups. The pursuit of this balance incurs various costs and the reduction of these costs constitutes a central focus within the subject of agency theory.

The agency theory involves a contractual relationship between owners and capital managers, where shareholders or capital owners, acting as principals, employ managers or capital managers acting as agents to make decisions and carry out the business activities of the company (Jensen & Meckling, 1976). Jensen and Meckling (1976) stated that when the firm is overseen by non-owner managers, there is a likelihood of straying from the objective of maximizing firm's value. In such cases, managers may incur unnecessary expenses driven by personal interests, diverging from the goal of maximizing the company's value. This dynamic gives rise to agency problems among shareholders and company management. The consequences of agency problems may manifest as agency costs, including welfare losses, monitoring expenses, and bonding costs, ultimately diminishing the overall performance of the firm.

These costs emerge when managers or executives prioritize their personal interests over those of shareholders, encompassing activities, such as misappropriation of company funds or manipulation of financial reports (Sapuan et al., 2021). The detrimental outcomes of agency costs extend to the performance of the company and the collective wealth of shareholders (Baykara & Baykara, 2021). Management's opportunistic behavior is a contributing factor to these costs, exerting a negative

influence on the operational efficiency and profitability of the company. Furthermore, agency costs hinder the establishment of efficient monitoring and preventive measures, thereby escalating administrative expenses and compounding the overall impact on the company (Pandey & Sahu, 2019).

Research findings on the impact of agency costs on firm's performance, as conducted by Hoang et al. (2019), Houqe et al. (2022), Khan et al. (2020), Nuhu et al. (2020) showed a negative and significant correlation between agency costs and firm's performance. A study conducted by Mehmood (2021) showed a positive impact of agency costs on organizational performance. However, studies by Kontuš (2021), Murdiansyah et al. (2020), and Yamasitha (2020) showed little to no significant impact of agency costs on firm's performance. In previous studies, research on the impact of agency costs on company performance has been conducted. However, to the best of the researcher's observation, literature directly addressing the influence between agency costs and company performance remains limited, especially in Indonesia. Moreover, variations in the research subjects across different studies have led to disparate findings.

The objective of this paper is to actively participate in the ongoing discourse by conducting an empirical examination into how agency costs influence the performance of publicly listed companies in Indonesia. Examining this matter in an emerging economy, specifically Indonesia, has the potential to offer valuable insights and make a substantial contribution to the existing literature.

This study contributes to the literature in several aspects. Firstly, this paper validates the assumption asserting that the agency costs have a negative impact on firm's performance. Secondly, by shedding light on the impact of agency cost on firm's performance, the researchers provide important insights that can be used to improve governance practices. Companies and policymakers can use this information to design governance structures that are more resilient to agency challenges, ultimately fostering improved performance and shareholder value.

2. Literature review

2.1. Agency theory

Jensen and Meckling (1976) argued that agency costs arise due to incomplete contractual relationship between shareholders (principals) and managers (agents). When both parties aim to maximize their own benefits, there is a possibility that the agent may not always prioritize the interests of the principal. Furthermore, there may exist a misalignment between the agent's decisions and optimal choices for enhancing the principal's welfare. These decisions can exert an influence on the company's performance (Ahmed et al., 2020; Gani et al., 2021).

Agency costs emerge as expenses incurred by the company due to conflicts of interest among stakeholders, particularly between principals and agents (Sdiq & Abdullah, 2022). This can manifest as misappropriation of company funds, falsification of financial reports, or excessive salaries and bonuses (Abdullah & Tursoy, 2022; Sapuan et al., 2021). These actions not only fail to contribute to the creation of corporate value but also undermine the overall objectives of the company (Sethi et al., 2023).

In measuring agency costs, this study employed two proxies: asset utilization ratio (AUR) and sales, general, and administrative (SG&A) expense ratio. The first measure, the asset utilization ratio (AUR), reflects the efficiency of company managers in utilizing their assets. A higher AUR indicates that assets generate significant sales, thereby suggesting lower agency costs (Ahmed et al., 2023; Hoang

et al., 2019; Kontuš, 2021). The second measure utilized is the sales, general and administrative (SG&A) expense ratio to total sales. SG&A expense represents the costs incurred by directors and management teams in non-production activities, encompassing managerial benefits, such as income, communication expenses, entertainment costs, travel expenses and others. Consequently, a higher ratio indicates higher agency costs (Choi & Park, 2019; Nguyen et al., 2020). These two measures have been employed in various studies to measure agency costs (Hoang et al., 2019; Nguyen et al., 2020; Puwanenthiren et al., 2020; Sdiq & Abdullah, 2022).

2.2. Hypothesis development

Within a company, managers may engage in inefficient fund utilization or participate in fraudulent and illegal activities, directly impacting the firm's performance (Javeed et al., 2021). This tendency can arise as a result of the misalignment of interests between company managers and company owners. The presence of conflicting interests gives rise to a cost known as agency cost. A higher agency cost may lead to reduced managerial accountability, diminished effort, and suboptimal decision-making, all of which can contribute to a decline in overall firm's performance (Baykara & Baykara, 2021). Increased monitoring and bonding costs may divert resources away from value-creating activities, further exacerbating the negative impact on firm's performance.

Most of the cited literature regarding the relationship between agency costs and firm performance has consistently demonstrated a negative association (Ahmed et al., 2023; Hoang et al., 2019; Houqe et al., 2022; Khan et al., 2020; Nuhu et al., 2020; Wijaya, 2021). When agency costs increase, it is anticipated that firm performance will decline. This can affect the long-term sustainability and competitive position of the company in the market. Based on the description above, the following hypothesis is proposed.

H1: Agency cost have a significant negative effect on firm performance

3. Research methods

3.1. Sample

The population in this study comprised companies listed on the Indonesia Stock Exchange (IDX). The research sample consisted of companies listed in the Kompas 100 Index during the 2016-2021 period. The data collection for this research utilized purposive sampling, a limited quantitative sampling method determined by criteria set by the researchers (Table 1).

3.2. Research variables

This study included three types of variables: a dependent variable, independent variables, and control variables. The researchers were aware that the presented empirical models were undeniably devoid of the endogeneity issues. There were risks of having skewed estimations because of the explanatory variables connection with the error term. To address this issue, the researchers purposefully used a set of control variables to solve the endogeneity problem (i.e., omitted correlated variable bias). Table 2 shows the definition of variables.

Table 1. Sample selection

Sample criteria	Total
Companies listed in the Kompas100 index in the 2016 -2021 period.	160
Companies that have not been listed in the Kompas100 index for six consecutive years in the 2016-2021 period	(98)
Companies that belong to the financial sector.	(9)
Companies that have not published financial reports or annual reports for six consecutive years during the 2016-2021 period.	(1)
Companies that do not publish financial reports in Rupiah.	(6)
The company has negative equity.	(0)
Total sample	46
Total observations (46 x 6 years)	276
Outlier data	(28)
Final observations after deducting outlier data	248

Table 2. Definition of variables

Variables	Definition	Formula	Data form	Previous studies
Dependent variables				
ROA	Return on asset	$\frac{\text{Net income}}{\text{Total asset}}$	Continuous	Ahmed et al., 2023)
ROE	Return on equity	$\frac{\text{Net income}}{\text{Total equity}}$	Continuous	Verawati et al., 2023
TQ	Tobin's Q	$\frac{\text{Market value of stock + debt}}{\text{Total asset}}$	Continuous	Dzahabiyya et al., 2020
Independent variables				
AUR	Asset utilization ratio	$\frac{\text{Net sales}}{\text{Total asset}}$	Continuous	Puwanenthiren et al., 2020
SGA	SG&A ratio	$\frac{\text{Sales, general, and administrative expense}}{\text{Net sales}}$	Continuous	Hoang et al., 2019
Control variables				
SIZE	Firm size	Ln(Total asset)	Continuous	Zakaria et al., 2022
AGE	Firm age	The number of years since the firm's establishment	Continuous	Sabila et al., 2023
LEV	Leverage	$\frac{\text{Total debt}}{\text{Total asset}}$	Continuous	Mardiyati & Siregar, 2022
LIQ	Liquidity	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Continuous	Laili & Dalimunthe, 2022
DIV	Dividend payout	1 if the firm paid the dividend, 0 otherwise	Continuous	Suherman et al., 2023

3.3. Analysis method

The analysis in this research employed a panel data regression model, a regression methodology that integrates time series and cross-sectional data. The panel data regression equation models in this research were as follows:

$$ROAit = \beta_0 + \beta_1 AUR_{it} + \beta_2 SGA_{it} + \sum Control\ variables + e_{it} \quad (1)$$

$$ROEit = \beta_0 + \beta_1 AUR_{it} + \beta_2 SGA_{it} + \sum Control\ variables + e_{it} \quad (2)$$

$$TQit = \beta_0 + \beta_1 AUR_{it} + \beta_2 SGA_{it} + \sum Control\ variables + e_{it} \quad (3)$$

where:

β_0	=	Intercept
β_1, β_2	=	Slope
ROA	=	Return on asset
ROE	=	Return on equity
TQ	=	Tobin's Q
AUR	=	Asset utilization ratio
SGA	=	SG&A to net sales ratio
∑Control variables	=	Firm size, firm age, leverage, liquidity, dividend payout
e	=	Regression error
it	=	i-th object and t-th time

4. Results

4.1. Descriptive statistics

In this research, descriptive statistics were carried out on the research variables. Descriptive statistical analysis functions to provide an in-depth picture of the collected data, including parameters, such as the average (mean), standard deviation, maximum value and minimum value. Information on the results of descriptive statistical tests from 248 observations from the 2016-2021 period in the research sample is shown in Table 3.

Table 3. Descriptive statistics

Variables	Obs	Mean	Max	Min	SD
ROA	248	6.91%	31.40%	-8.99%	6.07%
ROE	248	12.47%	90.74%	-57.28%	13.80%
TQ	248	1.22	6.52	-0.16	1.12
AUR	248	68.15%	212.63%	3.80%	45.09%
SGA	248	15.35%	49.60%	0.68%	10.83%
SIZE	248	30.85	33.54	28.95	1.01
AGE	248	44 years	115 years	12 years	21 years
LEV	248	45.33%	93.12%	12.57%	18.56%
LIQ	248	220.17%	775.97%	23.42%	150.07%
DIV	248	84.68%	1	0	36.09%

4.2. Multicollinearity test

The multicollinearity test is a statistical analysis that aims to assess whether there is a significant correlation between two or more independent variables in a panel data regression model. Table 4 shows that the value of each independent variable studied is < 0.80. This showed that there is no correlation between the variables in the research. So, it can be concluded that there are no multicollinearity in the data used.

4.3. Results

The hypothesis testing was conducted with a probability less than the specified significance level α (0.01; 0.05; 0.1). From the analysis results listed in Table 5, it can be identified that the regression coefficients for AUR were 2.369, 0.018, and 2.560, with corresponding probabilities of 0.018, 0.985, and 0.011. This indicated that AUR had a significant impact on the ROA and TQ models on α (0.05).

Table 4. Correlation matrix

	AGE	AUR	DIV	LEV	LIQ	SGA	SIZE
AGE	1.00						
AUR	0.18***	1.00					
DIV	0.11*	0.20***	1.00				
LEV	-0.01	-0.26***	-0.10	1.00			
LIQ	0.03	0.06	0.01	-0.64***	1.00		
SGA	-0.25***	-0.01	-0.18***	-0.25***	0.37***	1.00	
SIZE	0.22***	-0.15	-0.06	0.35***	-0.37***	-0.39**	1.00

***p<0.01, **p<0.05, *p<0.1 indicate statistical significance at the 1%, 5%, 10% levels respectively.

Therefore, it can be concluded that AUR positively and significantly correlated with ROA and TQ. This indicated that AUR positively affected the performance of the firm as measured by AUR. On the other side, the regression coefficients for SGA were -1.841, -1.751, and 0.835, with corresponding probabilities of 0.067, 0.081, and 0.404. This indicated that SGA had a significant impact on the ROA and ROE models. Therefore, it can be concluded that SGA negatively and significantly correlated with ROA and ROE.

Table 5. Regression results

Variables	ROA	ROE	TQ
AUR	2.369**	0.018	2.560**
	(0.018)	(0.985)	(0.011)
SGA	-1.841*	-1.751*	0.835
	(0.067)	(0.081)	(0.404)
SIZE	1.152	-0.651	-2.080**
	(0.730)	(0.689)	(0.034)
AGE	-0.005***	-0.007	-0.002
	(0.003)	(0.234)	(0.732)
LEV	-2.922***	-1.192	-0.342
	(0.002)	(0.657)	(0.823)
LIQ	-4.711***	0.667	-3.321***
	(0.001)	(0.356)	(0.001)
DIV	-1.212	0.143	-1.641
	(0.872)	(0.793)	(0.869)
Constant	2.102***	1.982	1.492***
	(0.003)	(0.441)	(0.004)
R-squared	0.893	0.627	0.881
Observations	248	248	248
Fixed/Random Effect	FEM	FEM	REM

***p<0.01, **p<0.05, *p<0.1 indicate statistical significance at the 1%, 5%, 10% levels respectively.

The regression coefficients for agency cost, measured by the asset utilization ratio (AUR), were 2.369, 0.018, and 2.560. Meanwhile, their probabilities were 0.018, 0.985, and 0.011, with ROA model being less than α (0.05), the ROE model being greater than α (0.1), and TQ model being less than α (0.05). Based on these results, it can be concluded that in ROA and TQ models, there is an indication that AUR had a significant impact on firm performance as measured by AUR. However, in ROE model, there is no significant indication, as the probabilities were greater than the significance level α (0.1).

The other regression coefficients for agency cost, measured by the sales, general, and administrative expense to net sales (SGA), were -1.841, -1.751, and 0.835.

Meanwhile, their probabilities were 0.067, 0.081, and 0.404, with the ROA model being less than α (0.1), ROE model being less than α (0.1) and the TQ model being greater than α (0.1). Based on these results, it can be concluded that in ROA and ROE models, there is an indication that SGA had a significant impact on firm performance as measured by sales, general, and administrative expense divided with net sales. However, in TQ model, there is no significant indication, as the probabilities were greater than the significance level α (0.1).

4.3. Discussion

Based on the data presented in Table 5, regression analysis indicated that the agency cost had a significant impact on firm performance as measured by AUR and SGA. This finding is consistent with research conducted by (Ahmed et al., 2023; Hoang et al., 2019; Khan et al., 2020; Nuhu et al., 2020; Selvira et al., 2022).

A greater ratio of asset utilization signifies a more effective utilization of assets, hence establishing an inverse correlation with agency costs (Ahmed et al., 2023). In the context of agency theory, this efficiency suggests a strong alignment between managerial actions and shareholder interests. This alignment motivates managers to maximize asset productivity, contributing to enhanced firm performance and diminishing the need for extensive monitoring and control measures. Thus, a higher asset utilization ratio serves as an indicator of well-managed firms, where resource optimization reduces agency-related challenges and fosters a harmonious management-shareholder relationship.

A high sales, general, and administrative (SG&A) expense, on the other hand, tends to indicate a high level of agency cost (Hoang et al., 2019). While sales, general, and administrative (SG&A) expenses are crucial for the operation of a business, an overly elevated ratio may suggest a deficit in cost-effectiveness and prudent management. In the framework of agency theory, an escalated SG&A ratio might be associated with managerial choices that prioritize personal interests over those of shareholders, possibly resulting in challenges related to oversight and control. This circumstance may encourage managers to partake in activities that personally benefit them but diverge from the long-term interests of the company and its shareholders.

5. Conclusion

This study investigated the impact of agency cost on the performance of firms measured by using asset utilization ratio (AUR) and sales, general, and administrative expense divided to net sales (SGA) among companies listed on the Kompas 100 index in the Indonesia Stock Exchange (IDX). Based on the findings of this study, it can be concluded that the agency cost variable has a negative and significant impact on both ROA and ROE models. This indicates that an increase in agency costs can affect the firm's performance. The negative impact of agency costs on firm performance may be characterized by conflicts of interest and inefficient resource allocation within the company. These costs arise from different interests among various stakeholders, particularly shareholders and managers. This can lead to suboptimal decision-making, excessive managerial compensation, resource misuse and the pursuit of personal interests at the expense of shareholders. These conflicts may result in diminished shareholder wealth, hindered operational efficiency and an overall decline in firm performance. To address the negative consequences of agency costs, it is crucial to implement strong corporate governance mechanisms, transparency and incentive alignment to ensure that managerial actions align with the best interests of the company and its shareholders.

This research has several limitations, including the use of historical data from 2016 to 2021, which may not reflect changes that occurred outside that period and only focuses on companies listed in the KOMPAS100 index. This potentially limits the research findings to the current context. Another limitation is that this research only considered factors, namely agency costs, so it ignored other variables that can influence company's performance. Additionally, the period in this study was limited to six years, which may not be sufficient to identify trends or assess the impact of changes in business strategy over a longer period of time.

By looking at the effect of agency costs on company performance, managers and company executives are expected to improve monitoring of operational costs as well as improve strong corporate governance practices that align managerial actions with the best interests of the company and its stakeholders, thereby promoting long-term sustainability and performance excellence. On the other hand, investors should incorporate a nuanced understanding of agency costs into their decision-making processes. Recognizing the impact of agency costs on firm performance allows investors to introduce an additional layer of risk into their investment and portfolio management strategies.

From the regulatory standpoint, the implications of agency costs on firm performance center on formulating effective policies and mechanisms to mitigate agency costs and ensure the integrity of financial markets. Regulatory initiatives may include information disclosure, executive compensation guidelines and enforcement mechanisms to prevent managerial opportunism. Striking a balance between corporate sustainability and investor protection requires collaborative efforts with investors to foster transparency, accountability and sustained corporate performance. For future studies, it is recommended that researchers add other variables, such as managerial ownership, corporate governance and ownership structure.

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