Simultaneous Effect on Debt and Managerial Ownership: Agency Theory Framework

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Abstract

This study aims to examine the debt policy and managerial ownership as tools to control the agency conflict. Debt policy and managerial ownership used in controlling agency conflicts have several considerations such as the risk of the company, the company's growth and the presence of institutional ownership in a company. The variables used in this study include earnings volatility as a measure of corporate risk, growth companies, managerial ownership, institutional ownership, debt policy, and total assets as a control. Furthermore, an analysis by means of regression models with simultaneous Two Stage Least Square method was used. The results found in this study stated that the risk factors, the growth of the company, as well as the existence of institutional ownership affect debt policy and managerial ownership control of the company within the framework of the agency conflict. This indicates that the use of policies to control the agency conflict must consider these three factors.

Keywords: agency conflict, debt policy, managerial ownership

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1. INTRODUCTION

Agency conflict is important topic in financial management. The existence of agency conflicts is caused by the many interests that exist within the company. One of the causes of agency conflict is the use of corporate cash flow (free cash flow) that is used for purposes that do not generate added value for the company (Mao, 2003). In addition, Widiantoro (2008) stated that the agency conflicts also occur due to dissatisfaction of compensation system based on corporate earnings that are less able to accommodate the interests of all parties.

Agency conflicts that occur within the company is also due to the separation of powers between the owner and the agent in the company (Dey, 2008). This separation gave rise to the asymmetry of information between the owner and the agent. This difference will result in managers to be motivated to take action or make decisions that less accommodate all interests by charging the cost of the company. As a result, the owner will bear all of the risks posed by the actions of the manager. Those risk that occurred because of manager action, make company have to make action to control the risk

Agency conflicts also occur because of problems that exist in the structure of ownership in the company (Jensen & Meckling 1976; Jensen, Solberg, and Zorn, 1992; Brock, Martin, & Unlu, 2010). Managers as agents who run companies whose ownership is less than 100% then the potential for such conflicts will inevitably arise (Jensen & Meckling, 1976).Companies whose managers have 100% ownership of the company as the individual companies will have zero agency costs, and there is no asymmetry of information between the owner and the agent.

The presence of agency conflicts within the firm raises some costs to be incurred by companies such as monitoring costs, the cost of damages arising from the actions of managers in using the company's cash flow. Hanafi (2008) also stated that some cost that occur in controlling agency problem have a purpose for a preventive step to ensure managers have goals on behalf of the owner. Monitoring that be done by company can restrict the managers for some riskier action. So,the emergence of these costs makes companies to must take control of this agency conflict.

Control of the agency conflict could be done by using two policy that is a policy of debt and increase managerial ownership. Debt policy of the company will limit the actions of managers in using the company's cash flow because of the responsibility for the payment relationship with the lender and the loan principal (Bathala, Moon, & Rao, 1994; Agrawal & Knoeber, 1996; Mao, 2003). This responsibility forced managers to use their cash flow efficiently.Increasing managerial ownership in the company will reduce the agency conflict due to the allignment of interests between managers and owners (Bathala, Moon, & Rao, 1994; Zhang, 2009). Managers who has owneship in their company logically become the owner too, so whatever decision that they made also affected to them.

Control of agency conflicts also have to consider some things, especially related to the use of debt policy and managerial ownership. Policy loans that are too high will cause a rise in the risk of the company. Such risks such as business risk, the risk of bankruptcy (Crutchley & Hansen, 1989). In addition to risk factors, the growth of the company is also an important factor in deciding the two policies. As in previous studies, this study also includes institutional ownership as an exogenous factor that will affect debt policy and managerial ownership in terms of controlling the agency conflict (Crutchley & Hansen, 1989; Bathala, Moon, & Rao, 1994). Institutional ownership, debt policy and managerial ownership can be used as a control of agency conflict. The assumption of this study is that the debt policy and managerial ownership as an endogenous factor that can be controlled by managers and institutional ownership as exogenous factors that are beyond the control of managers (Bathala, Moon, & Rao, 1994). Therefore, this study wanted to test the effect of the risk, the growth of the company as well as the existence of institutional ownership on managerial ownership and debt policy within the framework of the agency conflict.

2. LITERATURE REVIEW

2.1 Agency Conflict

Agency conflict is a financial term to refer to the conflict between the parties is in the company. Agency conflict can occur between the owner and the manager, shareholders with creditors, as well as the majority and minority shareholder (Brigham & Houston, 2007). The existence of agency conflicts occur for several reasons, such as dissatisfaction of compensation systems that are still considered traditional (Widiantoro, 2008), the separation of ownership between managers and owners (Dey, 2008), as well as the ownership structure of matter contained in the company (Jensen & Meckling , 1976, Jensen, Solberg, and Zorn 1992; Brock, Martin & Unlu, 2010; Vo & Nguyen, 2014).

The form of the agency conflict commonly used are related to the use of corporate cash flow (Mann & Sicherman, 1991; Mao, 2003). Free cash flow agency is caused by managers action who used the company’s cash flow to take action for their interest. This action such as do some investment in high risk project, make owner or stockholder in high risk too. Agency of free cash flow also happened because managers as agents are not satisfied with the compensation system, as well as the separation of ownership are encouraged to make decisions or policies by using company resources such as cash flow, on investments that are less able to accommodate the interests of all stakeholders.

The existence of agency conflicts lead to the costs to be incurred by the company. These costs include the cost of monitoring costs, bonding costs and residual loss. The emergence of these costs makes companies should control the agency conflict. In controlling the agency conflict, the company uses debt and managerial ownership (Crutchley & Hansen, 1989; Brigham & Houston, 2007). Debt can control the existence of a conflict because it limits the actions of managers in using the company's cash flow. Managerial ownership can be used to control the agency conflict between the interests of being able to bring together managers and owners. Managers who have ownership in their company also become the owner, it makes managers become conservative to use cash flow especially for high risk project and more carefull to take some action.

2.2 Debt Policy

Within the framework of agency theory, debt has the benefit of controlling the actions of managers regarding the use of company cash flow. Debt managers can restrict the use of the company's cash flow, because there is an obligation that must be carried out on the creditor (Mao, 2003; Zhang, 2009). The existence of such obligations make the manager more conservative in using the company's cash flow, it would be wise in using it.

In Modigliani and Miller theory (MM theory) stated that using debt has advantage. MM Theory compare that value of company with no debt is lower than the other company which use a debt. Company that has high level of debt can be used to tax shield, because interest is deductable for company's income. Tax shield advantage of debt also can affect on value of the firm.

As the trade off theory, debt policy within the framework of the agency conflict also has the advantage that as a tool to control agency conflicts, but weakneeses will also raise the cost and increasing the risk of corporate bankruptcy (Bathala, Moon, & Rao, 1994; Brigham & Ehrhardt, 2005). It means that debt that used by company has limited portion. If company reached optimum debt, they have to swtich to the other source of funding, because they still use debt it will increase risk and cost of capital for those company.It is proposed in Pecking Order theory that after debt has optimum capacity, switch source of funding into stock. This potential risk will be considered by the company to use debt as a means of controlling the agency conflict later.

2.3 Ownership Structure

Jensen & Meckling (1976) divides ownership in the company into two, namely managerial ownership and institutional ownership. The context of the agency theory of ownership structure can be used to control agency conflicts within the firm.

Managerial ownership can be used to control the agency conflict because it can be used as a means of control for managers because it can make allignment between the goals of owner and manager (Bathala, Moon & Rao, 1994; Crutchley & Hansen, 1989). Allignment of purpose arises because the manager will also act as an owner who will consider the value of the company.

Institutional ownership is also able to control agency conflict so that it can control the managers in making decisions (Bathala, Moon, & Rao, 1994, Crutchley & Hansen, 1989; Cofee 1991). Grinstein & Michaely (2005) explained that institutional ownership has the advantage of knowing the market conditions better than other investors, so the performance of better management can be assessed.

2.4 Relationship of Debt Policy, Managerial Ownership and Agency Conflicts

The existence of agency conflicts within the firm, forced the company to take steps to resolve the conflict. Efforts that can be done is to use debt policy and managerial ownership. Described earlier, the debt manager is able to restrict the use of corporate cash flow, making it more conservative to the risk incurred, whereas a high managerial ownership is able to allign the interests between managers and owners so that potential conflicts will be reduced.

Debt has a role as controlling conflict has special considerations, especially a risk (Bathala, Moon, & Rao, 1994; Brigham & Ehrhardt, 2005). When company has higher level of debt it will make company face bankcruptcy risk and as an alternative to switch to another funding through equity. It means that existence of risk will have a negative effect on the debt, and positive managerial ownership in terms of controlling the agency conflict instead of debt roles.

In addition to risk factors, the growth of the company will also form the consideration for the use of the two policies. Bathala, Moon, & Rao (1994) states, within the framework of agency conflict, growing companies tend not to use debt, and will move on to the stock. This is because the company has low asymmetry costs. Billett, King, and Mauer (2007) in the study expressed growing companies tend not to use debt as a conservative stance on the risks that arise in large investments. A previous study that described by Myers and Majluf (1984) also stated that the company has a growing tendency not to use debt and move on to the stock, as measures to avoid risks and oversight of rigorous external parties.

The presence of institutional ownership in the company is also a consideration in the use of debt policy and managerial ownership. Bathala, Moon, & Rao (1994) explain that institutional ownership can reduce agency conflicts, but its presence will affect the proportion of debt and managerial ownership of the company. Institutional ownership also can take over a role of debt to control agency problem from external parties. If company has higher institutional ownership, it will control the manager to take corporate action in order to allign with their interest, including debt policy.

3. FORMULATION OF HYPOTHESIS

3.1 Business Risk, Growth, Institutional Ownership Against Debt Policy

Debt policy has usefulness to reduce agency conflicts that occurred at the company. However, the use of debt also has some risks such as business risk, and the risk of bankruptcy (Bathala, Moon, & Rao, 1994). Risks arising will be measured by using earnings volatility as a measure of business risk and bankruptcy. The impact of such high risk, makes it better to reduce the level of debt that is used to control the agency conflict, and choose other sources of funding, namely through equity. Volatility of earning represent of agency because it can measure deviation of earning that happen within a company.Companies that are growing, will also tend not to use debt and will move on to the stock as well as measures to reduce the risk of reducing supervision by external parties ie creditors (Bathala, Moon, & Rao, 1994; Myers and Majluf, 1984). Therefore, the growth would have a negative impact on debt.

The presence of institutional ownership will also affect debt policy. Institutional ownership is said to be able to reduce the agency conflict because it can limit the manager. However, its presence will affect the proportion of debt, because companies no longer need to use debt to overcome agency conflicts. Institutional ownership acan reduce the debt in term when company used to much debt, they will take a control especially for a manager to not used higher debt because some risk consideration. (Bathala, Moon, & Rao, 1994).

Hyphotesis Ia : Business risk has negative impact to debt policy

Hypothesis Ib : Company's growth has negative impact to debt policy

Hypothesis Ic : Institutional ownership has negative impact to debt policy

3.2 Business Risk, Growth, Institutional Ownership Against Managerial Ownership

Rising corporate risk posed by the use of high debt to control agency conflicts make the company would turn to other funding sources, and one of them is through equity (Crutchley & Hansen, 1989). So in controlling agency conflicts, high risk will make managerial ownership increase because of the opportunity to buy shares of the company. In agency problem framework, managerial ownership can allign interest between owner and manager. Managerial ownership can restrict a manager to do some high risk project and become more careful to use company's resources.

The growth of the company will also have a positive impact on managerial ownership. Companies that are growing have the flexibility to use alternative sources of funding to finance its growth. Within the framework of the agency conflict, companies tend to use stock to avoid agency costs (Bathala, Moon, & Rao, 1994). Titman and Wessels (1988) also describes the trade off on the pecking order theory in which the company should better use of debt. However, within the framework of the conflict, using debt will make the cost greater.These costs such as bankruptcy costs, supervision of conflict costs, as well as the cost of capital. Therefore, they will choose to use equity.The presence of institutional ownership would have a negative effect on managerial ownership. This is due to institutional ownership as an exogenous factor and cannot be controlled by the manager. In the role of controlling agency proeblem, company that has higher the institutional ownership will has the smaller the managerial ownership. External control will take over to control manager in order to they work properly on behalf of the owner and avioding some harmful action. Since instituitonal cannot be controlled by manager, it more effective to reduce agency problem and can forced managers to make policy not only for their interest but to all stakeholder.

Hyphotesis IIa : Business Risk has positive impact to managerial ownership

Hyphotesis *IIb* : Company growth has positive impact to managerial ownership

Hyphotesis *IIc:* Institutional Ownership has negative impact to managerial ownership

4. METHODOLOGY

4.1 Population and Sample

Population of this research is manufacturig company listed in Indonesia Stock Exchange between 2009-2012. Sampling technique using purposive sampling with some criteria such as company must be listed and not delisting, company have proper financial statement especially has institutional ownership, managerial ownership. From criteria resulted 47 samples a years, then pooled in 4 years.

4.2 Variables and Measurement

Researcher want to test simultaenous effect between debt and managerial owership. There two equation that shown below (Bathara, Moon, and Rao, 1994)

$$DR_{it} = \beta_0 + \beta_1(RISK_{it}) + \beta_2(GRWT_{it}) + \beta_3(INSTOWN_{it}) + \beta_4(MNOWN_{it}) + \varepsilon_{it} \quad \text{.......} (1)$$

$$MNOWN_{it} = \beta_0 + \beta_1(RISK_{it}) + \beta_2(GRWT_{it}) + \beta_3(INSTOWN_{it}) + \beta_4(TA_t) + \beta_5(DR_{it}) + \varepsilon_{it} \quad \text{.......} (2)$$

Dependent variables are managerial ownership and debt. Managerial ownership measured by average managerial ownership over 4 years (Bathala, Moon and Rao, 1994). Debt measured by average long-term debt over 4 years. Debt and managerial ownership have some role as mechanism control to reduce agency problem and they have simultaneous relationship (Bathala, Moon & Rao, 1994; Crutchley & Hansen, 1989)

Independen variables are business risk (RISK). Business risk proxy is earning volatility measured by standar deviation of operating income divided by total asset over 4 years. Company growth (GROWTH) as a proxy of growth measured by growth of total asset for 4 years. Then, institutional ownership (INSTOWN) measured by institutional ownership of company. Then total asset as control variable (TA) measured by log total asset of company in each years. Total asset (TA) as control variable. Bathala, Moon and Rao (1994) stated that managerial ownership in smaller firm is more greater than larger firm. It means that proportion of share that managerial limited because diversification problems esecially for larger company

5. RESULT AND ANALYSIS

5.1 Findings

Table 1. Descriptive Statistic

Remark	DR	EVOL	GROWTH	INSTOWN	SIZE	MNOWN
Mean	0,128581	0,042508	0,087311	0,248628	2.390.773	0,047017
Maximum	0,544250	0,212170	0,506288	0,810300	41.509.324	0,272600
Minimum	0,000000	0,042730	-0,263609	0,030500	10.583	0,000250
Std. Dev.	0,110199	0,041730	0,075118	0,199977	6.571.976	0,062089

From table 1, describes the data used in this research. Descriptive statistics were obtained by using E-Views on 6 variables: EVOL, MNOWN, INSTOWN, LOGSIZE, GROWTH and DR to obtain data on the average, maximum value, minimum value, median and standard deviation.

Classical assumption made in this study include normality, heteroscedasticity, autocorrelation and multicollinearity tests. Based on the calculation that the study, data are free from both the classical assumption of normality, heteroscedasticity and multicollinearity.

Table 2. First Hypothesis Testing Results

DR = β0 + β1EVOL + β2GROWTH+ β3INSTOWN+ β4MNOWN + e			
Variable	Coefficient	t value	Prob.
EVOL	-0,293	-2,61	0,04**
GROWTH	-0,011	-2,21	0,035**
INSTOWN	-0,018	-1,96	0,015**
MNOWN	-0,259	-2,83	0,0058**
	F = 4,25,prob = 0,014		
	Adj R^2 = 26,91%		

In Table 2, the first hypothesis shows that EVOL, GROWTH, INSTOWN, and MNOWN have significant value. This is supported by probability values of the variables that are under the value of α = 5%. Simultaneously, F value is also of significant value with a probability below the value of α = 5% with a coefficient of determination equal to 26.91%

Table 3. Second Hypothesis Testing Results

MNOWN = β0 + β1EVOL + β2GROWTH+ β3INSTOWN+ β4LOGSIZE+ β5DR + e			
Variable	Coefficient	t value	Probabilities
EVOL	0,146	2,54	0,004**
GROWTH	0,013	2,46	0,002**
INSTOWN	-0,024	-2,65	0,039**
LOGSIZE	-0,011	-3,68	0,0215**
DR	-0,065	-0,83	0,158
	F stat = 3,80 (0,005)		
	Adj R^2 = 22,11%		

In Table 3, the second hypothesis shows that EVOL, GROWTH, INSTOWN, and LOGSIZE have significant value with a probability value below the value of α = 5%. Only, DR was not significant because the probability is above the value of α = 5%. Simultaneously, F value is significant with a probability below the value of α = 5% with a 22.11% coefficient of determination.

5.2 Discussion

The first hypothesis showed that all variables are significant in affecting debt policy. The first variable is the business risk has a negative and significant coefficient. These results are consistent with previous studies that the potential risk of causing companies tends to reduce their debts (Crutchley & Hansen, 1989; Bathala, Moon & Rao, 1994). The risk makes managers more conservative with corporate cash and restrict to use debt. Research from Gabriel and Barker (1980) stated that business risk has an impact in company's cash flow. It means that higher business risk in a company make uncertainty of cash flow. Company that has higher debt must have enough cash reserve to pay interest. When, company faced by higher business risk and higher debt, so it will be increasing bankruptcy because company does not have much reserve to fullfil their obligation.

Then the growth of the company has a negative and significant coefficient. This is in line with research conducted by Bathala, Moon & Rao (1994) which describes the framework of the agency conflict of emerging companies tend not to use debt and will switch to source funding through stock. Bathala, Moon, & Rao (1994) describe that growth company has low asymmetric information, so it possible to access external financing. Since debt has high risk, so company will switch their financing to stock. It finding also supported by research conducted by Billett, King, and Mauer (2007) which stated that the company would avoid using debt as a conservative measures for risks that may arise from investment activities. Myers and Majluf (1984) also explain that companies tend not to use any debts that are too large and opted to use equity to avoid the scrutiny of rigorous external parties.

The presence of institutional ownership also has a negative and significant impact on debt policy. Companies that have large institutional holdings tend not to use a large debt, because the control of the external (institutional) can be used to control the manager in running their duties (Bathala, Moon & Rao, 1994). Moreover, it is said that the risks of using stock is rated lower than debt when companies have a difficult time. The risk in question is the obligation to do the company to external parties, especially creditors who have the right to conduct the liquidation of the company in the event of default.

Managerial ownership has a negative and significant impact on debt policy. Managerial ownership as control over the use of debt is done by the company as the company steps to reduce the risks posed by the use of the debt. In the context of agency conflict, control by the use of debt as managerial managers measures to reduce the risks of investing in the company because of the increase in risk due to the use of debt companies. If the company is default and bankrupt, the shareholders of either managerial or institution will accept the losses, since shareholders are the party that received the last claim to damages. Therefore, control of managerial ownership will restrict the use of debt companies. Research from Datta, *et al* (2005) also stated that manager has freedom to choice level of leverage that company used even the maturity of those debt. Based on this statement, if company use debt as financing source, it will isolate the manager from external monitoring. Managers will have some restriction considering about their choice to use debt. This restriction is about the maturity of debt that can be used to. Company that has higher managerial ownership will decrease using debt that has high maturity because some risk consideration and vice versa.

In the second hypothesis, the results obtained are business risk, growth, institutional ownership and total assets have a significant effect on managerial ownership. Unlike the debt policy, as a control variable has a value that is not significant. Business risk (RISK) has a significant positive influence on managerial ownership. In line with research conducted by Crutchley and Hansen (1989) that the increase in risk resulting from the use of debt, making companies reluctant to use debt and equity to the switch. In control agency conflicts, this condition will be an opportunity for managers to be able to buy shares and increase the proportion of ownership. Other benefits gained by the increase in managerial ownership are the pooling of interests between managers and owners so that managers will perform their duties properly.

The growth of the company also has a significant positive effect on managerial ownership. This is due to the flexibility that is owned by a company that is growing to use funding sources. In the context of agency problems, this finding is in line with research by Bathala, Moon, & Rao (1994) and Titman and Wessels (1988) that the company will use the equity to avoid the costs that arise when the use of debt such as bankruptcy costs, monitoring costs and the costs of leveraging capital. Company that has growth stage also has lower asymmetric information. It can encourage company to use stock for avoiding debt. This finding also makes aligned with the capital structure of the Pecking Order theory that states the company should use the debt to finance growth, and if debt has optimal capacity, it better to switch the financing source to stock. If company forced to use debt, it will increase bankcruptcy cost and investor would make required rate of return more higher too.

Institutional ownership has a negative and significant relationship in managerial ownership. In line with the findings of Bathala, Moon & Rao (1994) that institutional ownership as an exogenous factor has a function as a control manager. Supervision of the institution will make managers more cautious. The rise in the proportion of institutional ownership makes managerial ownership decrease because the control function is already outside namely the institution. The research from Dharwadkar,*et al.*(2008) also stated about effectiveness of institutional ownership has contradict impact with firm-level especially in managerial ownership. It is because high level of institutional ownership has impact in lower managerial ownership. After control of agency problem is took over by institutional level, company doesn’t need to pay higher compensation to manager to make alligned of interest. Directly, the manager action will be controlled by institutional level. If manager take some action that has high risk for company, obviously institutional will increase their control.

Finally, the total assets as a control variable has a negative value but significant. This is due to the sample company is a company that has great assets. Bathala, Moon & Rao (1994) said that the company that has a great asset tend to have a smaller managerial ownership than companies with smaller assets. In addition to total assets, the ratio of debt has a significant impact on managerial ownership. Research conducted by Jensen (1986) states that the level of managerial ownership in the company number is not influenced by the large proportion of debt in the company. The opposite, in fact the manager has the authority to use debt, and this is in line with the findings in the first hypothesis that managerial ownership has a significant impact on debt policy.

6. CONCLUSION AND MANAGERIAL IMPLICATION

From the finding, this paper has been concluded that there is a significant effect on business risk (RISK), growth (GROWTH), institutional ownership (INSTOWN) and managerial ownership (MNOWN) as a control variable to the corporate debt policy in controlling agency conflicts. As stated before that when company using some high debt as source of financing, it will be increase risk, that company in growth stage will reduce of the debt for some risk consideration. In agency perspective, institutional ownership and managerial ownership take a control to reduce the risk, so they have negative effect for debt. In the second hyphotesis there is a significant effect on business risk (RISK), growth (GROWTH), institutional ownership (INSTOWN), as well as total assets (LOGSIZE). Different things happened on debt ratio (DR) that did not significantly influence managerial ownership in a company within the framework of the agency conflict. When company has high risk from using a debt, like in first hypothesis, it will increase a managerial ownership as a control mechanism to reduce agency problem, and managerial ownership can alligned interest between manager and owner. When managerial ownership used as control mechanism of agency problem, it will instead the role of institutional ownership, so for that reason institutional ownership has negative effect vice versa.

This research has managerial implication regarding for capital structure that company used. Since managerial ownership has significant effect to debt, it means that when company has high managerial ownership, proportion of the debt will be reduced because of some risk consideration. Especially when company in a growth stage so it needs more external financing, company will use debt, but from internal parties will take some control for proportion of the debt to anticipate the risk. When company has high proportion of the debt, control of the company will be more intensive even not only from internal parties, but from external parties such as from institutional ownership. Simultaneous effect that proposed in this research shown if company has high risk as the impact of using debt, it not only increase of managerial ownership as a control from internal parties to reduce agency cost but also institutional ownership as external control for company.

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