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The Effect of Corporate Governance on the Degree of Agency Cost in the Korean Market

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Abstract: This study examines the relationship between corporate governance (CG) and agency costs using Korean market data, particularly for chaebol firms. The final sample includes 660 firm-year observations between 2016 and 2020 for Korean non-financial firms listed on the Korean Composite Stock Price Index (KOSPI). This study employs an ordinary least-squares panel data regression model using two proxies for agency costs, namely, asset utilization ratio and operating expense ratio, and six CG individual metrics as independent variables (CG score, protection of shareholder rights, board structure, disclosure, audit organization, and managerial discretion and error management). We find that firms with high CG experience lower agency costs than those with low CG. Moreover, our evidence suggests that firms can decrease agency costs by improving the quality of CG. The results of our regression model also support the idea that CG is effective in reducing agency costs for chaebol firms but not for non-chaebol firms. Finally, our findings suggest that the implementation of effective CG mechanisms in firms might improve managerial behavior through better decision-making to maximize the value of firms.

Keywords: corporate governance; agency costs; chaebol firms; non-chaebol firms

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1. Introduction

Corporate governance (CG) includes all administrative mechanisms for firms and ensures appropriate decision-making processes and controls to benefit and preserve the balance of interests of all stakeholders, including shareholders, employees, suppliers, customers, and the community. It focuses on the processes to achieve firm's objectives according to the social, economic, financial, regulatory, and market environments, comprising the degree of confidence and trust stakeholders have in firm management (La Porta et al. 2002). An adequate CG structure supports the quality of decisions made by managers and the board of directors, enabling firms to sustain their business and create long-term relationships between parties while also increasing firm value (FV) (Tulcanaza-Prieto and Lee 2022).

Jensen and Meckling (1976) introduced the agency problem, which states the relationship between the principal and agent using a contract. The principal's role involves compliance with the contract between parties, the regulation of discretionary behavior, and the power of the agent in firm decision-making. However, it is difficult to maintain a permanent supervision of the principal over the medium and long term given limited resources. Agents with power have incentives and the ability to maximize their self-interests without promoting managerial principles. Agency theory examines classic conflicts of interest such as those between principals and agents, owners and managers, controlling and minority shareholders, and employers and employees. Therefore, agency problems are considered critical factors in the business cycle, given that they include ethical risks, decision-making conflicts, and access to relevant firm information. Conversely, CG principles can help