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## **THE IMPACT OF CORPORATE GOVERNANCE MECHANISMS ON AGENCY COST OF FREE CASH FLOWS IN LISTED MANUFACTURING FIRMS OF TEHRAN STOCK EXCHANGE**

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### **ABSTRACT**

This study examines the impact of corporate governance mechanisms on agency cost of free cash flows in listed manufacturing firms, of Tehran stock exchange. For doing the research, data of 80 firms has been used during 2007-2012. For testing hypotheses, panel data has been used. Indices of corporate governance mechanisms include number of board members, board independence, CEO and chairman of the board duality, managerial ownership and managerial remuneration. The results of the study indicate negative and significant effect of board independence, managerial ownership and managerial remuneration on agency cost of free cash flows. On one side the effect of number of board members on agency cost of free cash flows is positive and significant. Finally, duality of CEO and chairman of the board on agency cost of free cash flows is not effective.

**Keywords:** *Agency Cost, Free Cash Flows, Panel Data, Corporate Governance Mechanisms*

### **INTRODUCTION**

After industrial revolution in 19s, and with the development of stock companies, many investors were created that did not have direct role in managing economic units of their participation and they manage their economic units; just by board of directors and supervising them. The result of this process was the ownership separation from management of companies, ownership separation from management, leads to the creation of agency theory.

This theory is related to the cases that a person delivers responsibility of decision-making about distribution of financial or economic resources or doing services during a distinct contract to another person (Valipour *et al.*, 2011). By making agency relationship each parties of it, is going to maximize their personal benefits. Since the managers function favorability with owners is not equal, there is conflict of benefits between them (Nouravesh *et al.*, 2009).

On one side, theory of free cash flow of Jensen (1986), denotes that companies with high free cash flow are always faced with differences related to the profit between shareholders and managers. Shareholders want managers to invest cash money in projects that maximizes their share value but managers tend to invest their cash money for their personal goals. Jensen and Meckling (1976) denote in their paper that agency cost in companies with additional free cash flow is a lot. According to the theory of free cash flow, sometimes companies achieve more free cash money than what is needed for investment on projects with net present value (NPV) (Khan *et al.*, 2012).

However managers have the authority of using free cash flow and it potentially causes creation of the agency problem. Managers can use free cash flow in the direction of their personal benefits or investment for increasing resources under their control (Jensen, 1986). This investment by managers causes creation of the overinvestment problem. Overinvestment problem is the situation in which managers participate in many investment projects, even when these projects don't have benefits for shareholders (Jensen and Mackling, 1976). At this time, corporate governance discussion is brought up that its final goal is approaching to responding, clarity, justice and obeying rights of beneficiaries. Achieving mentioned goals is done by internal and external mechanisms (HasasYeganeh, 2005). Corporate governance mechanisms are the main effective factor on agency cost. Therefore, in this research, we are going to answer this question that what impact corporate governance mechanisms have on agency cost of free cash flows.

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### **Previous Research**

Florakis and Ozkan (2004) studied the effects of corporate governance mechanism on agency costs. This study included 897 English companies during the years of 1999-2003. Agency costs were measured by assets turnover ratio, and operational expenses ratio to the sale. The results of this study indicated that there is a significant relationship between management ownership, managers' bonus, and ownership concentration with agency costs.

Mcnight and Weir (2009) scrutinized the effects of corporate governance on agency costs. Their study sample included 534 observations of 128 large English companies during the years of 1996-2000. Assets turnover ratio and interactions between growth opportunities and free cash flows, and the numbers of companies, acquired by the company were considered as measurement for agency costs. The results of their study, suggested that increase, in manager ownership leads to decrease in agency costs. By using the interactions between growth opportunities and free cash flows as an index of agency costs, institutional ownership causes decrease in agency costs. Also, there is a negative and significant relationship between liabilities ratio and agency ratio by calculating agency costs as assets turnover ratio.

Valipour and Khorram (2011), examined relationship between corporate governance mechanisms and agency costs of 51 listed companies of Tehran Stock Exchange during the years of 2001-2008, and used panel data method for hypotheses test, and the results indicated that there is a negative and significant relationship between percentage of institutional ownership, manager ownership, board non-duty members, liabilities ratio to total debt and agency costs at 95% confidence level.

Gul *et al.*, (2012), examined relationship between ownership structure and corporate governance and agency cost of 50 listed companies of Karachi stock exchange during the years of 2003-2006. The results show that higher director and institutional ownership reduces the level of agency cost. Smaller sized boards also result in making lower agency cost. Board independence has positive association with asset utilization ratio. The separation of the post of CEO and chairperson and higher remuneration lower agency cost.

Kamyabi *et al.*, (2014) examined the relationship between ownership and corporate governance to decrease agency costs in listed companies of Tehran Stock Exchange during the years of 2010-2012. The results of the study indicate that, there is a negative and significant relationship between agency cost with managerial ownership, institutional investor ownership, and size of the board; on the other side, there are not any significant relationship agency cost with other investor ownership, number of board members, and CEO and chairperson of the board duality.

### **Theoretical Principles of Research**

#### **Agency Costs**

In the view of Jensen and Meckling (1976) agency relationship is a contract in which the principle (shareholders) hire an agent (manager) to act on his behalf. The agent has a responsibility to fulfill certain obligations for the shareholder, which includes maximization of the wealth of shareholders. However according to Jensen and Meckling these agents sometimes overindulge in personal pursuit at the expense of maximizing shareholders wealth.

Managers are responsible for the daily operations of the firm because they are the agents of the shareholders they have inside information which they can use for private benefits. Thus a conflict exists between two parties because their interests are not completely aligned. According to Jensen and Meckling (1976) the agency problem gives rise to the agency cost which is a sum of the monitoring cost, bonding cost and residual loss.(Siddiqui *et al.*, 2013)

#### **Number of Board Members**

Board of directors, is the most important factor at corporate governance (Jensen, 1993). Large boards are usually more powerful than small boards and, hence, considered necessary for organizational effectiveness. For instance, as Pearce and Zahra (1991) point out, large powerful boards help in strengthening the link between corporations and their environments, provide counsel and advice regarding strategic options for the firm and play crucial role in creating corporate identity. Other studies, though, suggest that large boards are less effective than large boards. The underlying notion is that large boards

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make coordination, communication and decision-making more cumbersome than it is in smaller groups. Eisenberg *et al.*, (1998) support such a view empirically (Florackis and Ozkan, 2004).

#### **Board Independence**

Boards with a significant proportion of non-executive directors can limit the exercise of managerial discretion by exploiting their monitoring ability and protecting their reputations as effective and independent decision makers (Florackis and Ozkan, 2004).

#### **Duality of CEO and Chairman of the Board**

As far as the separation between the role of chief executive officer (CEO) and chairman of the board (COB) is concerned, it is believed that separated roles can lead to better board performance and, hence, less agency conflicts (Florackis and Ozkan, 2004).

#### **Managerial Ownership**

Manager's ownership causes creation of more alignment of benefits between managers and shareholders and reduces agency problems between parties. When the percent of managers ownership is high, although maximize viewing of current profit leads to the receiving more remuneration by manager, due to diversity of this presentation in future, firm value (manager wealth as shareholder) reduces in future. The basis of this deduction is that it is expected managers with his ownership percent, during long-term period remain in a company.

Therefore by increasing ownership of managers, the motivation and their benefits aligned with benefits of other shareholders and the severity of the agency problem reduces (Karami *et al.*, 2010).

#### **Managerial Remuneration**

Murphy (1999) and Core (2001) suggest that incentive managerial remuneration was an effective way to motivate manager to take actions which helped to maximize shareholder wealth. If other conditions do not change, it meets managers and reduces agency costs to increase managerial compensation. Managers would not bear the risk of losing their jobs because of expropriating shareholders' benefit and working lazily.

#### **Research Hypothesis**

**Main Hypothesis:** Corporate governance mechanisms impact on agency cost of free cash flows.

**First Sub Hypothesis:** Number of board members impact on agency cost of free cash flows.

**Second Sub Hypothesis:** Board independence impacts on agency cost of free cash flows.

**Third Sub Hypothesis:** CEO and chairman of the board duality impact on agency cost of free cash flows.

**Fourth Sub Hypothesis:** Managerial ownership impacts on agency cost of free cash flows.

**Fifth Sub Hypothesis:** Managerial remuneration impacts on agency cost of free cash flows.

## **MATERIALS AND METHODS**

### **Methodology**

For considering the impact of independent variable on dependent variable of the research, the multi variable regression model in the method of panel data, will be used. Hypotheses will be tested through result of econometric and regression model. In this research, for testing significance of regression equation from Fisher statistic (F) in the level of 95 percent of certainty and for testing significance of each coefficients t student test at the level of 95 percent certainty is used.

### **Statistical Society**

Statistical society of the research includes all manufacturing firms accepted in Tehran stock exchange. For determining, considering sample volume, companies were chosen have been selected from statistical society that have the following conditions:

- 1- Firms have to be accepted in Tehran stock exchange before 2007.
- 2- In order to be comparable of the end of financial year company information should be end of March.
  - 1- Not being damaged in the period of considering the research.
  - 2- Required financial information should be available for data extraction.
  - 3- Firms stock should be transacted during studying period, constantly.

By considering above limitations, 80 firms were chosen during 2007 -2012.

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### Data Collection

Required quantitative data for doing research has been obtained regarding considered variables from various resources including financial statements and reports of activity of board of directors distributed by stock organization, company of Tehran stock technology management company by the internet address of ([www.fipiran.com](http://www.fipiran.com)) and management of research and Islamic studies development of Tehran stock exchange having the address ([www.rdis.ir](http://www.rdis.ir)). At the step of primary data collection and processing Excel software was used. After doing calculations and primary processing, output information is used for implementing model and testing hypotheses; by using Eviews 7 software.

For considering the impact of corporate governance mechanisms on agency cost of free cash flows, the following relation is used as basic model:

$$ACF_{i,t} = \alpha + B_1(BRDSIZE_{i,t}) + B_2(BRDIND_{i,t}) + B_3(DUALITY_{i,t}) + B_4(MREM_{i,t}) + B_5(MGR_{i,t}) + B_6(PBFT_{i,t}) + B_7(SIZE_{i,t}) + B_8(GROWTH_{i,t}) + \varepsilon_{i,t}$$

In which:

\* $ACF_{i,t}$  = Agency cost of free cash flows of I firm in t year

\* $\alpha$  = Mean of the effect of all variables deleted from the model on dependent variable

\* $BRDSIZE_{i,t}$  = Number of board members of I firm in t year

\* $BRDIND_{i,t}$  = Board independence of I firm in t year

\* $DUALITY_{i,t}$  = CEO and chairperson of the board duality of I firm in t year

\* $MREM_{i,t}$  = Managerial remuneration I firm in t year

\* $MGR_{i,t}$  = Managerial ownership of I firm in t year

\* $PBFT_{i,t}$  = Profitability of I firm in t year

\* $SIZE_{i,t}$  = I Firm size in t year

\* $GROWTH_{i,t}$  = Growth opportunity of I firm in t year

E = Model waste

### Variable Measurements

#### Dependent Variable

**Agency cost:** Free cash flow is used as a proxy of agency cost of free cash flow, and it is also the dependent variable of the study. According to Utami *et al.*, (2011), we defined free cash flows as net profit minus changes in fixed assets minus changes in net working capital divided by total assets.

#### Independent Variable

**Board Size:** Following Kamyabi *et al.*, (2014), board size is estimated through the number of board members.

**Board Independent:** Following Gul *et al.*, (2012) it is measured as the number of independent directors on the board relative to total number of board members.

**Ceo and Chairman Duality:** Following Gul *et al.*, (2012) duality is included as a dummy variable which is given a value of 1 if the CEO is also the chairperson of the board of directors and 0 otherwise.

**Managerial Ownership:** Managerial ownership, according to Kamyabi *et al.*, (2014), we estimated it through percentage of total shares of the company that are available for all of the company managers.

**Managerial Remuneration:** Following Gul *et al.*, (2012), it is measured as taking natural log of the sum of total annual benefits paid to all members of the board.

#### Control Variable

Control variables of the study are investment and growth opportunity, firm size and profitability.

**Firm Size:** This is defined as natural log of total assets.

**Investment and Growth Opportunity:** This is defined as Total sales of current period minus total sales of previous period divided by last year sales.

**Profitability:** This is defined as net profit divided by total shareholders' equity.

#### Data Analysis Stability

In order to be certain about the result of research and not being artificial of the available relations in regression and significance of variables, the stability testing and calculating unit root of research variables has been done. The mentioned test has been done by using Eviews7 software and augmented Dicky Fuller

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test. (The results of tests (table 1) show stability; of variables; so null hypotheses that based on having united root of variables, is rejected and variables are stable.)

$$\begin{cases} H_0: \text{existence of unit root} \\ H_1: \text{lack of unit root} \end{cases}$$

**Table 1: Result of stability of variables**

Augmented Dicky Fuller	Tests	Variables
187.170	coefficient	<b>Acf</b>
0.0000	Sig	
9.40877	Coefficient	<b>Brdsize</b>
0.0151	Sig	
54.7464	Coefficient	<b>Brdind</b>
0.0135	Sig	
81.4225	Coefficient	<b>Mrem</b>
0.0000	Sig	
5.27018	Coefficient	<b>Duality</b>
0.0000	Sig	
54.6349	Coefficient	<b>Pbft</b>
0.0091	Sig	
89.9458	Coefficient	<b>Size</b>
0.0599	Sig	
155.888	Coefficient	<b>Growth</b>
0.0001	Sig	
66.5773	Coefficient	<b>Mgr</b>
0.0092	Sig	

**Chaw Test or Structural Changes Test**

For testing research hypotheses first, the model of fixed time effects was estimated and then for considering significance difference, structural changes test will be used. This test is hypothesized for considering the existence of fixed effects as below:

$$\begin{cases} H_0: \text{lack of fixed effects} \leftrightarrow \text{pool model} \\ H_1: \text{existence of fixed effect} \leftrightarrow \text{fixed effect model} \end{cases}$$

The result of this test has been presented in table 2. Significance less than 0.5 percent shows rejection of H0 hypothesis; that is, model of fixed effects are chosen as best model.

**Table 2: Results of Chaw test**

Sectional cutting	Statistic	Freedom degree	Sig
Statistics F	3.164406	(79,384)	<b>0.0000</b>
Chi-square	240.666063	79	<b>0.0000</b>

**Housman Test**

As it is regarded, the result of Chaw test denotes choosing model of fixed effects. Now we should test model of fixed effects in contrast to the model of random effect. For this action Hausman test is used. Housman test is set for considering the existence of random effects as below:

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H0: There isn't correlation between personal effect and descriptive variables ↔ *random effect model*

H1: There is correlation between personal effects and descriptive variables ↔ *fixed effect model*

**Table 3: Results of Hausman test**

Sig	Freedom degree	Statistic	Effect of test
0.0000	11	81.220845	<b>random</b>

As it is considered, regarding significance H0 is rejected and model of fixed effects is chosen as prioritized model.

**Variance Anisotropy**

In sequence statistic, random variables that have different variances are called anisotropy variance. In contrast, a sequence of random variables is called similar variance; if they have fixed variance.

In this research, the test of Breach-Pagan-Godfrey has been used for finding anisotropy of variance.

H<sub>0</sub>= lack of variance anisotropy

H<sub>1</sub>= existence of variance anisotropy

As it is obvious from the results of table 4; significance level, lower than 0.05 shows rejection of H0. Therefore, variance anisotropy is confirmed. Under these conditions, the ordinary least square (OLS) method is not counted as the best linear estimator without bias (BLUE) and instead generalized least square (GLS) is used for estimating model.

GLS is the same OLS that data are changed in a way to supply suppositions that are needed for the GLS. GLS method is sometimes introduced as weighted least square; because in this method, weight sum of reminders are reduced whereas in OLS method their non-weighted sum are reduced.

**Table 4: Identifying inconsistency of variance**

Probability of statistic		Statistic		
0.0004	Prob. F(11,468)	3.145120	F-statistic	<b>Breusch-Pagan-Godfrey test</b>
0.0005	Prob. Chi-Square(11)	33.04090	Obs*R-squared	
0.0000	Prob. Chi-Square(11)	105.5719	Scaled explained SS	

**Autocorrelation**

As it is observed in these tempted results related to the hypotheses; statistics of Durbin–Watson shows the number 2.03 that shows lack of autocorrelation.

**The Result of Testing Hypotheses**

The result of testing hypotheses has been presented by using EGLS method in table 5.

**Table 5: Result of estimation obtained from hypothesis testing of the method EGLS**

Variables	Coefficient	Standard deviation	T statistic	Sig
fixed number(C)	0.477546	0.111552	4.280926	<b>0.0000</b>
Brdind	-0.217260	0.096986	-2.240121	<b>0.0096</b>
Mrem	-0.040879	0.006710	-6.092167	<b>0.0000</b>
Brdsize	0.011499	0.008421	1.365446	<b>0.0172</b>
Duality	-0.003178	0.006383	-0.497850	<b>0.6189</b>
Growth	-0.031455	0.008182	-3.844449	<b>0.0001</b>
MGR	-0.079031	0.028828	-2.741427	<b>0.0064</b>
PBFT	0.161043	0.027640	5.826512	<b>0.0000</b>
Size	0.050833	0.008353	6.085401	<b>0.0000</b>
Determination coefficient	0.738985		Modified determination	<b>0.678596</b>
Durbin–Watson statistic	2.027643		F statistic	<b>12.23705</b>
			Significance level of F	<b>0.000000</b>

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The result of testing model and coefficient of independent variables obtained by using mentioned method shows this subject that variables used in the model totally explain 68 percent of dependent variables. As it is regarded in mentioned table, F statistic shows meaningfulness of the regression equation. Regarding table 5, coefficient and t statistic related to variable of the number of board members denotes positive and significant effect on agency cost of free cash flows. Thus, first sub hypothesis is confirmed. The result of testing this hypothesis denotes that by increasing the number of board members, agency cost of free cash flows increases. Thus we conclude that as the number of board of directors is less, the agency cost reduces. The reason of this action can be this subject that by smaller member of the board of directors, the possibility of discussion and changing viewpoint about problems of the company is prepared more and free cash flow by managers is invested properly and used in proper sections. The result of this research, coordinate with the result of Gul *et al.*, (2012). But it does not coordinate with the result of Kamyabi *et al.*, (2014).

Coefficient and t statistic related to variable of the board independence denoted negative and significant effect of this variable on agency cost of free cash flows. Thus second sub hypothesis is confirmed. Effectiveness of separating decision by manager and controlling by board of directors is because non-executive managers due to their benefited are not ready to cooperate with administrative managers. Since non-executive managers have the most of implementing position of management or decision-making in other companies, have high motivation for getting fame as specialist of decision-making and having better job opportunity in future. Inconsistency of managers' motivation for using wealth of owners for their personal benefits with motivation of non-executive managers for achieving fame causes improvement of supervision on management of the company and leads to the reduction of agency cost therefore findings of the research is in accordance with the result of research of researchers such as Valipour *et al.*, (2011) and Florakisandozkan (2004). On one side the result of this research does not adapt with the result Gul *et al.*, (2012).

Variable of, CEO and chairman of the board duality is not significant due to t statistic at the level of 95% therefore third sub hypothesis is not confirmed. It means that duality of CEO and chairman of the board does not effect on agency cost of free cash flows. The result of current research and result of Kamyabi *et al.*, (2014) are adapted.

Coefficient and t statistic related to the variable of managerial ownership denotes the negative and significant effect of this variable on agency cost of free cash flows. Thus fourth sub hypothesis is confirmed. By the increase of share of a manager from firm's ownership, conflict of benefits between shareholders and also agency problems reduces. Because managers, who are shareholders of the firm; have more motivation for preserving benefits of the firm. Therefore regarding that agency cost constitutes important part of total cost of a company and the goal of shareholders about spending these cost, is being certain about accuracy of management activities and by increase of percent of ownership of managers, attempt of manager for increasing firm's value becomes more and the need for additional tests becomes less, the agency cost reduces. Therefore the result of researchers such as Florakis and Ozkan (2004) and Mcnigh and Wier (2009) and Valipour *et al.*, (2011) are adapted. Coefficient and t-statistic related to the variable of managerial remuneration denotes negative and significant effect of this variable on agency cost of free cash flows. Thus fifth sub hypothesis is confirmed. The reason of this action is resulted from this subject that remuneration, creates motivation in managers and this motivation encourages them in the direction of benefits of shareholders of the firm. Also more remuneration, encourage managers for continuity of receiving these advantages and also their job security, encourages to the activity that causes increase of wealth of firm's shareholders. The result of Gul *et al.*, (2012) showed that increase of remuneration of managers causes reduction of agency cost. The result of current research adapts with the result of Gul *et al.*, (2012). The result of research denotes positive and significant effect of the firm size on the agency cost of free cash flows. That is by enlargement of company the agency cost increases that is according to the findings of Valipour *et al.*, (2011).

Also, there is negative and significant effect of growth opportunities on agency cost of free cash flows. It can be concluded that companies with high development opportunity are managed better than companies

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with lower growth opportunity that is according to the result of Florakis and Ozkan (2004) and Valipour *et al.*, (2011).

Finally, the results denotes positive and significant effect of profitability on agency cost of free cash flows, the reason of this action can be the point that a profitable company preserves more cash money and it is possible the manager of that company use it incorrectly and for useless activities.

### **Discussion and Conclusion**

Theory of free cash flow of Jensen (1986) denotes that agency cost in companies with high free cash flow, is so many. And agency cost reduces firm's value. One factor of reducing agency cost, are corporate governance mechanisms. In this research, the impact of corporate governance mechanisms on agency cost was considered. The results denote negative and significant effect of board independence, managerial ownership and managerial remuneration on the agency cost of free cash flows. On one side, the effect of number of board members on agency cost of free cash flows is positive and significant. Also the effect of CEO and chairman of the board duality on agency cost of free cash flow is negative; although it is not significant statistically.

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