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Agency Costs and Ownership Structure: Evidence From the Small Business Finance Survey Data Base

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Agency problems* arise when a corporate organization (the principal) employs a professional manager (the agent) and thereby separates the business owner(s) from control of the business. Most previous studies of such agency problems used data from publicly traded companies. Applying these study results to small owner-controlled business reveals two limitations. First, in most publicly traded companies, the largest shareholders seldom own more than 50 percent; therefore, the results may not be applicable to problems faced by smaller, family/owner-managed firms. Second, since control is not separate from ownership, these small firms should, by definition, have no agency problem. Family shareholders usually are less likely to expropriate bondholder wealth than other shareholders; family firms may also have incentive structures that result in fewer agency conflicts between equity and debt claimants.

The author hypothesizes that agency problems suffered by larger firms are not statistically significant for smaller owner-manager or family-owned firms. The Federal Reserve Board's 1993 National Survey of Small Business Finances (NSSBF) database was used to test the hypotheses.

Findings

1. Agency costs of owner-managed and outsider-managed firms—as measured by the ratios of operating expenses to sales and sales to assets—are not significantly different. Similar results are documented for the family-owned small company. However, owner-managed firms are statistically different from outsider-managed firms in ratios of cash flow to assets for 100 percent management-owned firms and firms in which no owner or family owns more that 50 percent (diffused ownership). These results, together with the higher efficiency of the diffused-ownership firms, show that agency problems do not exist for smaller firms.

2. The above results do not take into account the interactive effect of internal monitoring, derived from ownership, and external monitoring derived from bank loans/debt holders. When regression analysis is used to study all these effects, it can be said that a large number of nonmanager stockholders will decrease the efficiency of small firms. The overall effect of bank monitoring is negative; therefore, the benefits of bank monitoring may be outweighed by the associated "hold-up" costs. For example, if a firm has only one creditor, it may incur higher refinancing costs because borrowing from other creditors is more costly.

3. Since the coefficients associated with family ownership are not significant statistically, but the debt-to-assets ratio is, it appears family ownership cannot mitigate, nor is it related to, agency problems of small firms.

4. After factoring in the "interactive effect" by using a more powerful statistical method, the above findings are maintained with the exception that family ownership indeed plays an important role in eliminating agency problems. The empirical evidence, therefore, supports the alignment-based governance system proposed by John and Kedia.

Implications for Business Owners

The study's findings have significant implications for small business owners. Because owner-managers are the most effective mechanism for eliminating agency costs, it is important for owners of small

*In this paper, "agency" refers to the relationship between a principal, such as a business owner or owners, and his or her agent, such as a manager.

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firms to participate actively in investment and financial decision-making. When the size of the company increases, as measured by sales, and when professional managers are recruited, delegation of authority becomes necessary. To reduce the associated agency costs, corporate control mechanisms involving family members and/or banking relationships should be established to monitor the behavior of the nonowner managers. Otherwise, the Wall Street scandals that plagued the Fortune 500 companies may become a reality for the small firm.

Methodology

To test the hypotheses, the author used, as proxies to measure agency costs, ratios of operating expenses to sales and sales to assets. Their joint effect is analyzed using the ratio of cash flow to assets. It is assumed that these three variables are affected by log sales, industry effect, firm age, different ownership (internal control dummy variable) schemes (owner-managed; >50 percent family owned; >50 percent primary owner), log of number of nonmanager stockholders, and external monitoring (number of banking relationships, length of the longest banking relationship, and debt-to-asset ratio).

Firms of two types—owner-managed and outsider-managed—are also grouped into six sub-groups: 1) all corporations; 2) corporations in which the primary owner owns 100 percent of the firm; 3) corporations in which the primary owner owns more than 50 percent of the firm; 4) corporations in which a single family owns more than 50 percent of the firm; 5) corporations in which no owner or family owns more than 50 percent of the firm; and 6) proprietorships. The average of each of the agency cost proxies was estimated and t-tests or z-tests were performed to examine the differences between owner-managed and outsider-managed firms.

The ordinary least squares (OLS) method was used to study the relationship between the dependent variables (the agency costs) and the independent variables mentioned previously. Since the multi-equation system was more appropriate for studying the optimal governance system, the author employed the seemingly unrelated regression (SUR) method to simultaneously test the variables of these ratios: operating expenses to sales, sales to assets, and cash flow to assets. The estimates from the SUR are believed to be more efficient than the OLS estimates.

This report was peer-reviewed consistent with Advocacy's data quality guidelines. More information on this process can be obtained by contacting the director of economic research at *advocacy@sba.gov* or (202) 205-6533.

Ordering Information

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