**AGENCY COSTS AND FIRM MARKET VALUE: EVIDENCE FROM COMPANIES LISTED ON THE NAIROBI SECURITIES EXCHANGE**

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**Abstract**

This study was an analysis of the effect of agency costs on firm value. Theory argues that shareholders are willing to incur agency costs to ameliorate on undesirable activities of management that may reduce the firm value. The economic theory of a firm rests of the value maximization goal of a firm for the benefit of the shareholders. Managers who are employed as agents may fail to be good stewards and engage in self-interest, instead of engaging in value maximizing activities. To control the activities of management, the shareholders are willing to incur independent audit costs, the implement robust internal control systems and they will offer managerial incentives to motivate the managers to appropriate behavior. These were used as the independent variables in the study while firm value was the product of share price and the number of outstanding shares. Multivariate regression analysis was used to analyze the data. The study generally agrees with theory that agency costs have a positive effect on firm value, with internal audit costs having the largest effect. Therefore, investment in a robust internal control system by shareholders seems to deliver superior value by discouraging undesirable activities of management. The study however did not consider the intervening variables that may affect the relationship, hence, direct interpretation may be simplistic.

**Background of the study**

One of the most important characteristics and requirements in running of publicly quoted companies is the separation of ownership of assets and control of those assets. The ownership of assets and resources is vested in the shareholders but the control and use of these assets is in the hands of professional managers appointed by the shareholders (Brealey and Meyers, 2003).

This separation of ownership and management often results divergence of interests between the shareholders and the managers. Managers may therefore end up making decisions which benefit them and are not beneficial to the shareholders. It is from this fact that agency conflict arises since the shareholders hire managers so that they can maximize the value of the firm for the benefit of the shareholders, but managers are aim at achieving selfish goals e.g. company size, market value and increase in perquisites. Such has been documented by many studies such as Jensen & Meckling (1976); Ross (1973); Kosnik & Bittenhausen (1992); Begen, Dutta & Walker (1992); Logan (2000) and Tate et al (2010).

It is from this conflict that agency costs arise and are incurred by shareholders in order to control the behavior of management. Berle and Means (1932) argued that agency costs will be incurred in the separation of ownership and control due to the divergent interests of the management and the shareholders. Ideally the shareholders could play a role in monitoring managers, however given the monitoring benefits for shareholders the benefit would be proportionate to their equity stakes (Grossman & Hart 1988) hence the extent of the costs will always depend on the extent of shareholder value that is being secured.

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#### Agency Costs

Jensen and Meckling (1976) defined agency costs as the sum total of monitoring expenditures by the principals, the bonding expenditures by the agent and the residual loss. Monitoring costs are paid by the principal to measure, observe and control their agents’ behaviors. These costs would include external and internal Audits, execution of executive compensation contacts and ultimately cost of hiring and firing to managers. Agency costs arise from issues such as conflict of interests between shareholders and management (Amir, 2005). Bonding costs refers to structures that managements ultimately set up to compel them to act in shareholders’ best interests and includes compensating shareholders in the event of failure to act as such. Residual loss refers to residual agency losses that arise from conflicts of interest after both monitoring and bonding measures have been affected (Baker and Anderson, 2010).

Therefore, these economic considerations that are made by the principals are aimed at ensuring maximization and achievement of the principal’s goals in the firm. Agency costs hence are the costs of designing, implementing and maintaining appropriate control system within the organizations and the residual loss resulting from the difficulty of solving control problems completely. Jensen Meckling (1976) defines agency relationship as a contract under which one or more persons (principal/s) engage another person (agent/s) to perform some service on their behalf which involves delegating decision-making authority to the agent. In a firm, there is separation of ownership and management. The shareholders appoint managers to run the firm on their behalf, hence making the shareholders the principals and the managers the agents. The shareholders are the owners of the firm and they seek to maximize their wealth through the firm.

However, there are two types of agency cost present in an organization: first, arising due to conflicts between shareholder and management (Myers, 1997) and the other one – due to conflicts between shareholders and debt holders (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1999). In addition, free cash flow (FCF) is also a form of agency cost which increase agency costs as managers use this for their own compensations and benefits or use in some low returns projects (Yermack, 2006; Zhang, 2009). Subsequently, agency costs have significant impact on organizational decisions (e.g., capital structure decisions, dividend policy decisions) and performance of organization.

The key insight of Jensen and Meckling (1976) was to model the relationship between owners and managers like one between a principal and an agent. The owners contract the managers to perform the controlling tasks of a firm, and as both seek to maximize their own utility and are self-interested a conflict of interest arises. The managers are hence expected to make decisions that help maximize the value of the firm for the benefit of the shareholders. While the main aim of the shareholders is to increase the firm’s value whilst managers may want to pursue other selfish goals or rather maximize their own interest like increasing company size, personal perks among others. In an agency relationship if both parties are utility maximizers then the agent will not always act in the best interests of the principal.

For the principal to curtail divergence from his interests he must provide appropriate incentives to the agent to ensure agents are always aimed at acting in the interests of the principal. One of these incentives is incurring agency costs. Shareholders are therefore willing to incur agency costs to control management behaviour so that the managers do not seek to maximize their own interests instead of the interests of the shareholders. Brigham and Gapenski (1992) defines agency cost as all costs borne by shareholders (principal/s) to encourage managers to maximize shareholder wealth rather than act in their self-interest.

Agency costs have been classified in various categories depending on what the costs are aimed at achieving. Baker and Powell (2005) classify agency costs either as direct or indirect. Direct costs can be those that benefit the management directly/ corporate expenditures at the expense of the shareholders, or those that are incurred in monitoring of management actions so as to keep the principal- agent relationship aligned. The first category of includes expenditures such as expensive travel and hotel bookings by management while they are executing their mandate. The monitoring costs include those of external auditors etc. Indirect agency costs refer to lost opportunity for example shareholders want to undertake a certain project that is aimed at increasing the value of the company however management is not ready to take that risk as they feel things might not go as expected if this is not done then the shareholders stand to lose a potential opportunity.

There agency costs in an organization may further be classified as follows: first, arising due to conflicts between shareholder and management (Myers, 1997) and the other one – due to conflicts between shareholders and debt holders (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1999). In addition, free cash flow (FCF) is also a form of agency cost which increase agency costs as managers use this for their own compensations and benefits or use in some low return’s projects (Yermack, 2006; Zhang,2009). Subsequently, agency costs have significant impact on organizational decisions (e.g., capital structure decisions, dividend policy decisions) performance and valuation of organization

Other way used to classify agency costs is in the form in which they are incurred; Internal costs which are the costs incurred by shareholders or principals by paying directly to the agents or are incurred to ensure that the agents are encouraged achieve what the principals would want this include compensation contracts, bonding and setting and monitoring of internal control activities through internal audit functions, within the firm. External costs include monitoring activities which include statutory and legislative monitoring by various bodies e.g. capital markets regulators, external auditors, costs of non-executive directors etc. These costs are mainly incurred to external parties whose opinions and guidelines the principals use to monitor and guide the way the agents (managers) are running the firms. Overall all these costs are incurred by the shareholders to protect their investments in the company and ensure that the value is maintained and grows over time and ensuring a going concern of the firm.

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#### Value of a Firm

Firm value is one of the fundamental metrics used in business valuation, financial modeling, accounting, portfolio analysis, etc. Because of the weaknesses of profit maximization as a goal, value maximization is considered the superior goal of the firm. Firm value is an economic measure reflecting the market value of a whole business (Kurshev and Strebulaev, 2005). According to Ehrhard and Bringham (2003), it is a sum of claims of all claimants: creditors (secured and unsecured) and equity holders (preferred and common).

There are many methods that have been suggested in determining the value of a firm. Goossen, Jensen and Wells, (1999) used the book value that just looks at historical costs and bases most of this in the generally accepted accounting frame work. Due to this it gives valuations that are a bit off t from the reality. Miller and Modigliani (1961) used the capitalized value of future performance and they pointed out that that although there are various ways of doing this the expected results should be the same if the markets are perfect, the people are rational, and future is known perfectly

Other methods may include use deductive judgement which depends on human judgement where the valuation of the firm is rated along a psychometric scale then these results are converted to a monetary value. Market value of the shares that are outstanding can also be used but it reliability depends on whether the securities market is efficient.

#### Nairobi Securities Exchange

The Indian Securities Contracts (Regulations) Act of 1956, defines Securities Exchange as “An association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities." According to Husband and Dockerary (1972) in their book on Modern Corporation finance they define Securities Exchange as "Stock exchanges are privately organized markets which are used to facilitate trading in securities."

The Nairobi Security Exchange is such a market for securities and was established in 1954 as a voluntary association of stockbrokers and its name at that time Nairobi Stock Exchange (NSE) its responsibility was mainly that of developing the securities market and regulating trading activities.  In those initial days business was transacted by telephone and prices determined through negotiation. It was later registered (1991) as a limited Company by Shares and later by guarantee after the Capital Markets Amendment Act of 1994 and the trading moved to a floor based outcry system

The ultimate mandate of the NSE has been to oversee the member firms in how they trade in the market. Over the years there have been various changes in the way it operates which ultimately has gone a long way in establishing it as one of the most respected Securities in Africa. In 1990 the CMA was constituted in January 1990 through the Capital Markets Authority Act (Cap 495A) and inaugurated in March 1990. The main purpose of setting up the CMA was to have a body specifically charged with the responsibility of promoting and facilitating the development of an orderly and efficient capital market in Kenya. The Central Depository and Settlement Corporation was established to provide clearing, delivery and settlement services of securities traded in the NSE. The company changed its name to Nairobi Securities Exchange in 2011 and in 2014 was given ago ahead from the CMA to demutualize where they it has been able to list its shares in the exchange amongst other companies.

Some of the securities traded in the securities Exchange include Ordinary shares, Preference shares and debentures. The exchange currently has 67 companies some of which are cross listed across the various stock exchanges in East Africa. The NSE is divided into three categories the Main Investment Market Segment (MIMS), Alternative Investment Market Segment (AIMS) and Fixed Income Securities Market Segment (FISMS). MIMS is the major segment in the market. The main requirements in this market are share capital of a minimum of 50 million and net assets of 100 million and at least 5 years of audited financial statements the firms are further segmented as per the industries e.g. financial and banking, agricultural, commercial and services, Energy and Petroleum, Construction and allied, Investments, telecommunications and technology, construction and allied.

The Aims are small segment compared with the MIMS and its requirements are a bit less stringent with companies being required to have 3 years audited accounts, KES 20 million net assets and Ksh 10 million worth of issued shares. FISMS is a debt capital markets segment and companies are able to list commercial papers or corporate bonds the requirements here are as those of MIMS, this section still requires sensitization and awareness as it is not as busy as the other ones.

#### Rationale for the study

Agency costs are incurred to ameliorate the agency conflict where the managers pursue selfish objectives instead of seeking to maximize the value of the company for the benefit of the shareholders. Baker and Anderson (2010) indicates that sometimes the management may misappropriate excess funds that ought to bring wealth maximization of the shareholders, the managers personal financial interests may sometimes override those of the shareholders hence the resultant conflict which can be resolved by incurring extra agency costs

The literature supports the argument that amounts paid to independent auditors are connected to the performance of companies (Hay, Knechel, & Wong, 2006; Stanley, 2011). Also, while it is predicted that the incentive-alignment effects of managerial equity ownership reduce the demand for additional costly monitoring mechanisms, empirical evidence of a relationship between managerial shareholdings and firm value is mixed and to a certain extent contradictory.

Even practically, there are several examples of companies that have been previously listed in the securities exchange and through various aspects of agency mismanagements have either been delisted or stopped trading hence eroding significantly on the value of the firms. Companies such as Uchumi Supermarket, Mumias Sugar, National Bank of Kenya amongst others have adversely been affected by the various actions of omission or commissions by the said agents that represent the shareholders leading to corporate underperformance and erosion of corporate value at the securities exchange. This study seeks to shed light on a local setting on the empirical relationship between agency costs and firm value. Other studies, for example Onsomu (2013), Salim (2012) focused on agency costs and capital structure and performance respectively.

The specific objectives will include

1. To examine the influence and effect of independent audit fees to the firm value
2. The effect of managerial incentives on the value of the firm
3. The effect of the costs of internal controls to the value of the firm

The study contributes to the literature of the relationship between agency costs and firm values of companies listed in the Nairobi Securities Exchange. It is hoped that findings of this study will be valuable to policy practice and to other researchers. The policy makers and regulators will use the results to design appropriate policies that will support creation of business value. Practitioners will be able to implement appropriate agent incentive programs that will reduce the agency conflict between shareholders and managers. Other researchers carrying out similar studies in other jurisdictions will use this study as a reference point in examining the existing body of knowledge in the subject. The study covers the companies listed on the Nairobi Securities Exchange as at the December 2020. However, companies with incomplete data were excluded from the study. For example, data on internal audit fees, which was the proxy for internal controls was difficult to obtain for some companies. Such firms were excluded from the study.

**Review of literature**

**Agency Theory**

Agency theory addresses the implications of contractual relationships that arise when one party (principal) delegates work to another (agent) to perform that work. In this setting, scope exists for an agency problem wherein agents may pursue their own goals which can conflict with the principal’s goals and therefore reduce firm value (Jensen and Meckling, 1976). Agency theory explains the relationship between principal (stockholders) and agent (management). At least there are two main problems in the relationship, managerial compensation and asymmetry information (Jensen and Meckling, 1976). The first problem appears because management desires higher managerial compensation in the form of bonus while stockholders wants higher dividend. Second agency problem about asymmetry information appears because management is an insider while stockholders are outsiders that only know about company’s financial condition from the financial reports prepared by management.

The first agency problem is possible to be solved by negotiation about managerial compensation and executive stock ownership program. Meanwhile, the second agency problem is expected to be solved by the role of independent (external) auditor. Independent (external) auditor should provide assurance services to stockholders that financial reports prepared by management are free from bias and material misstatement and in accordance with accounting standards.

Smith (1973) is perhaps the first author to suspect the presence of agency problem in firms. He forecasted in his work ‘The Wealth of Nations’ that if an organization is managed by a person or group of persons who are not the real owners, then there is a chance that they may not work for the owners ‘benefit. Later on Jensen and Meckling (1976) portrayed the firm as operating to maximize value and profitability always. This maximization can only be achieved if there is coordination and team work amongst the various parties (Dalton& Rajagopolan 2003; Wasserman 2006).

The agency theory is concerned with the agency relationship when the two parties engaged in an agency relationship. In this case, one party (the principal) delegates decisions and or work to another (agent) to act on his behalf. The theory recognizes that this separation of ownership and control of the firms creates conflicts of interest between the firm’s shareholders (principals) and managers (agents). The reason is that managers are often in the position to use the firm’s resources to their advantage thus, negatively affecting shareholders wealth (Jensen 1886). Berle and Means (1932) indicates that with an increase in professionalism of management, firms might be operating for the managers’ benefit rather than that of the owners. This conflicts results when the managers who are responsible for important decisions of the firm, are not primary beneficiaries of the firm’s net assets and their returns hence do not enjoy the returns of their decisions.

Eisenhardt (1989) states that agency theory is concern with analyzing and resolving this problem that occurs between the principal and the agents or the top management of the firm in their relationship. In order to resolve agency and risk sharing problems in principal agent relationships, agency theory prescribes two formal (and ideal ) types of management mechanisms to govern these relationships (Rungtusanatham e t al., 2007). One is outcome –based management mechanism. With this mechanism both principals and agents can observe outcomes, and the principals reward agents based on measured performance outcomes (Ekanayake, 2004). The outcome-based management mechanism emphasizes results regardless of how the agents achieve them(Choi and Liker,1995).

The other management mechanism is behavior-based. When this mechanism is taken, principals can use behavior controls to monitor agents’ behaviors and efforts which otherwise are unknown to the principals .The behavior based management mechanism emphasizes tasks and activities in agents ‘processes that lead to the outcomes of the agents (Eisenhardt,1989; Ekanayake, 2004). It is on this basis that shareholders are willing to incur agency to control the behavior of management. As a result, they will incur the costs of internal audit, they will implements internal control systems and they may also implement a management remuneration system that rewards movement towards meeting the goal of the shareholders.

The theory is therefore very relevant in this study as shareholders who are the owners of the quoted companies have delegated the responsibilities of daily running of the companies to the management who acts as their agents and hence great need for strong agency costs shareholders adequately safeguarded. It is therefore logically expected that the firm that incurs agency costs will deliver superior value to the shareholders compared to one that shuns agency costs.

**Stewardship Theory**

Stewardship theory is based on psychology and sociology. According to Davis, Schoorman and Donaldson (1997) “a steward protects and maximizes shareholders wealth through firm performance, because by so doing, the stewards utility functions are maximized”. As opposed to agency theory, stewardship theory stresses not on the perspective of individualism (Donaldson & Davis, 1991), but rather on the role of top management being as stewards, integrating their goals as part of the organization. Therefore, stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained.

Argyris (1973) argues that while agency theory looks at an employee or people as an economic being, which suppresses an individual’s own aspirations, on the other hand Donaldson and Davis (1991) argue that stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust. It stresses on the position of employees or executives to act more autonomously so that the shareholders ‟returns” are maximized. Indeed, Fama (1980) contend that executives and directors are also managing their careers in order to be seen as effective stewards of their organization, whilst, Shleifer, Andlei and Vishny (1997) claims that managers return finance to investors to establish a good reputation so that they can re-enter the market for future finance.

Meckling and Jensen (1994) further state the cost incurred to curb agency problems (reducing information asymmetries and accompanying moral hazards) is less when owners directly participate in the management of the firm as there is a natural alignment of owner managers’ interest with growth opportunities and risk. It follows from the above that stewardship theory unlike agency theory is a complete contrast and doesn’t emphasize on the need to incur monitoring or agency cost which includes establishing an internal audit function. Nevertheless Donaldson and Davis (1991) further note that returns are improved by having both of these theories combined rather than separated which implies that management must strike a balance. In our study the steward theory is supported by the fact that managers of quoted companies act as stewards of shareholders, suppliers, creditors, consumers and employees of the quoted companies.

**Equity Theory**

Equity theory argues that individuals subjective assessments of the ratio of their inputs (effort) and outcomes (compensation) to those of their contemporaries (referent others). A perceived imbalance is said to create dissonance, and may lead the perceivers to take actions such as decreasing their inputs, trying to negotiate higher pay, or ultimately leaving the organization. On the other hand, if the difference in pay is seen as justified based on the others’ greater inputs or outcomes, it is accepted as being fair. Wallace and Fay (1983) argued that the critical theme that exists at the center of all compensation theory and practice is equity.

Empirical evidence in social psychology indicates that individuals routinely overestimate their abilities and contributions relative to those of others (Moore and Small, 2007). Referred to as self-enhancement,‘ this human tendency has been shown to be particularly strong when there is ambiguity regarding individuals‘ contributions and performance (Fiske and Taylor, 2008), and is pronounced among top executives (Chatterjee and Hambrick, 2007; Hayward and Hambrick,1997). Such executives typically have generally experienced a lot of success during their careers, which often makes them the targets of ingratiating behaviors (Westphal, 1998). As a result, their dispositions and personalities leave these individuals prone to making self-enhancing comparisons with other top executives (Hayward and Hambrick, 1997).

Equity theory seems to be in concurrence with Labor economics theory contribution where it is posited that those who make greater contributions should receive greater pay and the CEO‘s arguably make greater contributions within the organizations. The traditional labor economics theory would attribute differences in pay between individuals in an organization to differences in their marginal products. Those who make greater contributions should receive greater pay. This concept is applicable to all employees in an organization; executives are supposed to be compensated in the same way. CEOs are argued to have greater impact on firms’ value due to the quality and importance of the decisions they made (Ang, et al., 1998).

**Tournament Theory**

Tournament theory argues that pay dispersion has positive effects because it promotes intra-team competition and provides an economic incentive that encourages the cream to rise to the top of the rank-order tournament. The tournament model advances the idea that pay gap between workers (players) in one rank and the next higher rank would be large and greater than their marginal products, thus, providing the incentives for the contestants to do their best. The pay gap is the prize of the tournament, which is expected to increase the higher the level of the tournament (Rosen, 1986).

Lazear and Rosen (1981) state in their tournament theory that employees are driven by the chance of a possible promotion to get an increase in salary. Top executives often receive very high salaries, which are used to motivate lower-level-executives to compete for promotions. The tournament theory also states that individuals are more motivated if there is a possible chance of promotion. Since CEOs have already reached the highest level in the organization they have to be compensated with extra incentives. Different components of compensation can make the total compensation of managers much larger than their fixed wage. According to Magill and Quinzii (2005) the reason for a more incentive-based executive compensation system is that it has to align the incentives of executives with the interests of their companies ‘shareholders.

Unlike the position held by proponents of tournament theory that pay dispersion promotes intra-team competition and provides an economic incentive that encourages the competition, Social comparison theory hold that individuals routinely compare themselves with referent others and hence pay dispersion will negatively affect decision making and teamwork. In essence, these theories seem to attach differing connotations to the effects of pay dispersion of the executive teams.

Agency costs arise when the interest of the firm’s manager are not aligned with that of the firm’s owners. Managers that do not have any equity stake in the firm tends to have a high preference for job perks, shirking, and making self-interested and entrenched decisions rather than creating wealth for the shareholders. The impact self-seeking behaviour have on firms depends on factors such as the nature of monitoring and bonding contracts, the manager’s taste for non-pecuniary benefits and the cost of replacing the manager (Jensen and Meckling, 1976; Shleifer and Vishny, 1989).

Prior researchers have examined both theoretically and empirically the effect agency costs have on financial performance of companies. Schulze et al (2001) examined the relationship between agency costs incurred by family firms and performance. The study was a cross-sectional survey which targeted a total of 37, 3011 chief executives of privately held U.S.A family businesses of which a sample of 1376 firms was selected. Analysis of the data showed a positive relationship existed between performance for non-family pay incentives but not for family pay incentives. The data also showed that strategic planning was positively related to performance and CEO tenure was negatively associated with firm performance, average board tenure and outside directors.

Pouraghajan (2012) studied the effect of free cash flows and agency costs on the performance of listed companies in Tehran Stock Exchange. The study covered the period 2006 to 2011 in which a sample of 140 companies was selected. Efficiency ratios were used as measures of agency cost and Len and Paulsen model issued to measure free cash flows. Results from research hypotheses testing have shown that there is no significant relationship between free cash flows and firm performance. While, there is significant and positive relationship between total asset turnovers with measures of firm performance. Negative and significant relationship is observed between operating income volatility with measures of firm performance.

**Managerial Incentives and firm value**

Antle and Smith (1986) find a positive association between total management compensation and return on assets as a performance measure. They do not find a positive relationship between total management compensation and return on common stock. Lambert and Larcker (1987) report a strong positive time-series relationship between CEO cash compensation and return on equity, as compared to a modest positive relationship with security market return. They also find that the degrees of above respective relationships are inversely related to the degrees of noise in the two performance measures. Riahi-Belkaoui (1992) concludes that accounting-based measures like sales to assets, and profits to assets are significantly related to executive compensation. He suggests that partially linking such compensation to accounting – based measures insulates executives from uncontrollable market price movements.

McConnell and Servaes (1990) find a curvilinear relationship between insider shareholdings and firm valuation. Their curve slopes upward until insider ownership reaches approximately 40% to 50% and then slopes slightly downward. In a more recent study, Mehran (1995) finds that firm performance as measured by Tobin’s Q and return on assets is positively related to the percentage of executive compensation that is stock-based, and the percentage of equity held by the management.

Hall and Liebman (1998) also found in their research a strong positive relationship between firm performance and CEO compensation. They gathered data about CEOs from 1980-1994 with a final sample consisting of 478 U.S. companies. The change in firm performance was almost entirely caused by a change in value of CEO holdings of stock and stock options. In their study Hall and Liebman (1998) find that cash compensation and firm performance are not related. However by adding equity payments they find different results. One important conclusion from their research is that the pay-performance sensitivity has massively increased due to compensation in the form of stock option grants.

Aduda and Musyoka (2011) apply an empirical cross - sectional design to measure the relationship between executive compensation and firm performance. They select ten large commercial banks that control 71.8% of the total industry deposit base and net asset value base. This population excludes medium sized and small sized commercial banks which are not listed at the securities exchange and some of which still remain family controlled businesses. The study operationalized executive compensation as the broad board remuneration since the financial reports do not give specific amounts due to executive and non – executive directors. There are remuneration components that reward past performance while there are also components that provide correct incentive for future performance.

Fatemi, Desai and Katz (2003) applies a multivariate regression model to examine the relationship between executive compensation and risk adjusted measures of firm performance that capture economic profits earned by the firm (EVA and MVA) as well as the causal direction between the wealth creation activities of the firm and the compensation of its top managers. MVA and EVA are used because they do not suffer from any industry - specific bias. The study based on 1,965 firm-years finds that executive compensation is positively correlated to the level of risk borne by the firm and MVA is a significant determinant of executive compensation while the relationship between EVA and compensation is weaker. In the sample, there are also firms at various levels of internationalization, however, overseas sales data are only available for 119 firms, and only for one year (1995) thereby making the tests of the pay-for-performance hypotheses that account for the global nature of the firm's operations limited.

**Internal Controls and firm value**

Cheng, Dhaliwal and Zhang (2013) and Sun (2016) examine the relation between firm’s IC weakness disclosure and investment decisions that could affect firm’s operations and future performance. However, these two studies do not directly investigate the impact of IC weaknesses on firm performance. Kuhn, Ahuja, and Mueller (2013) and Stoel and Muhanna (2011) examine the impact of IC weaknesses on operational efficiency and effectiveness; however, these two studies only categorize IC weaknesses into IT and non-IT related weaknesses. Feng, Li, McVay and Skaife (2015) mainly focus on firms with inventory-related material weaknesses. They find that firms with inventory-related IC weaknesses have lower inventory turnover ratios and are more likely to report inventory impairments. In addition, they report that once the inventory IC weaknesses are remediated, firms exhibit better operating results

Mawanda (2008) studied the effects of internal control systems on financial performance of Uganda’s higher learning institutions. The study sought to determine the influence of internal controls on financial performance. The scope of the internal controls was the control environment, internal audit and control activities whereas financial performance focused on liquidity, accountability and reporting. The research sought to determine the reasons for persistent poor financial performance from the perspective of internal controls. Analysis of the data found a significant influence of internal control system on financial performance.

Using the analytical approach and focusing on control activities and monitoring, Barra (2010) investigates the effect of penalties and other internal controls on employees‟ propensity to be fraudulent. Data was collected from both managerial and non-managerial employees. The results showed that the presence of the control activities, separation of duties, increases the cost of committing fraud. Thus, the benefit from committing fraud has to outweigh the cost in an environment of segregated duties for an employee to commit fraud. Further, it was established that segregation of duties is a “least-cost” fraud deterrent for non-managerial employees, but for managerial employees, maximum penalties are the “least-cost” fraud disincentives. The results suggest the effectiveness of preventive controls control activities such as segregation of duties is dependent on detective controls.

Ge and McVay (2005) find that companies with at least one IC material weakness on average have lower ROA. They focus on the general firm characteristics of firms that disclose at least one IC material weakness, but do not specifically investigate which weaknesses are associated with poor performance. Furthermore, they make no theoretical arguments linking IC to operational efficiency and effectiveness, which underpin firm performances.

Kuhn, Ahuja, and Mueller (2013) and Stoel and Muhanna (2011) examine the impact of IC weaknesses on operational efficiency and effectiveness; however, these two studies only categorize IC weaknesses into IT and non-IT related weaknesses. Feng et al. (2015) focus on firms with inventory-related material weaknesses. They find poor inventory-related IC affects firm’s inventory turnover ratio and leads to more inventory impairments.

**Independent Audit fees and firm value**

Logically, the amount of fees for audit services that a client firm pays to its audit firm reflects the level of audit work the latter has to perform in the auditing process. This level of work embodies the auditor’s assessment of the process’s complexity and the desired level of risk. Therefore, all other things considered, if an auditor wishes to decrease the risk of issuing a clean opinion when there are materially relevant distortions in the client’s financial statements, he generally acts on the nature, extent and timing of audit procedures, which, naturally, influence the final amount of required fees.

According to Hay, Knechel, & Wong, (2006); Stanley (2011), the total amounts paid to independent auditors for audit and non-audit services are connected to the performance of companies. Hallak & Silva, (2012) and Zaman, Hudaib, & Haniffa, (2011) suggest that auditors will typically spend more time (all else being equal) providing auditing and consulting services to highly leveraged companies, due to the greater risk of insolvency. Therefore, both these fees will typically be higher in companies with large debt loads.

Moutinho *et* al. (2012), Martinez *et al.* (2014) and Stanley (2011) showed a significant influence of spending on audit services in the firm performance. Moutinho *et* al. (2012) developed a model to test this relationship, using asample of 6000 observations of listed companies and verified a negative relationship betweenthese subjects. On the other hand, Martinez *et al.* (2014) made the distinction between audit andnon-audit fees to connect them with a firm value measure and concluded that when thecompanies spend more in the audit services the Tobin's Q increases. In contrast, Stanley (2011)provides evidence of an inverse relationship between unexplained audit fees and operatingperformance.

**Conceptual Framework**

Therefore, how agency costs affect firm value can be conceptualized as follows:

Managerial Incentives

* Managerial Bonuses and Commissions

Firm Value

* Number of Shares\*Market Share Price

Audit fees

* External Audit costs

Internal Control Costs

* Internal audit costs used as proxy

**Independent variables Dependent variable**

Source (Author, 2019)

**Methodology**

The research design constitutes the blueprint for the collection, measurement and analysis of data. It is a plan according to which we obtain research participants and collect information from them (Welman, and Kruger, 2005). This research will utilize an empirical design in its methodology. **Empirical research** is based on observed and measured phenomena and derives knowledge from actual experience rather than from theory or belief. This design is appropriate because empirical data shall be collected, which shall then be subjected to regression analysis to establish if there is a relationship between the independent variables and the dependent variable. For purposes of the study the population will be 63 companies quoted In the Nairobi securities exchange as at 30th June 2018. Only companies that were listed in the entire 5 year period of January 2013 to December 2018 will be included in the study. For the purpose of completeness of data, companies that do not have data for the entire period will be excluded.

According to Du Plooy (2001), sampling is a rigorous procedure of selecting units of analysis from a larger population. Sampling can be probabilistic or non-probabilistic. According to Cooper and Schindler (2003), the sampling frame can be described as a demarcation of the target population. They assert that the sampling frame is the list of elements from which the sample is actually drawn. It is a complete list in which each unit of analysis is mentioned only once. Ideally, the sampling frame should include all members of the target population. A census approach will be used, whereby all companies that have complete data for the entire period will be included. A census is appropriate where the population is small and sampling may distort the outcomes of the study. For purposes of this study secondary data shall be collected from the various audited books of accounts and the value of the company as per the last trading day of each of the calendar years of the study.

Karl Pearson correlation shall be used in preliminary data analysis to establish if there is any association between the independent variables themselves and with the dependent variable. Multivariate regression was used to analyses the relationship between the variables.

A model similar to Zhang (2009) as shown below will be used in the study.

Y = A + β1Xi + β2X2 + β3X3 + ε

Where,

Y = Value of the firm

X1 = Independent Audit costs of firm

X2 = Managerial incentives of firm

X3 = Cost of setting and monitoring the Internal Controls

ε = Error term.

A is a constant and β1, β2 and β3 are coefficients of regression equation.

**Findings**

Data was collected on the closing share price of the firms and the number of shares outstanding on the last day of trading of the year concerned. This was used in the computation of the value of the firm, which was determined as the product of share price and number of shares outstanding. Data was also collected from published financial statements on managerial incentives and independent audit costs incurred by the firms. For the cost of maintaining an internal control system, a questionnaire was administered on the range of internal audit costs, which was used as a proxy for the cost of the internal control system. From the range, a simple arithmetic average for every firm involved was calculated. In the questionnaire, the research also sought to find out the structure and functioning of the internal audit function for the firms concerned. In 84% of the cases, the head of internal audit was found to report to the Board of Directors Audit Committee. In the remaining cases, the head of internal audit was reporting to the senior management of the firms concerned.

In 64 % of the cases, the internal audit department was part of risk management department and one of the firms did not totally have a department dealing with risk. 98% of the firms had a fairly large internal audit section, with a staffing of over 20 members. Except for four firms, the internal audit function was largely automated. In 100% of the cases, all supplier invoices were reviewed by the internal audit section before payments were made. The study first sought to establish the relationship that prevailed between the variables used in modelling the study. In this case the Karl Pearson Moment correlation coefficient was sought for all the variables relative to each other. Of interest to the study though was the association between the dependent variable and each of the independent variables individually. The findings in this were computed with the help of the S software and the output is presented in the table below.

# Correlation Analysis

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Firm Value | Internal Audit costs | External Audit costs | Managerial incentives and bonuses |  |
| 1.0000 | 0.8621 | 0.5223 | 0.6445 | Firm Value |
|  | 1.0000 | 0.4688 | 0.4170 | Internal Audit Cost |
|  |  | 1.0000 | 0.7272 | External Audit Costs |
|  |  |  | 1.0000 | Managerial Incentives and bonuses |

According to table 4.1, there is a strong positive correlation between firm value and internal audit costs (0.8621), and medium correlation between firm value and external audit costs (0.5223) and firm value and managerial incentives and bonuses (0.6445). There is therefore positive association between the independent variables on one hand and the dependent variable on the other hand.

In order to determine the relationship that exists between the dependent variable and the independent variables, a multiple regression analysis was conducted. In this case the computer software; Stata version 13 was used to code, enter, and calculate measurements of the multiple regressions. Multiple regression analysis was used because it measures the relationship between independent and dependent variables by generating an equation which can be used to predict the dependent variable for some given independent variables. The model summary from the regression output was shown below in table 4.2.

**Table 4.2: Model Summary**

|  |  |
| --- | --- |
| R Square | Adjusted R Square |
| 0.7887 | 0.7491 |

Predictors: Internal Audit Costs, External Audit Costs, Managerial Incentives.

The model summary shows that the adjusted R Squares was 0.7491. This implies that the independent variables (internal audit costs, external audit costs and managerial incentives) explained the variations on firm value of the companies listed on Nairobi securities exchange by 74.91%. The remaining 25.09% is explained by other variables not captured in the model.

The study further presented the multiple regression model showing the relationship between the independent variables and the dependent variable. The model coefficients are presented in the table 4.3 below.

**Table 4.3: Model Coefficients**

 Coefficient std. error z p-value

 constant −2.03264e+01 6.35459e+09 −3.199 0.0014 \*\*\*

 InternalAuditcost 2296.22 350.937 6.543 6.03e-011 \*\*\*

 ExternalAuditcost~ 267.537 326.633 0.8191 0.4127

 Managerial incent~ 41.7070 29.9633 1.392 0.1639

From table 4.3 above, the model can be extracted as follows:

Y= - 2.03264+ 2296.22X1+267.537X2+41.7070X3+ e

From the regression equation above it follows that holding all the independent variables constant, firm value will decrease by 2.203264 units in absence of the agency costs of internal audit, external auditing and managerial incentives. The presence of internal audit has the largest effect on boosting firm value while managerial incentives have the smallest effect.

The study found that internal audit has a large influence on firm value. A unit change in internal audit costs causes a 2296.22 change in firm value. Correlation analysis also shows a strong positive correlation between internal audit and firm value. It could therefore imply that as firms spend more on internal audit, which was used as the proxy for internal controls, it reduces the agency conflict between employees and the firm and the employees end up pursuing goals that seek to maximizer firm value for the benefit of the shareholders. The results agree with Mawanda (2008), who found a positive influence of the internal control environment with financial performance.

The study found that external audit has an influence on firm value. A unit change in external audit costs leads to 267.537 change in firm value. Correlation analysis also showed a positive association between external audit and firm value. Therefore, the study implies that external audit plays a key oversight role in ensuring the interests of the shareholders are safeguarded. Undesirable activities of management which may lead to erosion of shareholder value can be partly mitigated by external audit. This study agrees with Moutinho *et* al. (2012), Martinez *et al.* (2014) and Stanley (2011) who all found a significant influence of spending on audit services in the firm performance. Martinez *et al.* (2014) made the distinction between audit andnon-audit fees to connect them with a firm value measure and concluded that when thecompanies spend more in the audit services the Tobin's Q increases.

Managerial incentives have an influence on firm value from the findings of the study. A unit change in managerial incentives leads to a 41.7070 change in firm value. Correlation analysis also shows a positive association between shareholder value and managerial incentives. The study therefore suggests that managerial incentives may have an effect of encouraging the managers to pursue activities that lead to shareholder value maximization, especially if value maximization is linked to their incentives. The study is in harmony with Antle and Smith (1986), Lambert and Larcker (1987) and Riahi-Belkaoui (1992) who all found a positive influence of managerial incentives on different aspects of firm performance. Hall and Liebman (1998) also found in their research a strong positive relationship between firm performance and CEO compensation.

Analysis of variance was used to test the fitness of the regression model. Analysis of variance in this case was intended to investigate if the variation in independent variables explained the observed variance in the outcome, in this case, the value of the firms. The ANOVA results are shown in table 4.4 below.

# ANOVA

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | Sum of Squares | Df | Mean Square | F | Sig. |
|  Model | 1.7003e+22 | 3 | 5.6677e+21 | 39.91 | 0.000 |
|  Residual  | 4.5539e+21 | 36 | 2.8462e+20 |  |  |
|  Total | 2.1557e+22 | 39 |  |  |  |

The p value was less than 0.001 (p<0.001), indicating that the model has less than 0.001 likelihood of giving a wrong prediction, at a significance level of 95%.

**Conclusion**

The study aimed at finding the impact of agency costs on firm value for firms listed on the Nairobi Securities Exchange. Internal audit costs were used as the proxy for internal control costs while data was also collected for the independent variables, external audit costs and managerial incentives and the dependent variable firm value. The firm value in this case was the market value, determined as the product of the closing share price of the calendar year and the number of shares outstanding. The motivation for the study was the need to shed light whether incurring agency costs by shareholders ultimately delivers shareholder value for companies listed on the Nairobi Securities Exchange. As such the study sought to answer three research questions, namely: What is the influence of audit fees on firm value? What is the effect of managerial incentives on firm value? And what is the effect of internal controls on firm value?

The study found that external audit fees has a positive influence on the value of the firm. Therefore, firms that spent higher amounts on external audit tended to have a higher comparative value. Same was the effect of managerial incentives and internal audit fees (the proxy for internal controls). Therefore, firms with higher managerial incentive systems and internal audit fees had higher market values. This may imply that increase in the incentives and internal controls aligns the interests of the managers and shareholders, delivering superior value to the shareholders.

##

## Recommendations

This study therefore recommends that firms enhance and streamline the managerial incentive programs to harmonize the interests of management and shareholders so that management are more focused on delivering value for the benefit of the shareholders. Firms should also create strong internal control systems and ensure they are well resourced to protect the wealth of the shareholders. Shareholders should be willing to sufficiently compensate independent auditors so that they can work for the benefit of the shareholders. Regulators like Capital Markets Authority should require that companies establish and resource internal audit and control departments to reduce undesirable actions of employees that may erode shareholder value.

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