Determinants of Multinational Agency Costs

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Introduction

Agency problems arise when a principal hires an agent to perform a task for the benefit of the principal. In many instances, the agent may have the opportunity to take actions which benefit the agent, but are detrimental to the principal. In the typical corporation, the primary agency relationship is between the shareholders (principals) and the firm's management (agents). Usually, management has the opportunity to take certain actions which may benefit themselves while reducing shareholder wealth (e.g. inflate their salaries, deter takeovers by other firms, etc.). Agency costs are the reductions in shareholder wealth that result from management's malfeasance and the cost of monitoring and bonding activities engaged in by the shareholders to prevent management misbehavior.

The agency problems facing U.S. firms have been discussed extensively by Jensen and Meckling [8], Fama [4] and others. Empirical research has shown that these costs are significant and affect the ownership structure and capital structure of domestic firms ([3], [5]). Agency theory, however, has not been extended to encompass direct foreign investment by multinational corporations (MNCs) or investment in foreign companies. MNCs which invest in productive assets in foreign countries (engage in direct foreign investment) or purchase shares of foreign companies encounter many agency-related difficulties as a result of these investments. Problems related to monitoring, adverse incentives and pressures, and compensation arise which are not normally encountered in the domestic operations of the firm. In this study we identify and discuss some of the factors that are expected to affect the agency costs associated with overseas investing.

Agency Problems of Direct Foreign Investment

Myopia of Foreign Managers

For firms engaging in direct foreign investment, there is a risk that the managers of the foreign operations will make decisions without fully considering the impact of these decisions on the parent firm. For example, foreign subsidiary managers often ignore exchange rate fluctuations, withholding taxes on earnings remitted to the parent, and additional taxes imposed in the parent's country (on the cash flows generated by foreign subsidiaries) in making investment decisions. Failure to consider these factors can lead overseas managers to make investment decisions that are not in the best interests of the parent firm's shareholders.

For example, the cost of ignoring exchange rate movements can be pronounced in countries that experience high rates of inflation. While the foreign currency cash flows a foreign project generates are generally enhanced by high inflation, the local currency's depreciation (against the dollar), caused by the inflation, may cause a reduction in the dollar cash flows from the project received by the parent. Further, decisions made by subsidiary management are more likely to conflict with shareholder goals if the host country does not have tax treaties with the parent's home country, because, additional taxesare likely to be imposed on income received by the parent from a subsidiary if there are no tax treaties between the two countries. This will cause a larger divergence between the after-tax cash flows the foreign manager believes a project will generate and the actual cash flows that the parent will receive.

Languages and Customs in Foreign Markets

Foreign languages and customs may also make it more difficult to monitor the performance of an overseas operation. Communication problems are more likely in host countries whose native language is not English. Language translation problems and the interpretation of local idioms and jargon may make it more difficult to determine exactly what the overseas management is attempting to do and thus, make it harder to ascertain if they are performing as desired. Foreign customs which relate to working conditions, fringe benefits, and vacations may make it harder to determine if foreign employees are diligently pursuing their responsibilities.

Accounting Rules in Foreign Markets

Differences in foreign accounting rules may complicate the monitoring of the performance of foreign operations and personnel. At a minimum, different accounting rules will cause the managers of the overseas operation to incur additional time and expense in preparing one set of financial statements for the parent MNC and one for the local authorities. More importantly, the foreign accounting rules may make it possible for overseas managers to more easily hide their malfeasance from parent management and escape senior management discipline. Detecting this type of activity requires a detailed knowledge of foreign accounting regulations that senior MNC management may not possess. This contention is supported by research by Morsicato [10] which suggests that top-level management is often unable to properly interpret foreign subsidiary performance.

Distance and Location

Monitoring the performance of overseas operations and personnel will, in general, be more difficult than for similar domestic operations. The distance of the overseas facilities from senior management and the board of directors is a major contributing factor. The farther a foreign operation is from the people responsible for monitoring that operation, the more expensive and time consuming it is for managers to travel to the overseas facilities to assess their performance. These considerations may cause managers to travel less to their overseas facilities than to domestic ones and result in less monitoring of their overseas operations.

Foreign operations may also enhance the ability of managers to engage in excessive perk consumption. Excessive travel to overseas facilities may result if those facilities are located in desirable locations. The existence of these overseas operations may also make it easier for managers to hide excessive perk consumption by transferring part of these expenses (e.g., through overhead) to the books of the foreign operations. Also, decisions on where to establish foreign subsidiaries may be influenced by managerial preferences to travel or to live in particular countries.

Incentive Mechanisms

Incentive pay mechanisms such as bonuses and performance based salaries will generally be less effective in motivating managers of foreign operations, especially if those mechanisms are based on dollar performance measures. By converting the cash flows of the overseas operation into dollars for evaluation purposes, the bonuses and performance pay of overseas managers becomes dependent on exchange rate movements. Thus, the variability (risk) in those incentive payments will be magnified by exchange rate variability. Risk — averse managers will require a larger average recompense to compensate them for this increased variability. Further, as compensation becomes less dependent on their performance and more dependent on factors beyond their control, such as exchange rates, incentive mechanisms will become less effective in motivating the desired managerial behavior as the relationship between actions and rewards is weakened.

Foreign managers of United States based MNCs whose performance evaluations and recompense are dependent on the dollar cash flows their operations generate may seek to reduce the variability in those dollar cash flows by hedging in the forward markets. While the variability of the dollar cash flows generated by the foreign operation will be reduced, hedging may not be in the best interests of the parent.

Giving stock and stock options as incentives may also not be as effective a motivational tool as it is in the United States. For American managers who are serving overseas for limited periods of time, stock options and share ownership are still viable incentive tools. As these managers serve overseas for only a short period of time it is likely that when they liquidate their holdings they will have returned to United States. and consume or invest the proceeds in dollar denominated items. If the managers are on long term overseas duty or are foreign nationals, the value of their stock options and shares (to the manager) will be dependent on the foreign currency value of those options and shares. Here again, the value of the cash flows will be dependent on exchange rates and, consequently, will be less valuable for risk-averse managers and less effective motivators.

Diversification Motives of Managers

The operation of overseas facilities by a MNC creates additional agency problems not encountered by firms with purely domestic operations, as well as exacerbating some agency problems faced by domestic firms. For example, it is well known that management tends to have a large proportion of their total wealth invested in the stock of their employer. This causes the portfolios of these managers to be are poorly diversified. Portfolio theory implies that risk-averse managers will not like this circumstance and will be interested in diversifying away the risk of their portfolios. One way to accomplish this is to use the investment policy of the firm to diversify firm cash flows.[1] This will cause shareholder wealth to decline if good investments are foregone in favor of less valuable investments with greater diversification benefits. As foreign stock returns are not highly correlated with the returns of United States stocks, this implies overseas investments may offer better opportunities for managers to diversify the firm's cash flows (at the expense of the firm's shareholders) than domestic investments.

Director Monitoring

Overseas operations will also tend to make monitoring of senior MNC management (in the United States) by the board of directors more difficult. MNC management may be able to hide some of their nonoptimal actions through the intracompany shifting of accounting revenues and expenses, and/or cash flows between the domestic and overseas operations of the firm. Uncovering such stratagems would require expertise in international operations and accounting and a significant investment of time by the board of directors. The board members may not possess these skills or may be unwilling to spend the time necessary to adequately monitor MNC management.

Host Government Pressure

Host governments of underdeveloped countries and those of a leftist nature may pressure MNCs that operate in their countries to spend money for "socially desirable" purposes [2]. This type of expenditure may come at the expense of the MNC's shareholders. However, Tavis and Crum [12] suggest that a subsidiary may sometimes be able to simultaneously satisfy the local government pressures and shareholder goals. For example, an employee training program may enhance productivity while it improves working skills of the host country's labor force. Nevertheless, some host government expenditure demands may not be as compatible with the goal of shareholder wealth maximization. If these expenditures are anticipated by MNC management, the costs can be viewed as costs of doing business in the country and incorporated into the investment decision making of the firm. If these costs are not fully anticipated, an agency cost is incurred and shareholder wealth is reduced.

Foreign Financing

Many MNCs seek to reduce the exchange risk of the cash flows of foreign operations by borrowing in the currency of the country in which the foreign operation is located. In doing so, the MNC has invited monitoring from a new source, the foreign lender. This additional monitoring of the MNC borrower by the foreign lender serves to reduce the agency cost of debt for the MNC. This may be detrimental to the shareholders if the foreign lenders are able, through restrictive covenants, etc., to circumscribe the wealth maximizing behavior of the shareholders or management.

MNCs that list their stock on foreign stock exchanges provide liquidity to foreign investors who own their shares. This additional liquidity makes the MNC's shares more

[1]Ahmihud and Lev [1] found evidence which tends to support the contention that managers use the investments of the firm to diversify away some of the risk of the firm.

desirable investments for foreigners and allows the MNC to better exploit foreign pools of capital when they raise new equity funds. It may also lower the cost of equity funds for the MNC. The foreign shareholders of the firm may, however, have different incentives than the United States shareholders of the firm. Foreign shareholders may be more sympathetic to the desires of their governments for the MNC to make 'socially desirable' investments in the foreign country. For example, a foreign subsidiary's decision to invest in pollution control equipment benefits the foreign shareholders directly (their air quality is improved) while most of the costs of the equipment are born by the United States shareholders who own the bulk of the MNCs shares. This is an agency cost of foreign equity ownership for United States stockholders.[2]

Firm Decentralization

When a firm expands overseas, a number of factors cause the operations of the firm to tend to become more decentralized. Aesthetic and technical requirements of products vary from country to country. Delegating authority for certain aspects of product design and production to the managers of foreign operations may facilitate adapting the product to local market conditions [6]. This decentralization will tend to increase as overseas production and sales increase [7]. MNCs which have operations in countries where the typical firm is more decentralized than in the United States (e.g., Japan) may be forced to adjust to local business practices by decentralizing the foreign operations of the firm [11]. Decentralization will also tend to occur when the MNC provides relatively little financing of the overseas operations and few intracompany transactions take place between the MNC and the foreign subsidiaries.

As decentralization occurs, operating and financial decisions are increasingly made by managers of the overseas operations. This may enhance the profitability of the MNC by allowing the foreign managers of the firm to adjust their operations to the demands of the foreign market in which they operate. This diffusion of decision making authority may also create additional agency problems for the MNC. As decision making authority is spread among the foreign operations of the MNC more people have the opportunity to use the resources of the firm for their own benefit. Further, as decision making authority is spread among more managers it becomes more difficult and costly for senior MNC management and the board of directors to monitor the performance of the firm and its managers. The increased opportunity for malfeasance and the difficulty in monitoring will probably cause the agency costs of the firm to increase as decentralization increases.

Agency Problems of Investing in Foreign Stocks

If a MNC decides against acquiring or establishing a wholly owned subsidiary or division overseas, it may still invest overseas by purchasing the shares in a publicly traded

[2] A counter-argument is that foreign shareholders would prefer the direct benefits of a maximized share price over indirect benefits that could occur if managers satisfied local societal preferences. Moreover, the foreign shareholders (especially institutional investors) may be able to prevent the host government from pressuring the subsidiary management to satisfy foreign societal needs.

foreign firm. The agency problems inherent in these foreign stocks are somewhat different from those found in United States stocks. The market for corporate control exerts pressure on managers to perform properly since substandard firm performance or malfeasance by management may trigger a takeover by outsiders and result in management's dismissal. The less active the market for corporate control, the less pressure there is on management to perform properly and the greater the agency costs incurred by the firm. In countries with a less active market for corporate control, the MNC will receive less help in monitoring the performance of the foreign firm from outsiders than it would if it purchased shares in a United States firm.

Foreign firms may, in some circumstances, be more heavily monitored than United States firms. In countries such as Japan, banks are allowed to both lend to and invest in the shares of corporations. The banks that lend to and own stock in the same firm are in a position to be an effective monitor of firm and manager performance. As lenders, these banks come into possession of highly confidential information about the firm not generally available to the public. As shareholders, these banks have an incentive to protect the values of their shares by using this information to monitor the firm's management. Potentially, these banks represent a valuable monitoring resource which benefits all the firm's shareholders. This monitoring may be especially valuable for shareholders in foreign firms as there is generally less publicly available information about foreign firms (even in their home countries) and, therefore, monitoring by non-inside shareholders is likely to be less effective.

The holding of the debt and equity of foreign firms by foreign banks may also reduce the agency costs of debt for foreign firms. Because these banks are shareholders in the firm, they are less likely to approve of stockholder appropriation of lender wealth (by asset substitution, etc.) as this will lower the value of the firm's debt held by the banks. As a consequence, the banks reduce the agency costs of debt for lenders to the foreign firm. The reduction in the agency costs of debt may at least partially explain why foreign firms in countries such as Japan have more debt in their capital structures [9].

Summary

MNCs which engage in direct foreign investment may find that their agency costs will increase. Among the contributing factors are the difficulty in monitoring overseas operations, the existence of different foreign accounting rules, the reduction in the effectiveness of widely used incentive and performance evaluation mechanisms, and the emergence of new opportunities for managerial malfeasance. Foreign stock investments also necessitate the reevaluation of the agency problems associated with share ownership because of the less active market for corporate control overseas and additional firm monitoring by foreign banks.

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