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Convergence of Interests & Managerial Diversification

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Abstract
This research intended to spotlight the fundamental tension on corporate governance, to assess the mechanisms' effectiveness affiliated to governance insider ownership structure under consideration of convergence of interests or managerial diversification theory and financial leverage in controlling principle-agents conflicts. The convergence of interests cites that higher the managerial ownership translating lower the agency cost and higher the firm value. Whereas, as fraction of managerial ownership is extremely high, then significant voting rights & others managerial influences may satisfy the entrenchment hypothesis. This study's results acknowledge the convergence of interests hypothesis which satisfied the existence of linear relationship under the light of managerial diversification on sample of 41 non-financial firms from four economic groups listed in Pakistan Stock Exchange from the period of 2010-2014. Furthermore, ownership concentration is also shown to impact significantly on agency cost but there is no significant shock on agency cost under the consideration of director's remuneration.
Keywords: Convergence of interest; Entrenchment; Insider equity ownership; Diversification; Ownership-concentration

1. Introduction

Sound practices of corporate governance help firms to lift their performance and bring in invertors' confidence while enabling shareholders' rights protection, qualifying the legal requirements and spotlight the vast public image about how they are operating their business. For the corporate controls in agency theory, even well-developed and mature markets seems to be nonexistent. Literature on corporate governance presumes the serious stress among corporate managers and shareholders (Berle & Means, 1932). So, leading to misstep and failures of markets, asymmetric information, adverse selection, moral hazard and incomplete contracts (Ale & Allen, 2001). Practices of poor corporate governance leads to the high profile corporate bankruptcies and accounting scandals in the past several decades and much more have been seen about the adverse selection and moral hazard in the financial crises of 2008 (Javaid, 2017). Mechanisms designated to hedge shareholders' interests are labeled as corporate governance mechanism (Jensen & Meckling, 1976; Allen and Gale, 2001). Higher agency cost problems will be faced by companies' when they exhibit weaker corporate governance structure, consequently managers catering in personal interests than firm value maximization (Core et al, 1999). In the time, shareholders' objective is their investment returns, managers likely to have diverse ambitions, like esteem and prestige to run powerful and large organization, perquisites and diversion of their position.

Indeed, Berle and Means (1932) traced the prospects of owners and managers interests' conflicts outlined by their classical theory of "ownership's separation from control." The influential efforts of Jensen and Meckling (1976), has given steam on the literature of corporate ownership focusing on ownership separation control which spotlight the swell to principals and agents conflicts. For this agency problem, a number of solutions had been offered by the researches between shareholders and managers likely fall under the tier of incentive alignment, discipline, monitoring and other diverse ambitions.

First, through the practices of Market based compensation or stock options, shareholders and the manager's incentives can be aligned. Agency conflicts arises due to two diverse forces that derive the response from the corporate managers (Merck et al, 1988). Managers naturally concentrate on to allocate the resources of the organization to increase their own power, wealth and perquisites. This force create the misalignment of interest with external shareholders. Whereas, the insider ownership as a second force to solve such agency conflicts. Since, conflicts' nature between owners and managers and its economic consequences exhibited in the classical theory using the corporate governance structure of Anglo Saxon (Barle & Means, 1932). A firm's owners and its management and ownership widely diluted among shareholders, so that monitoring management carefully do not have a strong incentive, company's shares do not held by the managers in larger fractions resulting in mismatching financial interests.

Whereas, larger chunk of shares held by managers as they identified common interest with owners. Besides, insiders' interests corresponding the entrenchment hypothesis among insiders and outsiders when fraction of insider ownership is extremely high (Jenson, 1983; Suk & Han, 1998). High equity stake of insiders

leading them more powerful and significant voting rights accelerating their freedom of personal goals fulfillment & translating higher agency cost. Other flipside argues that managers become entrenched just after there is steep managerial ownership thereby agency problem exacerbated (Fama and Jensen 1983; Demsetz 1983). However, in our study, we propose the theory of convergence of interests and managerial diversification which means that, high equity stake of insiders makes them less diversified & the only option for them is to maximize the shareholders' value. Hence, market value of firm increase as holding of insider's ownership increases (Jensen and Meckling, 1976).

Second, external block-holders gain the incentives to review and influence unproductive management decisions to secure their interests (Lang & Friend, 1988). Resulting from healthy economic stake, management is being looked closely by the block-holders, consequently insure the shareholders that managers don't involve and charge in diverse activities and interests. Latitude of managerial opportunism could be reduced by external block-holder, on that account mitigating direct agency conflicts among the shareholders and management (Vishny & Shleifer, 1986). Large shareholders had inducement to control and regulate the managers and be able to alleviate the problem of agency. Pound (1988) has challenged the Shleifer and Vishny's 'Active monitoring hypothesis' theory. He contends that external block-holders may be in the passive voters' tier who collude with managers and other corporate insiders against the dispersed shareholders' best interest.

Third party (Leverage or Debt holders) can reduce equity agency costs via management monitoring participation and providing more systematical decisions making. Capacity of debt to allow the investor to regulate managers and also to allow investor so that they collect information which is useful for oversee management (Raviv and Haris, 1990). Leverage policy seized to slice agency cost born before now by stockholders or managerial owners to debt holders, so, there is decline in equity agency cost. This fixates stress on managers to provide the real report of business to the investors of such financial institutions and to run the business profitability. This control and monitoring also reduces the agency cost of owner and manager.

Fourth, prediction is made on prior literature investigation, lower the agency cost by increased directors' remuneration or incentives which pressure the managers to work and align their interest with stockholders of the firm. In contrast, (Darren Henry, 2006) documented the remuneration structure mechanism as negative influence on agency cost, which projecting agency cost does not mitigating by steeper remuneration structure. Monitoring through an engaged and freewheeling boards of directors notify that managers enact in the shareholders best interest (Fama and Jensen, 1983). If these mechanisms serves as substitute tools geared at reducing agency costs, higher the level of insider ownership, ownership concentration, directorial remuneration & leverage expected results the lower the agency cost and vice versa.

2. Literature Review

For the determination of agency cost, financial policies and ownership structures there is large amount of empirical literature is available in previous studies, that links the relationship between them.

Agency theory initially developed by Berle and Means (1932) "The Modern Corporation & Private Property", which concerns the control & separation of ownership in a large firm. This circumstantial provides the floor for managers to create agency conflicts and to strive their own interest rather than shareholders' value maximization. He traced the prospects of owners and managers interests' conflicts outlined by their classical theory of "ownership's separation from control."

Alike, in the paper of Stulz (1990), he refined a model to explore how financing strategies and policies could be used to eliminate or reduce manager's agency problems of control on free cash-flows. In a firm which have poor investment opportunities and with enormous cash flows, manager may have encouragement to invest in a project which have Negative Net Present Value because their benefit are increases with the size of firm. He exhibit in his study that by putting constrained on manager, debt can be used in this scenario of overinvestment problem, so that they pay out enormous cash to debt holder. When firms with better opportunities of investment in which the projects that have positive NPV, the debt can create the dilemma of underinvestment. So, debts effect on the wealth of shareholders both by negatively and positively. He conclude that insider ownership seems to be a healthy option to increase firm's value.

In a model of (Raviv and Haris, 1990) they find out the capacity of debt to allow the investor to regulate managers and also to allow investor so that they collect information which is useful for oversee management. They investigated that even the liquidation of firm is in investor interest, manager wish to continue the operations of firm. This is because of that managers hesitate to provide information in detailed that could concluded in liquidation. Debt holder gives stress to managers so they provide detailed information because they have this legal right. The investor can also use this information to control the manager's activities.

(Merck et al, 1988) propose that agency conflicts arises due to two opposing forces that derive the response from the corporate managers. Managers naturally concentrate on to allocate the resources of the organization to increase their own power, wealth and perquisites. This force create the misalignment of interest with external shareholders. He examine the insider ownership as a second force to solve such agency conflicts.

He evident that, as equity ownership of managers increases, misalignment of the interest also decreases with external shareholders. Merck also figured out that is impossible earlier to anticipate at any level of managerial ownership, which force likely to dominate. Hence, the relationship between ownership structure and corporate value is an empirical issue.

A large quantity of other researchers had considered the impact of other factors which could lessen agency cost. Jensen and meckling in 1976 defined that large shareholders had extra influence and are more provoked and also investigated they can lessen the agency cost by bringing into line the interest of shareholders and managers. Likewise, the results of (Shleifer & Vishny, 1986) shows that large shareholders had inducement to control and regulate the managers and be able to alleviate the problem of agency. Though, the study of (Nekhili, et al 2009) investigated that the concentration of ownership increased the agency cost of cash flow by the usage of sample data of small businesses.

(Stuart Locke, 2005) conduct the study on managerial ownership relation with leverage using the unlisted firms' panel data of New Zealand covering the window 1998 to 2009. He applied the Granger causality tests which shows the significant bi-directional relationship between managerial ownership and financial leverage.

Instead of firm's value maximization managers have motive for their own utility maximization or also used the resources of firms for their own particular benefits, that's why agency cost increases because of separation of control and ownership. In their study, they describe agency cost in two types: agency cost arises in the conflict between manager and shareholders and agency cost which occurs between shareholder and debts holder conflict. Agency cost includes residual loss, bonding expenditure and monitoring expenditure is included in the study "Theory of the Firms" (Jensen & Meckling, 1976).

3. Methodology

Our sample consists of panel data, Panel data regression has two dimensions, one for cross- section units and the other for time series. Testing the hypothesis of panel data estimation approach takes account of hetroskedasticity and endogeniety in the data. However, the idea that the unit-specific effects do not differ in Pooled OLS makes it very restrictive and usually unrealistic. As argued by Baum (2006), pooled OLS regression can have a complicated error process such as heteroskedasticity across panel units, serial correlation within panel units etc. Due its severe limitations, the decision is taken in this thesis to consider only FEM or REM models. For the panel data estimation; (REM) Random Effect Model and (FEM) Fixed Effect Model are three key accessions. We applied "Hausman Test" to check which model (Random Effect or Fixed Effect) is suitable to accept. This test report the null hypothesis "Coefficients are not different systematically or Random effect Model is appropriate". By applying the test, this hypothesis does not hold.

The systematical structural forms of equations to be estimated in the study follows.

$$AGC_{it} = a_0 + a1INO_{it} + a2LVG_{it} + a3DRS_{it} + a4CO_{it} + \delta_i + e_{it} \quad (1)$$

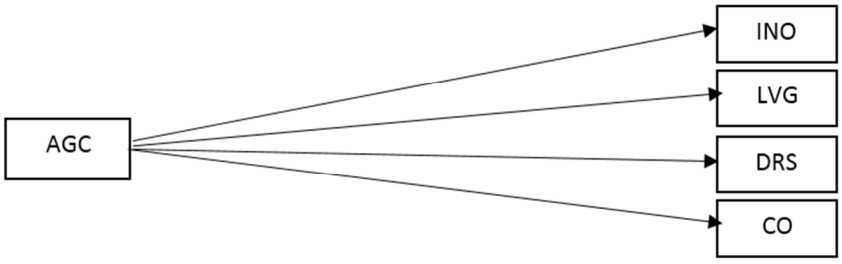
Where:

AGC_{it} = the dependent variable of the model, for firm i at t period.

α = the intercept

δ_i = the firm-specific fixed effect

e_{it} = error term



3.1 Data Sources and Sample Size

To execute econometric projection or estimation, data acquired from State Bank of Pakistan Statistics and Data Warehouse Department, data portal of SECP for the comprehensive audited reports of individuals and from the official websites of incorporated firms covering the period of 2010 to 2014. Thus, the study constitute on secondary data. The sample of 41 non-financial firm's basis incorporated listed in PSE index for the period (2010) to (2014). The reason of financial firms' exclusion (Insurance, Banking, Modarabas & Leasing etc.) from sample is that, this sector is highly regulated and are many restrictions and unique characteristics on its capital structure. Additionally, analysis of 41 non-financial companies clinching the five year financial data from 2010 to 2014, which led to 205 observations.

3.2 Definitions and Measurement of Variables

AGC (Agency cost): To calculate agency costs (Dependent Variable), we applied the alternative efficiency ratio mechanism could be enacted which periodically taken place in the accounting and financial economics, (James S 2000; Rabel A & Ang 2000; Cole, Wuh Lin, Davidson & Singh 2003). Expense ratio: Operating expense / annually sales

LVG (Leverage): Leverage (Explanatory Variable: Leverage grabbed by figuring out the debt ratio, which is "total liabilities" divided by "total assets".

DRS (Directors Remuneration structure): Prediction is made on prior literature investigation, lower the agency cost by increased directors' remuneration or incentives which pressure the managers to work and align their interest with stockholders of the firm. In contrast, (Darren Henry, 2006) documented the remuneration structure mechanism as negative influence on agency cost, which projecting agency cost does not mitigating by steeper remuneration structure. Monitoring through an engaged and freewheeling boards of directors notify that managers enact in the shareholders best interest (Fama and Jensen, 1983).

CO (Institutional Ownership or Block-Holder): Mitigating agency problem, decisive role played by institutional stockholders, who can influence decisions to be made by managers exposed by (Brickley, 1988; Lease & Smith, 2004; Henry, 1988). In divergence, institutional ownership do not geared to reduce agency cost (Doukas et al, 2000; Mcknight & Weir, 2008). Following Darren Henry (2006) Institutional ownership determined as slicing the total percentage stockholdings of all institutional stockholders.

INO (Insider managerial ownership): Insiders are firm's directors, managers, officers, relatives, association who have right to appoint the director with specific fraction of ownership to participate in the firm's management. Insider ownership be dug through the ratio of "Shares held by Insiders" to "total number shares issued", as a stand in or proxy for insider ownership.

Table-1 Insider Shareholdings

Fraction of Insider Equity Shareholdings										
	2010		**2011**		**2012**		**2013**		**2014**	
Fraction	N	%	N	%	N	%	N	%	N	%
0%-5%	0	0	0	0	0	0	0	0	1	0.02
6%-25%	4	0.1	3	0.07	3	0.07	4	0.1	2	0.04
Above 25%	37	0.91	38	0.93	38	0.9	37	0.9	38	0.93

4.0 Statistical Results and Analysis

4.1 Descriptive Statistics

Table 2 summarizes the descriptive statistics which shows the mean, median, maximum and minimum values with standard deviation of all independent and dependent variables from the period of 2010 to 2014. This paper includes the sample of 41 firms that are included in Pakistan Stock Exchange (PSE). This table shows that the mean of AGC is 0.10 and median is 0.08. In the whole sample the range of AGC is 0 with minimum value and 0.7200 with maximum value and the standard deviation (SD) is 0.0991. In this descriptive statistics INO mean value is 59.59% with the minimum value of 12% and maximum value of 95% and the standard deviation is 18.62%. Remarkably, the market ownership of managers of PSE is on average that is .5959(59.59%) which shows that is relatively higher as compared to US market ownership of managers, stated in the paper of Jsensen et al (1992) and Dutta (1999). As like with other variables the mean value of LVG is 0.47 with the standard deviation 0.21, the maximum and minimum values are 0.9400 and 0.01 respectively. The minimum value of CO is 0% and maximum value is as 77% with the mean value of 13.46% and standard deviation is as 14.18%. Meanwhile, this table shows the average value of DRS as 17.20 with the Standard deviation of 2.03 and the extreme value is 21.13.

Table 2: Summary of Descriptive Statistics

Variables	**Mean**	**Median**	**Maximum**	**Minimum**	**Std. Dev.**	**Obs.**
AGC	0.107512	0.080000	0.720000	0.000000	0.099154	205
INO	0.595902	0.650000	0.950000	0.120000	0.186295	205
LVG	0.475707	0.470000	0.940000	0.010000	0.219125	205
CO	0.134683	0.100000	0.770000	0.000000	0.141811	205
DRS	17.20863	17.36000	21.13000	0.000000	2.032929	205

4.2 Correlation Matrix

Table-3 shows the correlation matrix of all the variables that are included in this study from the period of 2010-

2014. For the detection of the problem of multicollinearity in the regressors, the mechanism of "Product-moment of Pearson correlation coefficient" extensively used (Kennedy, 1998). When the correlation is very high amongst the variables, it shows that multicollinearity exists (Saunders et al, 2003; Anderson et al, 2007). Hence, the problem of multicollinearity could be identified with the help of correlation matrix technique. When there is the availability of paramount correlation then the problem of multicollinearity will be found among the regressors. Moreover, the researchers become differed on particular benchmark, the correlation considered high. According to Kennedy (1998), when the correlation is more than 0.80 it will be considered high. The opinion of (Brayman and Cramer, 2001) shows that when the correlation is more than then the 0.80 between any two variables the problem of multicollinearity exists. While, the contributions of (Anderson et al, 1999) recommended as 0.70 to the high correlation benchmark.

In the Table 2 it can be seen that with the usage of Pearson's r, complete sampled data have been used for the detection of correlation among regressors. Ther efore, the results of table shows that there is no availability of high correlation between any of two independent variables, which shows that the problem of multicollinearity does not exist to create a strict problem. However, it is noted that not any of the coefficient of correlation of all available variables beyond the bound of -0.46 or +0.32. The rest of the analysis exhausted to find out the association among variables.

Pearson's r analysis shows some significance and notable outcomes. This table shows that the relation of agency cost with firms leverage, institutional ownership, Insider equity ownership and remuneration structure is negative, which indicated the mitigation of agency cost and shareholders' interest alignments.

Table 2: Correlation Matrix

	AGC	INO	LVG	CO	DRS
AGC	1.0000				
INO	-0.0529	1.0000			
LVG	-0.2523	-0.0648	1.0000		
CO	-0.0551	-0.4655	-0.1384	1.0000	
DRS	-0.1043	0.0577	-0.0526	0.0810	1.0000

4.3 Regression Analysis Based on FEM

Regression results are reported in table 3 by using the FEM, where AGC is response variable. The regression outcomes between INO, LVG, DRS and CO to AGC is on view. INO displayed the negative relation with AGC is significant at 5% which is consistent with ours hypothesis of agency cost mitigation through insider equity ownership and proofing the theory of Jenson Meckling. Whereas, contradicting with the finds of Singh and Davidson (2003) who found the negative relation between managerial ownership and assets utilization ratio. In addition, Morck al (1988) reported that as insider ownership increased to high level from moderate level could lead entrenchment phenomena. Increasing amount of compensation is required by managers as they become entrenched resulted in agency cost. Notably, our study contradicting the entrenchment theory of (Morck al, 1988; Suk & Han, 1998; Fame and Jensen, 1983; Demsetz, 1983) which is managers perform well in moderate ownership but agency cost will be high in higher ownership tier. Thus, at higher the level of insider ownership (Table-1) with a dominant stake in a firm where managers are less diversified and only incentive for the managers to increase shares holder wealth.

Furthermore, the regression outcomes reporting the highly significant negative relation between sampled firms' agency cost and leverage which is supported by numerous theories and consistent with the hypothesis. First, adding debt increased the monitoring of management, i.e. banks, and to put pressure to run firms profitable (And et Al, 2000). Second, debt crate the risk of bankruptcy risk and threaten the managers' job lost which considerably helps to align the managers and shareholders business interests (Williams, 1987; Gorossman & Hart, 1958). This outcome is also consistent with the study of (Cui and Li, 2003; Fleming et al, 2010; Hua et al, 2010).

Likewise, the results shows the fact that CO have negative relation with agency cost with the 1% level of significance. Similarly, Vishny & Shleifer (1986) investigate that shareholders and managers interests could be aligned by large shareholders or block-holders as they have incentive to discipline and monitors the actions of managers. Finally the DRS has insignificant relation with agency cost. Prior literature predicted higher directors' remunerations could reduce the agency cost because remuneration as directors' incentive will make sure the managers to act on in the best interests of the shareholders and company. However, Darren Henry (2006)

reported in their research that remuneration is worked as agency problems reduction.

Table 3: Regression Results Based on Fixed-Effect Model

Explanatory Variables	**Dependent variable**	
	AGC	Std. Error
Constant	0.403332	0.09803
INO	**-0.18032****	0.087362
LVG	**-0.29398***	0.04738
CO	**-0.26884***	0.097971
DRS	-0.00072	0.00399
R-squared	**0.64928**	
Adjusted R-square	**0.55659**	
F-statistics	**6.75124***	
Hausman's Test chi prob.	**0.0331****	
Observations	**205**	

*. Significant at the 1% level. **. Significant at the 5% level. ***. Significant at the 10% level.

5. Summary and Conclusion

In this study, we spotlighted the fundamental tension on corporate governance and assess the mechanisms in controlling or minimizing costs which strikes over from agency problems. We applied "Fixed Effect Model" method on sample of 41 non-financial firms listed in Pakistan Stock Exchange from the period of 2010-2014. This study answered the questions that insider equity ownership, concentrated ownership, and leverage can be considered as appliance and mechanism geared at reducing the effect of agency cost and Stock-holders' interest is protected in the firms with increased insider ownership. This study's results consistent the convergence of interests hypothesis under the framework of managerial diversification. Whereas, we found insignificant results of increased directors' remuneration or incentives which pressure the managers to work and align their interest with stockholders of the firm.

Henceforward, this study would also expected to provide some fruitful and innovative guidelines for the effective mechanism of corporate governance to hedge stockholders interests, instills their confidence and to look into the long term value creation of Pakistani firms. It would aid the managers in solving the agency conflict with shareholders to ensure the optimal decision making of ownership pattern and the value of their stocks in the capital market. Moreover, it would also help the policy makers to pre-identify those levels of insider ownership, block-holder ownership and leverage which would align shareholders and managers interests. The practical implications of the study is that those investors who desire long term performance of the firm may perhaps invested in those firms which are owned by insiders, block-holder or containing acceptable amount of debt, for the reason that such firms try to align with shareholders' interest and to maintain & continue long term performance.

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