

## **Voluntarily contribution and Agency cost of Free Cash Flow: Evidence from Manufacturing sector of Pakistan**

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### **ABSTRACT**

The purpose of this study is to examine the impact of firm volunteer contribution (donations, kind gift and charities) on the agency cost of Free Cash Flow (FCF). Either the voluntarily contribution increase the agency cost of free cash flow or mitigate it. To measure the agency cost of free cash flow firm free cash flow is used as a proxy. Voluntarily contribution is measured by the amount of cash paid out by the firm in the form of donations, charities and kind gift. Panel data of 54 manufacturing firms for the period 2006 to 2010 has been collected from the manufacturing sector of Pakistan. Results revealed that the firm contribution in donations, charities and gift increase the agency cost of free cash flow. Managers feel prestige in distributing the owner's cash in the form of donations, charities and kind gift. The paper shows the impact of voluntarily contribution on the agency cost of free cash flow. These indicates that the firms that want to maximize the value of the firms by reducing the agency cost of free cash flow should also keep in view the level of firm cash that is distributed by the firm in the form of free cash.

**KEY WORDS:** Free cash flow, social responsibility, agency costs, agency relationships

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### **1. INTRODUCTION**

In last decades there is a significant increase in the corporate activities associated with the corporate voluntarily contribution. While the definitions of the firm voluntarily contribution vary, the term voluntarily contribution generally refers to the cash that corporate paid out in the form of donations, charities and kind gift. The most important evidence is that the firm expense related to the voluntarily contribution is the most important component of the large corporation's operation. Most of the studies focused on the impact of the voluntarily contribution (donations, charities and kind gift) focus on the firm characteristics and the firm performance. In contrast we focus on the firm volunteer contribution in the form of donations, charities and kind gift and evaluate agency cost of free cash flow with respect to firm voluntarily contribution which postulate that managers can maximize their own interest through volunteer contribution. The manager of the firm justify the volunteer contribution beneficial for the shareholder as it increase the value of the share holder wealth because firm charities and donations generate firm good will that increase the customer's loyalty and the more lenient treatment by regulators and the government. According to the institutional view the managers feel good and look good by giving money in donations and charities, especially when they are giving someone else money (Barnea et al, 2010). Our study focus on the impact of manager's volunteer contribution in the form of donations, charities and kind gift on the agency cost of free cash flow.

A wide literature available on agency theory and voluntarily contribution in very different lights but the impact of firm voluntarily contribution on agency cost of free cash flow is missing in the literature. A common assumption that is widely found in the literature of the corporate social responsibility is that firm has to pay some percentage of discretionary cash in the form of donations and charities. It is reasonable to assume that the firm volunteer contribution increase and decrease with the availability of free cash flow. Agency theories claimed that the firm volunteer contribution is undesirable and is result in the managerial discretion, There is always a little pressure from the shareholders on the manager of the firm to invest free cash in the social activities, although the managers of the voluntarily chose to participate in the social responsible activities for their own recognition in the society.

The free cash flow theory of Easterbrook (1984) and Jensen (1986) states that companies with substantial free cash flow always tend to face conflicts of interest between stockholders and managers. Managers once have

satisfied all the obligations contracted by the company with funds generated by operations, can use the remaining flows from the treasury for their own benefit instead of the interest of shareholder. Shareholders want managers to invest cash in the projects that maximize their stock value whereas the manager's personal interest is in consuming perks. According to the free cash flow theory the firm sometimes generates more free cash that is required by the manager to be invested in the positive NPV project. Manager invests the excessive free cash in the non-value maximizing projects when they are lacking in the positive NPV projects because managers gain prestige being the manager of the big firm. Galaskiewicz (1985) states that the agency theory of free cash flow assumes that the manager of the firm gives corporate funds in donations, charities and kind gifts for their personal interest for example to advance their personal agendas and approval from social elites.

The main objective of this research is to test the impact of voluntary contribution on agency cost of free cash flow. In this study profit, investment and growth opportunities, firm size and managerial ownership is also measured to see its impact on the agency cost of free cash flow. The rest of this paper is divided into 5 sections. Section 2 reviews the previous research. In Section 3 explains research methodology to test a number of hypotheses relating to our research focus. Section 5 analyses and discusses the results. Section 6 is the concluding section.

## 2. LITERATURE REVIEW

Firms prefer to pay the donations, charities and kind gifts from the cash that is remained after fulfilling all the financial obligations. The impact of voluntary contribution (donations, charities and kind gift) on the agency cost of free cash flow is examined in the few studies. Some researchers conclude that the firm's voluntary contribution (donations, charities and kind gift) reduces agency cost associated and some studies concluded that the firm's voluntary contribution is the source of agency cost of free cash flow. Whereas some other studies show no effect of voluntary contribution on the agency costs of free cash flow. Some of these researchers are:

Wang *et al.* (1992) have conducted their study on the board composition and corporate philanthropy. They examined the relationship between the board composition and the corporate philanthropy by using the agency theory. They pointed out that there is always a conflict of views between the manager and principal of the firm about the corporate charities. They also revealed that the principal has residual claim whereas managers do not have that. They revealed that the manager of the firm pays more cash in the form of donation and charities as compared to the principal of the firm. They concluded that managers of the firm make more voluntary contribution for their own self-interest that increases the agency cost of the firm.

Seifer *et al.* (2003) have done the comparison between the big givers and the small givers. In their study they pointed out that managers prefer the voluntary contribution (donations, charities and kind gift) especially when they are giving away someone else's money. They stated that giving the donation and charities is the part of manager's discretion rather than the obligation. As it is the responsibility of the manager to pay the extra cash to the shareholders in the form of the dividend so that they would invest the cash according to their own interest. They also revealed that there is a little pressure on the manager to accommodate cash for social welfare although the manager of the firm voluntarily chose to participate in the corporate philanthropy by giving donations. They said that the manager gives donations for maximizing their personal agendas like to achieve appreciation from the social elites and to get social recognition. They concluded that the voluntary contribution of the firm increases the agency cost of free cash flow.

Brown *et al.* (2006) conducted his research on corporate philanthropic practices. He pointed out that the agency costs play a prominent role in explaining the corporate voluntary contribution. They argued that the corporate giving increases the shareholders' value. They also argued that giving programs of the firm also enable the manager to favor their own pet charities on the expense of the shareholders. They revealed that the firm's shareholders will be better off if the charity giving is correct because it reduces the free cash flow that is in the control of the manager and can be invested in the non-value adding activities of the manager.

Barnea *et al.* (2010) has studied the corporate social responsibility in the light of conflict between the shareholders. They pointed out that managers feel good while associated with the high CSR rated firm. They revealed that the manager's main concern is in maximizing the value of the shareholders' wealth. The low contribution in the social activities increases the firm value as it increases the productivity of the employees and reduces the agency cost of free cash flow. As the firm's cash is paid out for the activity that is increasing the value of the firm instead of being used by the manager for non-value adding activities. They argued that the specific level of firm cash contribution reduces the agency cost and maximizes the value of the firm. The over-investment in the voluntary contribution reduces the wealth of the shareholders and reduces the value of the firm.

### 3. METHODOLOGY

#### *Sample*

In order to examine the impact of dividend policy, leverage and voluntarily contribution on the agency cost of free cash flow in the context of Pakistan, present study initially selected 74 non financial firms from the top 100 index of Karachi stock exchange. KSE 100 index is that it is most recognized index of the KSE. It shows representation from all sectors of the KSE and includes the largest companies on the basis of their market capitalization. KSE represents over 85% of the market capitalization of the Exchange. The Index comprises of 100 companies selected on the basis of sector representation and highest market capitalization, which captures over 90% of the total market capitalization of the companies listed on the Exchange. The manufacturing sector is chosen for the present study. The reason behind selecting manufacturing sector is that it is a capital intensive firms and their cash builds up. Secondly manufacturing sector lies in the cyclical industries so they need to keep the extra cash in their reserves to ride up in the cyclical downturns. The need of keeping free cash in the reserve make the manufacturing more appealing for the study of agency cost of free cash flow.

Firms that were newly formed merged, de-listed, split or have missing data in the period of study is excluded from the sample. In sampling technique we have used convenience sampling. Present study recorded 290 observations. Only those firms have been included that remained in business for the whole study period, remained listed from 2006 to 2010, have not merged, due to any reason, has paid dividend at least once in five years ,have long term debt in their capital structure in the year of study and the firm that disclose the data of donations in their audited financial reports.

On the basis of the above mentioned criteria sample of 58 firms has been finally selected. Present study only considered cash dividends paid by the companies. Stock repurchase and stock dividend have been ignored. Data has been collected from the Annual reports of Karachi Stock Exchange (KSE), Economic survey of Pakistan, Published financial statements of companies, Balance Sheet Analysis of e Joint Stock companies and publication of the State Bank of Pakistan. Internet is also used to access data on company history, background information on sectors under study. Type of data structure used in this study is panel (balanced panel data). McKnight (2008) stated that panel data isolates both time series and cross sectional effects. Hsiao et al, (2003) explained that developing countries are lacking in collecting the data for long period. So in this situation panel data is the most appropriate type of data for answering the research questions. Bond (2002) in his study explained that several advantages of using panel data in the study. He stated that heterogeneity among the variables can be controlled by using panel data. By using panel we can measure those effects of the variables that cannot measure by using cross sectional and time series data.

#### *Measures*

Free cash flow is used as a proxy of agency cost of free cash flow and it is also the dependent variable of the study. Utami et al (2011) defined free cash flows as net profit minus changes in fixed assets minus changes in net working capital divided by total assets. Wu (2004) defined free cash flows as operating income before depreciation minus interest expense minus taxes minus preferred dividends divided by book value of assets. Chu (2010) calculated the free cash flows by subtracting total tax on income, gross interest expense and expense on investment activity from operating income before depreciation. Wang (2010) measured free cash flow by subtracting income tax, interest expense, common stock dividend, and preferred stock dividend, from operating cash flows divided by net sales. Lang and al (1991) define free cash flow as the operational income before depreciation, capital expenditures and taxes, divided by the book value of total asset in order to eliminate any size effect. In our study free cash flow is measured by

$$\text{Free cash flow} = \text{Operating Income before depreciation} / \text{Total assets}$$

Voluntarily contribution is used as independent variable of the study. In Pakistan all companies has to report their voluntarily contribution like Charities, Aids, Education, Hospitals and health providing services under the heading of donations in their annual financial report. In companies ordinance 1984 all companies has to mention their corporate donations, charities and kind gifts in profit and loss account. Existing literature on voluntarily contribution and agency cost of free cash flow use cash paid out in the form of donations, charities and kind gift as a proxy of voluntarily contribution such as (Seifert et al, 2003; Wang, 1992; Thanatawee, 2011). In the light of previous researches present study measures the voluntarily contribution by

$$\text{Voluntarily contribution} = \text{Donations} + \text{charities} + \text{kind gift} / \text{Earning before Tax}$$

Control variables of the study are Managerial ownership, Leverage, investment and growth opportunity, firm size and profitability. Tobin Q is used as a proxy to measure the investment and growth opportunities. It is measured by market value of equity plus book value of long term debt plus book value of short term debt divided by

total assets. Previous researches show positive relationship between the Tobin Q and the agency cost of free cash flow. They argued that the firm holds more free cash when they have investment opportunities that lead towards creating free cash flow problem (Ferreira *et al.*, 2004; Saddour, 2006). Size of the firm is calculated by natural log of total assets. There is a positive relationship between the free cash flow and the size of the firm (Ferreira and Vilela 2004; and Saddour 2006). Whereas the profitability of the firm is measured by earnings after tax/Total number of share outstanding. Previous researches concluded that profitability of the firm is positively related to the agency cost free cash flow as the profitable firms hold more free cash that can be used by the manager for their own discretionary purpose (Utami *et al.*, 2011; Ahmad, 2009). Managerial ownership of the firm is measured by the number of shares held by the manager divided by the outstanding shares. Agency cost of free cash flow reduces with the increase in the firm managerial ownership (James *et al.*, 2000; and Ahmad, 2009). Firm leverage is calculated as the debt divided by equity. Firm leverage reduces agency cost of free cash flow by reducing the cash that is under the control of the manager. (Lingling, 2004; and Harvey *et al.*, 2004)

**Table 1: Variable summary**

Symbol	Proxy	Variable Description.	Expected Relationship
<b>Dependent variable</b>			
FCF	Free Cash Flow	Operating Income before depreciation / Total assets	
<b>Independent variable</b>			
VOL	Voluntarily contribution	Charities + donations+ Kind gift/Net income	Negative(-) /Positive(+)
<b>Controlled Variable</b>			
Size	Firm size	Natural log of the total assets	Positive(+)
PRFT	Profit	Earnings after tax / Total number of share outstanding	Positive(+)
MGR	Managerial Ownership	Common shares own by insiders/total number of shares outstanding	Negative(-)
TOBNQ	Tobin Q	MV of equity + BV of long term debt+ BV of shorter debt/ Total assets.	Positive(+)
LVRG	Leverage	Total debt/total equity	Negative

**Statistical procedure:**

To check the impact of voluntarily contribution of the firm (donations, charities and kind gift) on the agency cost of free cash flow we use regression analysis on panel data. Random-effects Generalized Least Square (GLS) regression on panel data is used to examine the impact of voluntarily contribution and agency cost of free cash flow. The use of the OLS as an estimation method instead of GLS model does not result in the efficient estimates of the regression coefficient. To decide about whether RE (Random Effect) is more precise or FE (Fixed Effect) for a particular panel data, Hausman test is used. If the Hausman test is significant then in this case FE is more appropriate and if this test is insignificant then it reveals that RE is more precise for a particular data set (Saleh *et al.*, 2008).

The model of the study is

$$ACF_{it} = \beta_0 + \beta_1 VOL_{it} + \beta_2 PRFT_{it} + \beta_3 Size_{it} + \beta_4 TOBINQ_{it} + \beta_5 MRG_{it} + \beta_6 LVRG_{it} + \epsilon$$

Where

$\beta$ = regression coefficient     $i$ = index of  $i$ th firm     $t$ =time period     $\epsilon$ =error term

- ❖ Vol = voluntarily contribution
- ❖ LVRG=Leverage
- ❖ PRFT=Profit
- ❖ TOBIN Q=Investment and growth opportunities
- ❖ SZE=size
- ❖ MRG= Managerial ownership

**4. RESULTS**

Table 2 provides descriptive statistics on company available free cash flow, voluntarily contribution (donations, charities and kind gift), investment and growth opportunities and firm size. In this study free cash flow (FCF) is measured by operating income minus tax minus interest rate plus depreciation divided by total assets. Minimum value of FCF is -.3114 whereas the maximum value of the FCF is .6757. The minimum negative values of

free cash flow shows that firm of Pakistan are making large investment. The maximum value of the FCF shows that Pakistani firms hold maximum 67 percent of free cash to the total assets. Voluntarily contribution contains donations, kind gift and charities. It is measured by the donations plus Kind gift plus charities divided by net income. The average voluntarily contribution made by the firm is 0.017 which means that .017 percent of net income is paid up by the firm in donations, kind gift and charities. The minimum value of the voluntarily contributions is 0.00 where as in maximum 97 percent of operating income is paid out as the voluntarily contribution by the manufacturing sector of Pakistan.

Managerial ownership is the Percentage of the shares held by the manger of the firm. The average value of managerial ownership in Pakistan non financial firm is .0143 which means that on average 1.4 percent of total outstanding shares is held by the manger of the firm. This value can deviate 5 percent from the average value. The minimum value of the managerial ownership is .0000 and maximum value is .3263 which means maximum 32 percent of the outstanding shares are owned by the manager of the firm. These tell us that in Pakistani manufacturing firm managerial ownership are not so much in practice. Profitability of the firm is measured by net income divided by sales. The average profitability of the firm is .1061 which tells us the earning of the firms is 10 percent of its sales. The minimum negative value of the firm is -.4861. The minus sign is showing the loss of 48 percent of sales. Whereas the maximum value of the Pakistani firm profitability is 2.0224 showing that earnings of the Pakistani firms is 202 percent of total sales.

Tobin Q in our study is used as a proxy of growth and investment opportunities. It is measured by market value of equity plus book value of long term debt plus book value of short term debt divided by total assets. The mean value of Tobin Q is 1.8004 which shows that high growth and investment opportunities are available for Pakistan manufacturing firms. This value can deviate from its mean value up to 1.9270. The minimum value of Tobin q in Pakistani firms is .1982 where as the maximum value is of 15.6501. Size of the firm is calculated as log of total sales. The average size of the Pakistani non financial firms in terms of sales is 2.3441 which can deviate to 1.2568. The minimum value of the firm size is 19.2154 and the maximum value is of 26.1564.

**Table 2: Descriptive statistics**

Variable	Obs	Mean	Std.Dev	Min	Max
FCF	290	0.134	0.109	-0.311	0.676
VOL	290	0.017	0.096	-0.763	0.971
Size	290	23.42	1.969	0	27.334
PRFT	290	0.105	0.172	-0.486	2.022
MNGR	290	0.0143	0.049	0	0.326
Tobin Q	290	1.800	1.927	0.198	15.65
LVRG	290	2.081	2.7863	0.032	35.858

**Variable Definition:**

- ❖ Free cash flow = Operating Income before depreciation / Total assets
- ❖ Voluntarily contribution = Donations + charities + kind gift / Operating income.
- ❖ Size = Natural log of total assets.
- ❖ Profit = Earnings after tax / Total number of share outstanding
- ❖ Managerial ownership = Common shares own by insiders / total number of shares outstanding
- ❖ Tobin Q = MV of equity + BV of long term debt + BV of shorter debt / Total assets
- ❖ LVRG = Total debt / Total equity

Table 2 reports the regression results to see the impact of voluntarily contribution on the agency cost of free cash flow. Results shows that the voluntarily contribution (Donations, charities and kind gift) is positively and significantly associated with the free cash flow (0.003, p<0.10). This shows that the managers of the firm pay cash in the form of donations and charities that increase the agency cost of free cash flow. The firm leverage is negatively and significantly associated with the agency cost of free cash flow (-0.006, p<0.01). The result shows that firm with high level of leverage can reduce the agency cost of free cash flow. As firm with high debt in their capital structure paid most of the cash in the form of principal payments and interest rate. So less cash is available to the manager to be used for their own self interest. The size of the firm is positively and in significantly related to the agency cost of free cash flow. This shows that the firm agency cost increase with the size of the firm. Whereas the managerial ownership of the firm is also positively and insignificantly associated with the free cash flow (0.0624, p>0.01). The profitability of the firm shows positive and highly significant relationship with the agency cost of free cash flow (0.223, p<0.01). As the profitable firm carry more free cash flow than the non profitable firms that can be used by manager of the firm for their own discretionary purpose rather than spending for the interest of the share holder. In

the same way Tobin Q also positively and significantly related to the agency cost of free cash flow (0.0089,  $P < 0.05$ ). Firm with more investment and growth opportunities hold more free cash flow to be invested in the positive NPV projects. Holding high level of free cash flow in case of investment opportunities increase the agency cost of free cash flow.

**Table 3: GLS regression results**

Variables	Dep. Variable: FCF	
	FE Model	RE Model
Volunatrily contribution	0.003***	0.0065***
<b>Controlled Variables</b>		
Size	0.004	0.005
Leverage	-0.001*	-0.008*
Profit	0.223*	0.241*
Tobin Q	0.017*	0.018*
MNGR	0.062	0.027
Year Dummy	No	NO
R <sup>2</sup>	0.49	0.46
Hausman Test	Prob>chi=0.0001	

\*Significant at 1%, \*\*Significant at 5%, \*\*\*Significant at 10%

## Conclusion

The purpose of this study is to examine the impact of the firm voluntarily contribution (donation, charities and kind gift) on the agency cost of free cash flow. Dozens of empirical studies has been conducted on the corporate voluntarily contribution (donations, charities and kind gift) with different aspects but no study has examined its impact on the agency cost of free cash flow. Our research has contributed in the body of research by seeing voluntarily contribution (donations, charities and kind gift) impact on agency cost of free cash flow.

The finding of the study shows that the firm voluntarily contribution increase the agency cost of the free cash flow. The manager of the firm gets self benefits by distributing the free cash in the form of donation, charities and kind gift. Shareholders of the firm has the right on the firm retained earnings where as manger's don't have this right. According to the free cash flow theory the remaining cash of the firm should also be distributed to the share holder of the firm in the form of dividend. Insider of the firm voluntarily make donation from firm available cash as they get recognition in the society and praised by the elite class. The results of the study also showed that the profitable firm carry more free cash that can be misused the manager of the firm for their own discretionary benefit. In the same way the firm with more investment and growth opportunities carry more free cash flow so that they would not forego any positive Npv projects due to lack of agency cost of free cash flow. The high level of available cash in return increase the agency cost.

## Limitations and direction for future research

This research has also some limitations and the first limitation is that this study only focuses on 5 year, the year from 2006 to 2010. Secondly, generalization of the findings is another limitation of this study as sample size is based on 59 non-financial firms listed in Karachi Stock Exchange. The increase of sample size, inclusion of more firms and industry specific features in the future research and can improve their findings and make them more generalize. Another limitation of this study is the issue of the proxy used in this study as a single proxy of free cash flow to measure the agency cost of free cash flow. There is no way of measuring agency cost of free cash flow directly For precise impact of voluntarily contribution more proxies for agency cost of free cash flow should be used.

Besides the limitations there are some alternatives for future research and the first one is that this topic is further studied by conducting research including different variables and different sectors. Another extension would be including private firms. Due to the difficulty to find the necessary data for private firms, this research only involves Karachi listed firms. It is possible that in the future this data becomes better available. In further studies the effect of managerial incentives on agency cost of free cash flow can also be examined.

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