Research Paper ECONOMICS

# A Literature Review of Agency Theory

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**ABSTRACT**

Agency theory is a set of proposition in governing a modern corporation which is typically characterized by large number of shareholders or owners who allow separate individuals to control and direct the use of their collective capital for future gains. These individuals may not always own shares but may possess relevant professional skills in managing the corporation. The theory offers many useful ways to examine the relationship between owners and managers and verify how the final objective of maximizing the returns to the owners is achieved. This paper reviews the extensive literature of agency theory along with some of its limitations and it also focuses that a firm can improve its performance if agency cost may be reduced.

**KEYWORDS** Agency theory, Shareholders, Managers, Agency cost.

**INTRODUCTION-**
A firm can be owned by a single person or by more than one person. A firm owned by a single person is called a sole proprietorship concern. In this case the owner is the manager and his interests are no different from that of the firm i.e., maximizing the firm value. But in majority of cases a single individual cannot provide the entire capital, expertise and resources; and hence few individuals, with similar objective, collectively carry out the business. A large number of investor provides the risk capital. They are called shareholders. Shareholders have the residual claim on the assets of the company. Therefore, the right to control the use of the assets of the firm vests in them. They are deemed owners of the company. Shareholders delegate the power to manage the company to board of directors. The board delegates the same to managers while retaining its role to monitor and control the executive management. Corporate governance literature views shareholders as the principal and manager as their agent and describes the relationship as principal-agent relationship-

"An agency relationship is defined as one in which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. ( Hill and Jones, 1992)".

The divergence of interest between the owners and the managers, due to the separation of ownership from control, results in the agency costs.

Dealing with the agency problem is not free. Unfortunately, there is an agency cost associated with coping with the agency problem. Agency costs usually fall under the category of operating expenses. If employees of a company take a business trip and book themselves into the most expensive hotel they can find or if they insist on the best computer in the market for their offices, those are examples of agency costs. Those things don't maximize the wealth of the shareholders but instead minimize it.

**LITERATURE REVIEW OF AGENCY THEORY-** The agency problem inherent in the separation of ownership and control of assets was recognised as far back as in the 18th century by Adam Smith in his Wealth of Nations, and studies such as those by Berle and Means (1934) and Lorsch and Maclver (1989) show the extent to which this separation has become manifest in firms throughout the world. Under this agency relationship, both the agents and the principals are assumed to be motivated solely by self-interest. As a result, when principal delegates some decision making responsibility to the agents, agents often use this power to promote their own well-being by choosing such actions which may or may not in the best interests of principals (Barnea, Haugen and Sanbet, 1985; Bromwich, 1992; Chowdhury, 2004). In agency relationship, the principals and agents are also assumed to be rational economic persons who are capable of forming unbiased expectations regarding the impact of agency problems together with the associated future value of their wealth (Barnea et al., 1985). Agency theory is concerned with the contractual relationship between two or more persons. Jensen and Meckling (1976, p.308) define agency relationship as a contract under which one or more person (principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. Jensen and Meckling identify managers as the agents, who are employed to work for maximizing the returns to the shareholders, who are the principals. Jensen and Meckling assume that as agents do not own the corporations resources, they may commit moral-hazards (such as shirking duties to enjoy leisure and hiding inefficiency to avoid loss of rewards) merely to enhance their own personal wealth at the cost of their principal. To minimize the potential for such agency problems, Jensen (1983) recognizes two important steps-

1-The principal-agent risk-bearing mechanism must be monitored through the nexus of organization and contracts. The first step, considered as the formal agency literature, examines how much of risks should each party assume in return for their respective gains. The principal must transfer some rights to the agent who, in turn, must accept to carry out the duties enshrined in the rights.

2- The second step, which Jensen (1983, p. 334) identifies as the positive agency theory clarifies how firms use contractual monitoring and bonding to bear upon the structure designed in the first step and derive potential solutions to the agency problems. The inevitable loss of firm value that arises with the agency problems along with the costs of contractual monitoring and bonding are defined as agency costs,(Jensen and Meckling, 1976).

The principal-agent problem is also an essential element of the incomplete contracts view of the firm developed by Coase (1937), Jensen and Meckling (1976), Fama and Jensen (1983 a,b), Williamson (1975,1985), Aghion and Bolton (1992), and Hart (1995). This is because the principal-agent problem would not arise if it were possible to write a complete contracts. In this case, the investor and the manager would just sign a contract that specifies ex-ante what the manager does with the funds, how the returns are divided up, etc. In other words, investor could use a contract to perfectly align the interests and objectives of managers with their own. However, complete contracts are unfeasible, since it is impossible to foresee or describe all future contingencies. This incompleteness of contracts means that investors and managers will have to allocate residual control rights in some way, where residual control rights are the rights to make decisions in unforeseen circumstances or in circumstances not covered by the contract.

**Limitations of agency theory-** There are a number of limitations of agency theory (Eisenhardt 1989; Shleifer and Vishny 1997; Daily et al. 2003):

- Agency theory assumes complete contracts (i.e. contracts that cater for all possible contingencies such as ambiguities in language, inadvertence, unforeseen circumstances, disputes, etc). Bounded rationality does not allow for complete and efficient contracts. Information asymmetries, transaction costs and fraud are insurmountable obstacles to efficient contracting.
- Agency theory assumes that contracting can eliminate agency costs. The many imperfections in the market indicate that this assumption is not valid.
- Third party effects are not recognised. Third parties are those affected by the contract but who are not party to the contract. Many boards are conscious of third party effects and adopt social as well as financial responsibilities. Thus, whereas Maximum economic efficiency may (theoretically) be achieved under agency theory, it will not achieve maximum social welfare.
- Shareholders are assumed to be only interested in financial performance.
- Directors and management are assumed to owe their duty to shareholders. The law requires that duty to be owed to companies.
- Boards have a number of roles. Agency theory may be suitable for the monitoring-of-managers role of boards, but it does not explain the other roles of boards. Agency theory is not informative with respect to directors resources, services and strategy roles.
- Much of the corporate governance research is conceptualised as deterrents to managerial self-interest. Agency theory treats managers as opportunistic, motivated solely by self-interest. Many would argue that this theory does not capture those who are loyal to their firms.
- Agency theory does not take account of competence. Thus, if even incompetent managers are honest (or are made honest by board control) they will still be limited in their ability to meet shareholder objectives. It is not enough to incentivise people to get a task done; they must have the ability to carry out the task (Hillman and Dalziel, 2003).

**CONCLUSION-** As per the agency theory, due to the divergence of interests and objectives of managers and shareholders, one would expect the separation of ownership and control to have damaging effects on the performance of firms. Therefore, one way of overcoming this problem is through direct shareholder monitoring via concentrated ownership. The difficulty with dispersed ownership is that the incentives to monitor management are weak. Shareholders have an incentive to free-ride in the hope that other shareholders will do the monitoring. This is because the benefits from monitoring are shared with all shareholders, whereas, the full costs of monitoring are incurred by those who monitor. These free-rider problems do not arise with concentrated ownership, since the majority shareholder captures most of the benefits associated with his monitoring efforts. Several mechanisms can reduce agency problems. An obvious one is managerial shareholdings. In addition, concentration shareholdings by institutions or by block holders can increase managerial monitoring and so improve firm performance, as an outsider representation on corporate boards. The use of debt financing can improve performance by inducing monitoring by lenders. The labour market for managers can motivate managers to attend to their reputations among prospective employers and so improve performance. Finally the threat of displacement imposed by market for corporate control can create a powerful discipline on poorly performing managers.

To conclude it can be said, if agency costs may be reduced in the corporations, the firm performance can be improved.

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