European Journal of Business and Management www.iiste.org
ISSN 2222-1905 (Paper) ISSN 2222-2839 (Online)
Vol.9, No.2, 2017

Agency Theory: A Critical Review

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Abstract
The agency theory has interested several disciplines: accounting, finance, economics, law, political science, strategy or organizational psychology. This theory, which explains the relations between owners and managers, needs to be revisited in the light of current debates on the performance of companies and the remuneration of their CEOs.This article highlights the developments in agency theory since Adam Smith postulate until today, and revisits the different forms of agency problem and their challenges for corporate governance.
Keywords: Agency theory, agency cost, Principal-agent problem, Information asymmetry, Corporate governance

1. Introduction

Introduced for the first time in information economics literature to provide a theoretical model of the relation between one party (the principal) delegating work to another party (the agent), the agency theory received a lot of attention in organizational and information system literature (Thompson, 1967; Eisenhardt, 1985). The agency theory aims to globally explain organizational behaviours by putting an emphasis on the relationship between the manager as the company's "agent", and the shareholder as the "principal".

The theory was taken up by researchers in several disciplines, notably in accounting (Baiman, 1990), law (Banfield, 1965), economics (Cooper, 1949 & 1951; Ross, 1973), finance (Jensen & Meckling, 1976), sociology (Shapiro, 1987), strategy (Barnard, 1938) and political science (Mitnick, 1982a, 1993), among others. Researchers have increasingly used this theoretical perspective to analyze leadership behaviour in big private and public enterprises. As it is the case for most questions on organizations, the agency theory focuses on working people and on how they behave in their work environment. Given its roots in economics, the agency theory suggests that the actors who work in an organization have a utility maximization logic, and seek to get what is in their best interest, even it is perhaps not in the best interest of the organization (Eisenhardt, 1989).

Based on the essential contributions of the work of Barnard (1938) on cooperation in organizations, the agency theory focuses on the conflict between objectives, created by various individuals who, while engaged in these organizations, seek for what is in their best interest. However, this approach adds new complexities to the clichés that exist within the organization.

Abraham Lincoln said[1]: ***« The legitimate object of government is to do for a community of people whatever they need to have done, but cannot do at all, or cannot so well do, for themselves»***. Beyond its political connotation, this statement makes a rather accurate description of the issue at the heart of the agency theory. It is indeed a matter of delegation of power to people who are potentially more capable and better able to fulfill a mission, of holding them accountable and of finding a way to control and reframe their actions, based on the objectives assigned to them (with some difficulty due to the fact that their position in the organization gives them access to scoops and advantageous information) and of sanctioning them if necessary.

2. Key concepts

2.1 Agency and contracts

Although the notions of contract and agency are closely linked, some scholars note two major types of differences.

First, agents are usually not selected for a particular job or for a set of discrete tasks, but are hired for a broad range of activities, which can change over time and are compatible with the principal's fundamental objectives and interests. In this case, the principals involved must be, to some extent, interested in the personality of the agent, in its profile, and in other characteristics that are generally not an issue in contractual agreements. The principal will put an emphasis on the achievement of global objectives rather than specific tasks.

Second, in an agency relationship, there is generally significantly less independence between the agency and the principal than between contracting parties. In practical terms, this means that the principal-agent relationship is more hierarchical and impulsive than a contractual relationship, and that the principal is more at liberty to reward, punish and control the agent. A conventional view would even want the agency to be a specific application of the contract theory. However, some may argue that the opposite is also true: a contract is a formalized, structured and limited version of the agency, but the agency itself is not based on any contract.

[1] Lincoln, A., & Basler, R. P. (2001). Abraham Lincoln: His speeches and writings: Da Capo Press..

2.2 Agency relationship

Jensen and Meckling (1976) define an agency relationship as a contract by which one or more persons (the principal) hire another person (the agent) to perform some service on their behalf, giving the agent some of their decision-making power. By its nature, the agency relationship is problematic if the principal and the agent's personal interests are divergent.

The agency theory is based on two behavioural assumptions. The first assumes that individuals seek to maximize their utility and the second presumes that individuals are likely to benefit from the incompleteness of contracts. Agency relationships are generally more complex and ambiguous (precisely in the sense that the agent is required to serve the interests of the principal) than contractual relations, especially when it comes to the question of ethics. If we stick to the classic version of the agency theory which states that the agent must always act in the interest of the principal, it is assumed that the interests of the principal are always morally acceptable, or that the agent must often act contrary to ethics in order to fulfill its "contract" in the agency relationship. These are positions that obviously do not comply with any workable model of business ethics.

2.3 Agency costs

As it is impossible for the principal to make sure, at no cost, that the agent makes the best decisions for him. Both the principal and the agent will have to assume monitoring and obligation costs. Agency costs occur when suspicion arises between the two parties. According to Jensen and Meckling (1976), these costs can be grouped in three categories:

- Monitoring costs borne by the principal to limit the opportunistic behaviour of the agent and incentive costs (incentive systems) incurred by the principal to orient the agent's behaviour.
- The obligation or commitment costs that may have been incurred by the agent to win the principal's trust (motivation cost).
- The third type of cost is an opportunity cost referred to as "residual loss" which equates to the loss of utility suffered by the principal following a divergence of interest with the agent, such as the cost sustained by the principal following the unfavourable management of the principal's interests by the agent.

In order to avoid these deviations, it is important to establish levers at the corporate governance level to align the interests of all parties, better tune their behaviour and magnify their reports.

2.4 Information asymmetry

It is the difference of information between the two parties. Many economists use economic models that assume that both parties to a transaction detain perfect information. But the information in the market reality is usually asymmetric (Stiglitz, 1985; Vernimmen et al., 2015). The leaders in charge of the company's management have quite frequently access to insider information on the company's operations. Also, shareholders do not always have the necessary competencies to know whether a transaction will serve their best interests or those of the managers. It is therefore possible for managers to adopt an opportunistic behaviour by manipulating the information they manage. Problems of moral risks, adverse selection and opportunism are also associated to information asymmetry.

3. Origin and development

3.1 The Adam Smith's premise

Adam Smith's book *An Inquiry into the Nature and Causes of the Wealth of Nations*, (1776) and, particularly, his thoughts on the ineffectiveness of companies whose management was entrusted to a non-owner agent, is undoubtedly one of the most relevant reference for the study of problems related to the agency relationship. *« The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. »* A. Smith (1776, p.408).

3.2 The experts at the wheel, the decline of family businesses

As Kitsou (2013) explains, the 20th century marked the beginning of the decline of the family business. The size of a company increased the complexity of management and an opening of capital became necessary, sometimes blurring the line between private wealth and business assets. As a result, the general decline of the family as a reference of social structure started and since the 1920s, we witnessed a general crisis of genealogy, inheritance and transmission as guarantors of social order.

The distinction between owners and managers was permanently settled with the Great Depression of the

1930s, during which we witnessed the emergence of a new class; the "managers" (Berle and Means,1932). Schools and networks saw them as the new elite, devoted to the management of large enterprises (Bourdieu,1984). Technical expertise was preferred to the "right of blood" in a political context that demanded more and more to see one's competence to govern based on managerial knowledge as opposed to heredity. This inclination seen within the political sphere started to extend to big businesses. In general, the separation between management and ownership was inscribed in practice and in law.

Two factors then came in conflict: on one hand, the distinction between shareholders and managers implied that the latter could not run the business without taking into account the interests of the former, which, by definition, limited their discretional power; on the other hand, the nature of the legitimacy of the manager, based on his expertise, would ensure a discretionary management power of significant measure because, by nature, the manager is the one who knows how to define the company's interests (Gomez, 2003).

3.3 The assertion of the agency theory

In order to make the new forms of government compatible with the theory of private property rights, the development of corporate governance was associated with an aspect of theorization. This is how the agency theory progressively asserted itself. The question was not to define a principal-agent theory (as it already existed since Adam Smith), but to make the theory of private property rights, established in a previous period with a theory on the distinction of management power and property, compatible. In other words, it was about defining an exercise of power that was not the product of the owners, while maintaining the need for private ownership of the means of production.

The management of enterprises by professional managers was a rationale accepted by an overwhelming majority of those who then reflected on the management of new companies. Moreover, the discretional power of the executive, which was seen as very important, was also generally accepted in the name of a very scientific vision, typical of the period, which was also shared by Marxist thinkers advocating for the supremacy of the managing planner.

Jensen and Meckling, (1976), Fama and Jensen, (1983b) tried to show that the role of shareholders consists in exerting an essential counterweight to avoid that managers' discretional power becomes limitless and therefore potentially counterproductive. The functions of each party were therefore redefined. If the manager exercises power in a sovereign manner, with decisions informed by his managerial competence, he remains an agent designated by the principal (shareholders) and as such, he must sufficiently inform the market in a way that allows the shareholders to know and endorse the results.

Among the agency theorists, the principal does not intervene to control upstream, or to define the strategy instead of the agent, it intervenes afterwards to verify that the agent acted in accordance with the contract (Gomez, 2003). In other words, agency theorists go against the view of private property critics: it is the possible divergence of interests between shareholders and managers that allows to define and limit the power of the manager with an assessment of his results based on the interests of shareholders (Fama 1980, Fama and Jensen, 1983b). The discretionary power is thus reduced to a sovereign power which is important but limited by the final confrontation between the obtained results and the results expected by the shareholders. Countless studies have been written on how to identify the signals of good or bad management and on how to measure their effects (Charreaux, 1999).

The agency theory that came to dominate in the 80s was an statement against the omniscient technocrat and reinterpreted the corporate governance as a balance of powers and counter-powers.

3.*4 Mass shareholding*

The agency theory faced a short-term glory; just as it was establishing itself, mass shareholding changed the rules of the game of corporate governance and made the definition of a manager's sovereign power increasingly ambiguous.

If shareholding was of little importance in the period that established the primacy of the manager, the situation changed radically in the 80s with the development of pension financing by the markets, the privatizations undertaken in various countries, and employee ownership. During two decades, shareholding grew at exponential rates, to the point that at the end of the 1990s, it was clear that capitalism no longer resembled the one Marx had witnessed. The largest portion of shares of the world's largest companies were then in the hands of the public (Shleifer and Vishny, 1997). The debate on the private ownership of means of production had reached a new dimension. From then on, social exclusion as a result of privatization was not only the only issue. The *inclusion* of a large group players in the game of business ownership needed to also be taken into account, because it was creating new social and political consequences. Therefore, the recent Enron, WorldCom or Eurotunnel scandals not only concerned business strategies and venture capitalists, but could also jeopardize the savings and financing system on which depended the prosperity of our economies. Big business became a public space because its ownership was diluted in the public. (Gomez, 2003).

Institutional investors were increasingly forced to focus on the effective management of companies in which they invested, because they could not easily disengage themselves in case of difficulties (Pound, 1989). Institutional investors' activism became a necessity in order to maintain and guide the quality of information acquired at the market and the proper conduct of business (Monks, 1998). Result-based evaluations were getting increasingly risky and shareholders were led to either request more detailed information more frequently (including non-financial information) or question the quality of strategies and decisions at earlier stages. The sovereign power of the executive had then been destabilised.

4. The theory's new orientations

Beyond the classic conflict of owners versus managers, the agency theory is challenged today by various other conflicts, which are themselves linked to the variety of types of contracts and delegations that now exist. It is therefore quite legitimate to wonder about the relationship between franchisor and franchisee; between the majority shareholders and minority shareholders and even between managing shareholders (who hold the majority of voting rights) and the majority shareholders in terms of capital invested.

However, it is the shareholders - creditors conflict that seems to be the main axis of a new orientation of the agency theory. Creditors have the main claim on a share of the company's income in the form of interests and principal payments of debt and have a claim against the company in case of bankruptcy. Shareholders, however, retain control of operational decisions (through the firm's managers) that affect the company's cash flows and corresponding risks. Creditors lend funds to companies, at rates that are based on business risk and existing assets, on its current capital structure and debt financing, as well as on the expectations regarding the change risk of these two variables.

Shareholders, acting through the managers, have an incentive to encourage the company to choose new projects that have a higher risk than had been anticipated by the company's creditors. The increased risk will lead to a higher required rate of return on the company's debt, which in turn will cause a fall in the value of outstanding bonds. If the investment project in risk capital is successful, all profits will go to the company's shareholders, as yields bondholders are secured behind low interest rate risk. If the project fails, the creditors are forced to participate in losses.

5. Resolving the problem of agency

5.1 Robert T. Kleiman's proposals

"*In the private sector, too many laws may adversely affect managers and distract them from their core mission which is to create value, while too few laws may allow him to slip and expropriate those who deserve a greater share of the value.*" (Thornton and Labelle, 2005).

From the moment the agency theory considers the firm as a legal fiction serving as a nexus to a set of contractual interindividual relations (Jensen and Meckling, 1976), we can understand it as an incentive system where the organizational structure must play a conciliatory role.

Robert T. Kleiman[2] suggests two polar positions to resolve the shareholder-manager agency conflict. On one side, company managers would be compensated entirely based on the result of changes in stock prices. In this case, the agency fees would be low because managers have big incentives to maximize shareholders' wealth. It would be extremely difficult, however, to hire talented managers under these contractual terms because business gains are affected by economic events beyond the control of management. On the other side, shareholders would monitor or control all the actions of managers, but it would be extremely costly and ineffective. The optimal solution is between the two extremes, where executive compensation is linked to performance, but some monitoring is also undertaken. In addition to monitoring, Kleinman believes that the following mechanisms could encourage managers to act in the interests of shareholders:

- Performance-based incentive plans based,
- Direct intervention by shareholders,
- The threat of dismissal, and
- The threat of a takeover bid.

Most listed companies are now using value stocks, which are shares granted to management based on their performance which is defined by financial measures such as earnings per share, return on assets, return on equity, and the changing stock prices. If the company's performance is above targets, business managers can earn more shares. However, if performance is below target, managers receive less than 100% of expected shares. The incentive plans based on compensation, such as performance shares, are designed to meet two objectives. First, they offer incentive frameworks that take measures that can enhance shareholders' wealth. Second, these plans help companies attract and retain management who have enough self-assurance to risk their financial future on their own abilities, which should lead to better performance.

[2] Paper available online : http://www.referenceforbusiness.com/encyclopedia/A-Ar/Agency-Theory.html

5.2 McGregor's X et Y theories

One way to solve agency problems would also be to confront **the X and Y theories** created by McGregor (1960) to define the best managerial style between hierarchical superiors and subordinates in an organization. Based on empirical observations, Douglas McGregor made these two theories for the attention of management.

It suggests that the way an organization is run is a direct reflection of its leaders' views on human nature and human behaviour.

The X theory is based on 3 hypotheses:

- The average person feels an innate aversion to work, effort, and does everything to avoid it.
- Because of the hypothesis 1, we must control, direct, coerce, threaten and punish.
- The average person prefers to be directed, shuns responsibilities, shows little ambition, and seeks safety first.

The consequence of the beliefs associated with the X theory is that traditional organizational principles revolve around the central concept of authority as, an indispensable means of control and influence to manage people.

The Y theory is somehow the inverse image of the X theory, and emphases on the concepts of participation, responsibility and motivation, taking into account societal changes. Theory Y is based on the assumption that the efficiency of the leader is largely based on its ability to create a climate allowing the enrichment and development of each individual working within the organization. As a counterpoint to the theory X, Y theory also postulates that:

- Physical and mental efforts are as natural to humans as rest or play.
- If the person feels involved in the objectives of his organization, the individual will voluntarily give the best of himself without need for control or sanction.
- The average person placed in the right conditions learns to seek responsibilities.

In the context of the theory X, priority is given to the organization's requirements. The reward imagined by management is supposed to satisfy individuals, whose personal goals are not always taken into account. It is incomprehensible and inconceivable that the individual refuses the prize or offer made to him. In contrast, theory Y is based on the recognition of the needs of both the organization and the individual, taking into account a need for balance, without which the organization may suffer.

McGregor assumes that individuals will align their contributions (self-management) and will exert self-control as soon as they make sense of the objectives assigned to them. Furthermore, individuals' self-achievement opportunities are often a prerequisite to create a high level of job satisfaction and productivity.

McGregor believes that the choice between X or Y is very often an unconscious process, since a team leader will often tend to pay more attention to his most engaged employees, who do not hesitate to invest themselves in their work. And those who are reluctant, or who complain will be considered and treated as lame ducks.

6. Limitations and challenges

The agency theory is a concept that is sometimes unsuited to social life. It assumes that actors are self-interested and indivisible; and that the market is in no way influenced by social relations. In addition, it assumes that behaviour is motivated solely by personal financial interests and that cooperation indicates a contract between the parties. However, the action of the manager, like all social actions, is rooted in the social structures in progress and is not entirely determined by economic incentives and information asymmetries. Thus, it seems unrealistic that the agency theory adopts a vision in which individuals and organizations are being primarily motivated by financial gain (Hirsch and al., 1990). We know from behavioural research that individuals are motivated by status, their community, their need for self-fulfillment, etc. Even if we accept the principle that individuals are rational, selfish and opportunistic, this does not undermine the role of non-monetary incentives such as prestigious awards as effective mechanisms for the reduction of agency problems.

The agency theory assumes that behaviours and consequences are relatively homogeneous and easily controlled, which is not true in the real world. In a complex network of dyadic relations for example, the simplicity of the dichotomous choice between the monitoring and the proposal of incentives to regulate the conduct or outcome is not effective. Also, to stay guarded against opportunistic behaviour can lead to stifled initiatives, creativity, entrepreneurship and innovation in companies, a cost that is often ignored by agency theorists (Davis and al. 1997).

Theories of power and conflict would likely favour the possibility that owners can control or provide incentives to orient the behaviour of the agent. Yet, conflict theories argue that workers can be co-opted and unconsciously work to serve the interests of the organization (Burawoy, 1979). A comparable reasoning can be extended to managers-owners relationships. Similarly, the objectives of managers and owners can be aligned, either because the manager is of the same caste or social class as the owner, or because managers have been socialized in their current positions because of their education and professional experience.

7. Conclusion

We can at least say that the agency theory has experienced a clear evolution from the first questioning of Adam Smith in 1776, with various changes of course that have changed and refocused its concept and content. Specifically, it has taken various orientations and connotations, evoking in turn and among others, the problems of separation of powers, the different perceptions of profit maximization, the concept of property rights, and the asymmetry of information, such as shown in the figure below, developed by Chong (2007).

Although it is far from being wrong, the agency theory lacks in his reasoning, which was valid for capitalism of the 70s, but that is now outdated by the evolution of contemporary practices of corporate governance. The extremely interesting theoretical responses to managerialism capitalism are not readily adaptable to mass capitalism. All good writers who are familiar of this theory have noticed it and provide references for further and deeper research that reflect the current realities (Charreaux, 2002). Current research highlights the diversity of interests in play (Donaldson and Preston, 1995; new theory) and of corporate social responsibility.

Today, theorists of the agency problems and relationships suggest various areas for further research on the subject, in particular on the basis of the following questions:

- How can we apply the agency theory to empirical contexts where owners and managers have different objectives but all have access to the same information?
- How would the agency theory apply to the community or cooperative labour market?
- How can companies encourage entrepreneurship, but not opportunistic behavior?
- How can the presence of senior executives in shareholding reduce the information asymmetry with management?
- How does the agency relationship, especially information asymmetry, appear in state-owned corporations?

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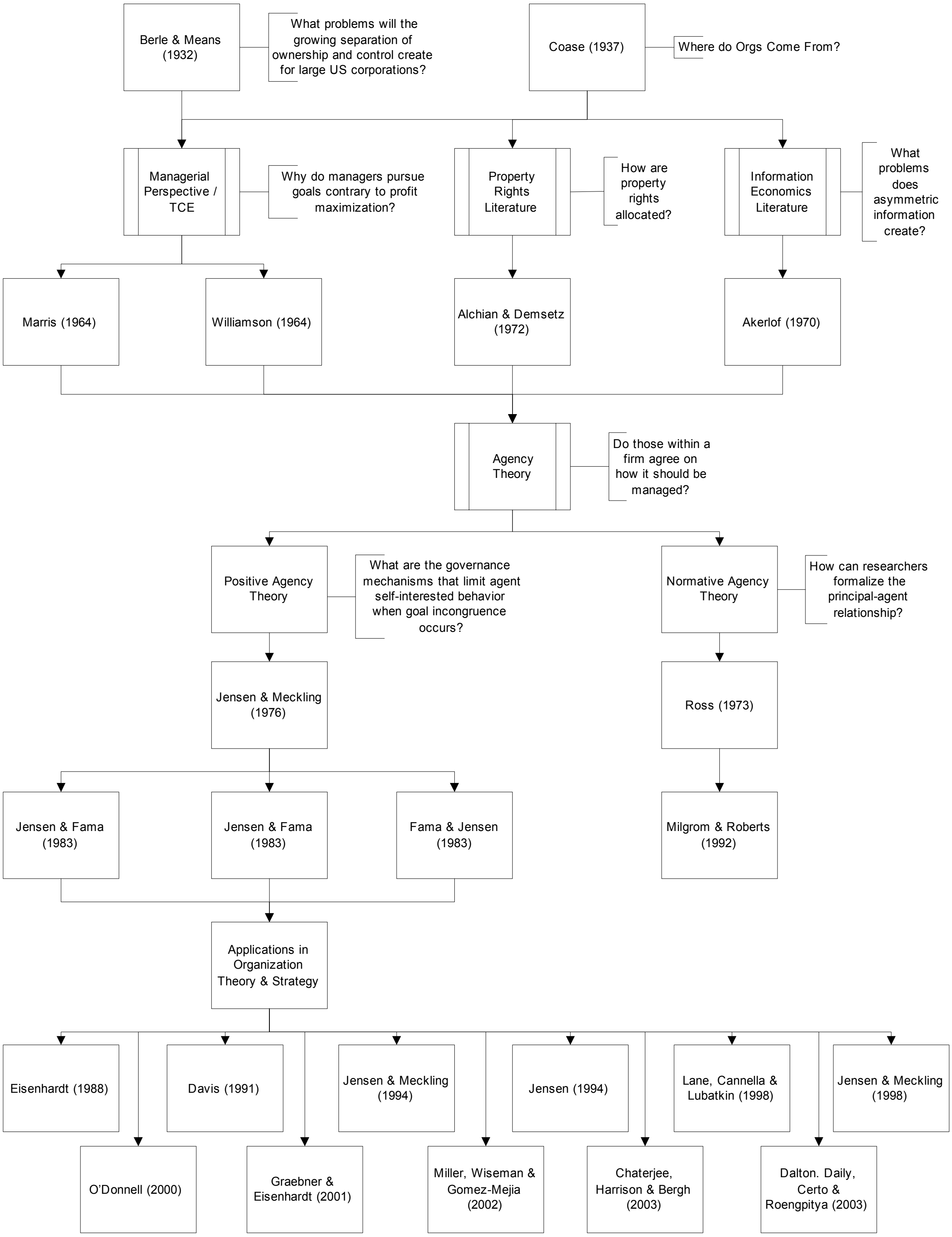

Figure 1. The Trend of agency theory
Source: Jan CHONG, *Organizational economics: Agency theory*