Agency theory versus stewardship theory accounting essay

Jensen and Meckling (1976) defined an agency correlation as a contractual set-up under which the business owner or the principal engaged a manager or the agent to execute some service on his behalf and may usually entail some decision making exclusively by the agent. The agency theory revolves on the basic proposition about humans, which deals with principals and agents as self-oriented focusing on exploiting their personal advantage (Corbetta and Salvato, 2004; Chua, Steier and Chrisman, 2006). Shleifer and Vishny (1986) explain the agency context in which the financiers needed the agent's specialization to obtain maximum returns from their funds, meanwhile the managers since they do not have enough capital on their own would utilize the finances of its principal. Agency theory described managers as opportunistic (Wasserman, 2006) by seizing its optimum advantage for his appointment and role as the mover in the firm for its own benefit, at the expense of the principal (Shulze, Lubatkin & Dino, 2003).

Both parties' goal is to gain that personal advantage in every way possible with the least outlay and expenditure. These expenditures are defined as agency costs (Jensen and Meckling, 1976). This is the total of cash outflows made by the principal for its organization be it in budget proportions, auditing, or employee honorariums; the expenses incurred by the agent for income generating projects and the marginal loss due to the decline in the expected income of the principal as caused by the resulted deviation of motives between the agent's resolution and the main goal of the principal to obtain maximum returns from its investments. Thus, high conflicting of interests between the principals and agents that resulted from information asymmetry is the main statement in an agency theory (Davis, Schoorman and Donaldson, 1997). Asymmetry of information between the two parties is displayed when the manager align his capabilities with the expected outcome, result and rationality of the principal (not knowing his own abilities) leads to satisfying decision-making on the part of the principal while this is an example of “ adverse selection” for the agent (Karra, Tracey and Phillips, 2006). More often than not, this leads to a number of non-satisfactory overall performances of the manager which will in due time lead to the destruction of the firm and the reputation of the agent (Jensen, 2004). As well as for the principals, their incapability of selecting candidates that acts appropriately in all circumstances are proofs of adverse selection. The outcome always entails an ambiguous job description on both parties. Nevertheless, there are still some factors that the agency theory fails to point out, other than motivational or self-gratitude. These maybe are the intrinsic inability or low ability, poor knowledge on business and misinformation of agents that resulted in their failure to deliver high performance for their principals (Davis, Schoorman and Donaldson, 1997).

Moral hazard as described by Chrisman, Chua and Litz (2004) is another agency problem confronted by the corporate governance. It’s another kind of opportunism which includes utilizing, seizing and assuming all extra benefits from a delegated authority to rule in behalf of the principal. Since it is difficult for the principal to monitor agents, this authority is undeniably has a chance of being abused or misused by the managers. This problem’s solution is to adapt a good monitoring system and internal self-governance by the principal which entails agency cost (Eisenhardt, 1989). As discussed by Berle and Means in 1932, a company does not behave based with the conventional model in which the agents must act in the best interest of the owners of the firm. Most likely as a consequence, the principal then would guarantee that the managers would act in their best interest. The idea of formulating a contract is relied upon by the agency theory to align the motives of both parties concerned. The goal is to balance the intention by allocating maximized values for shareholders and added incentives and benefits for the managers. Committee audits and performance evaluations by the board may act as effective authority tool for monitoring and scrutinizing potentially opportunistic agents (Mustakallio, Autio and Zahra, 2002). This internal governance system as a solution to ensure the compliance of the agents bounded by the contract will simultaneously be given to a non-executive sect who will be composed of auditors, supervisors and other structural arrangements. This non-executive part of the ownership structure serves as the middle man interconnecting the principal and the agent having a role in monitoring, thereby extending an enormous effect in the change or variation in control (Denis, 2001). In relation to corporate governance, legitimate actions against deceits and other modes of fraudulence may provide some fortification on the part of the principal. Economic analysis suggests that incorporating these solutions to the firm may considerably eliminate opportunism. But there are still factors that need to be considered in this special structure of the firm that is created for internal governance of which other forms of opportunism may arose in those entrusted with responsibility to check on the managers of the firm.

The study made by Yermack in 1999 suggests that the board particularly its composition as an authority to monitor managers has an effect on the governance mechanism. The study on the effect of small board of directors in a company got the significant result that there is a positive correlation of this small size to greater market valuation of a company. Meanwhile, Hannifa and Hudaib (2006) stands with the result of Yermack showing results based on more than 300 companies listed in Malaysia which proposed that a large board is less efficient in auditing the performance of the managers compared to a smaller one. Moreover, this huge composition of the board is quite expensive for the companies to maintain in terms of honorariums, commissions and compensation. But in terms of profit and company growth, the large board may seem to be of importance because of the diversity in experiences, knowledge and accountability. Nevertheless, the study made by Guest in 2009, showed a strong result on the non-relation of the large board size to the firm performance however they also robustly imply that they don't suggest to restrict large boards to obtain a better firm performance.

All these efforts executed by principals to avoid agency problems, minding the fact that there are still managers that won't deliver exactly what they're expected to, entails agency costs as discussed. Often, the goal of the principal is to minimize agency costs and focus on profit even if not in growth. Here comes the conflict of organizing the principal-agent relationship (Shapiro, 2005) wherein the idea is exemplified but the measures are often inadequate, thus the alignment of the interests of the principal and manager is hardly ever absolute.

A control-oriented firm is then considered necessary under agency theory which suggests that agents will not act to take full advantage of the returns to the principal if and only if systematic self-governance mechanisms are implemented in the firm to protect the shareholder's interest (Jensen and Meckling, 1976).

Stewardship theory

In 1993, Block believes that firms implementing stewardship by front-running service instead of self-interest are those that are most effective in corporate governance. He believes that both the firm and individual needs will be greatly achieved by establishing trust-relationships and treating subordinates as partners. Preston (1998) added a definition of Stewardship Theory to exemplify humane duties owed to all partners that recognizes the importance of a systematic fit of corporate governance considering the elements of its environment. Hosmer in 1996 identifies the need to augment the economic and social responsibilities in governance by recognizing the moral and ethical issues inherent in the stewardship theory. The manager's role in stewardship theory is to maximize the potential of the firm and to pursue long-term wealth acquisition with organizational and individual desires best accomplished by assessing collective ends (Hosmer, 1996). The goal is on assuming accountability and responsibility for the organizational community. The model of a manager should be as a steward whose behavior is ordered and organizational; whose collectivistic behavior is of higher reverence than individualistic, self-serving conduct (Albanese, et al 1997). They exemplify that man being intelligent makes rational, not irrational decisions, unlike agency proposers who dispute stewardship. Stewardship theory view employees as assets of the firm as the agency did but they differ in their treatment of the human nature's motivation and ability of control. A true steward is driven by his need of self-actualization, growth and achievement without being opportunistic and self-interested in his performance (Mejia et al., 2001).

Stewardship ideology proposes that corporate governance structures should exercise advanced authority and prudence. (Davis et al, 1997) . The proponents discussed that high-level of authority and discretion is attained when the Chief Executive Officer (CEO) also assume the position of Chairman of the Board. Stewardship principle argues that the issue is whether or not the ownership structure assists and facilitates in the management achievement of high corporate and firm performance. When the CEO is also the chairman of the board, the organization will be facilitative of this objective letting them assume apparent, clear and objective role expectations and authorize and empower higher and greater management. Thus, stewardship theory is not centralized on self-motivation through own financial gain, but the assumption of two roles as the chairman, at the same time as the manager of the corporation will produce superior results and maximized returns to the shareholders than separation of the roles of the chair and CEO as exemplified by the agency theory. Duality of these roles is considered a functional from in stewardship perspective. According to Fama (1980), being an effective steward of their firm, CEO's and managers are also effectively managing their own assets and careers.

Stewardship, however, has its own set of limitations and gaps. Since it is trust-based relationships, it assumes underlying informal agreements and not most of the time, the functional logic or précised obligations (Mejia et al., 2001). Some authors (Habbershon, 2006; Miller and Miller, 2005) argue that altruism mainly a compliment of stewardship might be influential in establishing an enormous network for the firm in its early stages, as employing a wide network of trustees or of relatives in cases of a family corporation (less concerned on their specifications) minimizing agency costs compared to a non-family member (Mejia et al., 2001). However, in the long run as the firm becomes more established, the need for well adept and professional managers arise to cope up with the competition thereby expect an increase in the agency costs.

In essence, the organization's over all environment systems influence the inclination of managers. In an organization which houses the philosophy for self-actualization and involve employee-owners association, managers are inclined towards the stewardship perspective. Furthermore, collectivist behavior and non-power distance cultures encourages stewardship principles (Davis, Schoorman and Donaldson, 1997).

Agency Theory vs. Stewardship Theory

Agency theory concentrates primarily on the association between the principal and the agents in corporations, having a formal and contractual nature of relationship however with the presumed goal indifference and incongruence of interest (Sharma, 1997). Meanwhile, Stewardship theory is involved mainly in analyzing the importance of the co-existence of trust-based relationships along with agency relations in firms (Corbetta and Salvato, 2004). The stewardship approach, which encompasses commitment and trust to shared goals and desires exhibited by the principal and the manager alike, aligns the interest of the two parties (Albanese, Dacin and Harris, 1997).

In 1997 Davis, Shoorman and Donaldson provided two key points that differentiated the Agency and Stewardship theories. These are the motivation and power comparison. In an agency type, the manager is motivated by personal interests and extrinsic rewards. In the stewardship, the manager is motivated by the human need for intellectual growth, achievement, and self-actualization, and by intrinsic rewards. In an agency theory, the power is institutionally directed while in the stewardship, it is based on personal ability and power to run the particular organization.

Davis, et al (1997) argue that the two theories are not mutually exclusive but create a link between agency and stewardship relationships. Clearly, the stewardship theory provided a room for the failures and gaps in the agency theory. A manager of a firm may choose what type of inclination he is up to particularly in decision making as long as these three assumptions are supplemented. First the decision must be mutually agreed upon by both the principal and the agent. Secondly, it will always depend on the situation, and third objective is the expectations of the parties involved. Basing on the result of their study of 2×2 matrices on the possibilities of the actuations of the principal and agent, the agent can either opt to perform in an agency or in a steward fashion, and so can the principal. There can be four possibilities of outcome in the governance using the link between agency and stewardship and depending on the choice of the concerned parties. Two of which are a concrete example of the agency theory where both have selected to uplift their self-interests and a true stewardship principle which maximize organizational performance. Other two possibilities of outcome which will result in one party taking advantage over the other and one recourse to injustice will result to low performance on the other party. When the principal acts as the steward and the manager acts as an agent, and on the other hand when the principal becomes opportunistic and the manager acts as a steward, which could pave the way for the frustration and declined feelings of self-worth to the aggravated party. The study on the relationship of these theories is very broad, thereby some wouldn't agree to the findings of Davis. According to Albanese, Dacin, and Harris (1997) there is a distinction between agency theory and the agency problem of divided self interest. They discussed that stewardship simply refined and advanced agency theory, it does not present an alternative. Eisenhardt's (1989) review shows that agency theory was continually developed and is studied thoroughly with the incongruent self-interests of the principal-agent as the fundamental supposition.

Summary

The agency model and stewardship model of the firm provide two different angles for understanding the governance of a firm, its decision making, its internal relationships, and its external relationships. This review advocates that the principal or manager acting as a steward, and employing people with similar expectations, is more in line with the traits needed for an organization to succeed like proper motivation, personal and company growth and self-actualization, thus increasing the potential for maximizing the performance of the firm. Moreover, the advantage of the stewardship model over that of the agency is that it presents managers an organized different array of motivations which could potentially include the interests of all relevant firm movers (Preston 1998).