

# The criticisms on agency theory and its application finance essay



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## **Introduction**

Issues on corporate governance, business ethics, decision making and risk-taking are the normal issues being faced by all types of corporations, both old and new. One of the main assumptions why such issues are often encountered by majority of companies and institutions can be attributed to the conflict of interests and the misalignment of corporate goals among those in the managerial position and the common shareholders.

According to Moldoveanu, M & Martin, R. (2001), in many cases, the application of right managerial decisions, which are considered the lifeblood of any organization, are not being practiced and applied therefore causing inefficiencies on the part of the company and its people. There is always a separation in terms of control and ownership in all corporations. However, this separation is what almost always causes conflict and is most often the root cause of all other problems and issues in the organization. Ideally, the design or framework of a corporation is well-defined in a way that control and ownership of the company's assets are clearly identified and distinguished among the people within the organization.

In a usual company setting, control over a corporation's assets is delegated to the people assigned in the managerial posts while the ownership of company assets is being handed over to the company's shareholders. Therefore, both the managers and shareholders within the organization are responsible and accountable for each of their deliverables and assigned functions (Moldoveanu, M & Martin, R., 2001).

Given that both the shareholders and managers perform very specific and highly-critical functions in an organization, it is but natural for the two to develop a specific kind of relationship. The development of this kind of relationship is indeed critical for the success of the corporation.

Nevertheless, out of this manager-shareholder relationship also stems the many issues and problems which often result or cause negative impact on the corporation's assets.

This special kind of relationship that exists between the shareholders and the managers is called an "agency relationship". In a typical corporate set-up, managers are given the right to control and manage the assets of the company which are owned by the shareholders. The function of the managers is therefore highly significant as their decisions and moves may potentially cause a positive or a negative impact on the company and its total assets (Economy Professor, 2004).

However, failures on the part of the managers are quite common given the structure and framework of most corporations which interfere with the proper decision making and task-delegations of most people on the managerial posts. According to Moldoveanu, M & Martin, R. (2001), two of the most common failures of professional managers nowadays are a.) failures due to honest miscalculations and errors which are beyond the manager's control and b.) failures related to a manager's integrity and selfish motives. These kinds of managerial control failures are what cause extreme damage on the company's valuable assets.

Hence, in order to safeguard the company from these potential threats and damages often caused by managerial failures, the shareholders find a less-riskier way of protecting company assets which are usually facilitated by a shareholder via a “reward & punishment” method. The purpose of the “rewards & punishment” method is to provide incentives for every properly executed managerial output. Other methods are also employed and utilized by the shareholders which are intended to protect the company assets such as the monitoring, assessing and checking on the decisions of the manager. Aside from incentives, sanctions are also given to the managers in order to align their interests and decisions based on that of the shareholders (Moldoveanu, M & Martin, R., 2001).

As in the case of any corporation, this manager-shareholder relationship exists and is most commonly referred to as the “agency relationship”. This paper on “The Criticisms on Agency Theory and its Application on Corporate Governance” is aimed at providing a detailed discussion of the agency theory, its history and basic concept, how it is currently being applied and manifested in many modern corporations nowadays and how this theory concept has been abused and improperly utilized by many corporations nowadays.

A specific focus will also be allotted on the various criticisms on this particular theory and why its focus on merely two stakeholders: the managers and shareholders, is highly criticized by many people, specifically, other stakeholders involved in the organization. Moreover, this paper will answer how this criticism was justified and how in a way, the agency theory negatively affects proper corporate governance.

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To be more specific, this paper on “ The Criticisms on Agency Theory and its Application on Corporate Governance” aims to answer the following questions:

What is the agency theory?

How did the agency theory begin and evolve?

What is the role of the agency theory in corporate governance?

What are benefits and advantages of adopting the agency theory in a corporation?

What are the threats and disadvantages of adopting the agency theory in a corporation?

Why is the agency theory being criticized with its focus on merely two stakeholders: the managers (agents) and shareholders (principal)?

How does the agency theory’s focus on merely two stakeholders: the managers (agents) and shareholders (principal) negatively affect corporate governance?

How does this criticism affect other stakeholders within an organization, apart from the managers and the shareholders?

## **A. Agency Theory: The Concept and its Beginnings**

According to the Economy Professor (2004), the agency theory originated in the year 1970s. This theory basically refers to the relationships that exist between the so-called “ owners of corporate assets” and the so-called “

controllers of corporate assets". In simple terms, the agency relationship refers to the corporate relationship that exists between the shareholders and the managers within an organization.

The agency theory also pertains to the firm's view on its network of people resources. This theory states that a special kind of corporate relationship is formed when one person or a group of persons (known as the "shareholders") decide to hire an individual or a group of individuals (known as the "managers") to provide some service or work for them. Moreover, the agency relationship also occurs when the "shareholders" assign or delegate some decision-making tasks to the "managers" (Economy Professor, 2004).

But aside from the shareholder-manager relationship, other forms of agency relationship may also exist in a corporation like for instance, the stockholder-debtholder relationship. Generally however, agency relationships are mostly used to refer to the shareholder-manager relationship. In many textbooks and journals, the agency theory is also being referred to as the "principal-agent theory" simply because it is a type of relationship that involves a "principal" or a shareholder and an "agent" or a manager (Economy Professor, 2004).

Moldoveanu, M & Martin, R. (2001) further defined clearly what occurs in an agency relationship. They stated that in an agency relationship, the shareholder or the "principal" is the one who hires and accepts the services of a manager or the "agent" based mainly on the latter's capabilities, professional competencies, decision-making ability and knowledge.

Normally, the principal hires the agent because the former believes in the capabilities of the latter to increase and safeguard the assets of the company. Since the principal or the shareholder is the owner of those company assets, he or she will not hire an agent or manager who is not capable of increasing or protecting the assets of the company. Once the principal hires the agent to be in-charge of the company assets, the principal must automatically transfer his or her decision rights to that asset over to the agent (Moldoveanu, M & Martin, R., 2001).

The transferring of decision rights from the principal to the agent is vital in order for the latter to take full accountability, control and management over that asset. If there was no transferring of decision rights over to the hired agents, issues and problems stem from it which cause a negative impact not only on the relationship between these two stakeholders but also on the agent's capacity to deliver the expectations of the principal (Donaldson, L. & Davis, J., 1991).

According to Lupia, A. (2001), the delegation of decision rights and power from the principal to the agent is highly important for an agency relationship to work. In the concept of the agency theory, the principal is known to be the person who performs the delegation process. The principal is the one who passes over the authority over the assets, specifically the power and authority to decide, to another person. The agent on the other hand is the one who acts as the recipient of the authority and power being delegated by the principal.

When the full transferring or delegation of rights and authority is already transferred to the agent, then the agent already has the full accountability over the company assets. The agent is then subjected to either a sanction or an incentive depending on his management over the assets. According to Donaldson, L. & Davis, J. (1991), various types of schemes are usually devised by the principals in order to prevent huge corporate losses due to managerial failures or the agent's failure to deliver the shareholder's goals and interests.

Some of these schemes include financial rewards through the form of benefits and compensations which would greatly motivate the agents to achieve their company goals and align themselves with the interests of the shareholders. This has been an effective corporate strategy which proved to motivate agents to perform their managerial roles better (Donaldson, L. & Davis, J., 1991).

## **B. The Role of the Agency Theory in Corporate Governance**

According to Donaldson, L. & Davis, J. (1991), the role of the agency theory in the modern corporations of today is quite important. Essentially, the concept of agency theory is both "stewardship" and "shared ownership".

Donaldson, L. & Davis, J. (1991), states that the concept of shared ownership in the agency theory is what pushes and drives the managerial executives (agents) to perform beyond the top management's expectations. The idea that the professional managers are "co-owners" of the company's most valued assets is what drives them to perform better their management functions. Aside from their liability and accountability over the company



assets, the idea that these managerial executives are “ co-owners” themselves of the company assets is what makes them more concerned and involved in the nitty-gritty of the corporate process and their own functions. This therefore maximizes the shareholder returns which benefit all stakeholders within the corporation.

Moreover, the agency theory encompasses the concept of stewardship. The agents or the professional managers act as the “ stewards” of the company and its assets. Their decisions and their ability to successfully deal with various corporate issues and concerns as well as their ability to increase the value of corporate assets is what makes the managers “ good stewards” of the business or the company (Donaldson, L. & Davis, J., 1991).

The capacity therefore of the agency theory to maximize shareholder returns by simply motivating the managers or the “ agents” to perform their management functions better is what makes this theory quite useful in corporate governance. Moreover, the role of the agency theory in corporate governance involves a number of important elements which facilitate the effective governance and management of a corporation. One of which is exercise and practice of the decision rights.

According to Moldoveanu, M & Martin, R. (2001), the agency theory is what strengthens and allows for the proper exercise of the decision rights of the principals over the company assets. Since technically, the principals are the owners of the assets and they are the ones assigned at delegating the power and decision-making authority over to the agents, their rights must still be protected. This decision right comes in three types: a.) the principal’s right to

create, initiate and implement a specific decision and b.) the principal's right to authorize or give consent and approval to a specific decision and c.) the principal's right to punish or reward an agent based on the results or outcome of a specific decision the latter has made.

On the other hand, the agency theory also puts emphasis on the managerial rights that should be utilized and exercised by the agents. These management-decision rights include: a.) the agent's decision right to propose, initiate or suggest a specific course of action or decision and b.) the agent's decision right to counter, resist or veto a specific course of action or decision (Moldoveanu, M & Martin, R., 2001).

The agency theory also acts as the initiator and motivator of the punishments and rewards system in an organization. The agency theory states that the concept of incentive (rewards) and sanctions (punishments) is possibly the best form of motivation among all stakeholders, not merely the managers or the agents.

Moldoveanu, M & Martin, R. (2001) states that managerial incentives usually come in two types: a.) incentives for observable and obvious efforts exerted by the agent or the manager which usually come in the form of monetary or financial rewards such as bonuses, stock grants or salary increases and b.) incentives for observable and obvious efforts exerted by the agent or the manager which usually come in the form of non-monetary rewards, acknowledgement and other privileges.

Given all these functions, the agency theory indeed performs a significant role in any organization in terms of safeguarding and increasing the

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company's most valued assets as well as motivating its stakeholders, specifically its agents or managers to go perform beyond top management's expectations given that their roles, functions and rights are clearly identified by the agency theory.

### **C. The Benefits and Advantages of Adopting the Agency Theory**

One clear benefit of adopting and utilizing the agency theory within an organization is its ability to maximize the potentials and use of a particular agent. While the agents are clearly motivated to perform or even go beyond their managerial roles, the ultimate benefit is still being experienced by the shareholders as it is their assets which are being maximized. Although oftentimes, when the shareholders' return on investment is quite high, all stakeholders also benefit out of it in the form of great financial rewards such as salary increases and bonuses (Sanchez, A. V., n. d.).

The increase in shareholder returns and the value of the company's assets is one clear benefit and aim that the agency theory brings in to any corporation that is why its utilization is still very much applicable in the set up of modern corporations. In simple terms, the agents and the principals as well as other stakeholders within the organization directly benefit out of this company financial gain (Sanchez, A. V., n. d.).

Another benefit in the adoption of the agency theory in corporations is the maximum utilization of the agency cost or the cost incurred by the shareholder by hiring the agent or the manager. Given that typically, an agent performs quite a number of critical roles including the important

function of decision-making, the cost incurred by the company in hiring the agent is therefore justified by the amount of work or services accomplished by the agent for the company. This clearly benefits the shareholders as their agency costs can also be considered an investment for the further growth of company assets (Sanchez, A. V., n. d.).

On the part of the agents, the application of the agency theory is also beneficial as it offers the application of the concept of maximum utility. The concept of maximum utility denotes a maximization of their potentials and skills which they have provided the company. In a way the end benefit is still clearly leaning towards the company. Nevertheless, the maximization of the manager's skills and potentials also directly benefits him or her as an agent (Sanchez, A. V., n. d.).

## **D. The Threats and Disadvantages of Adopting the Agency Theory**

According to Mallin (2007), the agency theory can possibly result into a number of threats or disadvantages in an organization. One of these disadvantages is the "opportunistic view" of the managers or the agents in the corporation. For instance, there were many instances when the agents (managers) took advantage of their power and used it for their own selfish interests. Apparently, some agents do not act in accordance to the interests and goals of the shareholders. Most of the time, the agents are tempted to use their power and decision-making advantages to pursue their own selfish interests and not act in behalf of the principals or shareholders of the company.

Moreover, the agents may have a totally different view of what their roles or functions are supposed to be which may be far from what was defined by the shareholders. For instance, some agents or managers may avoid risk-taking which the shareholders consider essential in order to effectively increase the value of a corporate asset. Also, agents or managers have the tendency to avoid making decisions, especially those decisions which are entirely needed to properly govern the corporation. When this happens, the clash between these two stakeholders begin which is another disadvantage brought about by the agency theory (Mallin, 2007).

Information asymmetry is also a common problem in the application of the agency theory. This happens when the amount or load of information accessed and received by the agent varies from that of the shareholder. When this happens, it results into an unbalanced amount of corporate knowledge or information between the two which may put either of them at a disadvantage. Also, the gaps in corporate knowledge or information may cause confusion or misunderstanding between these two important stakeholders. As a result of this, conflicts arise between the managers and the shareholders which hinder both of them from performing their distinct functions in a corporation (Mallin, 2007).

### **The Criticisms on the Agency Theory: Why this theory focuses on merely two stakeholders: the managers (agents) and shareholders (principal)**

The agency theory, coined and popularized in the 1970s, has long been an existing concept and theory that people in the past centuries have been

thinking of adopting. It was however only in the 70s that this concept was already adopted by many companies around the world.

The popularity of the application and use of the agency theory only commenced when corporate governance became a more difficult and complicated task to do. When the corporations began to expand, more and more clients and employees became part of both the external and internal stakeholders of the company. An implication of this was the tasks became more difficult to manage that the owners of the corporation needed additional people to offer special work or services for them. This then resulted to the birth of the demand on hiring “agents” (Mallin, 2007).

These agents, according to Mallin (2007), were recruited and hired based on their professional competencies, skills, talents and the ability to make decisions. The owners or the shareholders (principals) are the ones directly hiring these agents to offer special services them that would further grow or benefit the corporation.

Moreover, Mallin (2007) asserted that the complications brought about by the increase in demand of the services offered by a corporation and an upsurge in the number of its clients, brought about the need to separate control and ownership in a corporation.

Most of the time, shareholders or owners of a company are too busy to perform and attend to the important details in a corporation’s daily operations. The amount of work and responsibility that these owners need to perform are way too much that they need to add more employees to handle them. This therefore resulted into a separation of control and ownership in <https://assignbuster.com/the-criticisms-on-agency-theory-and-its-application-finance-essay/>

the company, with the shareholders performing the ownership function while the managers performing the control function.

According to Mallin (2007), when the shareholders or principals start performing the ownership function, that's when they begin to make the agents and other stakeholders in the company more accountable and responsible in their tasks and functions. The command and directives come straight from them which would then have to be managed by those under them. When this happens, the shareholders would have a direct control over the business or the corporation just as owners should have. Accountability increases over the shareholders' capacity to function as owners of the corporation and its most valuable assets.

On the other hand, direct control over the corporation's daily operations is exercised by the professional managers assigned by the shareholders. Full control and accountability rests on these individuals which make their functions highly critical in a corporation. These professional managers are concerned with the nitty-gritty of the daily affairs of the corporation as well as the handling of the people under them. Also, they are in charge of increasing the value of a corporate asset which puts more pressure on the functions that they perform in the corporation (Mallin, 2007).

Hence, the focus of the agency theory is basically to put emphasis on the importance of the functions that both the principals (shareholders) and the agents (managers) perform or play in the success of corporate governance. This explains the main reason why most corporations nowadays exercise or apply the agency theory in their business framework. Also, the corporations

found it to be very significant to maintain the healthy relationship between the principals and the agents as it is only then can they manage the various issues that corporations normally face.

Moreover the distinct advantages of applying the agency theory are tremendous, such as the maximum utilization of the company's agents and the increase of the company's most valued assets, that it led many corporations to apply the agency theory's principles in their businesses.

Nevertheless, Mallin (2007) argues that one of the most popular criticism against the agency theory is its focus on merely two stakeholders: the agents and the principals. According to corporate analysts, it is not healthy for a corporation to focus on merely two stakeholders and neglect all the other stakeholders that also play key roles in the organization.

In the long history of corporate governance, it has been proven to be true that the agency theory's focus on the principal-agent relationship has caused many threats and disadvantages as well to the organization. For one, these two stakeholders cannot properly operate or function without the presence of other key constituents or stakeholders within the organization. Other key stakeholders such as the manager's subordinates, suppliers and the investors also perform highly significant functions in the corporation which cannot be ignored or neglected.

The seemingly "unfair" and "unbalanced" focus of the agency theory on only two stakeholders have been for a long time resulting into negative impacts in the organization which was justified through the perception of other stakeholders on the "unequal distribution of power in the

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organization". The unequal distribution of power and privileges within the organization, mostly focused on only the principals and the agents, is what makes other key stakeholders feel deprived and unimportant in the corporation (Eisenhardt, K., 1989)

When this happens, these other stakeholders like for instance the investors and suppliers may be tempted to take away their loyalty on the corporation and move to its competitor. This then places the corporation into a threatening situation as its key stakeholders know much confidential information about the company.

## **F. The Stakeholder Theory versus the Agency Theory**

The many issues confronted by many corporations through the utilization and application of the agency theory in their corporate governance resulted into many negative impacts on the part of other stakeholders involved in the corporation.

For one, these stakeholders namely the employees, investors, suppliers, communities, subsidiaries, the media and the government and other internal and external constituents that the corporation usually deals with, are not given sufficient attention and privileges compared to the shareholders and the managers. This is because in the agency theory, the focus is merely on the shareholder-manager relationship or the principal-agent relationship and not so much on other stakeholders.

In order to avoid these kinds of issues on the part of other stakeholders, another theory was created which was the stakeholder theory. In essence, the stakeholder theory states the importance of addressing the needs and <https://assignbuster.com/the-criticisms-on-agency-theory-and-its-application-finance-essay/>

emphasizing the functions and roles of other relevant key stakeholders in the organization in order to effectively govern the corporation (Donaldson, T. & Preston, L., 1995).

Moreover, the stakeholder theory presents the first step to divert the attention from merely two stakeholders: the shareholders and managers, to other stakeholders such as the investors, suppliers, communities, media, political associations and the general public at large whom the corporation directly affects or influences (Donaldson, T. & Preston, L., 1995).

The stakeholder theory also gave a strong emphasis on the importance of identifying the corporation's internal and external stakeholders. This is because any corporation would not be able to stand in itself and operate by itself without the aid of other key stakeholders which the corporation serves or which help the corporation achieve its organizational goals. In other instances, even the competitors can also be considered part of the organization's stakeholders (Donaldson, T. & Preston, L., 1995).

The usefulness of the stakeholder theory compared to the agency theory is that the former has a clearer, wider view and concern with other people outside of the managers and the shareholders. The stakeholder theory puts more emphasis on their importance as a corporate entity and in a way helps the corporation properly position itself as well, especially in the community where it operates (Donaldson, T. & Preston, L., 1995).

The stakeholder theory states that by identifying the internal and external stakeholders of a corporation, the interests of the corporation would be balanced among the interests of the other key stakeholders. The corporation  
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therefore would not appear “ selfish” or “ apathetic” to the community and the general public at large because its organizational goals and principles are hinged from the best interests and common good of all its stakeholders, not just the managers and the shareholders.

The stakeholder theory also paints a “ good view” of the corporation to other stakeholders as it appears “ concerned” and “ ready to serve” the general public at large. Also, the application of the stakeholder theory implies that the corporation acknowledges that its decisions have either a positive or negative impact on the stakeholders in general. This makes the stakeholders therefore feel important being part of the corporation as its concerned and needs are acknowledged by the corporation where they belong compared to the agency theory which only highlights the contributions and roles of merely two stakeholders: the managers and shareholders. (Donaldson, T. & Preston, L., 1995).

## **Conclusion**

The agency theory in corporations is a useful and widely-used theory that has in itself a lot of distinct advantages and disadvantages to the corporation. Its focus on the important functions of the principals (shareholders) and the agents (managers) is what led to its popular application in corporate governance.

For many decades, the use of the agency theory has benefitted many corporations as it aimed to strengthen the relationship between the principals and the agents whose main functions are considered the lifeblood of the corporation. Also, the agency theory’s emphasis on the maximum

utilization of the agents resulted into tremendous increases in the value of the corporation's assets and the corporations' maximization of the agency costs they incurred out of hiring the services of these agents or professional managers.

Nevertheless, while the agency theory application resulted into many benefits and advantages, it also brought it certain negative impact and disadvantages in the corporations. For one, it resulted into conflicting interests between the managers and the shareholders. The shareholders often seem to have a hard time influencing the managers with their own organizational goals, while the latter focuses on pursuing his or her own selfish interests in the organization. Second, the lack of focus of the corporation on other relevant stakeholders brought forth more disadvantages in the organization as the other stakeholders felt unimportant and neglected in the corporation.

This issue has therefore given birth to another theory called the stakeholder theory which balances out the "unbalanced" treatment and view of the agency theory on the other relevant stakeholders in the company by stating the important roles and functions of other key stakeholders which the corporation directly influences and affects as well.