

# Agency theory and corporate governance research paper

[Business](#), [Company](#)



# **AGENCY THEORY AND CORPORATE GOVERNANCE**

## **Introduction**

Agency theory by definition is a theory that focuses on the interaction and relationship between a shareholder in a company and the company's manager. In every particular company, all stakeholders interact on different levels depending with the reason for their interaction, and this theory seeks to find a central point to solve conflicts between these two principals; the stakeholder and the company manager. Principle-agent scenarios are usually found in employer-employee relationships basically brought about by two reasons. The first reason is when there is a communication misunderstanding between the two principles; the stakeholder and the company manager(s). Prolonged communication misunderstandings always lead to conflict and this is where agency theory comes in, to settle the conflict. The second conflict that agency theory tries to address is the missions and goals' conflict and this is when the two principals differ in opinions. Every company has goals and objectives it tries it achieve, and any conflicts in these goals threatens the company's activities to come to a standstill<sup>1</sup>.

On the other hand, corporate governance is a cluster of rules, traditions and policies that influence affect and determine how a company will be managed and administered. It is a discipline that enables a relationship between the various stakeholders of the company to achieve their set goals and objectives.

Around the world, many states use different models of corporate governance, depending with the kind of society that the state is based. For example, many states across the globe are capitalists, unlike in the early 20th century whereby most of them were socialists, for example the former Soviet Union and Germany. These different approaches of administration lead to different forms of corporate administration, both in the Governments and the companies in these states. The agency theory and corporate governance always go hand in hand in an attempt to solve the agency problem<sup>2</sup>.

Corporate governance puts an emphasis on the stakeholders' accountability in all their activities, and ways to manage and reduce the principle-agent theory, usually addressed by the agency theory, and that is where the agency theory and corporate governance relate.

## **CRITIQUE AND ANALYSIS**

Corporate governance and agency theory are two different elements that have been defined in many different ways by different scholars. With most of agency problems being blamed on lack of witty governance which led to many societies demanding for better corporate governance, the end of the 20th century led to re-birth of new corporate governance which unlike the early 20th century, has taken a new twist in administration of policies both in Governments and companies across the world<sup>3</sup>.

Of these, the most popular emerging trend is the Anglo-American Model. Having been applied in many companies for the past 20 years, the Anglo-American model is one where leaders and managers in the given company

act and make decisions in accordance to their own vested interest. Their own will therefore comes first and that of the company second. This model therefore describes these leaders as opportunistic and self-centered. This eventually leads to an agency problem because the outcome is only favorable to the managers who use the employees to achieve their own personal success, and this consequently leads to dissatisfaction of the employees and other disadvantaged stakeholders to the company<sup>4</sup>. This model is especially common and easily applicable in capitalist states whereby there is no clearly defined corporate governance systems put in place. These states are characterized by free economies and free markets that create an unequal relationship in classes. Many people fall in the lower class levels in the society while the remaining few form the elite society. In communist/ socialist communities however, adoption of the Anglo-American model is difficult because so many checks have been placed in the corporate governance strategies whereby every stakeholder in the company is responsible and held accountable of his own area of specialty.

Agency theory has at its best addressed the issue by trying to put up corrective measures to the agency problem. Lack of proper and efficient communication backed up by lack of mutual agreement between board members and stakeholders in such companies have led to agency problems, which have been associated and blamed on the Chief Executive Officers and other top management leaders at the companies. Consequently, there is development of untrustworthy in the company. Lack of trust between stakeholders to a company and its managers/workers is lethal because without full trust, very little if any of the set goals and objectives will be

met5. When the issue of trust is swayed, there is the demand for top management teams' powers to be divided. This will ensure that not one opportunistic leader has too much power to use it for the benefit of himself. Organizations perform at their best when there is mutual trust by the stakeholders to the management team, the CEO's and all other stakeholders regardless of the positions they hold in the company.

The second view and perspective of agency theory and perspective maintains that future predictions can be determined from past behavior. This second theory unlike the Anglo-American settings' approach, maintains that top management leaders and CEOs are held accountable for all the outcomes and that result from their decisions and also have the responsibility to make the right decisions affecting the company, and their use of corporate resources. This model believes in transparency and has been applied particularly in the Middle and Far East countries such as Japan and The United Soviet union. This system of applying non-Anglo-American settings in working and corporate environments is also highly favored among the socialist and developing countries.

The system however has lower returns because low investments have been injected into the market as the corporate believes in low-risk investments. They are characterized by short-term contracts and these contracts can as well be revoked any time because this system of corporate governance believes in using and applying the most low-risking budgets possible. There is a more social and relaxed forms of administration and for this reason, these corporate institutions apply the Social Network theory. This theory focuses a lot on working and employing its workers through contracts.

Besides the theory's argument that people working in contracts will be more productive since they work towards finishing their job in the shortest possible time, it also observes that working under contract provides long term stability to the relationship between the corporate institution's stakeholders and the company's working team. This theory also ensures that there are lower risk levels especially in investments and the operating capital<sup>6</sup>.

Secondly, the Anglo-American model in this theory of corporate governance in these companies is different. For example, In terms of work and finances, Anglo-American model is based much on the contracts between the providers of finances such as banks and also human labor providers such as the human resource desk. These two departments are not permanent components of the company and are hired only once required. This therefore operates on the basis of outsourcing of labor. Before settling on the best service provider to outsource with, this model is characterized by a lot of bargaining before a concrete contract is signed<sup>7</sup>.

Anglo-American corporate governance therefore concentrates on narrowing down the differences between the stakeholders and the management in that particular institution. The board of directors and all other top management leaders are therefore expected to represent the needs and interests of the institution's stakeholders. This therefore calls for fairness in all the decisions they make concerning the company, and must therefore not be self-centered.

## CRITIQUE

As much as it calls for a good relationship between the management desk and the institution's stakeholders, the Agency theory is not fully fair because the management desk hold the notion that every man with economic production capability should be utilized to the highest possible levels, arguing that the man or contract company is getting paid for it<sup>8</sup>. This was in fact the situation in Japan in 1982-4 whereby those contract companies that took a long term contractual relationships, and these were given an upper hand even in matters of their contractual wages. Short term contract companies on the other hand were treated as less important. This is based on the argument that long term offences are easier to tolerate unlike those mistakes done by short term contract companies, since the corporate institution will take more time with the long term contract partner than the short term one.

The Anglo-American corporate governance system on the other hand operates on an external labor market that depends much on information to pass message across for example in case of vacancies or contracts, and this is viewed as a more freely and fairly competitive form of business transactions. Corporate governance can also be a risky form of business transactions because it tends to operate more on liquid capital but has an upper hand in that they emphasize on efficient managerial labor and skill<sup>9</sup>.

Looking critically at the two forms of corporate governance; Anglo-American and Japanese governance, the two models differ in their application solely because the Anglo-American model is easily applicable in the west where the

states and corporate are capitalists. In Japan however, most of the societies have grown within a communist environment, and this has led them to coming up with their own corporate governance model. The major difference in these two models is the fact that as Anglo-American model administrators strategize on getting as much as possible from the companies they work in contract with and the stakeholders in general, the Japanese model of corporate administration focuses on ensuring that the management team especially the chief executive officers maintain a good relationship with their economic partners, from their loaner banks to contractors and all the company's stakeholders in general<sup>10</sup>.

The second major difference between them is the fact that Japanese model of governance operates more on liquid capital unlike the Anglo-American model. In terms of capital and investments, Japanese model invests a lot in more risky business grounds comparing to the Anglo-American. This is based on the fact that they invest more of liquid capital than cash, and this will consequently protect them from going on big loses compared to when they invest in cash<sup>11</sup>. This gives them the confidence that makes them dare tread upon risky business grounds. This is unlike Anglo-American model whereby actual cash is invested in the venture leading the corporate company to be careful before involving themselves in any venture. This therefore calls for informed decision-making by the top management panel, because stakeholders hold r them accountable for the final outcome.

Corporate Act 2001 on the other hand insists on the importance for formal agreements especially in cases of signing contracts or leasing property. It



also emphasizes on the importance of the court system, whereby in case of a broken contract, the plaintiff can report the matter to court. This way, it acknowledges the court system as the supreme legal authority.

## **CONCLUSION AND FINDINGS**

From the analysis of the two theories; the agency theory and the corporate governance theory, both have their own strengths and weaknesses. They can be easily and efficiently applied in different settings and prove to be successful, but depending on the form of setting applied in.

Agency theory therefore can be concluded to be a system and a model that seeks to solve an agency problem in any company or institution. These agency conflicts resolve from some of the above described possibilities such as misinformed decision making or risk taking which may lead to failures resulting to the company's stakeholders' dissatisfaction. This method is mainly applied in companies that hold long term contracts with their management teams, a period long enough to trust them with critical decision making.

Corporate governance theory on the other hand is a model that seeks to not only ensure that there is a good relationship between the managers and the stakeholders, but also oversees that the company's set goals and objectives are met. This is possible through following the set code of rules, ensuring advised financial transactions between the contractors and loaners with the company and also informed decision-making within the company or organization<sup>12</sup>.

Corporate Act 2001 calls for a legal system in all the transactions that any company makes. It also insists on the important of written documents and these are two important elements observed by corporate governance and agency theory. These two models of governance are therefore in agreement with the Corporate Act 2001.

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