Analysis of agency theory

ASSIGN
BUSTER

Agency theory is one of the most important concepts of the business areas especially financial economics. Because of its importance, this theory is included in most of the introductory chapters of the modern financial economics books and publications. It is commonly cited as one of the key areas for progress and improvement of the modern financial economics. Moreover, its assumptions provide wide explanations for crucial business areas such as: merger activities, dividend policies, capital structure, corporate restructuring, and executive compensations, etc…

Agency theory defines the company or the firm as " nexus of contracts" between different resource suppliers. It is centralized on two different parties: principal, who supply the capital, and the agent who manage the day to day operations for the firm. In other words, it is the relation between one who determines the work and another who does the work. For example, in corporations, principals are the shareholders who delegates work to the agent which is the manager in the company. Agency theory assumes that shareholders and managers are motivated by their self –interest, thus managers are likely to persist their self-interest goal that contradicts with the goals of the owner. However, agents are supposed to work for the self-interest of the principal. This conflict results with a cost called the agency cost. This cost represents the cost of supervising the behavior of the agents as well as the profit loss resulting from operating policies and restrictions on management. Although the agency theory is controversial and contradictory, many scientist talked about this concept and explained its advantages and disadvantages on many business fields' especially financial economics.

Many scientist and scholars talked about the agency theory, and it is one of the most crucial theory in the economic and financial history fields. This theory was originated and created by two scholars, Stephen Ross and Barry Mitnick. Each one had a take a part of the agency theory and created. Economic wise, Stepeh Ross is the one responsible for the economic theory of agency, and financial wise, Barry Mitnick is responsible for the institutional theory of agency. These two scholars used the same concepts but under different assumption. Everyone introduced the theory in his own way or thinking. Ross introduces the agency theory from the side of problems of compensation relation and as an incentive problem. On the other side, Mitnick introduced how the institutions should evolve to deal with deficiencies that is created by the agency relationships. According to Mitnick, “ Behavior never occurs as it is preferred by the principal because it does not pay to make it perfect.” This is the main problem that Mitnick suggest as a deficiency of the agency relationship and he suggested that the society created rules and policies that help the companies to attend these imperfections, managing to deal with them, and adapting to them. Therefore, in order to understand the agency, people need both sides to see the incentive side as well as the organizational structure. However, this theory did not accurately defined properly and introduced to the world until the initiation of Jensen and Meckling articles in 1976. Jensen and Meckling introduces the agency theory as a relationship problem that arises between the owner of the resources and the one who is managing those resources. More general speaking, a conflict can arise between one who owns the capital and the one who is controlling the day to day operation since every party has his own interest that wants to be achieved and those interests can

be contradictory. According to Jensen and Meckling, “ Agency cost arise from the conflict of interest between a principal and an agent.” For example, when managers, who are responsible for decisions that impact the operation of the firm, are not the primary beneficiary of the firm net assets, and do not accept any effect regarding his or her decisions. Moreover, the agency cost is divided into three type of cost: structuring cost, monitoring cost, and bonding cost. Structuring cost is the cost that a firm should take it when manufacturing any product or service such as transaction cost, suck cost, and fixed cost. It is the fixed cost divided by the variable cost. Monitoring cost is watching and supervising the recording of cost daily, weekly, monthly, and yearly. It is very important for the owner to have mangers that allocate the proper time to the proper work and minimize cost as much possible. Due to this problem, Jensen offers many solutions to save the firm from this problem. Setting the use of contract is a cost that the firm should use in order to align the actions of the mangers with the actions of the owner. As Jensen (1994) suggests, “ Managerial decisions designed to strengthen organizations often meet with opposition from colleagues, employees… providing managers with incentives to compromise their decisions.” In other words, the best way to insure that the decisions are not conflicting is to ensure that the trade-off that mangers face are pushing them to take the correct decisions. Therefore, the goal of the agent should increase the firm wealth that lead to increase the performance and market price.

Moreover, in order the manager to increase value of the firm, the owner should create compensation plan that trigger the agent to spend his or her

efforts or works to maximize the firm profits and productivity. According to the agency theory, the shareholder should have the sense that offering a compensation package to the agents can reduce the agency cost which means that interest of the two parties will be in the interest of the firm as whole, and the two parties will be one team working to maximize the value and the wealth of the organization.

The agency theory creates many obligations that shareholders must take into consideration in order to save their firm. The agency cost is one of these assumption that is created in order to show the types of expenses that the firm should spend. It is divided into three types: expenditures to monitor managerial activities such as audit cost. Nowadays, auditing becomes one of the most important business issues that every organization especially the banking sector should apply. For example, due the agency problem, the Lebanese central bank oblige all the banking sector to have two independent big four auditors in order to assure all the financial information that is created by the managers. The second cost is the cost of structuring the organization such as appointing outside members to the board of directors or reengineering the organizational chart in the firm. To have a well design organization charts in a firm is very effective since it helps to allocate the jobs in a way that can maximize efficiency and get rid of relation problems. The third cost is the opportunity cost that is created by the owner such as voting in specific issues and limit the ability of the managers regarding the actions that advance the shareholder wealth. For this purpose, many mechanism are introduced to the business world that can minimize those costs and solve the agency problems. First, compensation plan can be

applied for the mangers such owning a stock in the firm and stock price changes. In this case, managers I obliged to work efficiently for the sake to increase the financial wealth to increase his or her stock value. Another extreme, is to have in the firm stockholders that have a theory X management style which means that they will manage each step or decision that is taken by the managers, but this would be costly and inefficient. The best solution to have a compensation that is based on performance and some monitoring should be undertaken. Moreover, the owner can create a sense for managers that if they make any wrong decision that affect the firm negatively, they will be fired or replaced by another manager. However, this solution is somehow risky in a case that creates problems in the workplace. For example, many publicly traded companies are creating shares based on performance levels which are shared given for the mangers based on performance which are explained by many financial measures such as earing per share, return on assets, and return on equity etc… If the performance is below the level, the shares will be less than 100 percent. These incentives are created for two main goals. First, they offer executives to take action that will increase shareholder wealth. Second, these types of plans help the firm to retrain managers that can have confidence to risk their financial wealth based on their abilities which can lead to better performance.