AGENCY THEORY

The Law of Agency

An agent is a person who acts on behalf of another person, the principal, in dealing with other people. For example, a selling agent acts on behalf of a principal, a manufacturer of goods, to sell goods on the manufacturer's behalf. Similarly, a stock broker is an agent who acts on behalf of a client (the principal) to buy or sell shares on the client's behalf. The agent acts on the name of the principal, and commits the principal to agreements and transactions.

In company law, the directors act as agents of the company. The board of directors as a whole, and individual directors, have the authority to bind the company to contractual agreements with other parties. Since most of the powers to act on behalf of the company are given to the board of directors, the directors (and the management of a company) have extensive powers in deciding what the company should do, what its objectives should be, what its business strategies should be, how it should invest and what its targets for performance should be.

The powerful position of the directors raises questions about the use of this power, especially where the owners of the company (its shareholders) and the directors are different individuals:

- How can the owners of the company make sure that the directors are acting in the best interests of the shareholders?
- If the directors act in ways that the shareholders do not agree with, what can the shareholders do to make the directors act differently?

Fiduciary Duty of Directors

As agents of the company, directors have a fiduciary duty to the company. A fiduciary duty is a duty of trust. A director must act on behalf of the company in total good faith, and must not put his personal interests before the interests of the company. If a director is in breach of this fiduciary duty he could be held liable in law, if the company were to take legal action against him. Legal action by a company against a director for breach of fiduciary duty would normally be taken by the rest of the board of directors or, possibly, a majority of the shareholders acting in the name of the company.

Agency Law and Challenging the Actions of Directors

In practice, it is very difficult for shareholders to use the law to challenge the decisions and actions of the company's directors. If shareholders believe that the directors are not acting in the best interests of the company, their ability to do something about the problem is restricted.

- The shareholders can vote to remove any director from office, but this requires a majority vote by the shareholders, which might be difficult to obtain.
- In a court of law, shareholders would have to demonstrate that the directors were actually acting against the interests of the company, or against the clear interests of particular shareholders, in order to persuade the court to take legal measures against the directors.

In summary, although there is a legal relationship between the board of directors and their company, the shareholders cannot easily use the law to control the decisions or actions that the directors take on behalf of the company.

Concepts in Agency Theory: The Agency Relationship

Whereas agency law deals with the legal relationship between a company and its directors, the theory of agency deals with the relationship between:

i. a company's owners; and
ii. its managers (directors).

Agency theory is based on the idea that when a company is first established, its owners are usually also its managers. As a company grows, the owners appoint managers to run the company. The owners expect the managers to run the company in the best interests of the owners; therefore a form of agency relationship exists between the owners and the managers.

Many companies borrow, and a significant proportion of the long-term capital of a company might come from various sources of debt capital, such as bank loans, lease finance and bond issues (debentures, loan stock and so on). Major lenders also have an interest in how the company is managed, because they want to be sure that the company will be able to repay the debt with interest.

The Agency Relationship

Agency theory was developed by Jensen and Meckling (1976). They suggested a theory of how the governance of a company is based on the conflicts of interest between the company's owners (shareholders), its managers and major providers of debt finance. Each of these groups has different interests and objectives.

i. **The shareholders** want to increase their income and wealth. Their interest is with the returns that the company will provide in the form of dividends, and also in the value of their shares. The value of their shares depends on the long-term financial prospects for the company. Shareholders are therefore concerned about dividends, but they are even more concerned about long-term profitability and financial prospects, because these affect the value of their shares.
ii. **The managers** are employed to run the company on behalf of the shareholders. However, if the managers do not own shares in the company, they have no direct interest in future returns for shareholders, or in the value of the shares. Managers have an employment contract and earn a salary. Unless they own shares, or unless their remuneration is linked to profits or share values, their main interests are likely to be the size of their remuneration package and their status as company managers.
iii. **The major providers of debt** have an interest in sound financial management by the company's managers, so that the company will be able to pay its debts in full and on time.

Jensen and Meckling defined the agency relationship as a form of contract between a company's owners and its managers, where the owners (as principal) appoint an agent (the managers) to manage the company on their behalf. As a part of this arrangement, the owners must delegate decision-making authority to the management.

The owners expect the agents to act in the best interests of the owners. Ideally, the 'contract' between the owners and the managers should ensure that the managers always act in the best interests of the owners. However, it is impossible to arrange the 'perfect contract', because decisions by the managers (agents) affect their own personal welfare as well as the interests of the owners. This raises a fundamental question. How can managers, as agents of their company, be induced or persuaded to act in the best interests of the shareholders?

Agency Conflicts/Problems

Agency conflicts are differences in the interests of a company's owners and managers. They arise in several ways.

a. **Moral hazard**: The prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk. A manager has an interest in receiving benefits from his or her position as a manager. These include all the benefits that come from status, such as a company car, a private chauffeur, use of a company airplane, lunches, attendance at sponsored sporting events, and so on. Jensen and Meckling suggested that a manager's incentive to obtain these benefits is higher when he has no shares, or only a few shares, in the company. The biggest problem is in large companies.
b. **Effort level:** Managers may work less hard than they would if they were the owners of the company. The effect of this 'lack of effort' could be lower profits and a lower share price. The problem will exist in a large company at middle levels of management as well as at senior management level. The interests of middle managers and the interests of senior managers might well be different, especially if senior management are given pay incentives to achieve higher profits, but the middle managers are not.
c. **Earnings retention**: The remuneration of directors and senior managers is often related to the size of the company, rather than its profits. This gives managers an incentive to grow the company, and increase its sales turnover and assets, rather than to increase the returns to the company's shareholders. Management are more likely to want to re-invest profits in order to make the company bigger, rather than pay out the profits as dividends. When this happens, companies might invest in capital investment projects where the expected profitability is quite small, and the net present value might be negative.
d. **Risk aversion:** Executive directors and senior managers usually earn most of their income from the company they work for. They are therefore interested in the stability of the company, because this will protect their job and their future income. This means that management might be risk averse, and reluctant to invest in higher-risk projects. In contrast, shareholders might want a company to take bigger risks, if the expected returns are sufficiently high. Shareholders often invest in a portfolio of different companies; therefore it matters less to them if an individual company takes risks.

e. **Time horizon**: Shareholders are concerned about the long-term financial prospects of their company, because the value of their shares depends on expectations for the long-term future. In contrast, managers might only be interested in the short-term. This is partly because they might receive annual bonuses based on short-term performance, and partly because they might not expect to be with the company for more than a few years. Managers might therefore have an incentive to increase accounting return on capital employed (or return on investment), whereas shareholders have a greater interest in long-term value as measured by net present value.

Agency costs

Agency costs are the costs of having an agent to make decisions on behalf of a principal. Applying this to corporate governance, agency costs are the costs that the shareholders incur by having managers to run the company instead of running the company themselves.

- Agency costs do not exist when the owners and the managers are exactly the same individuals.
- Agency costs start to arise as soon as some of the shareholders are not also directors of the company.
- Agency costs are potentially very high in large companies, where there are many different shareholders and a large professional management.

Agency costs can therefore be defined as ***the 'value loss' to shareholders that arises from the divergence of interests between the shareholders and the company's management***.

There are three aspects to agency costs. They include:

i. **The costs of monitoring:** The owners of a company can establish systems for monitoring the actions and performance of management, to try to ensure that management are acting in their best interests. An example of monitoring is the requirement for the directors to present an annual report and accounts to the shareholders, setting out the financial performance and financial position of the company. These accounts are audited, and the auditors present a report to the shareholders. Preparing accounts and having them audited has a cost.

ii. **Residual Loss:** Agency costs also include the costs to the shareholder that arise when the managers take decisions that are not in the best interests of the shareholders (but are in the interests of the managers themselves). For example, agency costs arise when a company's directors decide to acquire a new subsidiary, and pay more for the acquisition than it is worth. The managers would gain personally from the enhanced status of managing a larger group of companies. The cost to the shareholders comes from the fall in share price that would result from paying too much for the acquisition.

iii. **Bonding costs:** The third aspect of agency costs is costs that might be incurred to provide incentives to managers to act in the best interests of the shareholders. These are sometimes called bonding costs. These costs are intended to reduce the size of the agency problem. Directors and other senior managers might be given incentives in the form of free shares in the company, or share options. In addition, directors and senior managers might be paid cash bonuses if the company achieves certain specified financial targets. The remuneration packages for directors and senior managers are therefore an important element of agency costs.

Reducing the Agency Problem

Jensen and Meckling argued that when they act in the interest of the shareholders, managers bear the entire cost of failing to pursue goals that are in their own best interests, but gain only a few of the benefits. Incentives should therefore be provided to management to increase their willingness to take 'value-maximising decisions' – in other words, to take decisions that benefit the shareholders by maximising the value of their shares.

Several methods of reducing the agency problem have been suggested. These include:

i. **Devising remuneration packages for executive directors and senior managers** that give them an incentive to act in the best interests of the shareholders. Remuneration packages may therefore provide rewards for achieving a mixture of both long-term and short-term financial targets and non-financial targets.
ii. **Having a large proportion of debt on the long-term capital structure of the company**.

Jensen and Meckling argued that the problems of the agency relationship are bigger in companies that are profitable but have low growth in profits. These companies generate a large amount of free cash flow. Free cash flow is cash that can be spent at the discretion of management, and does not have to be spent on essential items such a payment of debt interest, taxation and the replacement of ageing non-current assets.

It is in the interest of shareholders that free cash flow should be either:

a. Invested in projects that will earn a high return (a positive net present value), or
b. Paid to the shareholders as dividends.

The directors and other senior managers of a company might want to invest free cash flow in projects that will increase the size of the company. These could be projects that will earn a high return. In a low-growth company, however, it is likely that managers will want to invest in projects that increase the size of the company but are only marginally profitable and would have a negative net present value. One way of reducing this problem would be to have a high proportion of debt capital in the capital structure of the company. Interest must be paid on debt, and this reduces the free cash flow. Management must also ensure that new investments are sufficiently profitable so that the company can continue to pay the interest costs on its debt capital.

iii. **Having a board of directors that will monitor the decisions taken for the company by its executive management**.

A different method of reducing the agency problem is to make the board of directors more effective at monitoring the decisions of the executive management.

a. A board will be ineffective at monitoring the decisions of management if it is dominated by the chief executive officer (CEO). This is because the CEO is the head of the executive management team. The board would be especially ineffective in a monitoring role if the CEO is also the chairman of the board.
b. Fama and Jensen (1983) argued that an effective board must consist largely of ***independent non-executive directors***. Independent nonexecutive directors have no executive role in the company and are not fulltime employees. They are able to act in the best interests of the shareholders.
c. Independent non-executive directors should also take the decisions where there is (or could be) a conflict of interest between executive directors and the best interests of the company.

For example, non-executive directors should be responsible for the remuneration packages for executive directors and other senior managers.

Jensen also argued (1993) that the board of directors becomes less effective as it grows in size. This is because a large board is often slow to react to events and will often be incapable of taking action quickly when it is needed. The directors on a large board are also less likely to be critical of each other than directors on small boards.

Accountability of Agents

Agents should be accountable to their principal for their decisions and actions. Accountability means:

i. Having to report back to the principal and give an account of what has been achieved.
ii. Having to answer questions from the principal about performance and achievements.
iii. The principal having power to reward or punish an agent for good or bad performance.

Greater accountability should reduce the agency problem, because it provides management with a greater incentive (obtaining rewards or avoiding punishments) to achieve performance levels that are in the best interests of the shareholders. However, the costs of accountability (which are monitoring costs) should not be excessive and should not exceed the value of the benefits that the monitoring provides. Accountability and the source of authority in an entity Accountability also determines where the centre of authority lies within an entity. Day and Klein (1987) made the following comment about accountability in public services, but the same principle applies to companies: ***'The ability to call people to account defines the [centre] of authority in any given society…. But the notion of the right to call people to account needs to be complemented by the notion of power in the ability to call people to account.'*** The accountability of management depends on both the right of the shareholders to call the directors to account, but also on their ability to do so.

'In brief, agency theory suggests that the prime role of the board is to ensure that executive behaviour is aligned with the interests of the shareholder-owners. Otherwise, self-interested managers will use their superior information to line their own pockets. This is the justification for the separation of the chairman and CEO roles, huge senior executive salaries and the over-riding requirement for independence of non-executive directors, and much more' (Simon

Caulkin, The Observer, 27 November 2005). There is an ethical aspect to agency theory. The theory is based on the view that individuals cannot be trusted to act in any way that is not in their own best interests.

AGENCY CONFLICTS IN OTHER TYPES OF ORGANISATION

Agency relationship in the Public sector

Managers are also agents acting for principals in public sector organisations so once again there is potential for agency conflicts.

- The principals in this relationship are the taxpayer and the electorate (often one and the same) and are likely to be concerned with value for money. There are problems associated with making an assessment of whether an organisation is indeed providing value for money.
- The principals are a heterogeneous group consisting of a large number of individuals. The group might not agree what actually constitutes value for money or even if the service is required at all. The government must make political decisions as to how public money should be spent in a way that they believe is best for the country. Citizens in a democracy then have an opportunity to vote against a government if they are unsatisfied with its performance in making these decisions.
- Another problem in the governance of public sector organisations is how to establish strategic objectives and then monitor the success of the public sector organisation in achieving these.

It is normal in most countries to have a limited audit of public sector organisations to ensure the integrity and transparency of their financial transactions, but this does not always extend to an audit of its performance or ‘fitness for purpose’.

Agency relationship – Charities

Managers are also agents acting for principals in charities so once again there is potential for agency conflicts. Charities often raise money by securing donations from the public. This means that donors are key principals. An important governance issue is whether donations are used for the intended purpose and not wasted, misdirected or embezzled?

Ways to reduce this agency problem include:

i. A requirement for the charity to be run by a board of directors overseen by a committee of trustees (sometimes called governors). In this case, the board manages the charity and the trustees act as a control on the board to ensure that the board is delivering value to the donors and are acting towards the stated and agreed benevolent aims.
ii. Open and complete financial disclosure
iii. Requirement for audits both financial and of effectiveness in achieving the charitable purpose.

Table 1: A Summary of Agency Relationships

	Companies	**Public Sector**	**Charities/Non-Governmental/Voluntary Organisations**
Purpose	Maximisation of shareholder wealth	Implementation of government policy	Achievement of benevolent purpose
Agents	Directors	Managers and sometimes elected representatives	Directors and Managers
Principals	Shareholders	Taxpayers and voters (in a democracy)	Donors, other supporters and Service users
Typical Governance Arrangements	Board of Directors monitored by non-executive directors; Non-executive chairman	Complex structures which try to achieve the best way to deliver services	Executive board accountable to independent trustees