AGENCY THEORY WITH RESPECT TO CORPORATE GOVERNANCE

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ABSTRACT

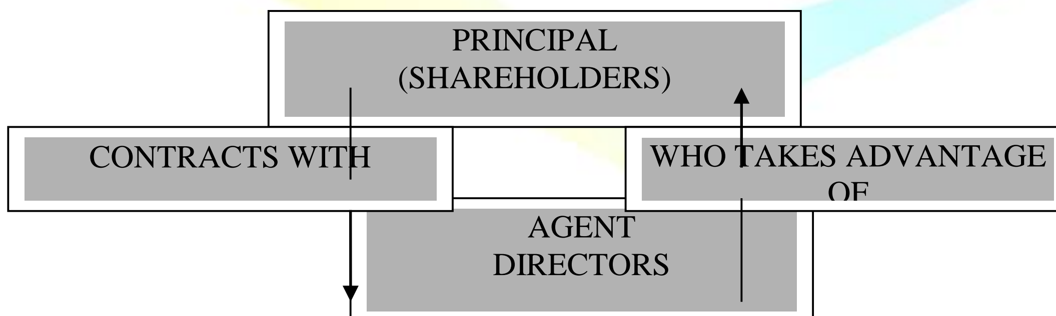
An inherent tension in corporate governance is between the directors, as managers of the corporation and of the shareholders as owners of the corporation. Through an analysis of "Agency theory" and its impact on practical corporate governance, this paper, elaborates about Agency theory which studies the problems and solutions linked to delegation of tasks from principals to agents in the context of conflicting interests between the parties. The primary agency relationships in business are with regard to director, management, shareholders, which are intriguingly in conflict with regard to interests pertaining. This has direct implication on business ethics and corporate governance. The first part of the paper deals with introduction and evolution of Agency Theory and explains mediating hierarchy approach is better as alternative. The second part of the paper talks about the impact of agency theory on risk and perceptions. The third part of the paper promotes the relationship between ethics and greed. Last but not the least, the paper has addressed the consequences related to Corporate Governance and sought to investigate the validity of the criticism against Agency Theory put forth.

Keywords: Agency Theory, Corporate Governance, Conflict of Interest, Delegation, Director, Management, Shareholders.

1. INTRODUCTION

The word ***"governance"*** means the activity of governing a country or controlling a company or an organisation; the way in which a country is governed or a company or institution is controlled' and thus it is a broad concept. According to Noble laureate Milton Friedman the term ***"corporate governance"*** means a "conduct of business in accordance with shareholders desires, which generally is to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs". The role of corporate governance is to ensure that the directors of a company are conscientiously required to perform their duties, obligations and responsibilities and to act in the best interest of the company, to give direction and to remain accountable to their shareholders and other beneficiaries for their actions.[1] The ***Kumar Mangalam Birla Committee observed that,*** Corporate Governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor's protection. It is the blood that fills the vein of transparent corporate disclosure and high quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure. Thus it is about promoting fairness, transparency and accountability. A good corporate governance occurs by maximising long term shareholder value and by reducing the conflict of interest.

Agency theory, or principal-agent theory as some refers to it, looks at corporate governance practices and behaviour through the lens of the agency dilemma. In essence, the theory perceives the governance relationship as a contract between shareholder (the principal) and director (the agent). Directors, it is argued, seek to maximize their own personal benefit, to take actions that are advantageous to themselves, but detrimental to the shareholders (see Figure 1).



[1] Dr. K.R.CHANDRATRE, Dr. A.N.NAVARE, CORPORATE GOVERNANCE – A PRACTICAL HANDBOOK 2 (1st ed., BHARAT)

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Fig 1. The governance relationship

Agency theory refers to a set of propositions in governing a modern corporation which is typically characterized by large number of shareholders or owners who allow separate individuals to control and direct the use of their collective capital for future gains. These individuals, typically, may not always own shares but may possess relevant professional skills in managing the corporation. The theory offers many useful ways to examine the relationship between owners and managers and verify how the final objective of maximizing the returns to the owners is achieved, particularly when the managers do not own the corporation's resources.[2]

Following Adam Smith (1776), Berle and Means (1932) initiate the discussion relating to the concerns of separation of ownership and control in a large corporation. However, the concerns are aggregated by Jensen and Meckling (1976) into the 'agency problem' in governing the corporation. Jensen and Meckling identify managers as the agents who are employed to work for maximizing the returns to the shareholders, who are the principals. Jensen and Meckling assume that as agents do not own the corporation's resources, they may commit 'moral hazards' (such as shirking duties to enjoy leisure and hiding inefficiency to avoid loss of rewards) merely to enhance their own personal wealth at the cost of their principals.

To minimize the potential for such agency problems, Jensen (1983) recognizes two important steps: first, the principal-agent risk-bearing mechanism must be designed efficiently and second, the design must be monitored through the nexus of organizations and contracts. The first step, considered as the formal agency literature, examines how much of risks should each party assume in return for their respective gains. The principal must transfer some rights to the agent who, in turn, must accept to carry out the duties enshrined in the rights. The second step, which Jensen (1983, p. 334) identifies as the 'positive agency theory', clarifies how firms use contractual monitoring and bonding to bear upon the structure designed in the first step and derive potential solutions to the agency problems. The inevitable loss of firm value that arises with the agency problems along with the costs of contractual monitoring and bonding are defined as agency costs (Jensen and Meckling, 1976).

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[2] ALAN DIGNAM AND MICHAEL GALANIS, THE GLOBALIZATION OF CORPORATE GOVERNANCE 37 (1t ed. 2009, ASHGATE PUBLISHING LIMITED)

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Several empirical studies have since adopted agency theory to identify solutions to specific contexts such as diversification strategies within firms (e.g., Kehoe, 1996; and Denis, Denis and Sarin, 1999). We relate the theory in a more generic sense of corporate governance. Keasey and Wright (1993) define corporate governance in terms of "structures, process, cultures and systems that engender the successful operation of organizations".[3]

2. EVOLUTION OF AGENCY THEORY

The introduction of limited liability and the opening up of corporate ownership to the general public through share ownership had a dramatic impact on the way in which companies were controlled. The market system in the UK and the USA*, inter alia,* is organized in such a way that the owners, who are principally the shareholders of listed companies, delegate the running of the company to the company management. There is a separation of ownership and control that has led to the notorious 'agency problem'. Berle and Means (1932) discussed the extent to which there was a dispersion of shareholding, which consequently led to a separation of ownership and control in the USA. Prais (1976) showed that a similar structure of ownership and control operated in the UK. The agency problem was first explored in Ross (1973), with the first detailed exposition of agency theory presented in Jensen and Meckling (1976). They defined the mangers of the company as the 'agents' and the shareholder as the 'principal' (in their analysis there is one shareholder versus the 'managers'). In other words, the shareholder, who is the owner or 'principal' of the company delegates day-to-day decision making in the company to the directors, who are the shareholder's 'agents'. The problem that arises as a result of this system of corporate ownership is that the agents do not necessarily make decisions in the best interests of the principal. One of the principal assumptions of agency theory is that the goals of the principal and agent conflict. In finance theory, a basic assumption is that the primary objective for companies is shareholder wealth maximization. In practice this is not necessarily the case. It is likely that company managers prefer to pursue their own personal objectives, such as aiming to gain the highest bonuses possible. Mangers are likely to display a tendency towards 'egoism' (i.e behaviour that leads them their own perceived self-interest: Boatright, 1999). This can result in a tendency to focus on project and company investments that provide high short-run profits (where mangers' pay is related to this variable), rather than the

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[3] ANIL KUMAR, CORPORATE GOVERNANCE THEORY AND PRACTICE 22 (1t ed. 2012, INTERNATIONAL BOOK HOUSE PVT. LTD)

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maximization of long-term shareholder wealth through investment in projects that are long-term in nature. Hence British industry has been notorious for 'short-termism'.[4] Short-termism has been defined as a tendency to foreshorten the time horizon applied to investment decisions, or raise the discount rate above that appropriate to the firm's opportunity cost of capital.[5]

The concept of ***Mediating Hierarchy Approach*** is an alternative to the Agency Theory as proposed by Blair and Stout which ensures that managers should not be under any direct control of stakeholder including shareholders and thus the alternative approach is based on the managerial autonomy. Managers are independent of Stakeholders and the managers need to focus on companies interests and objectives. Therefore it can be derived that under this mechanism, directors are not under any short of pressure and thus the conflict of interest doesn't arise.[6]

3. CONFLICTS BETWEEN MANAGERS AND SHAREHOLDERS

Corporate managers are the agents of shareholders, a relationship bristling with conflicting interests. To address the conflict of interest between shareholders and management, it is important to stress that even within the same class of shareholders, there may be conflicts, this conflict may relate to what proportion of the company's profit should be paid in the form of dividend and what proportion should be retained for future investments and for capital investment purposes.

The problem arises when the principal and agent have different attitudes towards risk. Because of different risk tolerances, the principal and agent may each be inclined to take different actions.

Agency theory raises a fundamental problem in organizations i.e., Self-interested behaviour. A corporation's managers may have personal goals that compete with the owner's goal of maximization of shareholder wealth. Since the shareholders authorize managers to administer the firm's assets, a potential conflict of interest exists between the two groups.[7] Agency theory suggests that, in imperfect

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[4] PRAVEEN B. MALLA, CORPORATE GOVERNANCE: CONCEPT, EVOLUTION AND INDIA STORY 30 (2d ed. 2010, ROUTLEDGE)
[5] JILL SOLOMON, CORPORATE GOVERNANCE AND ACCOUNTABILITY 17 (2d ed. 2007, JOHN WILEY & SONS LTD)
[6] H.R.MACHIRAJU, INDIAN FINANCIAL SYSTEM 9 (3d ed. 2008, VIKAS PUBLISHING HOUSE PVT LTD)
[7] Available at http://www.referenceforbusiness.com/encyclopedia/A-Ar/Agency-Theory.html. (last visited on Apr. 05, 2016)

labour and capital markets, managers will seek to maximize their own utility at the expense of corporate shareholders. Agents have the ability to operate in their own self-interest rather than in the best interests of the firm because of asymmetric information (e.g., managers know better than shareholders whether they are capable of meeting the shareholders' objectives).

Evidence of self-interested managerial behaviour includes the consumption of some corporate resources in the form of perquisites and the avoidance of optimal risk positions, whereby risk-averse managers bypass profitable opportunities in which the firm's shareholders would prefer they invest. Outside investors recognize that the firm will make decisions contrary to their best interests. Accordingly, investors will discount the prices they are willing to pay for the firm's securities.

4. RELATIONSHIP BETWEEN ETHICS AND GREED WITH REGARD TO AGENCY THEORY

Since agency relationships are usually more complex and ambiguous (in terms of what specifically the agent is required to do for the principal) than contractual relationships,_agency carries with it special ethical issues and problems, concerning both agents and principals. Ethicists point out that the classical version of agency theory assumes that agents (i.e., Board of directors or managers) should always act in principals' (shareholders) interests. However, if taken literally, this entails a further assumption that either (a) the principals' interests are always morally acceptable ones or (b) managers should act unethically in order to fulfil their fiduciary duty in the agency relationship.[8] Clearly, these stances do not conform to any practicable model of business ethics. There does not exist a direct contract between the agent and principal in terms of a company, as the shareholders indirectly appoint the directors or managers, on behalf of the company, as company is a legal entity, and cannot act on its own. But there can exist a situation that company's interest and shareholder's interest in conflict, and agent acting on the interest of shareholders, but not company is unethical in substance.[9]

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[8] Agency Theory as a Basis for Business Ethics, published in "Christian Business Faculty Association, October 2000 By Dennis Profit, Professor of Finance, Grand Canyon University.
[9] CHRISTOPHER HODGES, LAW AND CORPORATE BEHAVIOUR 11(1t ed. 2015, BLOOMSBURY Publications Pvt Ltd)

Usually what leads to the agent's action or the interest of shareholders which jeopardizes the interest of the company is the greed or the self-interest which is more important, in famous case of Enron where greed is important factor.

"According to some commentators, motives and attitudes behind the decisions and events leading to Enron's eventual downfall appear simple enough: most notably, that individual and collective greed are born in an atmosphere of market euphoria (or Bull market). Greed in this sense relates to differences in principals' and agents interests. As the fundamental assumptions of agency theory encapsulate, and Enron illustrates, owners are interested in maximizing return on investment, while managers have a wider range of economic and psychological needs."[10]Which basically lead to the downfall of the company on the whole, not a positive sign for corporate governance.

5. CRITICISM OF AGENCY THEORY

Agency theory is not normative theory. Agency theory's predictive strength lies in description of the situations where parties act rationally, focusing on their personal interest, with risk aversion or unbiased towards risk Donaldson (1990) criticized the agency theory dominance in terms of methodology individualism, narrow-defined motivation model, regressive simplification, disregarding other research, ideological framework, organizational economics and corporate governance's defensiveness. Focus of agency theory's studies is individual consistent with rational, economic model of human behaviour. However, absolute explication of every organizational activity should not be considered as equivalent to individual activity and that represents essential critic of structuralism.[11] A familiar real-life example is large corporations' layoff dilemma. Conventional wisdom holds that investors are rewarded when companies thin their employment rosters because operating costs are lowered, in theory leading to greater profits. This expectation is often made explicit in news reporting surrounding a downsizing episode; the reports highlight whether investors seem pleased or displeased with an announcement of a mass layoff, and the often-stated assumption is that corporate management has undertaken the layoffs in part, if not in whole, to please shareholders

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[10]Available at
http://www.iuc.edu.eu/group/Financial%20Enron%20and%20examination%20of%20agency%20problems.pdf.
(last visited on Apr. 22, 2016)
[11]Available at http://www.freepatentsonline.com/article/Annals-DAAAM-Proceedings/246014179.html. (last visited on Apr. 11, 2016)

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and enhance their wealth. In this instance it is obvious that shareholders' interests are advanced to the detriment of at least one other constituency, namely the employees. In such cases, observers question whether it is ethical to serve the principals' interests when those actions harm a large number of people, and whether the benefits shareholders receive are commensurate with the harm inflicted on the laid-off employees.[12]Goals' divergences, divergence in attitude towards risk and information decentralizations are agency theory fundaments. If these assumptions about conflict interests and information asymmetry are allayed, then agency problem becomes trivial and scientifically not interesting. In circumstances of equal information approach, principal would easily define and control agent's behaviour and fittingly compensate agent. If principal and agent have matching interests, then agent's motivation is not unclear.

Analyzing phenomena only within agency theory framework may result in:

1) Disregarding of principal's obligation towards agent;
2) Ignoring distrust development and disrespect of agents;
3) Neglecting ethical aspects and
4) Overlooking of prospective solutions consistent with ethical norms.[13]

Does good corporate governance produce better corporate performance?

Agency theoretical research has shown some linkages between company performance and various attributes of governance, such as women on boards' structure and size, or audit committee activities. However, it has to be said that, so far, most conclusions are weak.

Indeed, in some cases in which a positive relationship has been shown between good governance and better performance, other scholars have reworked the data to draw contrary conclusions. More convincing evidence of a relationship between good corporate governance practices and company performance comes from the behaviour of institutional investors who are prepared to pay a premium for companies they judge to have good governance because they feel it reduces their exposure to risk.

[12] Available at https://www.academia.edu/5582502/Corporate_Governance_and_Agency_Theory.(last visited on Apr. 11,2016)

[13] P. P. ARYA, B. B. TANDON, A. K. VASHISHT, CORPORATE GOVERNANCE 283 (1t ed. 2006, Deep & Deep Publications Pvt. Ltd)

However, a significant study was published by the Association of British Insurers (ABI) in 2008 (Selvaggi and Upton, 2008), which suggests that there is a robust casual relationship between good corporate governance and superior company performance. ABI represents the interest of insurance companies in the United Kingdom, which tend to invest long-term, reflecting their need to meet long-term obligations. The ABI Institutional Voting Service data base shows the extent to which listed UK companies comply with the provisions UK Combined Code, and adds expert judgements on other aspects of governance practices. A point is awarded for every governance failure, producing a numeric score, with a zero score being ideal up to a theoretical maximum of 42 if a company were to fall on every criterion. The ABI uses a colour code: blue-top companies have no areas of concern; amber-top companies have some concerns, such as abnormal salary increases; and red top companies show major concerns, for example where non-executive directors did not meet the independence criteria, or where an executive director serves on the audit committee.

Drawing on the government scores of 361 companies between 2002 and 2007, and using return on assets and 'Tobins Q' as the performance criteria, the study showed a clear connection between good governance and both good company performance and share price levels. Companies with poor governance showed a strong a negative impact on performance. Moreover, companies that were red-topped repeatedly underperformed by 2-5% a year in terms of industry-adjusted return on assets. The study also suggested that it was good corporate governance that led to better performance, not the other way around. Further, well governed companies delivered higher returns when adjusted for risk, and the volatility of their share price returns was lower. The study also discovered that the impact of governance on performance was long-term. Lags of between two and three years between poor governance and inferior performance were found. This study suggested that sound governance does have a positive effect on profitability and boosts share price. In other words, it shows that governance expenditure can be cost-effective.[14]

6. EMPIRICAL APPLICATIONS

Several studies validate agency theory predictions in different contexts. For instance, firms' public offer of new capital (Denis, Denis and Sarin, 1999), franchisee set up (Kehoe, 1996), technology strategy in the process of new product development (Krishnan and Loch, 2005), and labor union

[14] BOB TRICKER, CORPORATE GOVERNANCE: PRINCIPLES, POLICIES AND PRACTICES 63 (3d ed. 2012Oxford university Press)

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transactions are among a few such contexts that apply agency theoretic framework. Denis et al. (1999) state the reasons for why a firm's diversification strategy is likely to reduce firm value. They find that diversified firms trade at a discount as against their single-segment peers and further prior studies find significant positive relation between greater shareholder wealth and focused strategy for many leading US firms. Given that diversification can lead to value reduction, Denis et al. (1999) examine why managers resort to corporate diversifications. They argue that managers do so as their private benefits (pecuniary such as incentives and non-pecuniary such as power) related with diversified portfolio. Kehoe (1996) finds that franchisee set up is considered efficient to minimize agency problems of shirking. Franchisees are compensated from the residual claims of their individual units. Therefore, they tend to bear most or all of the costs of shirking. In conclusion, while there is a large empirical support for agency theory, new studies examine if the theory holds good for newer variants of organizational structures. Further, new studies also analyze how agency theory holds as against other theories. For instance, Denis et al. (1999) find that corporate diversifications are examined with strategic management-led stewardship theory as against the organizational economics-led agency theory.[15]

7. CONCLUSION/ AUTHOR'S VIEW :

Agency theory is an important set of propositions in the organizational economics discipline. The theory is founded under the assumption that when ownership is separated from the control of a large firm, the manager acting as an agent on behalf of the owner-principal is prone to creating moral hazards such as shirking and seizing wealth at the expense of the principal. The theory suggests that the principal builds appropriate ex ante incentive mechanisms to deter the agent from indulging in such behaviour.

If we are aware of modern business conditions where modern technologies provide possibility for lowering transactional costs, then the only distinctive competency of companies becomes ability to coordinate sub-contractual activities on the market. Therefore, companies ought to focus on human resources and their competencies. Agency theory, despite all limitations, can realize previously stated, but implementation of following postulates is necessary:

[15] THOMAS CLARKE, DOUGLAS BRANSON, The SAGE Handbook of CORPORATE GOVERNANCE 227 (1t ed. 2012, SAGE Publications Ltd)

(1) Company is institution of people, with distinct members, and not only one owner;

(2) Stakeholders have economic and noneconomic interests meaning that self-interest does not exclude interest for others;

(3) Company is not only based on contractual agreements and company is also association of people;

(4) Role of the company is not maximization of shareholders' wealth, yet self-actualization of all stakeholders