

# Agency Theory

**Agency theory:** *a theory that looks at how to ensure that agents (executives, managers) act in the best interests of the principals (owners, shareholders) of an organization.*

## ORIGINS

Agency theory addresses the relationship where in a contract 'one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent' (Jensen and Meckling, 1976: 308). This happens because of the separation of ownership and control, when the owner of the company or the board of directors (the 'principals') have to employ managers ('agents') to run the business and need to monitor their performance to ensure they act in the owner's interest. Economists Alchian and Demsetz (1972) were the first to argue that monitoring the performance of individual work effort is always a cost of any firm and that organizational inefficiencies are created when the flow of information on individual performance is decreased or blocked. This can happen if there are large teams, unsupervised professionals, or executives of corporations who act autonomously. The main concern of agency theory as proposed by Jensen and Meckling (1976) is how to write contracts in which an agent's performance can be measured and incentivized so that they act with the principal's interests in mind. Based on the idea that employees (at any level) will have diverse goals, two main *agency problems* are identified: how to align the conflicting goals of principals and agents, and how to ensure agents perform in the way principals expect them to. These problems can occur when executives or managers make self-interested decisions and manipulate information on performance, perhaps by moving numbers around or by 'creative accounting' to present better performance figures: 'The problem here is that the principal cannot verify that the agent has behaved appropriately' (Eisenhardt, 1989: 58). Another example is when a manager decides to buy cheaper and inferior raw material for a product because he benefits personally by



receiving a bonus for cutting costs. However, the longer-term impact of this decision results in deteriorating customer relations and lower profits due to a decline in product quality. Agency problems can also occur when executives or managers have a different attitude toward risk from that of the owners or shareholders. For example, an executive might not risk financing a long-term research and development initiative that may actually be a sound strategic move for sustainable growth of the firm because it may decrease profits in the short term.

The solution to either of these *agency problems* is to ensure that executives or managers act in the best interests of the owners by increasing the amount and quality of information available to principals and making senior executives part owners of the firm through their compensation packages. This contract between the principal and agent is the unit of analysis for agency theory from which scholars will attempt to determine:

the most efficient contract governing the principal-agent relationship given assumptions about people (e.g. self-interest, bounded rationality, risk aversion), organizations (e.g. goal conflict among members), and information (e.g. information is a commodity which can be purchased). (Eisenhardt, 1989: 58)

Another key question in managing the agency relationship is what are the most efficient forms of control – behavior-oriented controls or outcome-based controls? Behavioral controls measure effective behaviors, such as attitudes towards patients and patient care in hospitals, while output controls measure outputs and goal achievement, for example weekly production outputs compared to production targets.

In her 1989 article, Eisenhardt provides a comprehensive review of agency theory research that flows in two streams: a ‘positivist’ stream and a ‘principal–agent’ stream. Positivist researchers search for situations where the agent and principal have conflicting goals and then examine how an agent’s self-serving behavior is limited through different types of governance mechanisms. The focus is usually the relationship between boards of directors (principals) and the CEOs (agents) of large public corporations. For example, one specific mechanism to ensure the alignment of interest is the existence of the equity market which controls behavior through such threats as acquisition, hostile takeover, or the liquidation of equity by investors (Dalton et al., 2007). Principal–agent researchers are concerned with examining the efficiency of contracts given different conditions of certainty, risk aversion, information,



etc. The focus is usually more theoretical, more mathematical, and broader in terms of application (e.g. contracts with employees, suppliers, clients). Eisenhardt argues that agency theory provides a unique, realistic, and empirically testable perspective on the organizational problems of cooperative effort (1989: 72).

## DISCUSSION

Research using the concept of agency theory is quite broad and extensive and a full review is beyond the scope of this book, however, here is a look at some recent studies. In contrast to Eisenhardt's opinion, Nyberg et al. (2010) argue that the incentive alignment prediction of agency theory has not, so far, been empirically proven in studies of CEO (who are agents) compensation. In their study of 2,166 US firms with data from 1992 to 2004, the authors attempt to refine the concept of financial alignment, defined as 'equity ownership that leads managers who share ownership of their firm to embrace shareholder interests' (p. 1030), and examine its ability to predict organizational performance. Along with their newly conceptualized variable of 'CEO return,' defined 'as the percentage change in total firm-specific CEO wealth during a given fiscal year' (p. 1036), they found a statistically significant positive relationship between CEO return and shareholder return such that, on average, firms do create financial alignment and gain from doing so, 'when they create CEO-shareholders via long-term use of equity-based pay and policies that encourage/require executives to maintain equity positions in the firms for which they work' (p. 1041).

Another study, by O'Reilly and Main (2010), also questions the lack of empirical support for linking executive pay with firm performance. They believe executive pay may be more likely a function of management power and influence; that is, more of a behavioral than an instrumental phenomenon. Based on a study of 306 firms in a 2003 database provided by an executive compensation firm, they argue that agency theory may be a useful lens by which to study governance and incentive alignment, but that the ideas of reciprocity and influence are better at explaining why boards of directors sometimes design non-optimal compensation packages for their executives. The authors found that 'norms of reciprocity' – that is, the expectation that another will be obligated when you help them (p. 684) – and 'social influence' – that is, 'when the group signals, tacitly or explicitly, which attitudes and actions are appropriate and acceptable and which are not' (p. 686) – appear distinctly in



the issue of board compensation committees where higher compensation for the committee chair leads to higher rates of CEO pay, such that 'every \$1000 the board member receives is associated with an increase of \$1258 in CEO' total cash compensation (p. 700).

Agency theory tends to assume investors are an homogeneous set with only a long-term outlook, but Connelly et al. (2010) argue that just as agents have diverse goals, principals also have heterogeneous interests, especially when considering institutional investors. Typically institutional investors can be categorized into two types: dedicated institutional investors that 'acquire concentrated equity positions in a few firms and have extended investment horizons' and transient institutional investors that 'acquire less concentrated equity stakes in a dispersed portfolio of firms' with a shorter horizon (p. 723). And the two different time horizons can lead to competing competitive actions: *strategic competitive action*, which focuses on long-term sustainable growth, and *tactical competitive action*, which values short-term earnings and returns. Connelly et al. (2010) ask how principals, such as institutional investors with different horizons, might influence the competitive actions of executives. They looked at a sample of *Fortune 500* firms with data from 1997 to 2006 and found that competitive actions taken by executives are significantly related to firm ownership structures. In other words, an increase in dedicated institutional ownership leads to an increase in strategic competitive actions, an increase in transient institutional ownership leads to a decrease in strategic competitive actions, an increase in transient institutional ownership leads to an increase in tactical competitive actions, and mixed ownership structures can influence each of these negative or positive relationships to be less so. Clearly, their results 'suggest that principals with differing interests can influence the implementation of a range of executive actions' (p. 736).

When CEOs hold positions on Boards of Directors for other firms, are they distracted from their internal responsibilities? This question was asked in a study by Geletkanycz and Boyd (2011). A number of agency theory scholars argue that when a CEO holds an outside directorship, their firms do not benefit. This argument seemingly holds sway with the equity investment community as represented by the growth over the past few decades in the legal restrictions on the number of outsider directorships allowed. Yet, embeddedness scholars argue that outside directorships are quite valuable in terms of access to information and resources that could improve firm performance. In a study of



data from 460 firms in the 1987 *Fortune 1000* list, Geletkanycz and Boyd (2011) found that, in isolation, neither argument was adequate. They proposed a contingency perspective 'that when a firm experiences acute challenges, it is in both the firm's and its CEO's personal interest to deploy the organizationally relevant gains from outside board service' (p. 336). Firms do benefit when outside board service aligns with the strategic and environmental imperatives of the firms; it provides CEOs with improved environmental scanning and exposure to strategic alternatives.

Cai et al. (2011) researched the question of whether US firms that are more socially responsible might pay their CEOs less. In a complex study, they tested the 'overinvestment hypothesis' of agency theory, along with the 'conflict resolution explanation' of stakeholder theory. The overinvestment hypothesis purports that if corporate socially responsible (CSR) 'initiatives do not maximize firm value, such initiatives are a waste of valuable resources' (p. 160). The agency problem would arise because managers would over-invest in CSR activities simply to improve their reputation as good citizens in an attempt to increase their bargaining position in regard to compensation. Thus, an increase in CSR initiatives would lead to an increase in CEO compensation. The conflict resolution explanation purports that 'firm value depends on the interest of all stakeholders, and firms that practice stakeholder management will, other things being equal, outperform others that do not' (p. 160). CEOs would tend to take lower pay to decrease conflict and to increase their appearance as virtuous, while an increase in CSR initiatives would decrease conflicts between stakeholders. Thus, an increase in CSR would lead to a decrease in CEO compensation. Cai et al. (2011) studied 1,946 US firms with data from 1996 to 2010 that indeed showed firms with more CSR activities having, on average, lower CEO pay. This negative relationship between CEO pay and CSR initiatives was consistent with the conflict-resolution explanation of stakeholder theory, not the overinvestment hypothesis of agency theory.

**See also:** *Environment–Organization Interaction, Stakeholder Theory, and Transaction Cost Economics*

## FURTHER READING

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## Alienation

**Alienation:** *the estrangement and separation of people from themselves, their actions, society and their surroundings, resulting in feelings of a lack of control.*

## ORIGINS

The concept of alienation developed well before the advent of organization theory but is usually attributed to the writings of the 19th-century

