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A Brief Study on Evaluating Agency Theory

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ABSTRACT:

The link between the principal and the agent is examined by agency theory, a key idea in the study of economics, finance, and organizational behavior. A principle-agent relationship is established when the principal gives the agent the power to decide on their behalf. The Agency Theory, its fundamental ideas, and its applications in many circumstances are all described in this abstract. Conflicts of interest often occur in the principal-agent relationship as a result of the principal and agent's opposing motives and aims. While the agent may have various goals, such as maximizing personal advantages or avoiding obligations, the principal strives to maximize their interests. These conflicts may result in agency issues, which can have a negative impact on organizational performance, moral hazard creation, and poor decision-making Agency Theory's theoretical foundation may help us comprehend and resolve these issues. Designing ideal contracts and incentive programmers that balance the interests of the two parties is the main emphasis. The principal may encourage the agent to operate in the principle's best interests by matching incentives, thereby improving organizational performance and efficiency.We examine the key ideas of agency theory in this abstract, including information asymmetry, risk-sharing systems, and the function of monitoring and control mechanisms. Additionally, we go through how Agency Theory is used in a number of contexts, such as corporate governance, CEO remuneration, financial contracting, and public sector management.

KEYWORDS:

Agency, Agent, Corporate, Economics, Management, Principle.

I. INTRODUCTION

When the principal hires the agent to do a product or service, agency theory offers a condensed framework for analyzing the connections or transactions between the principal and the agent. According to the notion, these interactions and transactions constitute implicit contracts. The agent's contractual commitment to the principal and the agent's self-interest, which is thought to be different from the contractual obligation, are the two factors that influence the dyadic contract between the principal and agent. The agent is often chosen for the job based on his or her experience or competence, and the principal trusts them to act on the principal's behalf. However, this knowledge gap suggests that there are information asymmetries between the parties, and the agent may be at a disadvantage in terms of information compared to the principal. Sources of information asymmetry include moral hazard, which refers to post contrast hidden action or hidden information, and adverse selection, which refers to incomplete pre-contract information (for example, the agent is not as qualified or experienced as he or she appeared to be)[1], [2].

Due to the agent's self-interested motivations and potential for moral hazard or adverse selection, "agency costs" may arise during contract execution, which will lessen the result for the principal. The type of self-interest that is characterised by cunning is referred to as opportunism. However, a principal may reduce agency expenses by anticipating their occurrence and putting controls over the agent in place to prevent it.The principal's twoprimary tools for managing the The agent is being observed by the agent, and the agent is also being given incentives that fit with that. and is referred to as bonding. It is believed that monitoring an agent that has highly specialised knowledge becomes challenging, and incentive alignment becomes especially important. The principal is responsible for paying extra sources of agency expenses as a consequence of monitoring and bonding, which are not free of charge.

However, agency theory argues that owing to knowledge asymmetries, contracts may be drafted to have low preemptive control costs and result in much lower resident agency costs. In other words, agency theory presupposes that managers may operate the company in a way that serves their own interests more so than that of their owners. Shareholders may triumph, however, by keeping an eye on and rewarding the managers, which will connect management self-interest with shareholder interests and enable the achievement of the overall objective of maximisation of shareholder value[3], [4].

According to the organisation theory research paradigms proposed by Gibson Burrell and Gareth Morgan, agency theory is unmistakably in the functionalist paradigm; it favours preservation of the status quo or the sociology of regulation over radical change and takes an ostensibly objective rather than subjective stance. Agency theory emphasises the significant impact of economics and financial economics on management theory, together with industrial organisation economics and transaction cost theory. The theory has had a particularly significant effect on strategic management, demonstrating that economics' initial influence on the growth of this management area has persisted in new forms. Public choice theory is an adaptation of agency theory that is used in the related field of public administration. It addresses issues related to the relative unaccountability of government administrators and bureaucrats, who are shielded by their civil service protection, as well as the accountability of elected officials to their constituents[5], [6].

II. DISCUSSION

Agency theory, which has its roots in financial economics and is inspired by the law, is used to apply a contractual framework to a wide range of circumstances in which one party, known as the principal, makes use of the services of another party, known as the agent.The agent's self-interest may have a detrimental impact on the contractual responsibilities of the agent to the principal and result in "agency costs" that are incurred by the principal. The principal may, however, proactively put up measures to keep expenditures in check by anticipating that agency charges may arise.The influence of agency theory on management theory has been enormous. Most notably, it is the predominant theory of corporate governance, and agency theory has actually sparked interest in the field. This article examines some of the theory's expansions as well as how agency theory is used in the area of management. It looks at the reasons why agency theory is so controversial while yet being so influential.

Fundamentals

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Evolution

Accounting, law, management, financial economics, and other multidisciplinary fields are all part of the topic of corporate governance. Its definitions range from the stakeholder-based definition, which focuses on the rights, obligations, and relationships between stakeholders in determining the direction and performance of the firm, to the more specific definition connected to financial economics, which addresses the alignment of control mechanisms to maximise shareholder value. The latter concept is the basis of agency theory.The financial economists Michael C. Jensen and William H. Meckling promoted agency theory as a theory of the company in their influential foundational work from 1976, seeing the business as a "nexus of contracts."In this application, shareholder wealth maximisation is a key presupposition of agency theory, just as it is in financial economics. However, agency theory contends that if left to their own devices, managers have a propensity to overdiversify and overdevelop their companies at the price of maximising shareholder value. The publicly owned or public company was defined by Jensen and Meckling as having a problematic separation of ownership and control, as Adolf A. Berle and Gardiner C. Means had noticed some decades before. Corporate managers filled the hole left by owners or shareholders who no longer controlled the business or its management in the public corporation characterised by passive, distributed ownership; this approach is known as managerialism. While Berle and Means had earlier acknowledged the problem of the separation of ownership and control, Jensen and Meckling offered a resolution. They identified a number of ways by which owners or principals can cut agency costs and regain control over the managers or agents of businesses so as to maximise shareholder value as is legally entitled.

After that, Eugene F. Fama and Michael C. Jensen combined the idea of residual claimant status with a viewpoint on nexus of contracts. Agency theorists positioned owners as residual claimants who shoulder the firm's risk of insolvency and are therefore entitled to the firm's profit after all others specifically, its fixed claimants, which include workers and bondholders are paid. The maximisation of shareholder value furthered the priority of the responsibilities of owners and management to them by representing them as residual risk bearers and residual claimants.However, it should be remembered that despite its previous dominance in financial economics, Kathleen M. Eisenhardt's assessment of agency theory is what gave rise to its expanding use in management.

Eisenhardt distinguished between positive agency theory, which focused on governance structures that restrained the self-serving behaviour of manager-agents as demonstrated by Jensen andcoworkers and the more ethereal principal-agent research, which concentrated on the application of logical reasoningand proofs using mathematics. By assuming that managers have a different attitude towards risk than their shareholders and will typically make strategic decisions to favour their own attitude,

Eisenhardt took a theory that had little to do with management theory or practice indeed, it could be viewed as ant managementand presented positive agency theory in a way that demonstrated its utility in examining relationships and testing hypotheses. For instance, agency theory admits the possibility of goal conflict but presupposes that economic incentives should be aligned in order to resolve conflicts rather than using political tactics like bargaining, negotiating, and coalition building. The influence of managerial economic incentives on shareholder value may be tested and measured far more easily by management researchers than the impacts of coalition-building, bargaining, and negotiation.

While ignoring the potential effects of a more realistic range of human motivations and conditions, including the institutional context of the contract as noted by Eisenhardt, agency theory provided management scholars with the benefit of concise explanation and strong predictive ability relative to other theories.Corporate governance control mechanisms in the US and many other settings are made up of a number of internal or firm-level factors and a number of external or contextual pressures. Shareholder power, boards of directors, and executive salaries serve as internal control measures. The successful use of each internal control mechanism is outlined in agency theory. First, advocates of agency theory urge shareholders to take action to align management and owner interests, which is done through refocusing active ownership. Second, agency theory holds that boards of directors exist primarily to oversee management and make sure that managers are committed to the main business objective of maximising shareholder value; those managers who are not should be removed by their boards. Third, agency theory has blatantly pushed the use of executive stock options as a tool for balancing the interests of shareholders and executives. Under this idea, executives are granted shares in exchange for the company's stock rising to the option strike price.

There is also the external corporate-control mechanism of corporate takeover, often known as the market for corporate control, in which high-performing companies buy failing corporations whose market value has decreased as a result of their performance. Agency theory relies more on internal-control mechanisms, most notably executive compensation, and on the external mechanism of the market for corporate control, assuming that these are more effective than the other mechanisms. Other external corporate control mechanisms, or gatekeepers, include industry regulation, credit rating agencies, and auditors. They are the mechanisms that are most obviously linked to economic control mechanisms as opposed to political ones.

Importance

Certainly influential, challenging, and divisive is agency theory. It draws some management experts and gives them a framework for examining a variety of organizational phenomena; it repels others who criticize it; and it confronts a third group that simultaneously lauds many of its strengths and despises its flaws. Additionally, agency theory has "put a dent in the universe" through influencing corporate governance practices in business and changing how such practices are carried out. This section will examine the use of agency theory within the management academic community before examining the impacts of agency theoretic thinking's influence on business practice.

Impact on Management Theory

By using the principal-agent contract paradigm and assessing the effectiveness of systems for regulating the agent and so lowering agency costs, almost any relationship or transaction may be evaluated. The idea has been used by management academics to explain a variety of interorganizational phenomena, such as supply chain management, franchising, and public-private partnerships. It has also been used in intraorganizational phenomena, such as corporate entrepreneurship, employee performance, and decision-making. Corporate governance, which often draws from management, finance, law, accounting, and other disciplines, is the major field of application for agency theory in management.

Agency theory has been used to numerous elements of the composition and processes, institutional investing, investor activism, and other topics.mergers and acquisitions (often known as the "market for corporate control"), of boards of directors,broad context of consequences on organisational performance, and executive remuneration.However, agency theory is also one of the management

theories that receives the most criticism. The idea that humans are atomistic creatures who are mainly driven by self-interest, rather than socialised beings who are primarily motivated by norms, professionalism, and/or moral responsibility, is perhaps the source of the most common critique. Despite protestations to the contrary, agency theory has been seen as normative; as a result, it simultaneously pushes shareholder primacy as the main corporate objective and accepts self-interest as a driving force.

The absence of ethical responsibility in maybe unwittingly encouraging corporate wrongdoing and disdain for the social ramifications of business practise is perhaps the most serious criticism of agency theory. Self-interest may accidentally be encouraged by the designation of self-interest as the main driver of human behaviour, leading to a self-fulfilling prophesy.Some people believe that using a contractual approach to describe complex social problems is just incorrect and produces too simple answers. The interdependence and trust that define teamwork and organisational relationships are allegedly ignored by agency theory, and its top-down orientation may promote Taylorism. The approach overemphasises financial incentives, which may "crowd out" the benefits of nonfinancial (and often cheaper and more effective) incentives. This reduces management's job to that of only monitoring and paying people.

The justification for performance problems brought on by self-interest is exaggerated by agency theory, which ignores the challenges of making management judgements in a situation where there is uncertainty, ambiguity, and goal contestation. However, agency theory does not allow for the evaluation of alternative causes of poor performance. It is true that not all unsatisfactory organisational performance is caused by the agency costs of managerial mischief.The behavioral-agency theory of Robert M. Wiseman and Luis R. Gomez-Mejia, which incorporates some aspects of behavioural decision theory, and the stakeholder-agency theory put forth by Charles W. L. Hill and Thomas M. Jones are two attempts to address some of the criticisms by fusing agency theory with other management theories. From the enlightened stakeholder viewpoint, Luh Luh Lan and Loizos Heracleous bravely implement agency theory; in their model, the firm itself is the primary and the function of the board increases from monitors to "mediating hierarchs." By conceptualising multiparty contracts rather than dyadic ones, there have been attempts to represent the agency contract's higher complexity. These efforts have also focused on how the institutional environment of the contract influences agency costs. The concept of "principal-principal costs" has emerged; it suggests that investors' interests are heterogeneous and that influential shareholders, such as founding families, those who hold voting stock, and block holders, can advance their own interests at the expense of other shareholders. As a result, managers may end up as the puppets of strong, in charge shareholders.In many nations and circumstances, large, dominating investors take advantage of minor investors, therefore it is intriguing that agency theory has been used to advance this crucial topic of investor abuse. Perhaps as the theory develops, new applications and structures built on its foundation will emerge, addressing some of the concerns. It is undeniable that this too simplified framework helps us concentrate on the most fundamental parts of transacting, which may get buried in more encompassing theories, and it has inspired fresh theorising and a surge of response that may not have happened otherwise.

Impact on Business Practice

Because of how quickly agency theory gained popularity in the 1980s, real business practises changed as a result. The tremendous overexpansion and diversification of the 1950s to 1960s was hurting corporate performance, which was also suffering from the oil crisis, inflation, and international competition. In order to refocus businesses, agency theory offered a number of recommendations for exercising more influence over management.However, a lot of the remedies have either made things worse or led to new issues. First, relying too heavily on stock options to balance managers' interests with those of shareholders has often backfired, leading to misconduct such as accounting fraud and the backdating of options contracts. The usage of long-term stock awards is preferred over

Executive remuneration includes stock options, so both shareholders and executives are responsible for the negative and potential upside of strategic choices. Second,According to a number of studies, the increasing degree of executive oversight and the boards' increased use of executive replacement have led to higher executive salary levels as a consequence of the elevated risk of executive employment. Third, the corporate control market seldom operates as predicted.The cyclical nature of the activity promotes overpaying for the target, and integration expenses have a detrimental impact on the deal's rate of return. Small, high-performing businesses are often acquired by big, average-performing businesses.Fourth, despite its symbolic value, the campaign for more independent board members hasn't made a difference since the board nomination process is still problematic. Fifth, agency theory encourages the practise of companies "going private," which is the process by which companies leave the public stock markets and are afterwards held by a few private equity firms, to radically modify their governance structure.

This trend is concerning for two reasons: first, it may have a detrimental effect on corporate social performance due to newly private firms' slavish focus on shareholders and shareholder value; and second, it may have a detrimental impact on stakeholders such as employees, bondholders, and other stakeholders due to newly private firms' propensity for being overly leveraged and at undue risk of bankruptcy. Sixth, the watchdog system for industry supervision has to be revived since the great recession was exacerbated by the deregulation of the banks and other sectors, which was linked to the agency theory and the free-market ethos. It's possible that the group of management academics who both like and despise agency theory will continue to create more considerate, comprehensive, and sustainable models, "crowding out" the researchers who have used the theory without considering its consequences for business practise.

III. CONCLUSION

In the disciplines of economics, finance, and organisational behaviour, agency theory has become a key and significant idea. The theory provides important insights into the dynamics of delegation, decision-making, and governance in many organisational settings via its investigation of principal-agent interactions and conflicts of interest. Understanding the complexity of the principal-agent relationship and the difficulties that occur when decision-making power is delegated is made easier with the help of agency theory. Organisations may improve their efficiency and performance by identifying conflicts of interest, eliminating information asymmetry, and establishing suitable contracts and incentives.

However, it is important to recognise that Agency Theory has its limits and presuppositions, just like any theoretical framework. It makes the irrational and self-interested assumptions about others, which may not always be accurate in real-world situations. Furthermore, the application of agency theory could be context-dependent, and creating the best contracts and incentives in dynamic, complex situations might be difficult.Nevertheless, Agency Theory remains a pillar of organisational study and practise, directing attempts to strengthen accountability, align the interests of important stakeholders, and improve governance systems. Principles and insights from Agency Theory will continue to be crucial for negotiating the complexities of principal-agent interactions and supporting efficient decision-making and management practises as organisations change.

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