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CRITICAL OVERVIEW OF AGENCY THEORY

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Abstract: *Agency theory is an important, yet controversial, theory. This paper reviews agency theory and its contributions to organization theory. Assessment is done in comparison to stewardship theory. The intent is to clarify some of the confusions surrounding agency theory and to alert organizational scholars when using agency theory. Agency theory is confirmed as useful addition to organizational theory, but the paper offers alternative propositions based on a relaxing of agency theory's assumptions.*
Key words: *agency theory, stewardship & organization theory*

1. INTRODUCTION

Prior to intellectual fragmentation of organizational theories in 1970's, structural contingency theory dominated. In order to achieve optimal performance, organizations structurally adjusted to contingent factors meaning size, technology and strategy. Although indeterminate, managerial role was perceived positively. Development of diverse paradigms started in 1970's (Donaldson, 1995). Novel theories critically studied organizational rationality and managerial benevolence. Population-ecology theory, institutional theory, resource dependency theory and organizational economics (Jensen & Meckling, 1976), explicitly and/or implicitly contradicted structural contingency theory.

Organizational economics - including agency theory and transaction cost theory - is grounded on economic model of human behavior which assumes that individual's behavior is opportunistic, self-serving and motivated by satisfying personal goals.

2. AGENCY THEORY

Agency theory is developed as framework for analyzing conflicting interests between key stakeholders, in addition to the development of mechanisms for resolving conflicts (Tipurić, 2008). Besides prevalent contribution within discipline of corporate governance, agency theory application is extensive: agency theory may be applied in every situation in which one party (the principal) delegates work to another (the agent), who performs that work. Agency theory attempts to describe the relationship in terms of behavioral characteristics and provides mathematic instrument for evaluating situations between parties who lack mutual trust.

Intellectual foundation for agency theory development was in the work of *Coase* along with *Alchian* and *Demsetz*. Incentive for agency theory development was relationship between ownership and control function within large corporations. Pioneers, *Jensen* and *Meckling*, tried to verify that corporations do not operate according to the maximization principle, mainly because of the conflicting interests of major governing parties (Jensen & Meckling, 1976). Agency theory describes economic exchange relation between principal and agent. Principal–agent relation, in which principal delegates work to the agent, is described using the metaphor of a contract (Jensen & Meckling, 1976). Agency theory objective is to determine optimal contract between principal and agent. Agent (manager or employee) tries to maximize personal gains by satisfying principal's economic objectives and agent's commitment level is function of perceived reward value for satisfying principal's objectives.

In situation when principal delegates work to the agent, agency relationship develops. Agent's mission is to optimally accomplish principal's interests. In pursuit of the mission, the agent chooses way of doing business which results in certain effects. Principal bears a risk of eventual failure, but also adopts effects of agent's execution of mission reduced for agreed payment to the agent. Level of reward to the agent usually depends on principal's interest in realization of the assigned mission. A benefit, to the agent, in the form of reward represents cost to the principal while agent's effort brings benefits to the principal (with an assumption that higher effort is directly related to better results), and at the same time cost to the agent (Eisenhardt, 1989).

Relationship between principal and agent based on the contract is a focal point of agency theory. Principal wants to maximize his/her benefits while minimizing reward to the agent at the same time. On the other hand, the agent wants to maximize his/her benefits. Agency theory assumes that principal's wealth, *per se*, would not be maximized because agent and principal: (1) have different goals, (2) have different access to information (principal cannot monitor what agent does and know which information agent has), and (3) different propensity towards risk.

3. COMPARISON TO STEWARDSHIP THEORY

Agency and stewardship theory were developed as alternative theories and numerous researches focus on their differences. Both theories are constructive given that they describe possible situations among owners and managers and enlighten governing relations from different perspective. Stewardship theory rejects the agency theory assumptions and presupposes context in which managers perceive that satisfying shareholders goals is also in their personal interest. Separation of ownership and corporate control does not automatically lead to the conflict of goals and interests between owners and managers.

Agency and stewardship relation are opposite relations among owners and managers. In agency relation the emphasis is on building institutional and contractual mechanisms so that managers cannot achieve their own goals at the expense of the owner's goals, while in the stewardship relation, if it is successfully achieved, there are no such problems: the goals are shared, so the manager's activities are also in the interest of the organization. According to *Donaldson and Davis* (1993) central difference between agency and stewardship theory is in model of human behavior: the socio-psychological model of human behavior for stewardship theory and economic model of human behavior for agency theory.

Economic model of human behavior proposes divergence of interests between principal and manager, and therefore agency theory develops effective system for constructive agent's behavior due to the difference in risk propensity, information asymmetry etc. The socio-psychological model of human behavior for stewardship theory proposes that manager's behavior is pro-organizational and collectivistic, achieving higher utility by serving a group (organization), than by satisfying personal goals. A stewardship relation implies convergence of interests between principal and steward. Therefore, the relation is based on trust so principal supports and empowers manager-steward since the fundamental postulate of stewardship theory is that managers always act in such way to maximize the interests of a company, even if the control is completely absent (Podrug, 2010).

4. CRITICS OF AGENCY THEORY

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 behavior. However, absolute explication of every organizational activity should not be considered as equivalent to individual activity and that represents essential critic of structuralism.

It is extremely important to stress that *Williamson's* axiom about opportunistic agent's behavior over time has gained many different forms and interpretations. *Williamson* (1985) identified opportunistic behavior of the minority of individuals, the not majority. „Individual sometimes acts opportunistically and trustworthiness is hardly *ex ante* transparent. Therefore, it is compulsory to conduct *ex ante* screening and develop *ex post* assurance mechanisms or, in contrary, opportunistic individual will exploit circumstances towards less opportunistic individual." Since organizations cannot completely identify and eliminate opportunism, the fundamental proposition is that opportunism is possible and therefore control mechanisms are initiated. However, it is important to stress out that even in circumstances of highly specific assets, where the probability of opportunism is extremely high, there are individuals who will give priority to cooperation and trust and will not initiate opportunistic behavior (Hill, 1990).

Donaldson (1990) had an interesting observation that all of organizational economics' academics (*Jensen* and *Meckling*, *Barney* and *Ouchi*...) paid no attention to the organizational behavior research (*Argyris, Loche, Mitchell, Salancik*…), and ignored organization theory research (*Child, Burns, Galbraith, Hage, Woodward*…) and consequently developed assumptions disregarding essential conclusions from traditional management theory. Traditional management theory as well recognizes managerial errors, but not as calculated actions, but as a result of information insufficiency, knowledge shortage or as a group-thinking effect.

Proponents of agency theory state that control mechanisms are obligatory for directing opportunistic managerial behavior, although empirical researches confirm that control generates stronger individualistic behavior, reduces proactive organizational behavior and trustworthiness, and lastly results with distrust (Podrug, 2010). 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.

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 behavior and fittingly compensate agent. If principal and agent have matching interests, then agent's motivation is not unclear (Tipurić, 2008).

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.

From corporate governance perspective, successful resolution of agency problem (if possible) significantly reduces potential and validity of agency theory in analysis of governing relations, leaving opportunity for application of stewardship theory and other organizational theories.

5. CONCLUSION

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: (1) company is institution of people, with distinct members, and not only one owner; (2) stakeholders have economic and non-economic 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.

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