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# The agency theory of corporate governance

# نظرية الوكالة في حوكمة الشركات

**BOUKERMA Hamid**
Ahmed ZABANA University of Relizane. GMFAMI laboratory. (Algeria).
hamid.boukerma@univ-relizane.dz

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**Abstract:**
Corporations in their lifetimes' are surface to many and different problems that make its' continuity in danger. Between these problems we have a situation when the founder or the entrepreneur want to develop his activities' and need a secondary man to associate him to deal with the partners (workers, clients…) and take decisions in his place, this is what's called in management sciences an agency relationship. So, as the important of this relationship, the researchers study it to give its deferent components and mechanism to be able to keep it in well, it's called agency theory. Our work, by a literature revue, will give explanation for the important and key terms that introduced by researchers to understand this agency relationship in corporates, and using our professional experience in corporate, we tracked some elements that occurred real life.
**Keywords:** governance; agency relationship; agency cost; information asymmetry.
**Jel Classification Codes:** G34

**ملخص:**
تعترض المؤسسات الاقتصادية في مراحل حياتها إلى تحديات مختلفة قد تهدد حتى بقاءها. من بين هذه التحديات، عندما يريد مالك المؤسسة ان يتطور في أعماله، فهو بحاجة الى رجل ثان يستخلفه عند غيابه ليرعى مصالح الشركة مع أطراف فاعلة فيها من عمال وعملاء وحتى موردين، حتى يصل الى ان يتخذ قرارات استراتيجية نيابة عنه، هذا ما أسماه الباحثين في علم المناجمنت بعلاقة الوكالة. ونظرًا لأهمية هذه العلاقة، فقد خصها الباحثون بالدراسة وتطرقوا لمختلف مكوناتها وآلياتها حتى يكون بالمقدور الحفاظ على صحتها، وهي ما أسموه بنظرية الوكالة. فعملنا المقدم، وبالاعتماد على الدراسات السابقة لتوضيح بعض المفاهيم الاساسية لفهم هذه العلاقة، استطعنا، انطلاقا من خبرتنا العملية، تتبع بعض من هذه المفاهيم في واقع المؤسسة المعاش.
**كلمات مفتاحية:** حوكمة؛ علاقة الوكالة؛ مصاريف الوكالة؛ عدم تناسق المعلومة.
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Corresponding author: BOUKERMA Hamid, e-mail: hamid.boukerma@cu-relizane.dz.

## Introduction

Corporations in their lifetimes' are surface to many and different problems that make its' continuity in danger. Between these problems we have a situation when the founder or the entrepreneur want to develop his activities' and need a secondary man to associate him to deal with the partners (workers, clients…) and take decisions in his place, this is what's called in management sciences an agency relationship. So, as the important of this relationship, the researchers study it to give definition, its deferent components and mechanism to be able to keep it in well, it's called agency theory. toward understanding this theory, our purpose work is to give answering at the principal question: in what's important the agency theory? And how does it affect the corporation's management?

To know more about the agency theory, we developed governance concept as the context that it's occurred in and the assumptions of this theory of agency in which we gave a tracking of the problems that affect the corporates inspired from these assumptions.

## 1 Conceptual framework of corporate governance

In first time, with the founding father of political economy, conceptualized a presentation far from the current theories, by considering concretely the entrepreneur whose activities creates the firm.

The entrepreneur is at the same time the chief of corporate and the corporate (the concept of stakeholders wasn't conceptualized), this chief of corporate is considered the capital provider (he's taking the business risk).

This conception which stars from the physical person (entrepreneur) remains very significant both in institutional terms (definition's code based on the merchant) and economic reality (as in France 90% of companies remains individual, and the 10 % that are in the form of corporation, 90 % of them remains family businesses).

Governance corporate issues are thereby reduced, but from this time, cases for which the responsibility operations had to be delegated to operators separate from owners. The fathers of political economy such as Adam Smith then expressed (Pérez, 2003).

It was with the development of the large industry that companies began to call on public savings, and confirmed the growing separation between the directors of companies and their shareholders.

This is where the conceptualization of "the managerial theory of the firm" began, by several authors, namely A. Berle et G. Means [1932], William J. Baumol [1959], Edith T. Penrose [1964], Robin Marris [1964] et Oliver

Williamson [1964], Marchesnay [1969].

After this separation, the question of governance gained importance where the managers can develop a strategic that their objectives are note aligned with those of shareholders, the latter tend to become suppliers, among others, firm resources.

**2 Background**

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**2.1. Berle and Means thesis (the business profesor, 2011):**

The Berle-Means Thesis is a theory named after A. Berle and G. Means. It has to do with governance of public corporations in which the board of directors is put in charge of governance. The owners of the public depend on the board of directors to run the operations of the corporation.

The Berle-Means Thesis is one that maintains that the governance of public corporations is dominated by the board of directors, even the owners rely on them to run the affairs. A book written in 1932 by Adolf Berle and Gardiner Means in modern corporation and private property developed the Berle-Means Thesis.

This theory studies the foundation of corporate law in the United States as well as the emergence of big corporations. It posits that legal ownership and control of public corporations are separated. Those who own the corporations are different from those that control them. Both authors argued that *corporate law* in the U. S during the 1930s *enforced* the *separation* of *ownership* and *control* of public corporations.

According to this Berle-Means theory, owners of corporations' surrender to those who are in the control of the corporations and are just become wages or salary earners. The relinquish authority to the board of directors who control the corporation and also represent the interests of the owners of the corporation.

However, there are certain consequences attributed to separation in the ownership and control of a company. One major consequence is that owners of the company overtime have proportionally smaller capital stake and their application in the company might gradually reduce.

Berle and Means advocated transparency, accountability and embedded voting rights for all shareholders in a public corporation.

Faced with such a situation of the firm's managerial approaches, the

"Shareholders' people" could not stay indifferent and had to seek an appropriate response. In addition to initiatives from individual shareholders or grouped in associations, it was necessary to reconstruct a theoretical argument legitimizing these initiatives. Agency theory answered this waiting.

### 2.2. Jesen and Meckling (1976):

#### 2.2.1 Agency relationship:

Michael Jensen and William Meckling wrote a decisive paper on agency theory in 1976. A principal-agent relationship exists when one of the parties (the agent) agrees to act on behalf of another party (the principal).

An agency relationship arises whenever one party delegates decision making authority or control over resources to another.

The principal is the person delegating the authority and the agent is the person whom authority is delegated.

The relationship formed between agent and client is called a fiduciary relationship.

Shareholders who are the principals provide company with risk capital while the CEO as agent is expected to use that capital.

The firm is no longer represented there through the entrepreneur, as in its canonical form, but as a "knot of contracts". The different “stakeholders” are linked in this node of contracts with the legal fiction that creating these "legal persons" that are companies. For each part, the terms of the contract specify in more or less detail - we do not can always foresee everything, hence the "incompleteness of contracts" - reciprocal rights and duties.

Two principal actors are faced into the traditional question of governance which the agency theory brings several innovative elements.

#### 2.2.2. Agency cost (monitoring expenditures + bonding expenditures + residual)

Agency conflict between the owner and the manager usually result from the manager’s tendency to take over the company’s resources under his or her own assets and withdraw the resulting bonuses. The problem is to develop a contract that provides incentives for the agent to work in a way that benefits the principal.

When there is a decentralization or delegation process, it involves a loss of control that is costly for the principal. This cost is generally referred to as the “agency cost”. They are defined as the sum of the control expenses by the principal, the expenses by the liaison officer and the residual loss.

#### 2.2.3. Agency problems arise because contracts are both costly to write and impose Fama and Jensen (1983):

In the language of modern economic theory, agency costs arise when one or more person(s), the principal(s), engage(s) another person or persons, the agent(s), to perform some activity on their behalf, such that decision-making authority is substantially delegated by the principal to the agent. If both persons are utility maximizes, then there is good reason to believe that the agent will not always act in the interests of the principal, resulting in costs—agency costs—which are typically borne by the principal. A specific example of a principal-agent relationship, according to modern economists, is the contractual arrangement between the shareholders and managers of a public corporation.

The agency problem is a conflict of interest inherent in any relationship where one party is expected to act in another's best interests. In corporate finance, the agency problem usually refers to a conflict of interest between a company's management and the company's stockholders

- **market of corporate control**

R. Marris [1964]

through takeover takeovers; threats constituting a danger for the companies listed on the stock exchange - as R. Marris [1964] had already noted;

- **the "executives market"**

On which managers appreciate - or depreciate - depending on their performance; market which completes the previous one in the device contributing to "Discipline" the leaders;

- **the concept of "free cash flow"**

an indicator allowing to appreciate the discretionary margins available to managers, degree of freedom that should be reduce " Free cash flow (FCF) represents the cash a company generates after accounting for cash outflows to support operations and maintain its capital assets" (JAGERSON, 2019)

### 2.3 Definition of Agency Theory

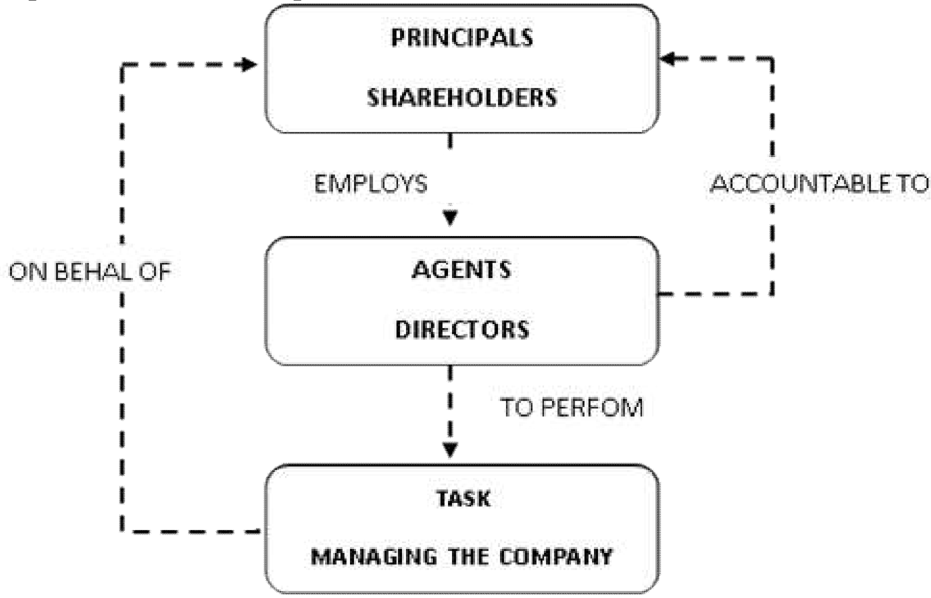
The agency theory is a supposition that explains the relationship between principals and agents in business. Agency theory is concerned with resolving problems that can exist in agency relationships due to unaligned goals or different aversion levels to risk. The most common agency relationship in finance occurs between shareholders (principal) and company executives (agents).

Agency theory addresses vertical links of ownership and control at multiple levels across the borders of firms and within the firm’s boundaries.

Jensen and Meckling defined: “A contract under which 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.” (C.Jensen & H.Meckling, 1976)

## 3. The separation of ownership and control

**Fig.1.** Separation of ownership and control




**Source:** ESQ. KENNEDY SADZIWA, Age ncy Theory presentation. University of Zimbabwe. 2018. P 08.

• Companies that are quoted on a stock market such as the London Stock Exchange are often extremely complex and require a substantial investment in equity to fund them, i.e. they often have large numbers of shareholders.

• Shareholders delegate control to professional managers (the board of directors) to run the company on their behalf.

• The Directors (agents) have a fiduciary responsibility to the shareholders (principal) of their organisation (usually described through company law as 'operating in the best interests of the shareholders').

• Shareholders normally play a passive role in the day-to-day management of the company.

• Directors own less than 1% of the shares of most of the UK's 100 largest quoted companies and only four out of ten directors of listed companies own any shares in their business.

• Separation of ownership and control leads to a potential conflict of interests between directors and shareholders.

• The agents' objectives (such as a desire for high salary, large bonus and status for a director) will differ from the principal's objectives (wealth maximisation for shareholders).

**4. Agency theory diagram**

The agency theory is presented in this diagram in which we can see the two actors the principal and the agent in position who are the both having to force the other by taking different opinion and orientation about risk, obligation and reciprocity, goal orientation and self-interest.

**Fig.2.** Agency theory diagram


**Source:** ESQ. KENNEDY SADZIWA, Age ncy Theory presentation. University of Zimbabwe. 2018. P 10.

## 5. Assumptions of Agency Theory

The agency theory is based on tow behavior assumptions (GARDES, 2013). the first one supposed that individuals look for maximize their utility, the second assume that individuals are likely to take advantage of incomplete contracts.

### 5.1. Divergence of interest

According to agency theory, managers are the agents of shareholders within the company and are intended to manage the company in the interest of the shareholders (C.Jensen & H.Meckling, 1976). However, managers and shareholders have different utility functions and act in a way that maximizes their respective utility. According to M. Jensen and W. Meckling, the manager tends to appropriate part of the firm's resources in the form of privileges for his own interests (discretionary expenses). successive developments have highlighted the motivation of managers to strengthen their position at the head of the company. They can as a result prefer the growth of profit, employing more staff than necessary. Their goal is to serve the social interest of the company before satisfying the interests of shareholders (distribution of dividends or revaluation of securities) or employees. In spirit, the manager's aspiration is to maximize his compensation and minimize his effort.

This divergence of interest is accentuated by the difference in risks incurred. The shareholder may lose his contributions, but the manager runs the risk of losing his job and his value on the job market. Consequently, the efforts made by the managers in favor of the company, if they are beneficial to the shareholders, involve for them a certain disutility. Executives who have most of their wealth (human capital) invested in their company are much more sensitive to the variability of company results than are shareholders who can easily diversify their portfolio, more important than shareholders. It is therefore in their interest to undertake investments that are less risky and more profitable in the short term than would be desirable from the point of view of the shareholder.

### 5.2. Asymmetry in the distribution of information, the problem opportunism

The asymmetry in the distribution of information associated with a divergence of interests gives rise to the agency problems. Indeed, if there is no divergence in the preferences of the actors, the information asymmetry will not pose problems insofar as the agent chooses his action in agreement with the principal. Likewise, in the absence of an information asymmetry problem, any conflicts of interest will be easily overcome since the principal will immediately detect any opportunistic behaviour on the part of the agent. However, the agency relationship only exists because the principal considers the agent better placed than him to manage his property. He recognizes his special abilities and knowledge. The asymmetry of information is therefore at the origin of the contractual relationship.

Agency problems are linked to both uncertainty and imperfection observability of the agent's efforts as well as the costs of establishing and executing contracts. As the complexity of managerial work cannot be precisely specified, the shareholder is therefore exposed to the opportunism of the manager. Thus, the more uncertain the environment, the asymmetric information and the measurement of individual effort problematic, the higher the risk of negligence prejudicial to the interests of shareholders.

Agency relationships therefore give new insight into the problems of *moral hazard*, adverse selection and *opportunism*. In fact, the managers who are responsible for managing the company have inside information on how it works. In addition, the shareholder does not always have the necessary skills enabling him to know whether a transaction serves his own interests or those of leaders. It is then possible for the manager to adopt an opportunistic behaviour by manipulating the information he manages, communicating only what serves his interest. The opportunism of the manager can lead him to divert for his personal profit decreasing by as much the residual profit of the owner. The principal will therefore have to puts in place an incentive system and control mechanisms if it wishes to limit the losses caused by a divergence of interests (C.Jensen & H.Meckling, 1976). The implementation of control techniques and incentive systems to guarantee the smooth running of contracts will generate agency costs. These can be understood as organizational costs and represent the symmetric of transaction costs.

To avoid such a situation, economic agents develop systems of control and incitement of behaviour, the establishment of such a system is expensive, these are the *agency costs*.

**6. Tracking the principal-agent relationships in SME Familial**

The corporate that I will take example from is familial company, its capital is providing by the father, and manager is his son, we can go from the recruitment till the negotiation with the clients.

**6.1. The Recruitment of the Manager**

As young is he, his academic and managerial levels aren't advanced, hasn't an experience in management, when you deal with him you don't appreciate a strong charisma (I speak as much as witness who attended it), so as his CV isn't reach, how can he managed the company? the Principal (his father) based his selection on an assistance in tow levels, the decisional and managerial levels, consequently the contract between wasn't based on objectives goals but on subjective gaols ( the father want his son to learn about management and the world of business).

Taking the management of the company, the agent ( the son) began to *control* the resources of the company and *act on his interest* when he increased his salary and had some privilege in paying for his plane tickets and his friends, and he *delegated* the management of the unit of production to his administration and Finance chief, creating by this act *another agency relationship* even if we consider the company as an nexus of contracts which means *more of agency problems*.

As in Great Britain, Transparency on compensation and stock options "The British government has decided to go even further on the subject. According to a law project deposit in the fall of 2001, the English groups shall in future submit the remuneration of their managers to the vote of their shareholders. "Too often leaders are rewarded for royal way for dull performances, even bad, "explained

Patricia Hewitt, Minister of Commerce and Industry, in presenting the text. " (Le Monde, 2002)

A summary table resume the *Compensation and performance* of great French managers (Thierry.Penard, 2003):

**Table 1.** *Compensation and performance* of great French managers

| Company | Name of director | Remunerations in 2002 (evolution by compared to 2001) | Stocks options attributed in 2002 | Evolution of stocks during in 2002 |
|---|---|---|---|---|
| Vivendi | Messier | 5,720 (+11,6%) | 0 | -70% |
| Vinci | Zacharias | 3,039 (+16%) | 750 000 | -15% |
| Total | Desmaret | 2,410 (-26,8%) | 60 000 | -10% |
| Danone | Riboud | 2,400 (+4,3%) | 50 000 | -5% |
| Suez | Mestrallet | 2,271 (+1,3%) | 350 000 | -50% |
| Bouygues | Bouygues | 1,994 (+22,1%) | 200 000 | -30% |
| AXA | De Castries | 1,963 (-2,8%) | 800 000 | -50% |
| Lafarge | Collomb | 1,789 (+30,9%) | 20 000 | -33% |
| Renault | Schweitzer | 1,664 (+52,5%) | 130 000 | +12,5% |
| Saint-Gobain | Beffa | 1,640 (-0,6%) | 240 000 | -35% |

**Source:** Thierry Penard. The contributions of agency theory. Course in Business Economics License 2 Law. University of Renne. 2006. p 09.

Noting that the absence of the first managers from the company will affect directly their turnover therefore the performance will decrease and by the future it will have a seriously financial problem. this decrease of turnover can be considered as an agency cost the principal can't be informed by and control it.

management of the business portfolio:

In the management of the business portfolio we two kinds of business, the business which is already in place and the new projects which need high level of negotiation skills.

**6.2. Contracts already concluded**

The strategic domain of activities is the transformation of plastics, the business of that company was strategically based on two potential clients which presented a big risk for the turnover of the company if one or both of the clients had internal or external troubles (mismanagement or political). effectively since tree years ago, the geostrategic politic is changed more and more causes damage to those economics operators and consequently for the company, and the young manager didn't have the skill to deal with this situation and the performance indicators are going more and more bad.

So the company had the obligation to diversify the business base on proposing new products with providing new investments which also required the necessary finance resources. There resources can be required by internal financing or external financing from the banks. the internal financing was chosen for the first time because the principal supported the agent and his decision and was reassured that he's acting on his interest and getting the desire to won the challenge of management and increase his wealth. but the reality reflected on financial statements been something else and the indicators was very bad. in front of this situation, the principal began to measure the risk involved which wasn't the same evaluation. the principal refused to finance the new investments, the agent has to require the bank service but it wasn't so easy and taking more time (which means loss of a part of market for competitors) without mortgage because the balance sheet structure was unbalanced caused by using the first method for financing the creation of the company and the launch of the activity.

### 6.3. New projects

For this category of management, the manager (agent) had the imperative to rectify the situation and try to amplify the turnover by targeting a new Strategic Domain Activity in carefully strategic of diversification, after negotiate with new partners to launch a new product. but to make the right decision at the right time, the manager had to consult the family board which is formed by the father (principal) and two other brothers.

The board with its formulation compounded conflicts interests between members and thereby causes lot of agency costs.

During negotiating with the contacts, the brothers take time to time the boat helm and impose their ideas, for example one of them stopped the negotiation because of 50 000 Euros saying that's so expensive and the supplier mast make reductions and waste time in average two months which will be very decisive in the future because the prices will decrease by 45 000 Euros and the shortfall of two months according to technical-economic study was 99 million Dinars, so the agency costs in that level was at 105 Million Dinars.

the second brother made matters worse when he sent a message to the client explaining to him how is the cost price calculated, and the client benefited from the situation and imposed to mention this method in the initial contract by reducing the price by more than 100 Dinars the unit, so for the business we have as decrease of price 25 Million Dinars, which represent an agency costs for the principal.

***These agency costs exist because of the agency conflicts between the agent and family board members.***

At this time, the new project is delayed by more than three months, which with the fall in the foreign exchange reserves of Algeria which decreases the revenue of the state generating the national economy and the arrival of the pandemic of corona virus which put the whole world in harsh examination and conditional therefore the future of the project.

## 7. Conclusion

To conclude this work, we can say that agency theory exists to solve the relationship problems that are imposed by the development of the company in the 1930th in the United states and after in the whole world by adopting the theory of separation the control from the capital and involving the need of governance systems appropriate to each company.

Family company, even if there is two or more shareholders, by the most of the capital is provided by founder and can be considered as the principal in the agency theory, the director (has in general a family bon with the principal) act as the agent of the shareholders, he must be selected in an objective vision by a family board compounded by members of family and strengthen the external control in assistance with an external audit and install internal control by implementing internal procedures , remembering that the remuneration of the director have to motivate him to do better than he can by index it to the performance and the turnover of the company.

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