

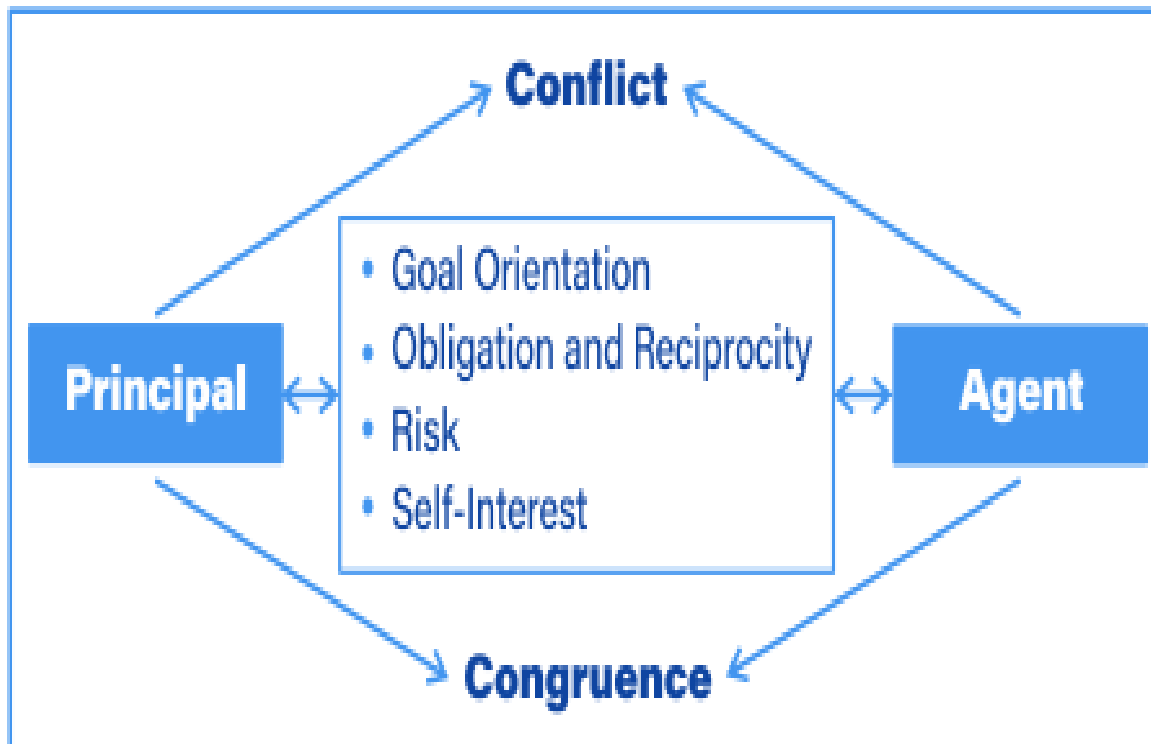
Agency Theory: Problems, Roles, Conflicts & Solutions Explained

Agency theory refers to the relationship between two parties: One party, the principal, delegates work to another party, the agent, to perform something on their behalf. It evidences that issues can arise when the agent and principal's objectives are not aligned. In the simplest of terms, agency theory describes what can go awfully wrong when one person decides on behalf of another person. What is agency theory?" The answer is – it is a theory that examines the issues and answer in the agency relationship between the agent and the principal, particularly in a business context.

Corporate governanceThe theory has been a pivotal factor in providing insight into corporate governance conflicts. Its most common application is in studying company management and shareholder relations. It enables companies to create better governance structures to constrain managers and enhance decision-making. It also explains why business needs trust, contracts and performance checks.

What is Agency Theory?

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What Is the Agency Problem in Corporate Governance?

The agency problem arises when the interests of the agent and the principal are not aligned. In business, this occurs when managers (agents) make decisions that benefit themselves at the cost of the owners

(principals). This is a huge problem in corporate governance. This is not a good scenario, which is why understanding this problem is critical to keeping the [business](#) honest and toward running the right way.

When there is no act on behalf of the principal agent the business will cut back. This issue is not new. It occurs in almost all organizations, big or small. Although the agent is paid to work on behalf of the principal, the agent may take improper steps that benefit himself. This is a conflict of interest touchpoint in agency theory.

How the Agency Problem Occurs?

Most companies have owners who hire managers to manage the business. These owners hope managers are maximizing company profit and are making good decisions. But sometimes managers may need to consider their own profit first. Such individuals may misuse office funds for their own benefit, conceal poor performance, and take high-risk decisions to reap short-term benefits.

And therein lies the agency problem. The principal (owner) desires sustainable growth and risk-averse actions. The conflicting interests can lead to an agent (manager) who acts for the sake of short-term goals benefiting himself. They can make quick-hit profits and get bonuses, not caring if those decisions hurt the company down the line. So both sides do not necessarily have the same goals.

Case Studies of Agency Theory in Action

Here are a few examples of agency theory:

- A CEO borrows money to inflate quarterly earnings. This raises the company's risk of defaulting on its debt.
- Take a fund manager who takes on risky investments for high returns to collect a bonus.
- A head of sales suppresses weak sales numbers to report strong performance.
- In all these examples, the agent does not act in the best interest of the principal. The result is losses, mistrust and poor corporate governance.

Role of Corporate Governance in Solving the Agency Problem

Agency theory of corporate governance is built around the ideas of rules and checks to minimize the agency problem. It facilitates creating systems such as:

- Performance-based pay
- Audit systems
- Independent board members
- Clear contracts with duties

These techniques help keep the agent honest and responsible. It leaves trust and discipline in its wake. Agency theory requires good corporate governance to manage risk of conflict of interest.

Understanding Principal-Agent Theory in Your Business

Agency theory is built on the principal agent theory. It speaks of the connection between Two. One is the giver of the task (principal), and the other is the doer of the task (agent). This relationship is observable in [companies](#), government, hospitals, and even schools. It helps us see how tasks transition from decision-makers to doers.

This portion in the article covers the functions, roles, and conflicts existing in the theory. It demonstrates how different goals lead to problems, and how clever systems can solve them.

Who is a Principal And Who is an Agent?

Power and trust are handed out by the principal. They own a job or a business and want outcomes. The party acting on behalf of the principal is the agent. They get things done, make decisions and manage resources.

Let's see if it makes sense through simple cases:

- Shareholders are the principals in a company. Managers are the agents.
- In a school community, the school board is the principal. The headmaster is the agent.
- Citizens are the principals in politics. Politicians are the agents

Why It's the Relationship That Can Go Wrong?

This agency relationship only works when the two parties are aligned. But that rarely happens. Agents potentially will have their own agenda. They might want more money, less work or fame. When they conceal information or act wrongly, it causes a breakdown in trust.

This phenomenon is called a conflict of [interest](#) in agency theory. The interests of the agent and principal diverge, the agent can take action that is in their best interest to the detriment of the principal. E.g. a manager might promote junk products to hit targets & earn bonuses.

Types of Agency Theory

The types of agency theory can be split into a few general categories:

Type	Focus Area
Corporate Agency Theory	Principal-agent issues in firms
Political Agency Theory	Issues between voters and elected leaders
Legal Agency Theory	Contractual agency in law and property management
Financial Agency Theory	Investor and fund manager relationship

The Relationship Between Investor and Fund Manager

All these types illustrate how trust is eroded and what to do to prevent power being misused." In each instance the agent possesses additional information. So it's information asymmetry. It allows the agent to act smart to cover up facts or not get caught.

We Should Fix The Principal-Agent Misalignment

Here are some helpful techniques to mitigate this issue:

- **Monitoring:** Principals should constantly monitor what the agents are doing.
- **Incentives:** Connecting agent income to company performance minimizes self-serving behaviors.
- **Contracts:** Clear write ups of agreements outlining tasks, rights and punishments.

Provide open access to all data and all [decision-making](#) to reduce misuse Transparency: This is all the things that make the agency relationship more robust and honest.

Limitations of Agency Theory and Potential Resolutions

Agency theory has many uses. But it is not perfect. The limitations of agency theory have long been pointed out by many experts. These limitations arise from [human](#) nature, shifting objectives, and underdeveloped trust frameworks. Here I explain what those limits are and what kind of agency problem solutions we can use.

The theory looks simple. But relationships in the real world are not. So, HR professionals have to think Highway, not Blind Alley. Money is not the only goal. So do trust, values, team behavior, and culture.

Limitations of Agency theory?

Here are a few key weaknesses of the theory:

Focus on Self-Interest Only

Agents are always most important in their eyes, goes the theory. But that is not always true. Of course, the majority of agents are loyal and honest. They take pride in the [company](#) and the work they do. The theory ignores this fact.

Too Much Focus on Contracts

Contracts can solve every problem is the belief of agency theory. But contracts are not the end-all, be-all for every task. There are a substantial number of job roles that are dynamic and require autonomy. To have agents feeling unhappy, or even with the feeling of being limited, due to too strict of contracts.

Ignores Group Behavior

The theory only considers one-to-one relationships. But decisions in real life are made by teams. There may be many agents working together. Goals of the group may impact actions. This is outside the context of the theory.

Fails in Long-Term Planning

In some cases, principal also pushes for [short term](#) profits. Agents can be pressured into taking incorrect action. In those situations, the theory fails miserably because both sides are at fault.

Cultural Limits

Work culture is emotional and relationship-based in countries like India. Not all behavior is captured by a contract-based perspective.

Solutions to Agency Problem

Despite these constraints, there are sorts of clever approaches we can use to ameliorate the agency problem. Such solutions foster and build trust and alignment.

- **Ethical Leadership:** Outstanding [leaders](#) impart values and integrity.
- **Ownership** — Give, because of Article 61 they are also owners.
- **Talk openly:** Regular conversations lessen fear and build trust.
- **Balanced Scorecard:** Evaluate your agents not only on profits but also their behaviour with other team members and long-term effects.
- **Independent Boards:** Independent board members temper management performance.

These agency theory solutions help companies perform better and protect both agents and principals. It enhances the relevance of agency theory in present-day business.

Relevance to ACCA Syllabus

Agency theory is a fundamental aspect of [ACCA's](#) Corporate and Business Law (LW), Strategic Business Leader (SBL) and Financial Management (FM) modules. It teaches students about the

principal-agent conflict, a key idea in any discussions of corporate governance, performance measurement, and ethical business leadership.

Agency Theory ACCA Questions

Q1. What does agency theory fundamentally ask?

- A) Clash between debt and equity holders
- B) The relationships of the government and auditors
- C) Divergent interests between owners and managers
- D) Supplier vs customer disagreements

Ans: C) Conflict of interest between owners and managers

Q2. Which of the following represents an example of an agency cost?

- A) External auditors' fees for an independent audit
- B) Payments issued to stockholders
- C) Short-term bonuses paid to directors
- D) Production workers wages

Ans: C) Short-term performance measures used to pay bonuses to directors

Q3. Answer: How do you solve agency problems in a company?

- A) Increase employee benefits
- B) Linking executive compensation to performance
- C) The abolition of the Board of Directors
- D) Increase in product prices

Ans: B) Performance based executive compensations

Q4. What subject of ACCA studies the agency theory and the governance mechanism?

- A) Audit and Assurance
- B) Strategic Business Reporting (SBR)
- C) Strategic Business Leader
- D) Taxation

Ans: A) Strategic Business Leader

Q5. What is one prevalent agency issue pertaining to financial reporting?

- A) Revenue under-reporting for tax saving
- B) Inflating performance via overstating assets
- C) Payments to creditors not made as scheduled
- D) Infrequent turnover of inventory

Ans: B) Overstating assets to make performance appear better

Relevance to US CMA Syllabus

Agency Theory: Strategic Financial Management It includes outlining managers' incentives, types of corporate governance, and how financial controls can align the agents' actions with the organization's goals in [CMA](#)

Agency Theory CMA Questions

Q1. What is the agency part of agency theory?

- A) Customers
- B) Government bodies
- C) Company managers
- D) Shareholders

Ans: C) Company managers

Q2. Which mechanism best aligns the actions of management with the maximization of Shareholder Wealth?

- A) Government regulation
- B) Distributing profit. includes the employees
- C) Managers share-holder scheme
- D) Increasing debt financing

Ans: C) Managers are richly compensated in equity

Q3. Which of the following is not considered agency cost?

- A) Monitoring expenditures
- B) Performance bonuses
- D) Opportunity cost of the wrong decisions
- D) Production material costs

Ans: D) The costs related to materials needed to produce

Q4. Which concept of strategic finance ensures that management goals are consistent with shareholders value?

- CSR ACCORDING TO YOU A)
- B) Stakeholder theory
- C) Agency theory
- D) Behavioral economics

Ans: C) Agency theory

Q5. How about budget preparation process Agency Problems What sort of financial discipline can help?

- About A) A strict budget with no leeway
- B) Giving consideration to Responsible/Varied
- C) Remove management bonuses
- D) Shrinking management teams

Ans: B) Responsibility accounting and variance Analysis

Relevance to US CPA Syllabus

Agency theory is in particular pertinent to the Business Environment and Concepts (BEC) and Auditing and Attestation (AUD) sections of [CPA](#). It is a guide to understanding internal controls, auditor independence and the roles of governance.

Agency Theory US CPA Questions

Q1. Agency theory is focused on the relationship between principals and agents in business and emphasizes the need for (in terms of CPA ethics and governance):

- A) Creative accounting
- B) Auditor-client familiarity
- C) Assurance by an objective third party
- D) How to do financial reporting the wrong way

Ans: C) Third-party assurance – objective

Q2. The internal control that reduces agency risk is?

- A) Manual data entry systems
- B) Separation of duties
- C) Sales forecasting
- D) Bringing in poorly qualified managers

Ans: B) Separation of duties

Q3. What makes an external audit important according to agency theory?

- A) Do to guarantee operational excellence
- B) To assist creditors in recovering dues
- C) To ensure management acts in owners' best interests
- D) To reduce taxation

Ans: C) To evidence management's interest in owners

Q4. To which kind of agency cost an audit fee is a sign?

- A) Incentive cost
- B) Monitoring cost
- C) Bonding cost
- D) Restructuring cost

Ans: B) Monitoring cost

Q5. What is an agent example for CPA audit considerations?

- A) Board of directors
- B) Internal auditors
- C) Shareholders
- D) Executive management of the company

Ans: D) Company's executive management

Relevance to CFA Syllabus

Agency theory: Corporate Governance and ESG ([CFA](#) Level I and II curriculum topics) It allows analysts to understand how incentive structures and governance models affect firm value and investor trust.

Agency Theory CFA Questions

Q1. Agency theory is the basis of the following areas of CFA ethics and governance curriculums:

- A) Passive investing strategies
- B) Application of leveraged buyout
- C) Disclosure and transparency obligations of reporting
- D) Avoidance of derivatives

Ans: C) Disclosure and transparency obligations of reporting

Q2. One of the cornerstones of agency theory in capital markets is neutrality to rational agents.

- A) Agents always tell the truth
- B) Principals and agents have information asymmetry
- C) owners own all operations
- D) Managers and owners' goals never conflict

Ans: B) Asymmetric information between principals and agents

Q3. One ties executive bonuses to the long-term performance of stock. This is to:

- A) Increase corporate debt
- B) Have successful business operations
- C) Lessen liquidity
- D) Harmonizing goals of the agent with goals of the principal

Ans: D) Aligning agent goals and shareholder goals

Q4. According to agency theory, it falls to the board to:

- A. Represent the interests of creditors
- B) Provide tax assistance for employees

C) Executive behaviour oversight

D) Set salaries for employees

Ans: C) For overseeing and regulating executive behaviour

Q5. Which governance mechanism protects against agency conflicts in investment choices?

Increase in working capitalQ.

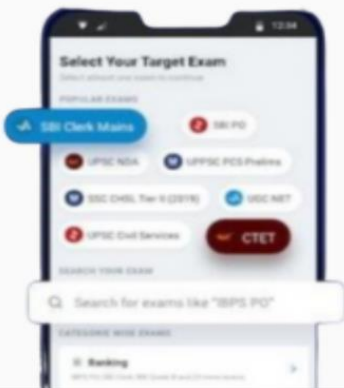
B) Use of a staggered board

C) Regular reviews of performance

D) Employee unions

Ans: C) Regular performance reviews

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