*Strategic Management*, 9e: Chapter 11 study guide

Agency theory-based strategy

**Definition**: Agency Theory is concerned with the added value that derives from one party - the principal - delegating the responsibility for one or more management decisions to another party - an agent acting on behalf of the principal - on the assumption that the agent is better placed or better informed to make the optimal decision.

For example, the *principal* might be a shareholder of a company who passes responsibility for the management of the company to a senior director. The director is acting as an *agent* for the owner and is taking responsibility for generating value in the company. Other principal and agent combinations might be a manager with an employee or a manager employing an advertising agency to develop work on behalf of the company.

As soon as responsibility is passed to someone else, agency theory argues that costs are involved. Such costs can occur in several ways:

 The cost of *negotiating* the relationship at the outset

 The cost of *monitoring* the relationship to ensure that it continues to give best value

 The cost of *enforcing* relationships that have not delivered the results. This might include the cost of terminating a relationship that still has some time to operate and the costs of pursuing the agent that has not done what was promised in the relationship.

Sometimes the relationship is set out in a formal contract and sometimes it is vaguer. If it is contractual, then there is usually a way to determine the costs. If it is less clear – for example, general advice from a consultant on some aspect of the business – then it becomes more difficult to determine whether the agent has really added sufficient value to justify the cost involved.

In addition, sometimes the costs - especially the full, true relationship costs - are more difficult to determine. The agent may have other interests that conflict with those of the principal. A well-established example may be that of senior directors – the *agents* - who have personal aircraft to ferry them around the country. They do this because they like the idea of the status that this brings, even though such expensive transport has much higher costs and reduces the profits available to the shareholders – the *principals* - of the company. This is where agency theory can provide interesting and relevant insights. But at the same time, it becomes more complex and difficult to operationalise.

In principle, agency theory argues that such conflicts can be avoided by the principal giving the agent *incentives* to work on behalf of the principal and providing *controls and constraints* that stop the agent acting on other interests. When this does not happen for whatever reason, then this is known as the ‘agency problem.’ According to agency theory, this problem can be resolved through the ‘market for corporate control.’ What this means is that managers who do not act to maximise the wealth of the principal face the possibility of being replaced by other managers.

For example, shareholders might press for the sale of a company whose senior managers were more interested in flying in expensive jets than in increasing the profits of the company. This example may be more complex in practice for at least three reasons:

 The shareholders may be reluctant to change the management because of the special skills and knowledge of the managers;

 The shareholders may not have any alternative managers to replace the existing ones;

 The shareholders may judge that the more drastic solution of selling the company has uncertainties in itself – will it fetch a sufficiently high price?

Agency theory has been described above in the context of shareholder/senior director relationships. But the same theory can be applied in many other relationships within the value chain of an organisation: for example, between managers and employees and between the company and outside suppliers of goods and services. Agency theory also has useful insights in other relationships like the operation of an alliance or a joint venture.

It is not possible to explore agency theory fully in this short note. Readers are directed to chapter 8 by Duncan Angwin in: *Advanced Strategic Management*, Second Edition, edited by Mark Jenkins, Véronique Ambrosini with Nardine Collier, published by Palgrave.

Professor Lynch acknowledges the above source in writing this note.