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Can the behavioral agency model refine a standard agency theory?

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ABSTRACT

Purpose — *The existence of agency problems is widely recognized in various academic fields. Nevertheless, as argued by many scholars, agency theory has obvious shortcomings both theoretically and empirically. The aim of this study is to analyze and compare the conventional Standard Agency Theory (SAT) and the Behavioral Agency Model (BAM) as a refined framework of an agency model.*

Method — *The methods used for this study were descriptive analysis, involving the review and comparison of the work of Wiseman & Gomez-Mejia (1998) and Pepper & Gore (2015). The technique employed and proposed for this method is to analyze and compare the relevant elements between SAT and BAM.*

Result — *It is found that BAM can provide a better framework for modifying and understanding such agency problems in organizations, particularly in terms of human factors, organization, and information assumptions that are considered to balance the roles of the principal and the agent as actors in the organization.*

Contribution — *This study contributes to the body of knowledge by refining the old and conventional standard agency theory (SAT) and introducing BAM as a new concept. BAM sheds light not only on the roles of actors and organizations but also on the application of a behavioral economics approach to provide a robust and rigorous method for analyzing "agency problems" in organizations, especially in private business families around the world.*

Keywords: *agency theory, principal-agent problem, behavioral agency model, standard agency theory*

INTRODUCTION

As part of organizational economics, standard agency theory (SAT) has garnered worldwide attention among scholars since its inception through influential publications over more than four decades (Eisenhardt, 1989; Jensen & Meckling, 1979; Panda & Leepsa, 2017). According to Eisenhardt (1989), agency theory aims to optimize the relationships between two important parties within an organization, namely the principal (as owner) and the agent (board). She argued that agency theory attempts to describe this relationship using the metaphor of a contract, which involves resolving two problems that can arise in agency relationships, namely (a) conflicting desires or goals of the principal and the agent, and (b) the difficulty or expense for the principal to verify what the agent is doing (Eisenhardt, 1989). Therefore, Panda & Leepsa (2017) suggest that discussing the literature on agency theory is very necessary to understand the agency problem, i.e., the different forms and the different costs required to minimize the problem.

The existence of agency problems is widely recognized in various academic fields. Empirical evidence can be found in various fields such as accounting (Subramaniam, 2006), finance and banking (Berger & Di Patti, 2006), economics (Shapiro, 2005), political science (G. J. Miller, 2005), sociology (Mische, 2011), and marketing (Arcas-Lario et al., 2014). The widespread application of the agency problem in different types of organizations has made this theory one of the most important theories in the organizational economics literature.

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Nevertheless, as argued by many scholars, agency theory has obvious shortcomings both theoretically and empirically, as it has mainly focused on the agent side of the principal-agent relationship, or type 1 agency problem, rather than types 2 and 3 of the agency relationship, namely the principal-principal problem and the principal-creditor problem (Le Breton-Miller et al., 2015; Panda & Leepsa, 2017; Pepper & Gore, 2015). Moreover, as Le Breton-Miller et al. (2015) argue, traditional agency theory is mainly suited for use in publicly traded companies rather than private family firms. To overcome these problems, some scholars have proposed a refinement of standard agency theory by proposing a behavioral agency model (BAM) (Dalton et al., 2007; Lim et al., 2010; Pepper & Gore, 2015; Wiseman & Gomez-Mejia, 1998; Woodman, 2017).

The purpose of this study is to analyze and compare the conventional standard agency theory (SAT) and the behavioral agency model (BAM) as a refined framework of an agency model.

METHOD

The method used for this study involved descriptive analysis, which entailed reviewing and comparing the work of Wiseman & Gomez-Mejia (1998) and Pepper & Gore (2015), who proposed the Behavioral Agency Model (BAM) as an evolution from the previous Standard Agency Theory (SAT) framework. The technique employed for this method was to analyze and compare the relevant elements between SAT and BAM, including the human factors, organization, and information assumptions that are considered to balance the roles of the principal and the agent as actors in the organization (Pepper & Gore, 2015).

The first step in the descriptive analysis was to provide an overview of agency theory by describing the three types of agency problems and their causes and consequences for organizational performance. Subsequently, the limitations and challenges of applying standard agency theory (SAT) as an outdated model were discussed. Finally, the refined BAM model was elucidated by analyzing and comparing the relevant elements between SAT and BAM.

RESULT AND DISCUSSION

Agency theory overview and three types agency problems

Fama & Jensen (1983) and Jensen & Meckling (1979) defined agency theory as a contractual relationship between an agent and a principal within an organization, in which the agent agrees to provide a service to the principal by making authority decisions. This relationship allows the agent not necessarily to act in the principal's best interest, resulting in a problem between the two parties. In other words, the defining characteristics of the agency problem are the divergence of interests between the principal and the agent, and the principal's imperfect information or information asymmetries about the agent's contribution (Bosse & Phillips, 2016; Le Breton-Miller et al., 2015). To achieve efficiency in the organization, "agency costs," defined as the sum of the principal's monitoring expenditures, the agent's commitment expenditures, and the principal's residual welfare loss due to the divergence of interests between the parties involved, are incurred to reduce potential conflicts of interest between the two parties (Fama & Jensen, 1983; Jensen & Meckling, 1979; Pepper & Gore, 2015; Williamson & Michael, 1976).

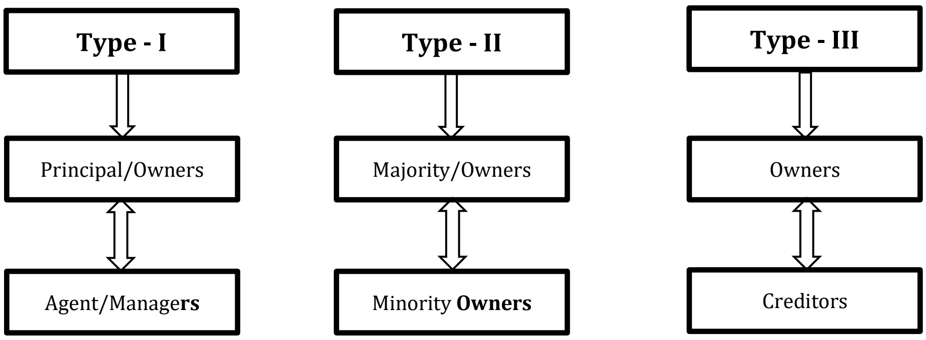
In terms of the organization, this theory assumes that an organization or company is considered as a black box focused on maximizing its value and profitability (Fama & Jensen, 1983; Jensen & Meckling, 1979). It aims to maximize the welfare of an organization or company, which can be achieved through proper coordination and teamwork among the parties involved in the company.

The three main assumptions proposed by Eisenhardt (1989) and Eisenhardt & Martin (2000) for human actors in the organization are: (1) all parties involved have distinct self-interests, (2) all parties involved are boundedly rational, and (3) agents are more risk-averse than principals.

Moreover, many scholars have divided agency problems into different types, which were summarized by Panda & Leepsa (2017) into three types of agency problems that can occur in an organization's economy, namely: type 1 (principal-agent problem), type 2 (principal-principal problem), and type 3 (principal-creditor problem) – as shown in Figure 1.

The first type is between the principals (owners) and the agents (managers), which arises due to information asymmetry and differences in risk distribution (Fama & Jensen, 1983; Jensen & Meckling, 1979). The problem of action between owners and managers in organizations, stemming from the separation of ownership and control, has been noted since the establishment of large companies. Owners entrust managers with the task of running the company in the hope that managers will work for the benefit of the owners. However, managers are more interested in maximizing their compensation (Panda & Leepsa, 2017). The conflict of interest between the principal and agent and the lack of proper monitoring due to the diffuse ownership structure leads to a conflict called principal-agent conflict.

Figure 1. Three types of the agency problems



Source: Panda & Leepsa (2017)

The second type of agency problem occurs between the principal and minor shareholders, known as principal-principal problems within an organization (Panda & Leepsa, 2017). It arises because principal owners make decisions for their benefit and at the expense of minor shareholders. The primary assumption of this type of agency problem is the conflict of interest between the principal and minority shareholders, and it usually occurs in a country or company where ownership is concentrated in the hands of a few individuals or family owners (family businesses), making it difficult for minority shareholders to protect their interests or assets (Lim et al., 2010; Schulze et al., 2001, 2003).

The third type of agency problem occurs between owners (principals) and creditors. This conflict arises when owners make riskier investment decisions against the will of creditors (Panda & Leepsa, 2017).

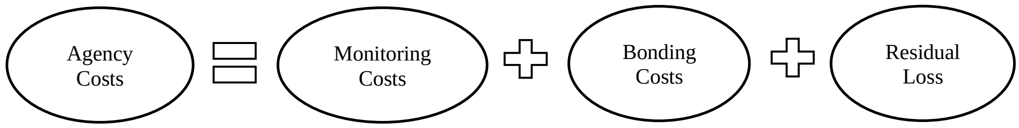
Causes and consequences of the agency problems

Scholars have identified various causes of agency problems in different types of relationships as follows (Baysinger & Butler, 2019; Lucian A Bebchuk et al., 2017; Lucian Arye Bebchuk & Fried, 2003; Panda & Leepsa, 2017): for type 1 of agency problem, the causes mainly relate to the separation of ownership and control, duration of agent's participation, information asymmetry, and moral hazard; for type 2 of agency problem, the causes mainly relate to retention of profits and decision-making; for the combination of type 1 and 3 of agency problem, the causes mainly relate to limited income and risk preference.

Interestingly, for type 3 of the agency problem, Panda & Leepsa (2017) did not find a root cause problem. This is most likely due to the lack of empirical studies for this type of agency problem. However, these causes of agency problems are mostly found in publicly traded companies (Boubaker et al., 2015) and not in private family firms (De Massis et al., 2015).

As a consequence to overcome these problems, the term "agency cost" should be used to reduce potential conflicts of interest between the principal and contractor. According to Fama & Jensen (1983) and Jensen & Meckling (1979), agency costs are among the internal costs associated with agents that arise from misalignment of interests between the agent and the principal. They include the costs of screening and selecting an appropriate agent, gathering information to establish performance measures, monitoring the agent's actions, commitment costs, and the loss due to inefficient agent decisions, which they described as the aggregate of monitoring costs, commitment costs, and residual loss (Figure 2).

Figure 2. The agency costs components



Source: Jensen & Meckling (1979)

Monitoring costs are the costs associated with monitoring and evaluating the agent's performance in the company. Binding costs are associated with managers when a firm's managers are bound by their contractual obligations that constrain their activities. Monitoring costs and retention costs are opposite, with retention costs increasing as monitoring costs decrease. Residual loss refers to inefficient managerial decisions that result in a loss because managers' decisions to maximize owners' wealth are not aligned (Fama & Jensen, 1983; Jensen & Meckling, 1979).

To address these agency cost consequences in firms, several researchers have developed and recognized specific remedies for agency problems, including managerial ownership (Kusumawati & Setiawan, 2019; Lafond & Roychowdhury, 2008), executive compensation (Lucian A Bebchuk et al., 2017; Lucian Arye Bebchuk & Fried, 2003; Hoi et al., 2019), debt financing (Fosberg, 2004; Ni et al., 2017), the board of directors (Ahmed & Duellman, 2007), dividend policy (Kilincarslan, 2021; La Porta et al., 2000), and the ownership of blocks of shares or highly concentrated owners (Chen & Yur-Austin, 2007; Waheed & Malik, 2019). As Eisenhardt & Martin (2000) stated, an appropriate governance system can reduce agency conflict and minimize agency problems by (1) implementing an outcome-based contract and (2) establishing a strong information structure in which the principal knows all the information about the agents' actions and they cannot misrepresent the principal.

Problems and limitations of SAT

Although agency theory is convenient and widely used, it still has some problems and limitations that have been documented by many scholars and authors (Bendickson et al., 2016b, 2016a; Bosse & Phillips, 2016; Chen & Yur-Austin, 2007; Le Breton-Miller et al., 2015; D. Miller & Le Breton-Miller, 2006; Panda & Leepsa, 2017). SAT assumes a contractual agreement between the principal and the agent for a finite or indefinite period in the future, where the future is uncertain. Moreover, SAT assumes that a contract can eliminate the agency problem, but in practice, there are many obstacles such as information asymmetry, rationality, fraud, and transaction costs (Le Breton-Miller et al., 2015). As Chen & Yur-Austin (2007) argue, shareholders' interest in the company is only to maximize their return, but their role in the company is limited, so the role of directors is limited to monitoring managers, and their other role is not clearly defined; moreover, the theory views managers as opportunistic and ignores managers' competence. As Bendickson et al. (2016b) stated, SAT only focuses on market-dominated listed companies operating in developed countries with a free market and puts less emphasis on private family businesses, which, in fact, contribute much more to real business life worldwide (Le Breton-Miller et al., 2015; Panda & Leepsa, 2017).

Another scholar, Perrow (1986), criticized Eisenhardt's view that positivist agency researchers have focused only on the agent side of the "principal-agent problem" and suggested that the problem could also come from the principal side (Panda & Leepsa, 2017). He stated that this theory does not take care of the principals who deceive the agents, shirk, and take advantage of them. Moreover, he added that agents are unknowingly drawn into a risky work environment with no opportunities for advancement, where principals act opportunistically. As a result, he held that people are noble and work ethically for the good of the company. In summary, the contribution of SAT has been limited by its simplistic assumptions of consistent risk aversion among actors, a redundant influence of risk choice on performance, and its inability to make unambiguous predictions about the influence of management on executive behavior (Lim et al., 2010; Martin et al., 2013; Wiseman & Gomez-Mejia, 1998).

Discussion

As mentioned earlier, SAT assumes that the organization is just a "black box," preferably a group of human actors working together, and that the agent as a human is always rational, self-interested, and risk-averse (Pepper & Gore, 2015). To address all these assumptions and the previous obstacles of standard agency theory, Wiseman and Gomez-Mejia (1998) proposed a behavioral agency model (BAM) as a refinement of the SAT problem. Thus, BAM aims to explain economic phenomena using descriptions of essential processes that are consistent with reality (Pepper & Gore, 2015) and focuses on managing risk aversion to losses in organizations (Woodman, 2017).

Coined by Camerer et al. (2004), BAM is based on four constructs identified by behavioral economists as key determinants of behavior: (1) loss aversion and reference dependence, (2) preferences related to risky and uncertain outcomes, (3) temporal discounting, and (4) fairness and unfairness aversion (Frey & Jegen, 2001; Poletti-Hughes & Briano-Turrent, 2019; Sliwka, 2007). As a result, BAM, as proposed by Pepper & Gore (2015) to refine the old standard agency theory, has modified some assumptions: (1) BAM believes that maximizing the agent's performance should be a primary goal of the principal-agent relationship and that the importance of the agent's work motivation, including intrinsic motivation, should not be underestimated; (2) it assumes that senior managers are primarily loss-averse and only secondarily risk-averse; (3) in terms of time preferences, it assumes that agents discount time using a hyperbolic discounting function rather than exponentially, as is the case with financial discounting; and (4) in terms of agents' perceptions of fair compensation (Pepper & Gore, 2015).

When agents feel that their input (the effort and skills they bring to their work) is fairly and adequately rewarded by the tangible and intangible rewards from employment, they are satisfied with their work and motivated to continue contributing at the same or higher levels, and vice versa. Table 1 provides a summary comparison between standard agency theory and BAM.

Table 1. Comparison overview between SAT vs BAM

Items	SAT	BAM
Key Theme	The primary importance of aligning the interests of principals and contractors. The relationship between client and contractor should reflect efficient	The primary importance of agent performance and work motivation. The principal-agent relationship should reflect efficient and effective management of the relationship between executive compensation, corporate performance, and shareholder interests

	management of information and risk costs	
Unit of study	Contract between principal and agent	As for SAT
Humanbeing Assumptions	Agents are rational, self-interested, risk averse	Agents are boundedly rational, loss averse, risk averse, uncertainty averse, hyperbolic time discontinuers, injustice averse, and there is a trade-off between intrinsic and extrinsic motivation
Organisational assumptions	As a black box that serves as the nexus of contractual relations between actors. Partial conflict of goals between principals and contractors, efficiency as the most important performance criterion, information asymmetry especially among principals	An organisation is seen as a set of people/actors who themselves fulfil a mission. Partial conflict of goals between principals and agents, efficiency and effectiveness as main performance criteria, information asymmetry, can be both principal and agent
Information assumption	Asymmetric information and incomplete contracting	As for SAT; goal setting used as a pragmatic solution to information asymmetry
Major factors of the principal-agent relationship determination	The principal's desire to align the agent's goals with the principal's own goals (alignment)	The principal's desire to align the agent's goals with its own goals (alignment) and to motivate agents to perform at its best given its capabilities and opportunities (motivation)
Contracting issues	Moral hazard and adverse selection	As for SAT
Principal points	Monitoring and incentive contracts	As for SAT, except that incentive contracts can also help to meet the motivation objective
Problem areas	Where principals and agents have different goals and risk preferences e.g., regulation, compensation, vertical integration, transfer pricing	As for SAT; especially relevant to executives and executive compensation

Source: Adapted and modified from Pepper & Gore (2015)

It can be observed that most of the criteria and units of analysis are quite similar between the two theories; however, there are some refinements in terms of human factors, organization, and information assumptions that are considered to balance the roles of the principal and the agent as actors in the organization (Pepper & Gore, 2015). Moreover, the refinement model of BAM could better explain the agency problem, especially the second type of agency problem that occurs between the principal and minor shareholders or principal-principal problems within an organization (Panda & Leepsa, 2017 and Pepper & Gore, 2015).

In support of this refinement theory, several empirical results have shown that using BAM as a method and approach for analyzing organizations can provide a better framework and more comprehensive insights into understanding the roles of actors of principal-agent problems across different types of principal-agents in firms, especially in private family firms (Cui et al., 2018; Gomez-Mejia et al., 2019; Larraza-Kintana et al., 2007; Le Breton-Miller et al., 2015; Lim et al., 2010; D. Miller & Le Breton-Miller, 2006; Pepper & Gore, 2015; Sanders & Carpenter, 2003; Vitolla et al., 2020; Woodman, 2017). For example, Cui et al. (2018) found that the best way to understand the relationship between family engagement and CSR investment by family firms is to apply the BAM framework. Meanwhile, Gomez-Mejia et al. (2019) suggested that refinements to the BAM formulation could advance understanding of the unique nature of agency problems in family firms. With respect to top management compensation within the organization, Pepper & Gore (2015) argue that Behavioral Agency Theory provides a better framework. However, Le Breton-Miller et al. (2015) and Miller & Le Breton-Miller (2006) found that both SAT and BAM assume both positive and negative influences on entrepreneurship in family firms, while empirical studies do so together.

In summary, most researchers and scholars find that BAM has proven to be a refined standard agency theory and can be applied in analyzing agency problems not only in larger publicly traded companies but also in private family firms in both developed and emerging markets.

CONCLUSION

This study discussed the concept of agency theory, its assumptions and problems, and the causes and consequences of most agency problems between principal and agent in organizational economics. It was found that this standard agency theory has some shortcomings, particularly in terms of its assumptions regarding people and the organization itself, and that it is heavily biased towards application in larger firms.

The Behavioral Agency Model (BAM) that emerged later can be seen as a refinement of this Standard Agency Theory (SAT) by refining and modifying new assumptions not only for the roles of the actors and the organization but also for the application of a behavioral economics approach in the application of this model to provide a robust and rigorous method for the analysis of 'agency problems' in organizations.

As for the practical implications of these findings and discussions, the BAM refinement model can be applied as a new framework for a more detailed analysis of the agency problem, especially for understanding the second type of agency problems between majority and minority shareholders of family firms in emerging markets.

However, as this study only evaluates the academic literature, the author can only provide limited recommendations for the application of this concept in real business situations. Therefore, it is of utmost importance for the future research direction to conduct an empirical field study to fully explore this refinement model, especially for small family businesses where the agency problem may occur in their daily business operations.

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