FUNDAMENTALS OF BUSINESS ECONOMICS

Stephen Adams traces the development of theory on the principal-agent problem – an issue that companies have yet to solve satisfactorily.

The inclusion of the principal-agent problem in the CO4 syllabus can be taken as evidence of growing concerns about the nature of organisations, corporate governance and the possibility of conflict among stakeholders. But the issue is not new: Adam Smith, writing in An Inquiry into the Nature and Causes of the Wealth of Nations (1776), stated that he doubted the value of joint-stock companies because he felt they reduced the financial incentive for managers to perform, since the capital was provided by shareholders rather than the managers themselves.

He had this to say about the directors of such a business: “Being the managers rather of other people’s money than of their own, it cannot be well expected that they should watch over it with the same anxious vigilance with which partners in a private copartnery frequently watch over their own.” Perhaps Smith was still influenced by the scandal of the South Sea bubble 60 years earlier.

In the 19th century the issue lost its attraction for economists, indicating the apparently crucial role that joint-stock, limited-liability companies played in economic growth during that period. Even corporate scandals, particularly evident in the US, failed to arouse much academic enthusiasm. But interest revived in the 20th century. This reflected partly the academic discussion of organisations in other disciplines and partly the growing awareness of the increasing dominance of large companies in western economies.

In 1932 Adolf Berle and Gardiner Means coined the phrase “the separation of ownership and control” in their book The Modern Corporation and Private Property.

Three decades later, J K Galbraith argued that a divorce of ownership from control, with managers, not shareholders, dominating decision-making had resulted from the growth of large corporations and the organisational consequences of advanced technology and mass production.

“Corporate size, the passage of time and the dispersion of stock ownership do not disenfranchise the stockholder. Rather, he can vote, but his vote is valueless,” Galbraith declared in The New Industrial State (1967).

The principal-agent problem is now seen as a crucial element in our understanding of management and decision-making in enterprises. But it is not a purely business phenomenon. It arises in a wide range of human activities and is part of what is known as agency theory. This is concerned with the relationship between a principal and an agent who acts on behalf of that principal.

Examples include:

- Shareholders delegating powers to boards of directors.
- Patients leaving decisions about their treatment to doctors.
- House-buyers employing solicitors to purchase houses on their behalf.
- Local authorities appointing private firms to perform routine council services.

Principal-agent activities are clearly common. The problematic element usually concerns the inability of principals to ensure that the agent always acts in their best interests. The relevant factors here are knowledge and power, which can be analysed in the wider context of organisational stakeholders. A stakeholder is an individual or group that has some interest in the way an organisation is structured, managed and behaves. In the case of a hospital, for instance, the stakeholders will include the medical staff, the managers, the patients and the government that funds it.

In this group we can distinguish among:

- Internal stakeholders, such as managers and medical staff.
- Connected stakeholders, who have a direct link to the organisation but function outside it, such as the government.
- External stakeholders, who have an interest in the organisation but are not part of it, such as patients.

Two types of stakeholder involvement can also be identified and measured: their level of interest in the organisation and their level of influence on its behaviour. Sometimes a positive correlation between interest and influence exists. Internal stakeholders such as managers have a lot of interest and a lot of influence, whereas external stakeholders may have little of either. But this correlation does not always hold. A patient will have a high level of interest in his or her treatment, but may have far less influence on the process because they will tend to lack medical knowledge. In other cases, a lack of power...
As long as company failures come as a surprise to investors, the principal-agent issue will retain its shock value.
designing effective incentive packages becomes an extremely difficult task.

Shareholders don’t normally design directors’ remuneration packages anyway; they are required only to approve them. These are normally devised by remuneration committees – consisting primarily of directors. Even when these are non-executive directors with some independence from the management team, it might be natural to make the packages generous, with targets that are either easy to achieve or too flexible to act as a real control on performance. Perhaps these non-execs, who are often senior managers in other companies, are generous given that they also have such packages devised for them. Directors’ remuneration systems are often complicated, too. Most FTSE-100 companies hire specialist consultants to devise executive pay schemes, which are not easily understood by private shareholders.

Despite all of this, there is a lot of pressure on directors to perform for shareholders. A low share price arising from poor management may invite takeover bids from rivals who intend to replace the management team and thereby improve performance. Furthermore, this concern for the position of shareholders has been reflected in various proposals concerning corporate governance. Although these have addressed many issues, a main theme has been the strengthening of shareholder control and reinforcement of directors’ responsibilities to shareholders.

The principal-agent problem is alive, well and directly relevant to our understanding of the relationship between shareholders and managers. As long as executive reward schemes continue to involve large sums of money, the issue will have topical value. Last year, for example, the US firm Home Depot parted company with its chief executive and his pay-off was reported to be £105m. And, as long as company failures come as a surprise to investors, the issue will retain its shock value. Given what happened to Northern Rock’s share price recently, its shareholders may well be feeling the force of Adam Smith’s comment that when directors are managing someone else’s money, they might take less care with it than when managing their own.

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The results for strategic level and TOPCIMA papers were sent out by first-class post or airmail on January 17 and the results for managerial papers were sent out on January 24. The results were e-mailed on the same day as they were posted.

The institute cannot give out results over the telephone or to personal callers at any CIMA office.

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Post-exam guides for each subject will be available three to four months after the exams. These are essential reading for unsuccessful candidates and for those studying a new subject.

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