

COUNTERPOINT

Agency Theory and “Management Research”: A Comment

by

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1. Introduction

The application of agency theory to management research issues such as organisational design, strategic management and corporate policy is becoming increasingly common (Lyles 1990). Within this broad suite of topics, corporate governance issues have become the focus of increasing concern. Relevant issues include “appropriate” board structures (i.e., independent versus executive directors) as well as the separation of the chief executive officer (CEO) and chairperson’s (chair) rôles (i.e., the “duality” question).¹ Donaldson and Davis (1991) address the latter issue, comparing the relative merits of what they call the agency perspective to one they term “stewardship theory”. In addition to serious problems with their methodology (Whittred 1993), their analysis is based on a misunderstanding of agency theory.

Donaldson and Davis characterise the agency perspective in a relatively simplistic and misleading fashion, such that natural conflicts of interest between widely dispersed owners (i.e., shareholders) and professional managers preclude managers acting in shareholders’ best interests. Modern agency theory argues to the contrary: that firms create long-term wealth for their owners *because* those owners are relatively diverse and cannot intervene, while managers motivated by (among other things) debt and capital structure are put in charge. In contrast, Donaldson and Davis present stewardship theory as a stark alternative which gives due recognition to managers’ “desires” to perform satisfactorily. We contend that

1. Additional, more indirect issues of board structure arise via consideration of “compulsory” board subcommittees.

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this distinction is misleading. A more complete view of the agency cost perspective recognises that many parties play a rôle in the organisation and operation of the firm. A “costly contracting” perspective emphasises that the purpose of the firm is to facilitate mutually beneficial exchange among all the contractual participants. In this way, the distinctions drawn by Donaldson and Davis between agency and stewardship theory are at best arbitrary, and potentially very misleading.

Our concern with the misleading premise on which Donaldson and Davis is based is heightened by the approach to corporate governance issues adopted in several recent reports. The Bosch Committee (1993) in Australia, the Cadbury Committee (1992) in the United Kingdom,² and the American Law Institute (1992) in the United States have all recently addressed “desirable” attributes of corporate boards.³ For example, the most recent version of the Bosch Committee report (1993, pp.11–13) recommends that a majority of directors be “independent” of management, as well as opposing the “concentration” of power in a single CEO-Chair. These views appear to make precisely the error that Donaldson and Davis mistakenly attribute to agency theory, namely that “more” monitoring of professional managers is necessarily a good thing. Donaldson and Davis’ view (1991, p.49) that “agency theory argues that shareholder interests require protection” appears to have increasingly permeated the regulatory perspective.

We believe this approach is narrow and mistaken, ignoring as it does the rôle in corporate governance of other participants (e.g., employees, lenders) who also have contractual stakes in the firm. Although the precise focus of Bosch, Cadbury and the American Law Institute varies, such committees seem attracted to making universal recommendations about corporate governance.⁴ Studies such as

2. In References see: United Kingdom, Committee on the Financial Aspects of Corporate Governance, 1992.

3. Both the Bosch (1993) and Cadbury (1992) Committee reports were prepared by broadly-based working groups composed of representatives of interest groups such as the Institute of Directors, the accounting profession, stock exchanges, and law councils. They make recommendations regarding “best practice” which, although not legally binding, were supported by the constituent groups (e.g., through their codes of conduct or disciplinary procedures). Both committees explicitly recognised the likelihood of legislation if corporations did not adopt the principles expounded.

The American Law Institute (1992) has issued ten “Tentative Drafts” for the reform of corporate governance in the period 1982 to 1990. Revisions have also occurred to both the Bosch and Cadbury committee reports (both from “draft” to “final” versions and as reflected in subsequent “editions” of the recommendations).

4. We note that these committees typically fail to ask *why* all firms do not have identical forms of corporate governance. Rather, they identify “best practice” (based on unspecified criteria) and support its application to all firms. For example, in reviewing his committee’s work, Bosch (1993, p.11) argues: “There can be no doubt that investments are safer when most of a board’s directors are independent.”

Donaldson and Davis' provide potential support for this narrow focus on the separation of ownership and control. In the following section, we argue that a broader focus is consistent with recent developments in the costly contracting (or agency cost) literature. We especially note that simplistic support for increased monitoring of professional managers cannot be justified by any sensible economic theory. In Section 3 we briefly consider the methods used by Donaldson and Davis. We show that not only are their results to be expected, but also that they fail to support their case. Finally, we offer some brief conclusions as well as suggestions for further research on corporate governance.

2. Simplistic Agency Models (and Donaldson and Davis) are Misleading

2.1 A Costly Contracting Perspective

An economic view of corporate governance begins with recognition that the demand for such governance follows not only from the separation of ownership and control, but also from consideration of capital structure, production methods, employment procedures and investment opportunity sets. Conflicts of interest which arise between the various stakeholders in large corporations have been discussed for hundreds of years, at least since the writings of Adam Smith. While these conflicts of interest are often described as agency costs (Jensen and Meckling 1976), modern agency theory, like stewardship theory, does not focus on conflict over the distribution of income between owners and managers. Instead, agency theory asks what set of governance rules will enhance efficiency and thus maximise wealth.

A simplistic perspective on the separation of ownership and control is superficially appealing, leading as it does to suggestions for "improved" or even "necessary" corporate governance attributes. Such attributes are justified as reducing the apparent conflicts of interest between widely dispersed shareholders and professional (non-owner) managers. But financial economists recognise that affected parties have incentive to search for efficient solutions to conflicts of interest, thereby reducing (or even eliminating) the need for mandated attributes of corporate governance. More importantly, these "affected parties" extend beyond shareholders and professional managers to incorporate employees, creditors and suppliers.

By way of supposed contrast, in Donaldson and Davis' view of stewardship theory "the executive manager, . . . far from being an opportunistic shirker, essentially wants to do a good job, to be a good steward of the corporate assets" (1991, p.51). The distinction between stewardship and agency theory is not clear because every manager, like every person, will want to do a good job within the confines of the incentives, essentially property rights, facing him or her.

Does Donaldson and Davis' stewardship model actually propose that managers will deliberately disregard or act against their own self-interest when *no* constraints are placed on them? Are they suggesting that managers act as stewards

for corporate assets on a purely “volunteer” basis, without any form of reward, including prospective reward? Perhaps stewardship theory rests on the notion that better managed corporate assets automatically mean greater penury for the managers involved?

Donaldson and Davis seem to recognise the ambiguities in their presentation of stewardship theory when they state (p.60) that:

It might be that managers seek to maximise organisational performance and shareholder returns, as stewardship theory states, so long as the fundamental coalition between managers and owners remains intact, that is, the organisation is on-going. Once the continuation of the organisation and employment of managers therein is threatened by the possibility of takeover which might dislodge incumbent executives, then managers react to protect their own self-interest as this is threatened and future organisational prosperity may have no benefits for them personally.

It is not clear from this description of stewardship theory that it differs from an agency-style model with some sort of termination contract. The manager loses the perks of office when either takeover or (say) bankruptcy lead to displacement of the existing management team. For example, in the models of Garvey and Swan (1992a, 1992b) an appropriate capital structure leads the manager to reward performing subordinates and to indirectly (i.e., unintentionally) maximise shareholder wealth. At the same time, shareholder interests are to plunder managers and workers who have performed. Short-term profitability would be enhanced at the expense of efficiency if the manager were always to heed the interests of shareholders. Hence, by placing managers in charge and keeping shareholders at bay, the wealth of the firm is maximised. The result appears to be a Donaldson and Davis version of “stewardship” theory, but is, in reality, quite the reverse. The actions of all participants are entirely self-interested, but the result is the long-term maximisation of corporate assets.

Put simply, the point is that by looking beyond the separation of ownership and control, the agency theory prescriptions for corporate governance are fundamentally altered. Financial and employment contracts cannot be “isolated” from methods of corporate governance when a costly contracting perspective is adopted. Similarly, institutional factors must also be considered, such as laws which affect the operation of the market for corporate control. Even if one focuses narrowly on the separation of ownership and control, it is possible that an active market for corporate control and other corporate governance mechanisms (e.g., independent directors) may overcome any problems of duality (Arthur and Taylor 1992). Moreover, other factors, such as the presence of large shareholders (Holderness and Sheehan 1988), may significantly influence the optimal set of corporate governance attributes for particular firms.

Some existing empirical evidence can be drawn upon to support this view. Dalton and Kesner (1987) compare board structures of large industrial companies drawn from the United Kingdom, the United States and Japan, finding differences

not only in the frequency of CEO-Chair duality across the three subsamples, but also other board characteristics. CEO duality was found to occur in 11% of Japanese firms, compared to frequencies of 82% in the USA and 30% in the UK.⁵ Significant differences were also found in the average number of directors on the board. Japanese firms have, on average, a larger number of directors than either UK or US firms, while board composition is also significantly different among firms from these three countries. The proportion of outside directors in Japan is significantly lower than both the United Kingdom and the United States.⁶ These results bring into question the appropriateness of applying any single model of “best practice”.

Reasons for international variations in corporate governance attributes, such as board composition, may include the relatively high level of ownership concentration for Japanese public companies (Anderson 1984) as well as reported high levels of involvement of financial institutions in monitoring management (Waldo 1985). The question that arises is the extent to which differences observed in international comparisons would apply in any analysis of Australian firms. For example, the existence of large shareholders may be relevant in explaining the board composition of Australian firms.

2.2 *A Narrow Focus on Agency Costs: An Example*

In contrast to the nexus of contracts perspective which we have briefly described, Donaldson and Davis present agency theory as a narrow, perjorative view of the causes and consequences of the separation of ownership and control. Others have adopted a similar focus and appear to have been relatively unsuccessful. A prominent example can be seen in studies which try to relate the separation of ownership and control to firms’ performance (i.e., the impact on share values of insider/managerial ownership). These studies fail to identify a linear relationship as suggested by Jensen and Meckling’s (1976) simple analysis and of the type which underlies Donaldson and Davis’ version of agency theory.⁷

In contrast to the linear model implied by Jensen and Meckling (1976), Morck, Schleifer and Vishny (1988) suggest a piecewise linear relationship between insider ownership and equity value. Their model reflects the notion that higher levels of insider ownership are expected to increasingly result in entrenchment of the incumbent management group, thereby overwhelming any

5. In Australia, the proportion of listed companies with executive chairperson is approximately 16%, according to the 1991 Korn/Ferry survey released in April 1992.

6. The absolute number of outside directors, however, is higher in Japan than in the US or the UK.

7. That is, as the separation of ownership and control increases, so does the extent to which managerial actions diverge from shareholder wealth maximisation.

“incentive alignment” benefits of the type suggested by Jensen and Meckling (1976). Further, at even higher levels of insider ownership (i.e., beyond the point where entrenchment is achieved), incentive alignment effects are expected to reappear as the dominant factor. Using a sample of large US firms, Morck et al. (1988) document empirical support for such a model, with the “best” turning points being at 5% and 25% insider ownership.

Stulz (1988) argues that separation of ownership and control will result in a curvilinear relationship between insider ownership and performance. His model is based on the costs and benefits of managerial opposition to takeover offers, rather than the more general issues underlying the model of Morck et al. (1988). While McConnell and Servaes (1990) find empirical support for the model of Stulz (1988), using a similar research setting to Morck et al. (1988), they are unable to find any evidence of a piecewise linear relationship between insider ownership and equity value.

More generally, models of optimal insider ownership typically fail to account for other organisational features (e.g., method of financing and/or organisational structure), as well as the prevailing institutional mechanisms (e.g., regulation of takeovers). In this case it is not surprising that empirical results are so mixed, with no evidence to support a simple linear relationship of the type which underlies Donaldson and Davis’ version of agency theory.

In Australia, Craswell, Saywell and Taylor (1993) find little evidence, if any, to support any generalised model of optimal ownership structure. Their analysis includes the level of insider ownership, as well as the presence of significant institutional shareholders. They investigate quite different market environments and firm-size groupings. These results add weight to the view that simplistic agency cost models which focus on the separation of ownership and control are of relatively little value.

3. Donaldson and Davis’ Method: An Assessment

Although our principal concern is with the way in which Donaldson and Davis characterise agency theory (and the contrasting stewardship model), there are also fundamental weaknesses in their experimental method. The Donaldson and Davis study uses two methods to measure firm performance:

- i. ROE, an accounting measure of return on equity which is an average of three years of accounting profit divided by book value of net assets; and,
- ii. gain in shareholder wealth, consisting of dividends plus capital gains, from holding shares for three years from 1985.

As Whittred (1993) points out, in this volume, the first measure is highly volatile and inferior to measures such as return on total assets or investment which take into account differences in debt or leverage. Rechner and Dalton (1991) consistently obtained the opposite results using three measures, namely ROE,

return on investment (ROI) and profit margin. These three measures are presented individually for six years instead of a single average over three years. The ROI measure, being return on total assets, is not confounded by leverage problems. They are also more careful than Donaldson and Davis in that they use a random sample of Fortune 500 companies and only include companies which have had a stable board structure in terms of CEO duality for a period of six years. Donaldson and Davis' sample is confined to firms with executive compensation schemes surveyed in a business magazine and does not control for changes in corporate governance structure.⁸ Moreover, Donaldson and Davis only criticise one aspect of this earlier study, namely the failure to allow for any industry effects.

Donaldson and Davis' second measure—the increase in shareholder wealth (the sharemarket return on shareholder equity)—sheds no light on the issue of optimal board structures. This is because the *initial* share price in 1985 includes the market's expectations as to the return a firm will achieve with its particular board structure. Thus, if Chairperson-CEO duality is (say) superior to separation, dual firms will have a higher *initial* share price than non-dual firms, but the risk-adjusted expected *rate-of-return* for the two firms will be the same. The change in shareholder wealth as measured by share price movements can only reflect some surprise element, such as an *unexpected* change from duality to independence or vice versa.

Donaldson and Davis (1991, p.55) appear to recognise some of these issues when they state:

This shareholder wealth measure has the advantage that, since many corporations would have changed their structure prior to 1985, the impacts on price of stock up to 1985 would be compounded into 1985 price and so would not register as a post-1985 gain. This means that the share price appreciation component of the index registers only post-1985 gains, though the effect on dividends will be registered.

Donaldson and Davis are correct to state the structure of the firm prior to 1985 would be reflected in the 1985 price. But they are incorrect when they state that the share price appreciation component of the index registers post-1985 gains. Any such gains will be unexpected windfalls and unrelated to the board structure prior to 1985. Likewise, if higher dividends are anticipated due to structure prior to 1985, these higher dividends will be offset by lower share price appreciation.

Elementary theory implies no difference in the change in shareholder wealth between those firms that exhibit duality and those that don't, even if one is perceived by the market to be far superior to another. Only unexpected changes in

8. In the Rechner and Dalton (1991) study, 44% of their original sample had to be rejected because of changes in Chairperson-CEO duality.

board structure, or similar unexpected events, will give rise to significant differences. Since there was no indication of unexpected changes (i.e., information events), the theory's predictions are borne out with no significant difference between the means for shareholder wealth increase of \$166.39 without duality and \$175.30 with duality (1991, p.58).

Why won't the same problem with market anticipations invalidate entirely the results based on accounting ROE measures? In fact, they will if the starting value for shareholders funds in 1985 reflects the benefits or otherwise of board structure. It is only if shareholders' funds are based on accounting asset values related to book values, which are *not* reflective of the advantages or disadvantages of board structure, that any kind of meaningful results could be obtained. Additional measures such as profit margins, used by Rechner and Dalton (1991), may be more convincing because they are not subject to the same anticipation and valuation problems. Accounting ratios, however, may differ systematically between dual and non-dual firms, reflecting a relationship between accounting methods (e.g., cost capitalisation decisions) and the investment opportunity set (which is a potential determinant of duality).

Donaldson and Davis also fail to adjust fully for possibly confounding factors, such as firm size and industry, in that very crude techniques are used. Multiple regression could, for example, have been used to advantage. Even if Donaldson and Davis' ROE figures (especially increase in wealth figures) meant something, Donaldson and Davis do not adjust for differences in risk and beta coefficients for the firms in their sample, nor for differences in leverage.

4. Summary

As regulatory pressure intrudes further on corporate organisation and governance, it seems fundamentally important that the economic foundations of corporate governance are understood and tested. Donaldson and Davis is potentially dangerous if others adopt a similar method of enquiry.

Although their experimental design leaves much to be desired, our principal objection to Donaldson and Davis is their misunderstanding of an agency theory perspective of the firm, which has led to an invalid test of the theory. Our primary contention is that a simplistic premise based on the separation of ownership and control is an insufficient foundation from which to make recommendations about appropriate corporate governance mechanisms, such as the separation of CEO and chairperson rôles. A wider perspective, such as the nexus of contracts approach, provides a more secure foundation for investigations of corporate governance. Recognition of the rôle played by capital structure and organisational hierarchy, as well as the prevailing legislative framework, results in a view of corporate governance mechanisms as endogenously derived, rather than exogenously imposed. This insight is particularly important to counter the tendency to assert that a particular corporate governance mechanism is a universal panacea.

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