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Agency Theory and Corporate Governance

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Abstract: This study provides an overview of the research in the field of agency theory and corporate governance. This research is aimed to extend existing research contributes to the agency theory literature and particularly, the growing body of literature of corporate governance mechanisms. The agency theory suggests that corporate governance can reduce agency costs which in turn leads to improved firm performance. The problem that occurs is known as the principal-agent problem where two parties, the principal and the agent. The separation of ownership and control in the open financial system can result in the agency problem between management and shareholders. The separation of control and ownership in corporations has caused agency problems and a series of corporate governance mechanisms have been implemented to mitigate them. The primary objective of corporate governance can play an important role in minimizing the agency problem and ensuring that management's interests are aligned with those of shareholders. The agency theory implies that the board of directors is elected to manage the potential conflict of interests between management and shareholders.

Key words: Agency theory, corporate governance, principals, agent, financial system

INTRODUCTION

The agency theory is based on the relationship between the principals (shareholders) and management (agent) these two parties are separated and both parties' wants maximum benefit but that is not possible. It exist conflicting interests and the reason for that are that the two parties are separated. Macintosh and Quattrone (2010) also describe the foundation of agency theory as the separation between owners and managers in a company. Shareholders play the part of the principal that delegates the research and decision-making to the managers or so-called agents that carry out the job. The theory explains the two parties' different preferences and behaviour where their objectives and goals distinguish from each other as well as their attitude towards risk. Both the principal and the agent are presumed to be acting rationally in their research and are primarily motivated by self-interest. Given that the agent is utility maximizing there is a chance that the result is not the best for the principals' own interest. These so-called agency problems that occurs needs to be resolved and this causes approved costs, agency costs that function either as an incentive or sanction which will adjust the self-interest of the agents, so that they are more correlated with the shareholders interest (Roberts, 2005).

The agency theory has an important starting point and that is the assumption that in the company the decision-making is made by decision makers and these decision makers are not risk carriers, they do not carry the risk for the invested capital (Fama, 1980). So, the problem is the motive the decision makers have when they do not own the company. One consequent of the separation that have been emerging of business management theories is the focus on how the owners drives the company's management to maximize returns for risk-bearers (shareholders) even though the management have other objectives than the owners (Cyet and March, 1963; Simon, 1958).

As early as 1776, the Scottish scholar Adam Smith, who was the researchers of the famous opus in classical economics named "The Wealth of Nations", argued that the separation of ownership and control created poor incentives for managers to operate the company efficiently (Pande, 2011). Therefore, Smith already in the 18th century called attention to the conflicts of interest between the owners of large corporations and their managers and directors and questioned how to align these separate interests more efficiently (Jensen and Meckling, 1976, 1994; Pande, 2011; Linder and Foss, 2013). Although, Smith neither uses the word agency costs nor

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correctly anticipates the evolution of governance mechanisms that obviously have made the survival of the corporation possible and even made this organizational form prosper in a variety of economic activities throughout the world, he is often portrayed as the original agency theorist since, he clearly understood the agency problem (Jensen and Meckling, 1976, 1994; Denis, 2001; Hermalin and Weisbach, 2003).

While the issue of separation of ownership and control may have been noticed by Smith it was the classic research of Berle and Means "The Modern Corporation and Private Property", popularized 156 years later that had a crucial impact on accounting research and regulation, according to Bricker and Chandar (1998). Just like Smith and Berle and Means pointed out the inconsistency of interests between managers and outside shareholders and emphasized the costs these conflicts gave rise to Jensen (1993a, b). But by combining legal and economic perspectives and putting forth a provocative theory namely that the "separation of the risk-bearing functions of ownership and the control function of management created conditions in which professional managers could take actions to the detriment of the owner and to their own personal gain" (Bricker and Chandar, 1998) these researchers view came at exactly the right time in the United States. This was due to the fact that this agency approach came in the wake of the Wall Street Crash of 1929 and consequently, found favour in the eyes of American regulators of securities (Bricker and Chandar, 1998). Therefore, it also became the foundation for the adoption of the Securities Act of 1933 and 1934 which established legal obligations in conjunction with the agency relationship between shareholders and managers.

The discussion about corporate governance started in the beginning of 1990s in the UK. The discussion started after the Cadbury report was published. The reason for why corporate governance got a lot of attention is because of several high-profile corporate scandals. These scandals were partly due to deficiencies in the practice of corporate governance and the bad job from the board. It was in 1992 the Cadbury report was published by the Cadbury Committee. They called the report Code of Best Practice and the report issued that it should be three directors, at least in the board that should come from the outside. The report also recommended that the same person should do not hold the chairman and CEO position. The reason for these recommendations was to improve the board oversight (Dahya *et al.*, 2002).

The purpose of this study to point at the significant relationship that exists between agency theory and corporate governance which role corporate governance plays in the dilemma between the principal and the agent and what good corporate governance can contribute with in this situation trying to control (OECD, 2004).

MATERIALS AND METHODS

Agency theory: Thus, the Berle and Means research became the starting point for ensuing capital market agency models in accounting (Bricker and Chandar, 1998). After that the awareness of agency problems in economics was almost non-existent until the end of 1960 when fundamental advances in economic analysis of especially uncertainty and information, brought forth a systematic and stringent approach to these problems (Linder and Foss, 2013). Hence, agency theory broadened the 1960 and 1970s risk-sharing literature which examined information and risk sharing behaviour among individuals and groups (Subramaniam, 2006). This literature mainly described the risk-sharing problem as one that emerges when collaborative parties that is those who are expected to research together have various risk attitudes (Eisenhardt, 1989). By expanding this view and introducing the ubiquitous agency relationships in which one party (the principal) delegates research and decision-making responsibility to another (the agent) who then performs the research, agency theory was considered to provide an additional perspective on how two or more parties with different objectives and research distributions may act (Eisenhardt, 1989; Subramaniam, 2006). Furthermore, a study which by Jensen (1993a, b) was described as one of the original papers of the 1970s risk-sharing literature concerning agency theory, namely Ross (1973) stated that examples of agency are universal. Given this fact and the fact that agency theory obviously has its roots in the information economics literature (Eisenhardt, 1989; Lambert, 2001; Subramaniam, 2006), managers (and other agents in a principal-agent setting) are no longer seen as only passive reactors to information systems (Subramaniam, 2006). Further because accounting and other information therefore is placed into an explicit decision-making setting (Lambert, 2001), it is no surprise, given the role accounting information de facto has in organisational decision making that the use of an agency framework to explain and predict both managerial and organization behaviour was warmly welcomed by accounting researchers (Subramaniam, 2006).

From its origin in the famous research done by Smith and Berle and Means and the subsequent progress in information economics, the further development of

agency theory resulted in two almost completely distinctive and valuable literatures that to a large extent, address the same problem: positivist agency theory and principal-agent theory (Jensen, 1993a, b; Eisenhardt, 1989; Subramaniam, 2006). The two lines of literature share a common unit of analysis: the contract between the principal and agent (Eisenhardt, 1989) and both assume that individuals are rational and engage in self-interested behaviour (Baiman, 1990; Subramaniam, 2006). Eisenhardt (1989) and Subramaniam (2006) argue that while the basic assumptions about people, organisations and information of the agency theory branches are different in extent and character, the empirical issues explored by prior studies across the different literatures share many common objectives. For example, both the recognition of factors that result in optimal contracts (the generation of value creating incentive schemes and/or employment contracts) and the formulation of monitoring mechanisms which improve the quality of information and finally firm value have been common research goals of prior agency studies (Subramaniam, 2006). That is both research streams provide similar frameworks for understanding the factors and reasons of the efficiency loss generated by the divergence between cooperative and self-interested behaviour (the loss derived from agency problems) and analyzing and understanding the effects of various control processes (e.g., monitoring systems and employment contracts) in order to relax the loss of efficiency from agency problems (Baiman, 1990). Another common key insight derived from the agency theory framework is the existence of a trade-off between risk and incentives which formed the basis for Holmstrom (1982)'s informativeness principle (Subramaniam, 2006). This principle states that accounting and related performance measures have information value since they consider the decisions and actions taken by the agent (e.g., the manager) (ibid).

Even if both literatures focus on the contracting problem between self-interested maximizing parties and both essentially use the same minimizing agency cost framework they do, however, differ in many ways (Jensen, 1993a, b). Since the remaining part of this study will focus on the use of agency theory in financial accounting, external auditing and corporate governance and because these aforementioned organisational phenomena to a large extent use a positive agency framework (Sharma, 2013), I will only briefly explain what generally distinguishes the principal-agent branch from the positivist agency literature. The principal-agent literature is generally considerably more mathematical and non-empirically oriented than the positive agency literature (Jensen, 1993a, b; Jensen and Smith, 2000).

Consequently, studies in the principle-agent stream tend to involve a detailed set of assumptions which are then followed by logical and theoretical deduction and mathematical proof (Eisenhardt, 1989; Subramaniam, 2006). To a much greater extent than positive agency researchers, principal-agent researchers concentrate on developing a general theory of the principal-agent relationship, a theory that can be used in a variety of different agency relationships (Eisenhardt, 1989). In general, the focus of the principle-agent literature has been to define the optimal and most efficient contract between the principal and agent in a given situation for the purpose of aligning the agent's behaviour with the principal's interests (Jensen, 1993a, b; Eisenhardt, 1989; Subramaniam, 2006). The original simple principal-agent model assumes goal conflict between the self-interested agent and principal an easily measured outcome and an agent who is more risk averse than the principal (Eisenhardt, 1989). This simple agency model has since then been developed further in a lot of different ways by a variety of researchers for example, Holmstrom (1982) and his informativeness principle applied in a multi-agent setting and Baldenius *et al*. (2002) who studied the optimal assignment of monitoring tasks by means of a mathematical model in a multi-agent setting. In sum although, the principal-agent research may have a broader focus and include many more testable consequences than the positive agency theory these two research streams can be viewed as complementary, according to Eisenhardt (1989). This is because the positivist theory identifies various contract alternatives, and principal-agent theory indicates which contract is the most efficient under varying levels of outcome uncertainty, risk aversion, information and other variables (Eisenhardt, 1989).

Jensen and Meckling (1976) wrote about agency theory they choose to rely upon traditional economic literature and the assumptions made there as the assumption that all individuals act with self-interest. With this assumption (and the assumptions about information and risk) as a foundation they considered the conflicts and relationships between agents and principals and stated how contractual mechanisms can help in minimizing the agency costs to the firm. Eisenhardt (1989), furthermore implies that agency theory put new light on the importance of self-interest and incentives when it comes to organizational thinking. According to Lambert (2001) the link between information systems, different incentives and the behavior of individuals is rigorously examined in the agency theory.

Beyond the different attitudes towards risk, agency theory also included the agency problem that occurs when there are different goals and different divisions of

labor between the cooperating parties. The base and the ground focus of agency theory is the basic agency structure which focus on the relationship of a principal who delegates research to a performer an agent. By doing this the principals have to let the agent do some decision-making for them (Jensen and Meckling, 1976). The relationship between the principal and the agent create a lot of uncertainty and potentially also conflicts because of the various information asymmetries and also because of the different attitudes towards risk (Deegan and Unerman, 2011).

Agency theory assumes that individuals are rational and that information throughout the organization is distributed asymmetrically. Eisenhardt (1989) mentions two problems that exist in agent relations. The first problem is about the difficulties for the principal to get complete information about what the agents are doing. This problem includes that the principals and agents goals and objectives in line with their different interests are separated from each other as well as it's expensive and difficult for the principal to verify what the agent is doing and if the agent is following their agreed guidelines. This first problem often develops as a form of moral hazard or adverse selection. In this context, moral hazard is defined as the agents an incentive is to conceal or cheat in their actions in violation of the established contract. Adverse selection can for example on the other hand mean that the agents enhances abilities that he/she does not have when being recruited or by the time the contract has been established when the principal can not be assured about the veracity in what the agents are saying. The second problem that often exists in agent relations includes the principals and agents different preferences when it comes to risk and how this risk should be divided. To confine the effects of these problems the agency theory concentrate on how an effective contract between the two parts best can be structured so, that the agents act in agreement with the organizations best (Eisenhardt, 1989).

Jensen and Meckling (1976) highlights one specific contract within a firm that is important in agency theory; the agency relationship. This is a contract under which one or more principals delegates research to an agent. This relationship results in so called agency costs for the principal since the agent may act in a way that is not maximizing the principal's profit. There are two specific problems that arise from information asymmetries and that are especially connected with the incentives and monitoring problem in the relationship of a principal and an agent; adverse selection and moral hazard (Soltani 2000). Adverse selection refers to the problem that arise when it is time to enter a contract and the part that has the most information (in this case, the agent) acts in a way that is self-interest seeking and doing so with guile. The principal cannot properly measure the performance, skills and abilities that the agent have. He cannot measure it before hiring, neither while the agent is working (Eisenhardt 1989). The problem referred to as moral hazard occurs when the principal can judge the outcome of the agent's research but have no access to monitor the agent's behavior. That is: it occurs after a contract is entered. Now, the agent is acting in a way to maximize his own wealth and may not have incentives to work as hard as agreed-upon. Consequently, he may primarily focus on great outcome and shirk when it comes to the way he works towards the goal (Soltani, 2000).

Bushman and Smith (2001) note that one purpose of using financial accounting is to reduce information asymmetries among investors. Though, Bushman and Smith (2001) further, note that accounting measurements is most important when it comes to contracting within the organization, In summary, financial accounting is very important when it comes to the principal-agent relationship (and other internal contracts) but less important when we are talking about contracting with other companies and similar.

According to Deegan and Unerman (2011) principals when it comes to accounting theory, assume that the agent will act in self-interest if he is not restricted. The principal will therefore expect that the agent will undertake activities that could harm the economic welfare of the principal himself. Deegan and Unerman (2011) claim further that within agency theory it is also assumed that this is what will happen if there is no mechanism or contract that will lure the agent to do otherwise. It is said that many of these contracts are tied to accounting numbers.

Lambert (2001) note that the heart of agency theory is found in the incentive problems and this is also the primary connection with accounting. A big reason why researchers want to do accounting and auditing is to control incentive problems. When it comes to this, agency theory is great for the accounting researchers since it opens up for integration of conflicts of interest, incentive problems and mechanisms for controlling incentive problems into the models that the accounting researchers use.

The focus among positivist researchers has to a very high level, been the principal-agent relationship between managers and owners of public corporations. The focus has been to identify situations where there has been likelihood for conflicting goals between the principal and the agent and then try to describe the best mechanism that can limit the self-serving and opportunistic behavior of the agent. The positivist stream clarify that agency

problems exist and that there are various alternatives of contracts available to deal with these problems. Positivist research is not very mathematical; it is more about describing the use of information to make the agent act in the behalf of the owner. Because of this, the positivist research is quite easy to follow and is widely known. This fact is thought of as an explanation of why this line has been more criticized than the line of principal-agent. The criticism against positive agency theory that have been highlighted are primarily the claim that it is too limited that it is repeating itself and that it has a lack of proof (Eisenhardt, 1989).

Corporate governance: Initially the study will present the definition the Organisation for Economic Co-operation and Development (OECD) gives of corporate governance: corporate governance involves a set of relationships between a company's management its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined (OECD, 2004).

The definition gives the wide meaning of the concept corporate governance which includes the rights and obligations the managers, shareholders and other stakeholders have. Corporate governance is an important part in the research of enhancing the economic efficiency and growth as well as increasing the trust from investors (OECD, 2004).

Corporate governance refers to the systems, processes and principals through which a company is guided. It gives guidelines for how the company can be controlled or governed so that the company can achieve those goals that are set up, the best way possible. This striving to achieve the goals in a particular way improves the company's future value and are also useful for all of the stakeholders in the long run. Stakeholders would in this situation include all parts from board of directors, shareholders and management to employees, customers and society. Consequently, the company's management take over the part as a trustee for everybody else (Bhuiyan and Biswas, 2008).

OECD (2004) states that good corporate governance should give the incentives that are right for the managers and owners so, they can achieve goals that are of interest for the company and their shareholders and this ought to ease effective monitoring. The existence of an effective system for corporate governance in a private company and over the economy as a whole, contribute to give a level of trust which is crucial for a well-functioning market. If that works it will lead to lower capital costs and the companies is encouraged to use their resources in a more effective way and thereby support growth.

Even if there are several factors that affect governance and decision-making in companies that are valuable for the long run success the OECD (2004) still concentrates on the problems with governance that has to do with the separation of ownership and control. They continue to explicate by saying that this is not just a question about the relation between shareholders and management even if that is the central core of the problem. In some jurisdictions, the governance questions also arise from the power of some controlling shareholders over smaller minority shareholders. The principals must therefore be a complement to a much wider strategy for the dilemma when dividing the power (OECD, 2004).

Corporate governance is overall much affected by the partakers and their relation to each other in the governance system. The earlier mentioned controlling shareholders can be all from an individual, a family business, bloc alliances or even a company that works through another holding company. All these types of controlling shareholders can significantly affect the behaviour of the specific company they are trying to control (OECD, 2004).

There are three components that can be seen as corporate governance structure. These three are functions, principles and mechanisms. Corporate governance principles has four different principles these are honestly, resilience, responsiveness and transparency. Honestly is about the corporate communications and that it shall be fair, transparent, accurate and trustworthy. Resilience is about the structure in corporate governance and that it is resilient. It shall be sustainable and manage setbacks. Responsiveness is about being responsive to the stakeholders' interests and desires. Transparency is about being open with information you share relevant information and the disclosure has to be accurate, reliable and fair (Rezaee, 2007).

Corporate governance have seven functions these are; managerial, compliance, monitoring, oversight, external audit, advisory and internal audit. The oversight functions are about overseeing and give strategic advice. This job has the board of directors they have an oversight over the managerial and there performance (managerial). Managerial function is about the alignment of the interest the management has with the interest the shareholders have and this effectiveness. Compliance function is about the framework. The advisory function or the legal and financial advisory function is about giving advice and

assist not only to the company but also to employees, directors and officers in complying with for example, laws (Rezaee, 2007).

With corporate governance mechanisms researchers both have internal corporate governance mechanism and external corporate governance mechanism. Internal corporate governance mechanisms provide the company with controls, the reason for that is to help the corporation to be on track. The companies' progress and activities are overseen and monitored by the controls. Independent audits, policy development, oversight of management, etc., are also included in the internal mechanisms.

Those outside, the company control the external mechanisms control. And it is the external stakeholders that impose the external mechanism on the corporation. And often it is the external stakeholders that organizations report to. The report contains the external corporate governance mechanisms status and the compliance.

In corporate governance it's common to speak about two main systems; it's the market-oriented system and the network-oriented system. The widespread ownership through the capital markets and a clear delegation to operational management to run the business is what characterize the market-orientated system. In the system there are two main governance problems that the systems focus on. The first out of the two is the so-called principal-agent problem which means that the shareholders and the management do not necessarily share the same interest. And the second problem is that the shareholders tend to focus on relatively short-term performance and the reason for that is that the shareholders are scattered and distanced from the company´s daily operations. So, the shareholder and the management have different insight in the company. The network-oriented system has more of a concentrated ownership in the companies. In both systems (market and network-oriented) it is the management that is responsible for the operations. But the biggest benefit with the network-oriented system is the blockholders, the blockholders have access to information so, it's easier for investors to do long-term investment because of the asymmetry between the investor and management is reduced in this system.

Criticism and agency theory: Within the corporate governance research has agency theory been the dominant theoretical perspective (Clarke, 2007). However, criticism to this theory has arisen and the criticism has been widespread and has come from different directions (Donaldson, 1990). Criticism has been directed towards agency theory; some have argued that the theory has a narrow view on corporate governance. The reason for that are the quantitative measures. They argue that factors like incentive compensation and board composition are misleading and that these factors alone cannot explain company's performance. Tricker (2009) is also critical to the contractual relationship, he mean that you can not solely look from the contractual relation between the board and management. He thinks you have to look at other factors as well, factors such as group dynamics, personal behavior and political beliefs to clarify corporate governance.

Eisenhardt (1989) noted that the proponents for agency theory was seeing it as a start of a revolution and that it was the foundation of a powerful theory of organizations. The detractors on the other hand said that the agency theory was trivial and dehumanizing, even "dangerous" was a word they used. Lan and Heracleous also criticize the agency theory. They mean that there is a need for re-thinking the agency theory. They question the way agency theory describes how to mitigate agency problems they also criticize the general assumptions made in agency theory they mean (just like IEA) that the assumptions simplify too much which limits the understanding of the complexities that is characteristic for the real-world organizations. Lan and Heracleous, especially question the self-interest assumption. They also advocate that researchers look beyond normal science and re-think the way researchers see the principals and the agents of the firm.

Agency theory represents the key to explaining why managers chose a certain accounting method. The theory therefore provided an explanation of the importance of different accounting methods. Consequently, agency theory had a big influence on the development of Positive Accounting Theory (PAT) (which describes a perspective of why managers would prefer one accounting method before another when confronted with the choice of competing accounting methods). When Watts and Zimmerman developed the PAT they greatly relied upon the key study about agency theory that Jensen and Mackling wrote in 1976 (Deegan and Unerman, 2011).

The agency theory starting point is principal which are the shareholders and the agents which are the management this seem like a simple explanation of agency theory, however, it can be seen as a simple explanation to a complicated reality. This principal and agent concept seems easy to separate from each other but sometimes they can be difficult to disentangle. If for example, a pension fund invests in a hedge fund and the hedge fund in turn make investment in a private equity company and the private equity company again places the capital in the pension fund who are the principals and who are the agents? (Tricker, 2009).

The human being is basically selfish and has their own interest in mind that its what the agency theory assumes. The theory assumes that people will put their own interest above others interest. This assumption in corporate governance mean that the management will act selfish and when the opportunity arises to set their personal interest first they will take it and they will use this power to get personal benefits. The human morality does not get any explaining so, the assumption is therefore criticized (Tricker, 2009). Criticism is also directed toward agency theory's contract eyesight this has been questioned. The focus on contracts is a simplify picture and it emphasized only self-interest. And according to Donaldson (1990) self-interest is not the only factor that affects the behavior of individuals.

The agency theory does not in a satisfactory manner, explain the difference between small and large organizations. And the difference between these organizations forms that is not explained are the separation of decision making in decision management and decision control (Klein, 1983). In for example, a small firm that is owner-managed is more likely to not have any distinction between risk bearers (the business owner) and decision-makers (corporate management) (Blom *et al*., 2012).

The relation between the management and the owner are not the only thing that affects the steering (Muth and Donaldson, 1998). The owners monitoring are not the only mechanism that come into play, mechanisms such as a new owner threating to coming in is also important. The new owner can come in and make changes in the management composition. Other mechanism is that the market where the management operates is a market there it is important with corporate reputation and to have a good corporate reputation is critical for future positions (Fama and Jensen, 1983).

The agency theory counter pole is the stewardship theory. With this theory you have a legal perspective and you look at corporate governance from this perspective. The corporate management is like a trustee and are nominated and appointed by the shareholders so, each company is a separate legal entity. This means that the one with ownership has the position of power within the company and the company's management is for that reason required to consider the owners interests. With this way of thinking, the individual are not acting solely on their own interests they can also act based on interest for others. So, the stewardship theory differ from agency theory, the theory differ in the way that individual can act based on interest for others (Tricker, 2009).

Corporate governance and the principal-agent problem: With the agency theory perspective the board is like an organ an organ for the owner. The reason for that is to manage and control so that the management will act in accordance with shareholders' interests. However, the theory perceives a conflict, a conflict of interest. If you look at agent theory from corporate governance perspective than the theory contemplates the interaction between the principals and the agent like a contract. Agency theory assume that agents do not always have the shareholders best interest in consideration, the theory assume that the agents acts in self-interest and the theory therefore reflect the behavior the management haves with disbelief. The management is those who operate and manage the business and the shareholders give the management the confidence to doing so. When the management gets such confidence to operate and manage the business, he/her can abuse this situation and use this opportunity to charge high benefits and fees. Since, the shareholders and management have different opinions and looks at things differently they can have different perspective on things such as risk. This can lead to a mismatch and the agent may not fulfill its principal's desire. In the majority of cases, the management is better educated they have often more knowledge about what is happening within the company and this can lead to an imbalance. In such, a situation the agent and the principals do not have equally access to information (Tricker, 2009).

Corporate governance in relation to agency theory assumes a bicameral form of rigid control where there are owners on one side and managers on the other. Here speaks agency theory of a situation where mistrust and friction develops between the two. The general structure of the company is therefore a web of contractual relationships between different groups that has got a share in the company. A well-developed market for corporate control are in the agency theory non-existent which in turn leads to market failures, moral hazards, incomplete contracts, asymmetric information and adverse selection to name a few.

When applied on corporate governance the shareholders that are set to be principals and the problems that arise after separation of control and ownership is how the principal can guarantee that his agents in this case directors in the company will serve the shareholders' interests instead of their own. This discussion concerns the dilemma that is famously known as the principal-agent problem where the involved groups have different goals and objectives which in turn leads to a conflict of interest. This type of separation has been evident in companies in major extent all over the world. These problems that occur between different parties in a company has given root to substantial costs. Here,

corporate governance plays an important and crucial role as a mechanism to prevent and reduce such costs (Bhuiyan and Biswas, 2008).

Bhuiyan and Biswas (2008) discuss these types of control mechanisms and that they are perceived to be essential in the research of reducing the differences between the principals and the agents interests. Corporate governance functions as a control mechanism and is used for effective use of the company's resources. One can say that corporate governance is a mixture of both internal and external mechanisms which seeks to achieve a utilization of the company's resources as effective as possible. Some of the most prominent corporate governance mechanisms that are advocated to reduce these agency costs will now be presented. In the following study, these are divided into three sub-groups, internal and external mechanisms and independent audits.

Zattoni and Judge (2012) thinks that the most prominent sets of a company's control comes from the internal mechanisms these controls serves as to monitor the development and the activity in a company, so that they can take corrective actions when the firm is beginning to get off track. The mechanisms are used to serve the internal goals as well as the internal participants, including managers, owners and employees. These goals and objectives comprise a smooth and steady business, good lines of communication and to measure results. The control mechanisms that are included are for example, monitoring of the managers, independent internal auditors and the composition and size of the board of directors.

Jensen (1993a, b) mentions when the board is too big the monitoring gets more difficult while the decision-making and communication also proves to deteriorate. Further on, the composition of the board is important as an internal control mechanism where directors play an important role. They have a responsibility to assess the performance of the managers and when needed so, fire the CEO. Song and Hanson (2001) mean that forceful actions and more firm internal control are more likely when the board consists of directors who are independent of management.

Internal auditing is an independent and objective activity that seeks to create more value and improve the work in a company. The internal auditing helps the company to achieve those goals that are set up with a strict and systematic method. Thereby, they can evaluate and enhance the efficiency in governance processes, controlling and risk management and where they have an open communication with the managers and audit committee. The independence the auditor has from the board of directors is of great importance for the shareholders because it's perceived to be crucial when it comes to deliver qualitative auditing performances. (Laker, 2004). Further on, the audits serves to monitor the managers which in turn will contribute to better corporate governance overall and thereby protect the shareholders interests.

Another important internal mechanism advocated in scientific studies is the compensation to managers. Regular performance appraisals and compensation based on performances in the form of bonuses or options can reduce some of the agency problems. This is because managers that are satisfied will research more for the principals best instead of their own to some extent. One can often find relations between the workers performance and financial rewards. Included here are some other mechanisms for example when you give the managers the chance to rise through the ranks. When you give career possibilities and promises of bigger rewards you give incentives for effective managers to increase the company's value and they will reduce their self-interested behaviour in return (Conyon and Schwalbach, 2000).

Those who serve outside of an organization on the other hand control the external mechanisms. Here, the research lies in fulfilling the objectives for regulators, financial institutions, trade unions and governments. These goals include appropriate debt management and legal compliance. External stakeholders impose, mostly in the form of regulations or union contracts these types of external mechanisms on companies. These external groups or organizations suggest proper guidelines for how the research should be implemented and the companies choose either to approve or ignore them (Zattoni and Judge, 2012).

An independent external audit of a company's financial reports is also a part of the governance structure. It serves both internal and external stakeholders interest when an audit of a company's financial reports is presented. The financial report and the following audit report helps shareholders, governments, investors and employees determine the company's financial performance. It can also give them an idea of how the future of the company might look like (Broadley, 2006). The external auditors involvement in the process of identifying agency problems could in this case contribute to corporate governance efforts. The auditor would ease a situation where managers are encouraged or pressured to take more responsibility. Through, a suitable application of accounting principles, the external auditor can simplify a situation where creative accounting policies are discouraged. The external audit remains a significant part of the corporate governance that makes the

managers responsible to shareholders for their management of the company. Auditing standards have a role to play to ensure that factors like integrity, independence and objectivity are respected. Elements that is essential when it comes to the auditors' performances (Ojo, 2009).

Ashbaugh and Warfield (2003) discusses audits in corporate governance and mentions that audits are one of many institutional functions which are central for a company's corporate governance which supports transparency in the financial reporting. They continue to say that auditors are an important part of effective markets because audits can increase the credibility of financial information which ultimately affects a company's allocation of resources. Therefore if stakeholders demand reliable financial information the audits are important in the research of corporate governance.

RESULTS AND DISCUSSION

Agency theory can be helpful when you try to explain opportunistic behavior and the problem with this behavior. The reason for why the agency theory is helpful is because the theory assumes that people are selfish and they act in their own interest. The theory is also based on information and that asymmetric information exit between the principal and the agent and for the agent this asymmetric information is a benefit for him/her (Eisenhardt, 1989). If the agent and the principal have different opinions on how to perform certain research, the agent will go and do what he/her thinks is best and in a manner that suits him/her. This will happen, if the agent incentive to perform in a manner that the principal wants, he/her will choose the manner that suits him/her best. This can better be explained in an example. If you have the owner on one side and the manager on the other side, the owners goal is for the company to be as profitable as possible, however, they want the company to follow the accounting rules and they do not want the company to be profitable by irregularities. In accordance, with opportunistic behavior the manager will to everything in his/her power, even if they have to cross some regulations or rules to be as profitable as possible. And the reason for way they will cross some regulations or rules to reach their goals is because they believe that they do not will get caught with the errors (Eisenhardt, 1989; Jarva, 2009; Ramanna, 2008).

The focus of positive agency research has almost exclusively been the principal-agent relationship between owners and managers of large, public corporations with widely dispersed ownership structures (Jensen and Meckling, 1976; Fama, 1980; Fama and Jensen, 1983; Eisenhardt, 1989). In particular, agency theory declares that in a public corporation there exists a fundamental problem with respect to shareholders' interests, namely that top management does not always behave in a manner which maximizes shareholders' return on investment (Kulik, 2005). Consequently, agency costs arise because of the diverging interests between managers and shareholders as well as difficulties for owners to control management: shareholders have imperfect information that prevents qualified decision-making; contractual restrictions to management discretion may be problematic to implement and shareholders may encounter free-rider problems because of their relatively small shareholdings in a particular corporation, thereby decreasing motivation to exercise their rights (Eisenhard, 1989; Aguilera and Jackson, 2003). Corporate governance mechanisms such as laws and regulations (Francis *et al*., 2003; La Porta *et al*., 1997, 1998, 2000) corporate information disclosure (Bauwhede and Willekens, 2008; Broberg *et al*., 2010), external auditing (Adams, 1994; Arnold and De Lange, 2004) and independently structured boards (Fama and Jensen, 1983) are therefore, introduced to control the agency problem and assure that executives act in the best interests of shareholders. Traditionally, the aforementioned agency framework has also been widely used by corporate governance researchers, perceiving the modern corporation as a nexus of contracts between risk-bearing shareholders and executives with specialized expertise (Aguilera and Jackson, 2003, 2010).

Some sort of principal-agent situation constantly arises whenever a principal (shareholders) delegates the authority and responsibility to the agent (managers). Their different attitudes and interests cause problems which damages the company and here corporate governance plays a vital role as a wide control mechanism. It's a mixture of both internal and external control mechanisms that seek to achieve an effective utilization of the company's resources which are necessary to reduce deviation of the two parties (the principal and the agent) interests. With help from control mechanisms such as board of directors, independent internal auditors and external auditors, the problems that arise in a principal-agent situation can be minimized.

CONCLUSION

Agency costs arise because of the diverging interests between managers and shareholders as well as difficulties for owners to control management: shareholders have imperfect information that prevents qualified decision-making; contractual restrictions to management discretion may be problematic to implement

and shareholders may encounter free-rider problems because of their relatively small shareholdings in a particular corporation thereby decreasing motivation to exercise their rights. The focus lies on the corporate governance and the role it plays when it comes to preventing and minimizing the problems and costs that arise in the principal-agent situation. Corporate governance have seven functions, these are managerial, compliance, monitoring, oversight, external audit, advisory and internal audit. In corporate governance, agency theory is important because it forms the basis of policy regarding the proper governance of corporations. Corporate governance mechanisms such as laws and regulations, corporate information disclosure, external auditing and board Independent are therefore introduced to control the agency problem and assure that executives act in the best interests of shareholders.

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