# Managerial Behavior, Agency Cost and Ownership Structure

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## Abstract

In Jensen and Meckling (1976)'s journal article "the theory of the firm: managerial behavior, agency cost and ownership structure", they put forward a theory of firms' ownership structure on the basis of the agency cost of outside equity and debt. They accomplished their purpose by drawing on the theory of agency, property and finance. The motivation of their research is to analyze ownership structure of the firm systematically based on agency cost theory. They synthesize managerial behaviors, ownership structure and financial structure to demonstrate the optimal capital structure. (Jensen and Meckling, 1976); and show the impact of managerial behavior on firm's value.

## Keywords

Management; cost; economy.

## 1. Introduction

This review essay is organized as follows: the first part is the theories relating to the author's research, the second part is the basic theory their research based on: agency cost; the third part is author's theory of corporate ownership structure; the last part is the author's contribution and doubts about their research.

Before their analysis, they introduce the theoretical basis of their research. Different from former literatures, their research follows the model of individuals' maximizing behaviors (Jensen and Meckling, 1976).The first theory Jensen and Meckling (1976) put to use is "property rights", emphasizing it is the individual rights conduct the direction in which costs and rewards has gone among members in organizations. In addition, contracts will give details about individual rights. Subsequently, these contracts influence individual behaviors (managers' behavior when it comes to firms) to some extent. Jensen and Meckling's paper apply the influence of "property rights" on managerial behavior to contracts of firms with separate owner and managers.

Another theory relates to their research is "the theory of agency". First of all, it is critical to understand agency relationship.According to Jensen and Meckling (1976, p308), "an agency relationship is a contract under which one or more persons (the principal (s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent." They argue the agent is reluctant to direct in the principals' favor mostly if both sides are tempted to maximize their utility (Jensen and Meckling, 1976). It appears that agency cost incurs due to the misaligned interest and information asymmetry.

## 2. Best Interest Service

In their analysis, for the principal, to lessen the disadvantage of their interest, they will take measures to stimulate the principals to make efforts in their interest or monitor the activities running counter to their benefit (Jensen and Meckling, 1976). While, they have to offer the incentives or pay for monitoring. In another way, it requires bonding cost to have the agent made certain their behavior will not go against with the principals' benefit. Otherwise, they will make compensation for the principal due to the violation.Without the according cost, it is unlikely that the agent will make efforts

in order to maximize the principal's interest. According to Jensen and Meckling (1976), the "monitoring cost" and "bonding cost" exist in most situations when it comes to agency relationships. They mention there is still some discrepancy to do with the agent's decision making which inferior in principal's best interest. The "residual loss" is the amount converted to such discrepancy.

Jensen and Mecking (1976) define the agency cost as the sum of "monitoring cost", "bonding cost" and "residual loss". They note that the definite principle-agent relationship is not the prerequisite for agency cost, and it incurs whenever the joint efforts made by two sides or more. Their implications of agency cost is consistent with Alchian and Demsets (1972) who state "shirking and monitoring of team production"in the theory of firm. Jensen and Meckling (1976) claim agency problem exist widespread in firms with "separation of ownership and control", for the definition of agency is tally with the actual situation between shareholders and manager. The authors emphasize the universality of agency problem and attribute the formality of capital structure theory to the agency cost. They limit the scope of their research to the agency cost due to the relationship of shareholders and managers (Jensen and Meckling, 1976).

In terms of approach, the widest popular one among literature is presenting solutions to realize that agent is willing to service in the principal's best interest. While, Jensen and Meckling (1976)' approach, on the assumption that these solutions are provided, they research the motivation of both sides and the factors contributing to the agreement in contract between the inside managers and outside owners.

Next, Jensen and Meckling (1976) focus on the definition of firms. In the paper, they compare two opposite comments of firms: Ronald Coase (1937)' conclusion giving importance to the role of direct authority in distributing resource and Alchian and Demsetz (1972)' emphasizing on the function of contract in exchange. Jensen and Meckling (1976) agree with Alchain and Demsetz that monitoring plays a significant role while they dissociate themselves with the condition of "joint input" they confined. They give further explanation that "contractual relationship" is the reason for being of firm, among all stakeholders of it. Agency cost coexists with contractual relationship, no matter whether there is joint input or not.

They regard the nature of organizations as legal fiction tying various contractual relationships together. "Firm is one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which generally be sold without permission of the other contracting individuals." (Jensen and Meckling, 1976, p311). With the definition of firms, they further state that it is non-logical to consider the firm's "objective function" or "social responsibility", which mistake firms as individual.

In the following part, Jensen and Meckling (1976) stress the foundation of their research: agency cost theory. They differentiate two types of agency cost. The first part of agency cost is related to outside equity. In a corporation, if the owner is also the manager, he has the entire residual claims of the corporation. Every dollar he cost is expected to get one-dollar return for him, including pecuniary or other forms (Jensen and Meckling 1976).

In contrast, when he owns 95% of equity, his residual claims turn to 95% accordingly. Firstly, to get one-dollar return for the corporation, the efforts he made remain the same while he only get 95% of total return. Subsequently, a problem is the manager would give up many value-creation opportunities involving his extra commitment. Therefore, the firm's value is under-performed for the existing agency relationship (Jensen and Meckling, 1976). Secondly, if he increases his non-pecuniary benefit, he only has to pay 95% of the cost. In this way, the manager employs the firm's resources, including the outside owners', to seek personal gains for himself.

Realizing it, the shareholders will attempt to monitor him and the share price they pay will reflect the monitoring cost and the discrepancy formed by managers' personal behavior (Jensen and Meckling, 1976).Specifically, the methods for monitoring are provided by authors such as "auditing, formal control systems, budget restrictions, and the establishment of incentive compensation systems". Jensen and Meckling (1976) note it is the owners who will pay for all the monitoring cost.

On the other hand, there are also methods for the bonding cost such as auditing the financial statement independently or to form restrictions on managers' extent of power (Jensen and Meckling, 1976).They further argue the extent of monitoring and bonding behaviors make it possible to achieve efficiency, but fail to bring about the value maximization of the firm. For the shareholders, they are likely to expense the cost as long as it could generate more benefit than the cost. Jensen and Meckling (1976) conclude agency cost incurs whenever there is separation of owning and management. They claim agency cost relies on monitoring cost.

## 3. Agency Cost

To some extent, the size of agency cost is contingent on the firm's condition, such as the manager's preference in personal gains, the feasibility for manager replacement, the market for the form to sell their shares (Jensen and Meckling, 1976). Furthermore,they emphasize monopoly or competition does nothing to the amount of agency cost since the incentives of owners to prevent the managers from violating their benefits is identical in the two opposite conditions.

In Jensen and Meckling (1976)'s analysis, they argue agency cost also exist with debt. Before explaining it, they analyze some issues for the corporate structure. Specifically, they mention the function of "limited liability". According to Manne (1967) and Alchian and Demsetz (1972), it has one significant characteristic: bearing limited liability of equity claims of firms. While, Jensen and Meckling (1976) argue, instead of extinguish the risk, it actually transfers risk to others. As a result, it is the directors who undertake the potential risk of unpayable debt.

Another question they pay attention to is how the firm's value influenced by capital structure. Jensen and Meckling (1976) explain the influence of bankruptcy and tax subsidies will generate cost, and the change of bankruptcy cost will bring about changes on the "distribution of future cash flow". They apply agency cost to analyze the relevance between the distribution of future cash flow and the financial structure.

The second significant part of agency cost is related to debt in firm's financing. The agency problem also generally exists between the owner-manager and bondholders. The manager is willing to choose high-risk investment under debt relationship, since if investment succeed, he will get high profits; if it fails, the debt holders will bear loss due to limited liability (Jensen and Meckling, 1976). Within the manager's decision- making power,he can choose the way to have the wealth rightfully belongs to bondholders transferred to him. Under the circumstances, to protect their benefit, the bondholders will make limitation on the managers' actions by covenant (Jensen and Meckling, 1976). The cost generated on the process of forming covenant is part of agency cost.

In addition, it may lead to some loss since the manager is limited to choose the high-return investment to avoid risk.Jensen and Meckling (1976) note that the monitoring cost is not borne by the bondholder actually. As the bondholders realize cost, they will factor them in their debt claim price that they would like to pay. So the cost will be transfer to the ultimately bear, the owner of the firm.

For the owner-manager, he will attempt to minimize the monitoring cost for the reason that the cost influence the firm's future cash flow. When he voluntarily providesfinancial reporting and independent auditing at a lower cost, it arises bonding cost (Jensen and Meckling1976). The authors put forward a question that why debt is not the firm's solely outside financing; and answering it by illustrating the third part of agency cost of debt. That is the bankruptcy and reorganization cost.

First of all, they state a firm runs into bankruptcy when it is unaffordable for debt or run against the provisos for bankruptcy(Jensen and Meckling, 1976). In this case, the bondholders take the brunt of the remainder of loss while there is no more claim with the stockholders. They continue to argue bankruptcy involves cost in reality since its process will expend a division of rest property. Thus, before making buying decisions the buyers will factor in the possibility of bankruptcy cost to decrease their return, which form an element of cost due to agency relationship (Jensen and Meckling, 1976).

## 4. Property Assessment

In the condition that bondholders have made assessment of the cost of bankruptcy, the according agency cost will once again to be borne by the owner manager. They note once the firm face bankruptcy, its revenue and operating cost will be negatively impacted, and merger might be chosen by firm to evade paying bankruptcy cost. Therefore, the potential risk of bankruptcy and firm's financial structure will affect the profit and operating cost of the film.

Thus, the agency cost of debt comprises of the loss of inferior investment due to limitation of debtholders; the monitoring and bonding cost and the bankruptcy and reorganization cost (Jensen and Meckling, 1976). The authors continue to analyze the reason for the popularity of debt financing though the users are aware of relevant cost. The first attribution given is the tax subsidy on interest payments. Additionally, to seek more benefit from profitable investment, the owner needs to expand financial resources from debt. He is willing to pay for cost as he can get more profit after paying it. It can be seen, the owners have incentives to incur both outside equity and debt (Jensen and Meckling, 1976).

Jensen and Meckling (1976) form the theory of corporate ownership structure to shape the optimum structure of owner-manager's equity, outside equity and debt. They claim agency cost is the determinant of "corporate ownership structure". They argue the optimal ownership structure is to strike a reasonable balance between various way of financing, realizing the minimum agency cost (Jensen and Meckling, 1976). They argue the proportion of outside equity and debt is contingent on agency cost. In efficient market, the information of monitoring cost and change in agency relationship is implied in prices of equity or debt.

For agency cost is borne by owner-manager as Jensen and Meckling (1976) explained in former part, the ideal scale of financing to the manager is the one incurs the lowest agency cost for him. They present agency cost raise with the increasing proportion of outside equity for the manager have more incentives to use outside equity for personal gains; and decline with the decreasing ratio of debt as manager will find it become harder to shift bondholders wealth to his. Jensen and Meckling (1976) state in condition that the manager hold the entire residual claim, it generate the lowest agency cost.

For the model they present, Jensen and Meckling's (1976) hypothesize is that a larger firm will result in a larger amount of agency cost due to the increasing difficulty and cost in monitoring. They analyze managers are likely to hold less equity than his wealth allows in order to reduce risk, increase though agency cost is.Next, they explain the crossing of "the demand for outside financing" and "marginal agency cost" will resolve the optimum outside financing; and show the key to right outside financing, which is "Pareto optimal"to claim that agency cost could be lower only when someone's situation become worse (Jensen and Meckling, 1976).

Jensen and Meckling's agency cost theory has been seen as a classical approach to analyze financial structure issues and contributes to the theory of dividend policies, the acquisition of debt reputation and so on(Kursten, 1995).

However, some doubts about classical agency theory have been raised during the development of modern formative system of this theory. The model given by Jensen and Meckling are regarded as a simple one by many scholars (Kursten, 1995; Gorman, 1986).Kursten (1995) argue conjectures in Jensen's theory are texted to be invalid. To hypothesizes that the debt ratio will cause the monotone changes of increase of agency cost (debt) and decrease of(equity),according to Kursten (1995)' test, heargue it is invalid to lessen agency cost of debt by simply reduce debt percentage.Furthermore, according to Roberts and Viscione (as cited by Gorman, 1986), the ultimate bear of agency cost of debt are both bondholders and owner-manager instead of owner-manager solely. In Wan and Xu's (2009) research, which is in the context of china, it appears that 'equity structure reform' impact agency cost significantly; specifically, the state owned share contributes to the decrease of agency cost (Wan and Xu, 2009).

Kursten (1995) questions the way of sum up minimum agency cost to get optimum ownership structure.In his theory, he claim there is interactional relationship between the problems generated by

debt and equity; while, Jensen's approach has ignored it and misjudge that cost of debt and equity isolate each other. Similarly, Gorman (1986) argue the definition of agency cost Jensen and Meckling given fails to consider equity-related cost and debt-related cost are interdependent, which influence both shareholders and bondholders; and they have ignored the possibility of owner-manager's risk aversion.

Chu (2011) examines what kind of value the owner-manager could employ for non-pecuniary benefit. The owner-manager's option is limited to free cash flow instead of all the firm value, which is assumed in Jensen's theory. Free cash flow tends to play substantial roles to restrict manager's power to seek personal gains and accordingly change agency cost; and it has a mutually beneficial relationship with financing structure, which impacts optimal financing structure (Chu, 2011). However, Jensen and Meckling fail to factor it in their model.In addition,Wang (2011) points out the lack of analysis of relationship between free cash flows and agency cost. Consistent with Chu (2011), Wang (2011) gives importance to the impact of free cash flow on agency cost; while the result is two sides. Firstly, free cash flow has managers attempt to seek more personal benefit, increasing agency cost; meanwhile, since free cash flow stems from effective managing performance, making it possible to influence agency cost negatively (Wang, 2011).

## 5. Conclusion

It seems that Jensen and Meckling's agency theory are treated as a classical approach currently. Based on their theory, recent literatures make new contributionsto it.

## Acknowledgements

The study was supported by 'Training Program Foundation in University of Heilongjiang Bayi Agricultural University'.Project Title: 'Design and Application of Audit System of Modern Commercial Bank based on Audit model'(Grant No.XRW2017-06)".

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