Agency Theory for Online Analysts

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Abstract

Although in its infancy, the practice of Web Based analysis is dramatically altering the way corporations approach the discipline of Competitive Intelligence (CI). The same can be said for the impact of the World Wide Web on Business Strategy research and instruction. This paper outlines an innovative approach to understanding Agency Theory, and offers the case of Light Company to illustrate the use of Web based online evidence as both a research and teaching tool for experienced and budding analysts.

Imagine this. You are forty-two years old. You have just been named CEO of a Fortune 1000 company. Five thousand employees now refer to you as “Boss.” Fifty thousand individuals and entities own stock in your corporation. Thousands of analysts, academics, journalists and market watchers now care about what you say. Suddenly into your mind pops a number of questions. Who do you really report to? How will your performance be judged? What rules or regulations should guide your behaviour? What does success mean in your case? These are issues directly or indirectly addressed by Agency Theory, the topic for paper.

This paper suggests that evidence to test the validity and reliability of Agency Theory, and present it, is publicly available online in a format that is easy to comprehend. A case is offered that highlights why CI analysts should be knowledgeable about explanatory perspectives such as Agency Theory. Three assumptions underlie this argument. First, the entities under study are publicly traded corporations regulated by the Securities and Exchange Commission (SEC). Second, these corporations file yearly 10K Annual Reports and DEF 14A Proxy statements with the SEC and these documents are publicly available on the EDGAR database. Third, Agency Theory explains the make-up of the contractual relationship linking corporate executives to shareholders.

This paper proceeds as follows. First, Agency Theory is summarized from an organizational perspective. Second, the recent problems of Light Company are used as a case illustration to highlight the relevance of Agency Theory to CI analysts. Third, a teaching program is outlined that makes use of laptop and Internet communications technologies. Finally, the paper is concluded.

Theory

Using the metaphor of the contract, Agency theory addresses the Agency issue in which one party (the principal) delegates work to another (the agent), who performs that work. Agency theory is concerned with resolving two problems that can occur in agency relationships.[i] The first is the agency problem that arises when the desires or goals of the principal and agent conflict and when it is difficult or expensive for the principal to verify what the agent is actually doing. The problem here is that the principal cannot verify that the agent has behaved appropriately. The second is the problem of risk sharing that arises when the principal and the agent may prefer different actions because of the different risk preferences. In the corporate world, an agency relationship exists between a firm’s outside stockholders and its managers to the extent that stockholders delegate the day-to day management of their investment to those managers.

The agency relationship between managers and shareholders can be effective as long as managers make investment decisions in ways that are consistent with stockholders’ interests.[ii] Thus, if stockholders are interested in maximizing the rate of return on their investment in a firm, and if managers make their investment decisions with the objective of maximizing the rate of return of those investments, then stock holders will have few concerns about delegating the day-to-day management of their investments to managers.[iii]

Unfortunately in numerous situations the interests of the firm's outside stockholders and its managers do not coincide. From a financial perspective, there are two primary sources of agency costs. A first is when managers decide to take some of a firm's capital and invest it in perquisites that do not add economic value to the firm but do directly benefit those managers. A second source of agency costs is the risk profile of the managers. According to this line of thinking, stockholders lose out when managers are more risk averse in their decision making than stockholders would prefer them to be. From an organizational view, agents might not adequately pursue the interests of principals for two reasons termed *moral hazard* and *adverse selection*. Moral hazard refers to a lack of effort on the part of managers. Adverse selection means that agents misrepresented their abilities when hired. So how do theorists respond to these concerns?

Principal-agent theory seeks to determine the optimal or most efficient contract under varying levels of outcome uncertainty, risk aversion, information and other variables.[iv] Essentially, the question asked is whether behavior oriented contracts (e.g. hierarchical governance) are more efficient than outcome-oriented contracts (e.g. transfer of property rights, market governance).

Under principal-agent theory, principals either have complete or incomplete information regarding agents. When information is complete, principals will make use of behavioral contracts to monitor agents. When information is incomplete, principals must deal with the agency problem because of the fear of opportunistic behavior in the form of moral hazard or adverse selection on the part of the agents. In this situation, principals are theorized to have the options of monitoring agents through hierarchy related investments in information systems (such as budgeting systems, reporting procedures, boards of directors, separate layers of management) or market related contracts based on the outcomes of agent's behavior. This latter option in turn serves to transfer risk to the agent. Thus, when seeking to manage worrisome agents, diligent principals or shareholders will seek to match specific contract features to specific information contexts. This concludes our discussion of Agency Theory. We now move on to a case illustration of this important perspective.

The Case Example

"We won't touch a .Com"

How things have changed. In the span of only a few months the attractiveness of .Com firms has gone from high to low in the eyes of many an investor and venture capitalist. Gone are the heady days of seemingly perpetual share price increases replaced by a stone cold attitude of "show me the profits before I hand over the money." In these days of caution, shareholders and potential investors are now far more diligent in their efforts to understand corporate activities and are no longer quite as willing to believe heady tales of future prosperity. Increasingly these same stakeholders are returning to tried and true protective practices as they seek to make sense of, and assess, complex opportunities. One useful and available framework for conducting such an assessment is that of Agency theory, illustrated in this case as the relationship of a Chief Executive Officer and his employer, Light Company. The following paragraphs suggest the applicability of Agency Theory for CI professionals and do so in an innovative manner. Excerpts of online information sources are highlighted to demonstrate their role in building an argument for or against the effectiveness of an incumbent executive and how they might be positioned in a case write up.

Prologue

Where might a case write up on Agency Theory begin? This writer suggests a "catchy" opening paragraph to grab the readers' attention. A good example was a story found on the Cnet News.com Web site dated January 28th, 2000. In this instance, Light Company is portrayed as a successful yet controversial company.

> Light Company has made its David and Goliath struggle to shake up the recording industry the cornerstone of its business model…But legal experts, stock analysts and other companies in the burgeoning online music industry say Light Company may have taken the tactic one step too far this month when it launched two new services offering customers access to their CD collections online. …Having focused on creating a platform for relatively unknown artists on its Web site, Light Company's Instant Listening and Beam-it services catapulted the company into a new realm--that of dishing up major label artists it didn't have access to before. ….Consumers have a right to take the CD they own, rip it and upload it to a remote server," one observer added. "The legal question is whether consumers have a right to end up in the same place with Light Company's help." [v]

The Company

Following this introduction, Light Company itself would be described briefly using information found on a press release off its homepage. An exemplar is noted below.

> "Light Company, Inc is pioneering a revolutionary approach to the promotion and distribution of music. The Company's website has grown into a premier online music destination. The Company uses the Internet and data compression technologies to enable a growing number of artists to broadly distribute and promote their music and to enable consumers to conveniently access this expanding music catalogue. The Company's website contains over 56,000 songs from over 11,000 artists, representing one of the largest collections of digital music available on the Internet. Consumers can search, preview and download music free of charge. Our strategy is to harvest the breadth and uniqueness of our music community and our services to generate multiple commercially feasible revenue streams. Our primary focus to date has been on building an advertising-

> based model that offers advertisers the opportunity to target specific music fans regionally and globally through different types of advertisements and sponsorship options". [vi]

As with many modern corporations, Light Company touts its business model as advantageous to its future. Details of this operating philosophy would also be available to CI professionals from Light Company's SEC filings. Using key words such as "business model", one would find 10K Wizard.com extremely useful in digging up information such as the attributes noted below.

> "Our unique business model provides the following advantages for artists and consumers:
> - creates an easy and convenient way for consumers to listen to, download and purchase music;
> - dramatically lowers costs for artists to promote and distribute their music;
> - enables artists to reach a large number of consumers worldwide;
> - enables consumers to discover local and lesser-known artists in ways they cannot through traditional music retailers; and
> - facilitates direct communication between fans and artists." [vii]

The Candidate

Following the company description and a discussion of its business model, the Chief Executive Officer would then be profiled highlighting his or her previous accomplishments and work experience. One source for this information would be Light Company's most recent DEF 14A proxy statement filed with the Securities and Exchange Commission with an excerpt as follows:

> "Bob Stanfield founded Light Company and has served as our Chief Executive Officer and Chairman of the Board since March 1998. From September 1995 to March 1998, Mr. Stanfield operated several web sites that focused on merging search technologies with commerce. From September 1995 to September 1996, Mr. Stanfield was President and Chief Executive Officer of Mounds, Inc., a developer of digital picture software. From January 1994 to August 1995, Mr. Stanfield was President and Chief Executive Officer of Muc Software, a developer of networking and security tools. Mr. Stanfield received his Bachelor of Arts from the University of North Carolina".[viii]

According to Hoovers.com company capsule, Bob Stanfield also own 37% of the outstanding common stock of Light Company.[ix]

The Context:[x]

Next, the operating environment of Light Company could easily be introduced highlighting aspects of the industry within which it competes. . One interesting source for information of this nature is the Industry Profile catalogue available through Wet Feet.com. Which industry does Light Company compete in? A glance at its Wet Feet.com company profile, suggests a category. Illustrative excerpts from the industry profile are noted below.

> "…. millions of people are online at any given time, and an entire industry has sprung up to take advantage of the promise that the Web might completely transform the economy. Trying to fulfill that promise, many Internet startups have singled out some activity to reinvent by conducting it on the Internet—distributing textbooks, software, groceries, or greeting cards; disseminating medical information, fiction, or law school classes; planning parties; or swapping homes for vacation. ….the Internet makes it possible to distribute information of all kinds and conduct a transaction at the same time, anywhere in the world, immediately. That combination has never existed before, and Internet firms are in a mad rush to figure out how to take advantage of that fact."

Along with a basic overview of the industry, Wet Feet.com industry profiles will also suggest major trends that impact firms competing in this arena as well as specifics organizational types. These trends include:

1. "Internet companies need the content that is owned by the traditional media companies,
2. The abstract value of market capitalization now carries as much weight as actual cash.
3. As sensitive information is increasingly funneled through the Internet, privacy issues are coming into conflict with free speech rights.
4. In order to entice first-timers to visit websites and build loyalty thereafter, companies are offering incentives—sweepstakes, frequent-flier miles, rebates, magazine subscriptions, and coupons are among the favorites."

The industry as defined by Wet Feet.com is broad. Although a Vendor, Light Company may face competition from other organizational types including online publications, aggregators, portals, online communities and Internet service providers. Each of these is described below:

> "…..**Online publications** make money by selling advertising or subscriptions or both. …..**Vendors** make money by selling goods or services….. Search engines are **aggregators. Portals** are sites that serve

as home base for Web surfers. All of these sites make money from banner advertising or, increasingly, through alliances with companies that pay a lot of money to be the gateway or aggregator's "preferred provider" of goods and services…… **Online communities** serve as centers for people who share special interests and make money from advertising and alliances. ….. **Internet service providers** (ISPs), companies allow users to get online….help develop Web sites, provide services including management and strategic consulting specialized for Web companies, online advertising, e-commerce development, user-interface design."

The Concern

With a general understanding of the company, its CEO, and its competitive environment in place, one now returns to the idea raised in the opening paragraph – that Light Company is a somewhat controversial entity. Aside from the recent press clipping noted above, a most obvious place to identify concerns facing shareholders and stakeholders of this young company is its S1 Form and associated amendments. Aside from the section labelled "Risk Factors," a key word search again using 10K Wizard and the term "business model," offers a number of issues that would worry even the most optimistic of investors. A May 1999 excerpt from an S1/A filing noted below, suggests caution.

> "Our model for conducting business and generating revenues is new and unproven. Our business model depends upon our ability to generate revenue streams from multiple sources through our website, including: website advertising fees from third parties; online sales of CDs and music-related merchandise; promotional activity fees; and leveraging our aggregated artist and consumer information…" [xi]

One month later, excerpts from a 424B4 filing from Light Company suggests panic.

> " It is uncertain whether a music-based website that relies on attracting people to learn about, listen to and download music, mostly from lesser-known artists, can generate sufficient revenues to survive. We cannot assure you that this business model will succeed or will be sustainable as our business grows. In order for our business to be successful, we must not only develop services that directly generate revenue, but also provide content and services that attract consumers to our website frequently. We will need to develop new offerings as consumer preferences change and new competitors emerge. We cannot assure you that we will be able to provide consumers with an acceptable blend of products, services, and informational and community offerings that will attract consumers to our website frequently. We provide many of our products and services without charge, and we may not be able to generate sufficient revenue to pay for these products and services. Accordingly, we are not certain that our

> business model will be successful or that we can sustain revenue growth or be profitable”. [xii]

The Contract[xiii]

Clearly, shareholders and stakeholders of Light Company have reason to watch its performance with great attention. With this in mind, how might they protect its future prosperity? One approach is to structure an employment contract with the CEO in a manner that encourages this individual to act in their best interest. In this instance, an employment contract would be found in the Tech Deals section of the Findlaw.com Web site. Excerpts from this agreement are as follows.

> This EMPLOYMENT AGREEMENT (the "Agreement") is made and entered into effective as of May 13, 1999, by and between LIGHT COMPANY (the "Company"), and BOB STANFIELD ("Executive"). The Company and Executive are hereinafter collectively referred to as the "Parties," and individually referred to as a "Party."
>
> The Company hereby employs Executive, and Executive hereby accepts employment by the Company, upon the terms and conditions set forth in this Agreement for the period commencing January 20, 1999 (the "Hire Date") and ending December 31, 2002. Notwithstanding anything herein to the contrary, either Party may terminate Executive's employment under this Agreement at any time, with or without cause, subject to the terms and conditions of Section 4 herein. Executive shall have the title of Chief Executive Officer of the Company and shall serve in such other capacity or capacities as the Company may from time to time prescribe. Executive shall report to the Board of Directors. Executive shall do and perform all services, acts or things necessary or advisable to manage and conduct the business of the Company and which are normally associated with the position of Chief Executive Officer, consistent with the Bylaws of the Company and as required by the Company's Board of Directors. The employment relationship between the Parties shall be governed by the policies and practices established by the Board of Directors, except when the terms of this Agreement differ from or are in conflict with the Company's policies or practices, this Agreement shall control.
>
> The Company shall pay Executive a base salary of $150,000 per year (the "Base Salary"), payable in semi-monthly payments in accordance with Company policy. Such salary shall be prorated for any partial year of employment on the basis of a 365-day fiscal year. Executive's compensation may be changed from time to time by mutual agreement of Executive and the Company. Executive shall be eligible for an annual performance bonus of up to $50,000 payable at the sole discretion of the Company's Board of Directors. All of Executive's compensation shall be subject to customary withholding taxes and any other employment taxes as

> are commonly required to be collected or withheld by the Company. Executive shall, in accordance with Company policy and the terms of the applicable plan documents, be eligible to participate in benefits under any Company benefit plan. This Agreement does not supersede or alter in any way the terms and conditions of the Founder Stock Agreement dated March 18, 1998.

Is the contract binding Bob Stanfield to Light Company outcome of behaviourally based? The following sentence extracted from the paragraphs above suggest that it is an outcome based relationship.

> "Executive shall do and perform all services, acts or things necessary or advisable to manage and conduct the business of the Company and which are normally associated with the position of Chief Executive Officer, consistent with the Bylaws of the Company and as required by the Company's Board of Directors."[xiv]

The Comparison

A, CEO Compensation

How well was Light Company's CEO paid in 2000? "Very fairly", if its April 28, 2000 DEF 14A Proxy Statement filing to the SEC[xv] is any indication. In an absolute sense, for the year 1999, a search using key words "executive compensation" on 10K Wizard, indicated its CE0 received $158,626.00 in salary, $148,500.00 in Bonus payments, and $4,850.00 towards a car lease. This was an increase from a salary of $70,833.00. How did this fare with competing CEO's? Using the two competitors listed on the Hoovers.com company capsule as a base[xvi], this salary compares favourably as the most directly competing CEO received $162, 500.00 in base salary along with Stock options.

B, Corporate Performance

How did Light Company perform? In an absolute sense, not well. On 1999 revenues of $22 million dollars, it lost $42.5 million. Relative to competitors, however, it fared okay. According to the Hoovers.com company capsules[xvii], its two most direct competitors lost $57.8 million and $37.5 million dollars on sales of $10.3 million and $16.6 million dollars respectively. In terms of share price performance[xviii], the results were not outstanding either. From an initial IPO priced above $60.00 per share, stockholders ended 1999 with shares worth half that amount. This was in line with the performance of its major competitor who initial price of $35.00 per share melted away to $20.00 per share at year end.

The Conclusion

So how might these results be interpreted in light of Agency Theory? Light Company shareholders chose to use an outcome-based contract to retain the services of Bob Stanfield, who also owns 37% of its shares. Performance in the first year as a publicly traded company was not outstanding. Indeed shareholders saw their equity decrease significantly. However, the salary and benefits of the CEO were not excessive in light of this performance, indeed relative to other CEO's, it is quite low. Although share price did decrease, Bob Stanfield certainly did not benefit from this bad news and indeed shared the pain. Thus, the interests of shareholders were protected fairly effectively. These points are summarized below in Figure 1.

Figure 1

Performance Summary - Online Agency Theory

Executive	**Outcome**	**Share Price Trend**	**Director?**	**Good Deal or Bad Deal**
A	Respectable Revenues with a net loss.	Downward	Yes	Good Deal Salary is moderate. Risk is shared by CEO

Epilogue

Thus, Bob Stanfield appears to be working in the best interest of shareholders. How credible are the information sources used to make this assessment? In a nutshell, and as per Figure 2 below, – the sources are very credible. The bulk of assessment information used to build the case for or against this executive originates with Securities and Exchange Commission regulatory documents. Sources with more inherent biases, such as Company Homepage Information, Independent News Stories, and Commercial Industry Overviews were used.

Figure 2

Overview of Online Information Sources

Case Write Up Section	**Online Information Sources**	**URl**	**Level of Online Information Credibility**
Prologue	Cnet News.com – News Story	http://www.cnet.com	Moderate

Company	Light Company Press Release 10K Wizard, Securities and Exchange Commission Home Page Form S1/A	http://www.Light Company http://www.10kwizard.com http://www.sec.gov	Moderately - Low High
Candidate	10K Wizard, Securities and Exchange Commission Home Page Forms DEF 14A	http://www.10kwizard.com http://www.sec.gov	High
Context	Wet Feet.com – Industry Overview article	http://www.wetfeet.com	Moderate
Concern	Securities and Exchange Commission Home Page Forms S1/a and 424B4	http://www.sec.gov	High
Contract	Findlaw.com – Employment Contract	http://www.findlaw.com	High
Comparison	10K Wizard – Securities and Exchange Commission Forms DEF 14A Hoovers.com – Company Capsules	http://www.10kwizard.com http://www.sec.gov http://www.hoovers.com	Moderate to High
Conclusion	Personal Insight	N/A	N/A

The Teaching Application

Agency theory is a powerful, if controversial approach[xix], for understanding corporate behaviour. Unfortunately, it is also an approach whose empirical basis has been questioned[xx] as has its relevance for those seeking to explain the occurrence of "actual events". [xxi] Fortunately, the discipline of Competitive Intelligence serves as a natural aid to analysts seeking to make sense of the existing competitive playing fields using this approach. The advent of sophisticated Internet technologies, user friendly, Web based search tools, and a growing body of online information sources offer CI professionals and others an opportunity to test the relevance and rigour of Agency Theory in a straight forward manner. They also offer the uninitiated a platform for on the job CI training, be it in the classroom or in the work place.

A means to realistically and cost effectively accomplish this latter task is to simulate the operating environment of a typical corporate CI analyst. One approach for doing so is to explore the intricacies of Agency Theory using a lap-top based teaching environment. How this may be accomplished is summarized in the following paragraphs and is based on the experiences of this writer at Acadia University. To begin consider the setting.

The Setting

Picture yourself as an instructor in a classroom without any chalk-board, pens, and paper. In front of you are forty students, each of whom is logged on to the World Wide Web and is very comfortable operating with the standard Microsoft suite of office products. Although relatively unschooled in the practice of CI, these same individuals have moved beyond using Napster.com and Gnutella.com to find down loadable Web based music files and now spend significant amounts of free time working in virtual teams attempting to override the constraints imposed by the university Fire Wall. This is not the future everywhere. For some it is the present and a typical lap-top based, electronic classroom teaching environment.

The Context - Course

With the challenge of understanding Agency Theory and mastering CI ahead, the students are positioned to succeed. Students work in pairs. They adopt a publicly traded (U.S.) firm that files annually with the Securities and Exchange Commission and track it over time. An ideal firm is one that is in the high technology sector, has recently taken the form of an IPO thus possessing an electronically attainable SI form, and has been in existence for more than one year thus ensuring that both a 10K Annual Report and DEF 14A proxy statement are available. Early in the twelve-week course, specific search techniques are taught and important online information sources identified and illustrated. Analytical skills are developed and honed through the completion of week-by-week assignments – one being Agency Theory.

The Context - Objective

Competitive Intelligence is a term that can take on different meanings.[xxii] Definitional differences aside, the aim of this lap top based program is to teach students the art of resolving important business concerns through online analysis by developing personal interpretive skills and matching them with appropriate analytical frameworks and specific Web-based information sources.[xxiii][xxiv]

Theory – The Basics of Agency Theory

With the context and setting in mind, students are then introduced to a series of perspectives, such as Agency Theory, that underlie specific analytical frameworks. Summarized, the main points of Agency Theory[xxv] are presented as:

- A question of "How do Principals (shareholders) protect their interests from Agents (managers)?"
- For complete information, use behavioural contracts;
- For incomplete contracts choose between behavioural and outcome contracts;
- Behavioral contracts are enacted through the use of hierarchy, boards of directors, M.I.S. systems, and budgets; and,
- Outcome based contracts are enacted through the use of market governance or "just come back to us with the final product."

The Assignment

With this in mind, in pairs, students are asked to complete the following tasks and respond to the following questions:

- For each executive, please indicate whether the compensation package or formula is primarily outcome based or behaviorally oriented.
- Relative to its most recent annual share price performance and that of its major competitors, please assess whether the most recent compensation of the firm's executive management team was in the best interest of shareholders.
- Please examine the make-up of the firm's Board of Directors. How many of these individuals are also members of the firm's senior operating management team? Does there appear to be any connection between the individual's status as a Director and his or her compensation formula?
- What are the implications of these findings and responses?

The Presentation

Aside from written assignments, groups of four are assigned to present, using Power Point and Web based evidence, an analytical framework, such as Agency Theory, that assesses a company or an industry.

The Rebuttal

While the presentation is occurring, a second group constructs a Power Point critique using Web based evidence while collaborating in a virtual team using ICQ.com software. Ten minutes following the presentation, it presents its rebuttal.

The Class Audience

During each in class presentation, groups of class-mates search the Web for information that the presenting groups may have omitted.
Again using ICQ, and working in virtual teams, audience members discuss the Web based evidence, and then collaborate online to write, and submit, a one-page group critique.

The Professor

Along with guiding the class, the professor also plays a role by accepting the presentation critiques submitted by ICQ by the audience groups. These are assessed at a later time.

Real Time Case Analysis

Assignment. Presentation. Rebuttal. So what? With one more added feature and repetition every class for an entire thirteen- week semester, students develop a comfort zone for undertaking and participating in real time case analyses. Upon completion of each in class rebuttal and online submission to the professor of a written critique, another important technology is introduced into the class mix. ICU software allows the professor to capture any lap top screen operating in the class and transmit it on to the projector screen. This technology allows quick and interactive presentation of compelling online evidence discovered by students seeking to challenge or support points made the presenting or rebutting groups.

The Acquired Skills

As noted earlier, the definition of Competitive Intelligence is not always commonly accepted. Skills useful to graduates seeking to practice Competitive Intelligence in Internet enabled operating environments are however somewhat easier to list. With the aid of a lap-top based teaching environment and the riguour associated with successfully deciphering the real time application of Agency Theory, upon completion of such a course, students would reasonably be expected to.[xxvi]

- Conduct lap-top based multi media presentations.
- Undertake Web based financial and strategic analysis
- Work in virtual team based distributed computing environments
- Work comfortably with the standard Microsoft Suite of software products
- Seamlessly share documents using tools such as Lotus Notes, ICQ.com, or Microsoft Outlook

Conclusion

The advent of the Internet and growth of the World Wide Web has revolutionized the manner by which analysts and CI professional monitor competitive environments and assess complex business relationships and concerns. It has presented an opportunity to academia to continue its pivotal role in creating and managing knowledge.[xxvii] It has also offered an opportunity to proponents of powerful, yet traditional, explanatory models such as Agency Theory to offer further evidence of its reliability, relevance, and rigour. This paper described this perspective, provided an illustrated case supported by online evidence, and summarized a teaching program that leverages communications, software, and teaching technologies to develop the next generation of CI analysts.

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