AGENCY PROBLEMS: INTERNATIONAL EXPERIENCE AND UKRAINIAN PRACTICE

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Even in 1776 describing the built of nations` wealth, Adam Smith said that "it seldom happens… that a great proprietor is a great improver…" This statement is more than relevant nowadays. Only today we are talking not about landlords but about shareholders employing menagers to act in their best interest.

But often individual subgoals might conflict with achieving the organization's goals. This situation in corporate governance is called Agency Problem, also known as Principal-agent problem or agency dilemma.

In the light of recent corporate scandals (Enron, Deutsche Bank AG, Volkswagen, WorldCom) the importance of implementing strong and effective corporate governance is a hot topic. Expecally it concerns Ukraine, where traditions of corporate governance are comperetevly young and were forming under special circumstances.

This article is devoted to the analysis of international experience in solving agency problems, in particular the ones involving the conflict between the firm's owners and its hired managers, and possibilities of applying these strategies in Ukrainian reality.

Actually almost any contractual relationship, in which one party (the 'agent') promises performance to another (the 'principal'), is potentially subject to an agency problem. Managers think that since they have some power and authority in the business firm, they can use it for their own benefit, and maximize their own self-interests rather than the wealth of the shareholders. The evasion of orders, malingering and intentional lack of dependability fall within the definition of sabotage as the "willful withdrawal of efficiency from the production process."

As stated by Paul Milgrom and John Roberts, the basic agency problems are results of "an informational advantage" of agent. Moral hazard and adverse selection problems are caused by asymmetric information. Agent is in the better position as the one who knows what actions were taken and the true evaluation of their effect. As a consequence, the agent has an incentive to act opportunistically, skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal.

Paul Lautenschlager distinguishes three types of information asymmetry: the uncertainty in the qualitative characteristics of the agent, moral hazard and the possible malversation of the agent.

Another reason for principal-agent problem is an incomplete contracting. The advantage of an incomplete contract is that it provides the management of the firm with a "general clause" allowing them to adjust the terms as the situation changes.

So if agents are really to perform consistently in the manner they are supposed to, they will need to be suitably motivated by some combination of material incentives, moral incentives, and/or coercive incentives that will make it seem worth their while to attend faithfully to their service obligations and fiduciary duties.

John Armour, Henry Hansmann, Reinier Kraakman name two big sets of mitigating the agency problems strategies: regulatory and governance.

Regulatory strategies include another two blocks: the agent constrains and the affiliation terms. By the agent constrain they mean rules and standards. The affiliation terms involve regulating terms on which principal affiliate with agent, meaning terms of entry and exit. The entry strategy is particulary important in screening out opportunistic agents, requiring, for example, them to disclose information about the likely quality of their performance before contracting with principals. The exit strategy allows principals to escape opportunistic agents. Even the thread of withdrawing or using the transfer of control rights can be a highly affective device for disciplining management.

Paul M. Johnson to techniques used to overcome or alleviate the agency problem includes the elections whereby the recent performance of the agent may be periodically scrutinized by his or her principals and competing candidates for the job may be allowed to make their case for replacing the incumbent agent by revealing his or her shortcomings and showing how performance might be improved through a change in command.

The governance strategies consist of appointment rights, decision rights and agent incentives. Appointment rights give principal the power to select or remove directors. Decision rights expand the power of principals to initiate or ratify management decisions. But only the largest and most fundmental corporate decisions require the ratification of shareholders.

The incentive strategies include reward and trusteeship strategies.

There are two principal reward mechanisms in corporate law. The first one is the sharing rule that motivates loyalty by tying the agent`s monetary returns directly to those of principal. Managers are frequently given the option to buy stock at a bargain price. The more the stock is worth; the more valuable is this option. In fact, options are often used to motivate employees of all types, not just top management.

Boris Nikolov and Tony M. Whited outline that the equity share aligns the manager's interests with those of shareholders, but the bonus can move him away from the objective of maximizing stockholder value by causing him to put excessive weight on the objective of maximizing current profits or increasing stock prices, not always using legal methods.

Another reward mechanism is the pay-for-performance rigime in which an agent is paid for successfully advancing principal's interest, meaning that CEO's salary should be based on the company's profits.But there can be a problem of measuring the agent's performance. In the case of large organizations, metering is complicated by the fact that most production is what Alchian and Demsetz call "team production," so that no individual's marginal productivity is clearly identifiable, and it is difficult to determine the individual's share of the joint output.

Year-end bonuses are also a common form of this sort of pay system. Khalid Abdalla propose to align the incentives of employee with the employers the use of “seniority wages” – when workers are initially hired at a rate lower than their marginal productivity but see their wages rise as they demonstrate their value to the company. On the contrary, in Shapiro-Stiglitz model emloyers pay workers an above-market wage called an efficiency wage so as to prevent workers from slacking off

The trusteeship strategy assumes that in absence of strongly focused monetary incentives to behaive opportunistically agents will respond to the low-powered incentives of conscience, pride and reputation. The example of such strategy is the concept of “the independent director”.

Kenneth Arrow on the contrary is sure that monitoring helps to mitigate the principal-agent problem. There is a need to pay attention to operating expenses, watching out for the President’s hotel suit for a business trip or frequent unexplained use of corporate jet. And most of all monitoring concerns accounting documents, as they often appear to be the object of disinformation. Therefore, corporate governance requires constant attention from shareholders, business consulting firms, and government regulators.

In Ukraine resolving agency problems has some peculiarities. The corporate sector, which was created by privatization, is characterized by prompt, large scale growth and resulted in considerable advance changes to a legal base and corporate governance culture. And joint-stock companies in Ukraine which were not created by voluntary association of private capital but by directive methods of "fair" property distribution are “man-made” formations. Under the circumstance of fragmentation of national share capital, caused by uncompensated distribution of shares, minority shareholders cannot affect the behavior of managers in the public corporation.

The result is a complete concentration of power in the hands of management and identification in one person the owner and manager. Equity is mostly dispersed between senior management, middle management and lower power and employees. So the chance of forming effective corporate governance has been lost from the start.

Stock options are a good way to match managerial and shareholder goals. But it can be used only in public companies, which stocks are listed on the stock market. The practice shows that their quantity in Ukraine is not big. Nevertheless a lot of them are claiming to try for IPO.

Another popular way of reducing the risk of agency problems is Internal and External Auditing System. But it is also highly problematic for Ukrainian companies as they are still afraid to reveil the information and are just lerning the data disclosure. Not to mention the high level of shadow economy.

There is also a problem with CEO's salary based on the company's profits. And many Ukrainian companies are loss making.

So as we see agency problems in corporate economy are the result of absentee ownership, and probably nowadays, the best strategy for Ukrainian corporations is a combination of efficiency wages and creation of coercive conditions.