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How is dealt with the agency problem and what is the role of the board of directors in it?

Bachelor Thesis

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Introduction

"Even an acquittal would probably not have saved the firm. "The verdict doesn't matter anyway", says Arthur Bowman, editor of Bowman's Accounting Report. "Arthur Andersen is dead. Once the indictment was handed down, clients started jumping faster than they did off the Titanic." A third of the firm's 2,300 clients have jumped ship; the top clients are gone, and parts of the company have been sold off. About 5,000 of the 26,000 U.S. employees remain." (Booth, 2002)

The paragraph above refers to the Enron scandal revealed in 2001. The case of Enron's scandal is an example where the agency problem reached such substantial proportion that it has led to a collapse of the company where heavy financial losses to the shareholders are involved. The reason why for example Enron had to cope with such a scandal is because their managers don't act in the shareholders best interest.

In general the agency theory states that a problem exists in a company with regard to the shareholders interest: the management does not always act in the way it maximizes shareholders' return on investment. To solve this problem, it is important that the interest of the managers and the shareholders are aligned. Several mechanisms can be used in order to accomplish this: for example, monitoring by the board of directors, incentives such as salary and stock ownership and threats like a takeover or the competition in the executive labor markets (Rediker & Seth, 1995). However, there are costs to it, called agency costs. Therefore, the agency problem will always exist in the sense that managers' behavior will never completely be aligned with the interest of the shareholders (Fama, 1980). The agency theory assumes that firms try to solve the agency problem in the most efficient way, namely by aligning the interests of the managers and shareholders with as less as possible costs (Kulik, 2005).

It is stated that corporate boards of directors are perfectly suited to perform monitoring functions. They could mediate in the conflict between managers and shareholders by preventing managers to conduct opportunistically pursuing their own interest rather than the interest of the shareholders (Dallas, 1996). Since the board of directors has a great influence on the agency problem it is interesting to investigate to what extent this influence holds and under which conditions this is the case. For example, in what way affect particular attributes of the board, such as composition and compensation, the board's monitoring?

As already described in the introduction, the agency problem has such a substantial influence on the firm that it even includes very large losses. These losses should be avoided; therefore a solution for this problem has to be found. Many different conclusions have been drawn after examining the agency theory, where the agency problem is approached in several different ways. What would be the best way?

This raises the question for this thesis:

How is dealt with the agency problem and what is the role of the board in it?

In order to answer this question, first the agency problem will be explained. After that a little introduction on the board of directors will be given. Then there will be an investigation in the different ways of approaching the Agency problem, how to come to a solution and the role of the board of directors will be explained.

In the conclusion the best way to deal with the Agency problem will be described. The role of the board of directors will be cited again here.

The agency problem

The agency theory, as developed primarily by Jensen and Meckling (1976), is a popular dogma in corporate governance today. Jensen and Meckling (1976) define an agency relationship as "a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision making authority to the agent." The relationship between the stockholders and managers of a corporation with diffused ownership is a classic example of such an agency relationship (He & Sommer, 2006). More specific, it concerns the relationship in which the board of directors delegates work to the managers who perform that work (Eisenhardt, 1989). The agency problem occurs when cooperating parties have different goals and divisions of labor (Jensen & Meckling 1976; Ross 1973). Brennan (1994) states, that the agency problem argues from the device where the interests of the agent is of large difference from those of the principal because of the difficulty, or maybe even the impossibility of perfectly contracting for every action possible of an agent whose decisions affect both, his own welfare and the welfare of the principal. Therefore, inherent in any principal-agent relationship is the understanding that the agent will act for and on behalf of the principal. The agent assumes an obligation of loyalty to the principal that he will follow this principal's instructions and will not intentionally perform improperly. It is expected that an agent does not take personal advantage of the business opportunities the agency position uncovers. In turn, a principal returns trust and confidence in the agent. These obligations bring forth a relation between principal and agent based on trust and confidence. (Schulder, 2002).

However, the principal-agent relationship that exists between the shareholder and the directors and also between the directors and managers contains some conflicts (Malonis, 2000). The agency problem increases when incomplete and asymmetric information arises between the principal and the agent (Janssen, 2009). Shareholders, as principals, expect directors, as agents, to make decisions that will lead to the maximization of the value of their equity. In turn, the directors expect the management to implement strategies and operations that are going to generate this value maximization. The shareholders who normally benefit from the profitability do not have direct insight in what management, who has to generate that profitability, does. At first, the board of directors is an intermediary in-between, secondly, the agent has more information about his actions and incentives because it is too difficult for a principal to monitor the agent completely (Laffont & Martimort, 2001). This problem, which follows from the separation of ownership and control, provides concerns that the management team may act in its own interest, which will not be beneficial to the shareholders. The distrust, arising from this situation, increases the problem of lack of aligned interest (Fama & Jensen, 1983).

In sum, the agency problem in a firm setting is referring to the conflict in incentives between an agent and a principal. This problem arises due to separation between ownership and control. Because it is difficult for a principal to monitor the agent completely, an information asymmetry might arise. Due to this information asymmetry, worries may raise at the hand of the principal that the agent is acting in its own benefit instead of in the principal’s benefit. In this paper the focus will be on the agency problem in a firm setting.

Reinforcement of the agency problem

The agency problem occurs whenever it is difficult or expensive for the principal to evaluate the performance of the agent. It also arises when the motives of the parties to an exchange may be different, such that the parties have the incentive to act in their own interest. It is the existence of the factor 'uncertainty' in environmental, organizational or task conditions that makes it difficult and expensive to evaluate other's performance. The parties may have incentives to act different because they have different risk preferences or they may have different tendencies to act opportunistically (Jones & Butler 1992).

Moral hazard

Agent opportunism is a function of the agent's belief that they will achieve a desired goal in an uncertain context. The causes and effects of opportunism and the form it may take are very subtle in an enterprising context. Risk aversion encourages managers to select projects with little risk that provide normal rates of return. The managerial behavior resulting from that is in the interests of the organization, but it isn't optimizing the profitability in the long run at all. Opportunism, or moral hazard, in enterprising context, causes managers to actively shirk their responsibilities and put forth below normal effort that does not result in even normal returns, but sup-optimal performance (Burgelman, 1983). The definition of shirking is that one avoids his or her duty or responsibility. This problem comes from the inability or the high expenses to monitor enterprising behavior. The value of this enterprising behavior can only be evaluated in the long run when the effects of changes in a firm's structure and/or strategy will be reflected in changes in long run profitability. It is impossible to measure such a change in a short time period of several years.

When it is difficult to monitor an agent, they have the incentive to chase their own interests. This shirking problem is even made worse by the fact that entrepreneurship normally is the result of the joint product of the actions of many entrepreneurs in the large corporation (Burgelman, 1983). In such a situation it is difficult to monitor one's individual contribution in a group setting. When agents are not rewarded for their enterprising contributions in the form of profits instead of normal salary, they will have less intention to perform entrepreneurially. They will have more incentives to shirk, pursue their own interests and reduce their performance. When the effects from individual input are difficult to distinguish, or when the cost of monitoring are too high because of uncertainty, the individual will not have the incentive to minimize or control the production costs, and will not have the motivation to maximize his effort (Jones, 1984). Besides the fact that the individual will receive a reward for the contribution to the organization for normal or extra effort, they will also receive unearned a part of every other individual's contribution, regardless the level of their own performance (Latane, Williams & Harkins, 1979).

In sum, the nature of the enterprising process makes it risky, or unprofitable, for individuals to show some extra effort or enterprising behavior to produce above average returns. It is important to note that the agency problems, arise when the enterprising role is difficult to distinguish from the managerial role. It also makes it difficult for a company to maintain high levels of internal cooperation.

Managerial risk aversion

Risk preferences cause an agency problem in the enterprising context because the principal and the agent have different risk preferences (Jones & Butler 1992). Specifically, principals are considered risk neutral in their preferences for individual firm actions, since they can diversify their shareholdings across multiple firms. Conversely, according to Donaldson (1961) and Williamson (1963), since agent employment security and income are inseparable tied to one firm, agents are assumed to exhibit risk aversion in decisions regarding the firm in order to lower the risk to personal wealth (Wiseman & Gomez-Mejia, 1998). Given this division structure, agents have no incentive to behave entrepreneurial because the share of risk bearing is not equal (Jones & Butler 1992). Risk bearing plays an important role in agency models of executive behavior (Beatty & Zajac, 1994). Specifically, normative agency scholars have argued that risk bearing increases risk aversion by enlarging the overinvestment problem faced by managers (Amihud & Lev, 1981; Holmstrom, 1979; Holmstrom & Milgrom, 1987). Risk bearing generally occurs by design, through governance mechanisms devised to transfer risk from the principal to the agent. In other words, the income of the agent is placed more at risk (Wiseman & Gomez-Mejia, 1998)**.** When an agent made special investments in the firm they will face another problem because the acquired skills will have less value elsewhere. When the firm engages in highly uncertain ventures that may lead to bankruptcy when things go wrong, the agent will face non-trivial costs because it is difficult to secure an equivalent employment alternative. For this reason, they will have no incentives to put effort in highly uncertain projects and will prefer the projects with as little risk as possible. Even though these projects are less profitable, they will keep them employed. These two facts cause a difference in interest of the entrepreneurs and managers and will result in a loss in a firm's enterprising ability (Jones & Butler 1992). Besides, risk aversion of the agent creates opportunity costs for risk-neutral principals who prefer that agents maximize firm returns in favor of the shareholders (Wiseman & Gomez-Mejia, 1998).

Board of directors

Differences in interests between shareholder and manager call for strong corporate governance measures. This is to prevent shareholders from financial losses and any corporate and market financial scandals. When exploring the agency problem, one might come up with monitoring as an possible solution. That is correct, but the cost that comes with monitoring has to be taken into account. When ownership and control is widely spread, not one of the shareholders wants to be responsible for these costs. Therefore, the shareholders as a group select a board of directors to monitor the managers (Berk & DeMarzo, 2007).

The boards of directors are now expected to take responsibility for the monitoring task and to ensure that the interest of the managers and shareholders are aligned. This leaves them with a challenging job; how does the board of directors deal with the agency problem?

Origination of the Board

An evolution occurred regarding public ownership, when ownership and management became separated. In former times the most companies were small and owned and managed by family. These family companies shape particular corporate governance challenges (American Companies Circle, 2009). As these firms grow over time, a professionalization of the managing of the firm is urgently needed. Hence, it is important for current businesses to provide a solid corporate governance structure (Van de Vijver, 2004).

A question often asked: why does a board of directors exist? An answer could be that they exist simply because of regulation. If this was really the only reason, just to satisfy regulatory requirements, the board would be a deadweight cost to the firms. In fact, according to available evidence the contrary holds: if boards were a deadweight cost to the firm they would minimize the members to the fixed size of six. However, in general boards are much larger than this requirement of six (Hermalin & Weisbach, 2003). According to Hermalin & Weisbach (2003), a more likely statement would be that boards are a market solution to an organizational design problem, an endogenously determined institution that helps to better the agency problems that bothers any large organization.

The literature of Hermalin & Weisbach (2003) states that the board of directors is an economic institution that helps to solve the agency problem, while others believe that the board also creates the problem in some instances (Adams & Hermalin & Weisbach, 2010). Yet another research agrees with Adams et al. (2010) and explains it more in depth, where they state that "delegating governance to the board improves monitoring but creates another agency problem because directors themselves avoid effort and are dependent on the CEO" (Kuma & Sivaramakrishnan, 2008).

Until now, it is not quite clear what role the board of directors plays in the agency problem. When we go back to 1776, Adam Smith was the first economist to address boards of directors:

> The directors of [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance [as owners] . . . . Negligence and profusion, therefore, must always prevail, more of less, in the management of the affairs of such a

company (p. 700).

This quote points out the agency issues where economists are interested in and since the view of Adam Smith, much of the regulations of the board of directors has been driven to solve this agency problem (Hermalin & Weisbach, 2003). An idea of explaining why boards have emerged is that the directors' mutual monitoring was critical for inducing shareholders to trust the directors with their money (Hermalin & Weisbach, 2003).

To have a better understanding of the question: What is the role of the board of directors in the agency problem? We will first have a look at the characteristics of a board of directors and the most important tasks they fulfill.

Characteristics of the Board of Directors

In general, directors are divided in three categories: inside directors, gray directors and outside directors (Demarzo & Berk 2008). Inside directors are employees of the firm, former employees or family members of employees. Gray directors are people who are not as directly connected to the firm as insiders but who have existing or potential business relations with the firm. The third types of directors, the outside directors, are the directors that are considered independent and are the most likely to make decision primary in the interest of the shareholders (Demarzo & Berk 2008). After Fich and Shivdasani (2006) did a research considering a sample of 508 corporations, they found that on average, outside directors make up for 55 percent of the directors, inside directors 30 percent and gray directors the remaining 15 percent. That the outside directors dominate on the board can be explained by the typical lifecycle of the firm. When founding families quit and firms become more professionally managed, agency problems can become worse as those in control are no longer the significant owners. In response, firms prefer to add outside directors to alleviate this problem (Adams et al., 2010). Outside directors are often assumed to play the monitoring role inside boards (Hermalin & Weisbach, 2003). Next to the directors, the CEO is responsible for the leadership of the firm. They are on the same team but they don't fulfill their responsibilities in the same way (Benjamin, Hermalin & Weisbach, 1998). The board of directors' main task is to govern while the CEO's main job is to manage. One might have the presumption that problems may cause between those two parties. The CEO has the incentive to 'capture' the board to ensure that he can keep his job and increase the other advantages from being a CEO. On the other hand, Directors have the incentive to maintain their independence, to monitor the CEO and to replace it when the performance is poor (Hermalin & Weisbach, 2003).

In principle, the board of directors has a fiduciary duty to protect the interest of the shareholders (Adams et al., 2010). Fama and Jensen (1983), describe the role of the board as an information system that the stockholders within large corporations could use to monitor the opportunism of top executives. Looking at the general tasks of the board, the board performs two main functions according to Kuma & Sivaramakrisnan (2008), namely monitoring and contracting. Taking a look at their task more in depth, the board of directors hires the executive team, sets its compensation, approves major investments and acquisitions, and dismisses executives if necessary (Berk & DeMarzo 2007). Using the information generated by monitoring, it contracts with the manager on behalf of the shareholders. This contract determines the manager's capital investment decisions, effort and compensation (Kuma & Sivaramakrishnan, 2008).

Board of directors and the agency problem

Independence

The most corporate governance rules worldwide require boards of directors of listed companies to have a combination of inside and outside directors on their board (Jackling & Johl, 2009). To be considered an outsider, a director's primary employment must be with a different organization than the firm on whose board he serves (Adams et al., 2010). An inside directors is a member of the company's board who is either an employee or stakeholder in the company. A common presumption is that outside directors will behave differently than inside directors. This can be seen in the difference in decisions that the board makes (Adams et al., 2010).
From an agency perspective, it is claimed that a greater proportion of outside directors on boards act to monitor independently in situations where conflict of interest between the shareholders and managers occurs (Jackling & Johl, 2009). This conflict refers to the agency problem, a theory where the main focus in this paper is on. The agency problem

is namely based on the premise that there is an inherent conflict between the interests of a firm's owners and its management (Fama & Jensen, 1983).

Researchers have found that boards of directors where outside directors dominate are better monitors of managerial effort and actions. An early study showed that a board of directors was more likely to fire the firm's CEO for poor performances if the board had a majority of outside directors (Demarzo & Berk, 2008). Borokhovich et al. (1996) and Huson et al. (2000) agree with the fact that outsiders are more likely to fire the firm's CEO. They take it even one step further, they argue that outsider-dominated boards are more likely than insider-dominated boards to replace a CEO with someone from outside the firm. Another study has found that firms with independent boards, and therefore more outsider, make fewer value-destroying acquisitions and are more likely to act in shareholders' interest if targeted in an acquisition (Demarzo & Berk, 2008). One can conclude from the arguments above, that an important factor for determining a board's effectiveness is its independence from the CEO. Independence from the CEO's influence is the underlying factor in many discussions between the boards and their relationship with the management (Hermalin & Weisbach, 2003). This discussion implies that a board's independence depends on a bargaining game between the board and the CEO: the CEO prefers a less independent board, while the board prefers to maintain its independence. When the CEO has bargaining power– especially when he can convince them that he or she is indispensible – the board's independence declines (Hermalin & Weisbach, 2003). Hermalin and Weisbach (1988) stated that three kinds of factors are statistically related to changes in the board. These changes will lead to an shift in amount of independent directors (outsiders) and therefore have a influence on the degree of independence of the board. First, poor firm performance increases the likelihood that inside directors will leave the board and outside directors will join. Second, the CEO follow up process appears to be in connection with the board-selection process. When a CEO is close to retirement, firms tend to add inside directors, who are potential candidates to be the next CEO. The one that didn't get the function tend to leave after the change because they are the 'losing' candidates. Because the amount of inside directors changes in a short time period also the degree of independence of the board changes. As third, Hermalin and Weisbach stated that after a firm leaves a product market, inside directors tend to depart the board and outside directors tend to join. Denis and Sarin (1999) confirm these findings even on a much larger sample and non-overlapping time period. Their explanation for these findings is that because of changes in the ownership, there is also a change in the alignment of the CEO's incentives with those of other shareholders. The level of importance of outside monitoring changes as the CEO's shareholdings change (Hermalin & Weisbach, 2003). In literature is assumed that inside directors minds are generally aligned with that of the CEO. In contrast, with most of this literature Raheja departs from the idea that the non-CEO inside directors and the CEO have coincident incentives. Insiders control the CEO through the threat of 'giving him away' to the outsiders, who will then join with the insiders in firing the CEO, should the CEO misbehave. Demarzo and Berk also argue that having more outsiders on the board is not always an advantage but they give another argumentation. When the composition of the board looks like insider, gray and independent directors, the role of the independent director is really that of a watch dog. But because independent director's personal wealth is likely to be less sensitive to performance that of insider and gray directors, they have less incentive to closely monitor the firm. Even the most active independent directors spend only one or two days per month on firm business, and many independent directors sit on multiple boards, further dividing their attention (Demarzo & Berk, 2008). Nevertheless, a preference for greater representation of outside directors is structured around the notion of the separation of ownership and control aligned with agency theory (Jackling & Johl, 2009). Support for the agency view of the positive relationship between board composition and financial performance has been noted by numerous studies (Baysinger & Butler, 1985; Rosenstein & Wyatt, 1990).

From this paragraph we can conclude that in the context of corporate governance, agency theory implies that adequate monitoring mechanisms need to be established to protect shareholders from management's self-interests. Therefore a high proportion of outside directors on the board is viewed as potentially having a positive impact on the agency problem and therefore on the performance (Fama & Jensen, 1983; Jensen & Meckling, 1976)

Practises

Monitoring

Monitoring is a mechanism that can be used by the board to align the incentives of the shareholders and the managers. Whitin the agency problem, the difficulty is choosing the appropriate monitoring and bonding control mechanisms to align interests and optimize performance (Jones & Butler, 1992). Firms seek to structure their boards of directors to ensure sufficient monitoring of managerial behavior (Randolph & Edward, 1994). Fama and Jensen (1983) confirm this by arguing that effective corporate boards would be composed largely of outside independent directors holding managerial positions in other companies. The reason for that is that effective boards have to separate the problems of decision management and decision control. However, if the CEO was able to dominate the board, separation of these functions would be more difficult, and shareholders would suffer as a result. But they contend, that since reputational concerns and perhaps any equity stakes come into view, this provides them with sufficient incentive to separate these functions and exercise decision control. So, corporate boards should act as monitors in disagreements amongst internal managers and carry out tasks involving serious agency problems, such as setting executive compensation and hiring and firing managers (McColgan, 2001). As said before, the monitoring of managerial actions can, in part, be seen as part of a board's obligation to be vigilant against managerial malfeasance felon (Adam et al., 2010). A Good control systems and monitoring by intelligent people of integrity in a well-designed governance system are always necessary for effective control of corporate agency problems (Jensen, 2005). Yet, being realistic, it is difficult to see a boards actually being in a position to detect managerial malfeasance directly (Adam et al., 2010). The problem here is that we do not now know how to create a well functioning governance system (Jensen, 2005). Monitoring is currently too difficult and expensive to solve the entire agency problem, it can only help to mitigate. Jones and Butler (1992) agree in this, in the entrepreneurial context, monitoring entrepreneurial behavior and the outcomes of that behavior to align interests is very expensive and not effective on short term. Only monitoring is not going to solve the agency problem, also other practices should be conducted.

Executive compensation

Besides monitoring, another way of mitigating the conflict of interest between managers and the shareholders is aligning their interests through the managers' compensation policy. That is, by tying compensation to performance, the shareholders effectively give the managers an ownership in the firm by giving the management the chance to buy shares. These practices might be called the share options in executive compensation plans. Under this approach, often labeled as 'optimal contracting approach,' boards are assumed to design compensation schemes to provide managers with efficient incentives to maximize shareholders value (Bebchuk & Fried, 2003). In practice, company stock can now be bought by the management at a fixed price at a given time in the future. Result is that the ownership of the company increase by inside mangers, therefore it is likely that their incentive to invest in a positive NVP is much larger and that the private consumption on behalf of the firm will reduce. The higher the value of the firm, the higher the value of the options and the profit managers can make upon exercising them. (Pasternack & Rosenberg, 2003). Agrawel and Mandelker (1987) argue that stock options encourage management to make investment and financing decisions which increase the variance of the firm's assets and is therefore traded in the meaning of the shareholders. In fact, McColgan (2001) even states that the most important mechanisms, to align the interest of shareholders and managers, are executives' compensation plans and their equity holdings. A payoff structure comprising stock options can also be used to reduce the managerial risk aversion. This is expected to motivate risk – taking as profits progressively accrue to managers when a firm flourishes (Suh, 2011). When a manager owns common stock and stock option in the firm, a variance-increasing investment by the firm can have three effects on his personal welfare: the value of his common stock and option holdings in the firm increases; the value of his human capital decreases; and the variability of his total wealth changes. When a manager has a large stock and options holding in the firm, the effect of an increase is stock and option holdings is more likely. This because he will make every effort to accomplish that increase in stock value, because it affects his own money. Therefore, large stock and option holdings by a manager induce him to select variance-increasing corporate investments (Agrawel & Mandelker, 1987). Additionally, Denis, Denis and Sarin (1997) find that executive ownership is associated with greater corporate focus, indicating that the severity of the managerial risk aversion problem may be reduced through higher equity stakes. Amihud and Lev (1981) argue that, when the manager's income is tied to changes in firm values, an increase in the variance of the returns on the firm's total assets will take place. An increase in the variance and a reduction of the certainty equivalent of the stream of his employment income will follow. The manager obviously dislikes such decreases in his human capital and therefore has an incentive to reduce the variance of returns on the firm's total assets (Agrawal & Mandelker, 1987). This provides better alignment between the managers and the shareholders.

Performing concerns

The board can monitor CEOs by linking their compensation to the owners' wealth or by redundancy of the CEO in the event of poor performance. Agency problems are reduced when the firing or retention of the CEO by the board is sensitive to changes in owners' wealth. The threat of firing during periods of poor firm performance and retention during periods of good performance encourages managers to act in the interests of the shareholders (Geddes & Vinod, 1997). According to McColgan (2001), one of the most consistent empirical results in the corporate governance literature is that directors are more likely to lose their jobs if they are poor performers. Poorest performing management would lose their jobs at the request of directors, especially when such poor performance persist for a long period. Therefore, managers may be forced to take shareholder requirements simply in order to keep their jobs. This facilitates in the process of protecting the interest of the shareholders (McColgan, 2001). Elaborating on this, an idea dating back at least to Fama (1980) is that concern for his reputation will cause a manager to act more in his principal's interests than standard approaches to agency might suggest. A strong reputation presumably helps in achieving their preference, getting more board seats or retaining the ones already held (Adams et al., 2010). However, Holmstrom (1999) claims that one must be careful with this approach. Reputational concerns also can generate agency problems with respect to the agent's choice of risky projects (Adams et al., 2010). It may cause caution in the decision making concerning investment. With the fear of losing their reputation managers may avoid risky projects which and therefore miss large returns on investment.

Nevertheless, Baker et al. (1988) agrees with Geddes and Vinod, he states, if the likelihood of redundancy is high when performance is worse, than the threat of firing can provide incentives that are aligned with shareholders' incentives.

Conclusion

The agency problem in a firm setting is referring to the conflict in incentives between an agent and a principal. This problem arises include due to separation between ownership and control. Because it is difficult for a principal to monitor the agent completely, information asymmetry might arise. This could lead to a rise of worries the hand of the principal that the agent is acting in its own benefit instead of in the principal's benefit. The agency problem is reflected in different ways. The agency problem is for example clearly highlighted in the phenomena moral hazard and managerial risk aversion. The nature of the enterprising process makes it risky, or unprofitable, for individuals to show some extra effort or enterprising behavior to produce above average returns which leads to moral hazard. Managerial risk aversion is caused by the difference in risk bearing between the directors and the managers and the fact that managers invest a lot in specializing in the firm. For these reasons they will have no incentives to put effort in highly uncertain projects which will result in a loss in firm's enterprising ability. To prevent the shareholders from such and other financial losses a board of directors is composed in every firm. The board has the fiduciary duty to protect the interest of the shareholders, mitigating in the agency problem is included. The composition of the board plays an important role in this because it influences their decision making. From an agency perspective, it is claimed that a greater proportion of outside directors on boards act to monitor independently in situations where conflicts of interest between the shareholders and managers occur. A good control system and monitoring in a well designed governance system is always necessary for effective control of corporate agency problems. Because monitoring can be incomplete due to the difficulty and expensiveness, more practices need to be considered when solving the different ways the agency problem manifests itself. The practice ‘optimal contracting approach’ uses the ownership of the firm to align the interest of the shareholders and the managers. By issuing shares to the managers they become part owner of the firm and have therefore more interest to act in the interest of the firm. This approach also mediates the managerial risk aversion problem because managers are triggered to maximize the firm value. Besides linking the compensation to performance, also the probability of redundancy can be used as a reduction of the agency problem. The threat of firing during periods of poor firm performance and retention during periods of good performance encourages managers to act in the interest of the shareholders.

The agency problem is indispensable in businesses and emerges in different capacities. The board of directors influences the way which is dealt with the agency problem because of its composition and therefore its degree of independence. Besides the level of monitoring they can decide whether they use the ‘optimal contracting approach’ and or the probability of redundancy. It has already been mentioned that monitoring is difficult and expensive. Besides, there are also flaws raised against the other two practices, from which can be concluded that the agency problem cannot easily be solved. Nevertheless, when the board of directors has the right composition and uses the different practices in the proper proportions a lot can be achieved in order to minimize the agency problem.

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