STRATEGIC MANAGEMENT: THE LINK BETWEEN THE AGENCY THEORY AND THE COMPANY'S COMPETITIVE ADVANTAGE

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Abstract

This paper's main objective is to give an in-depth view of strategic management theory, emerging issues in strategic management and show the link between the Agency and the organizations' competitive advantage.
A review of the relevant available literature will be carried out and the linkage among the three basic concepts of strategic management theory, emerging issues and Agency theory will be identified. An explication of Agency theory will be done in order to unravel its main contribution to the organization's competitive advantage which leads to the optimum performance of an organization.

Key words: Agency theory, competitive advantage and Strategic Management Theory

Introduction

The aim of this paper is to examine the agency theory and its contribution to the strategic management in organizations as far as competitive advantage is concerned.

First, the following terms will be defined to enable the reader understand the concepts and the subsequent discussion. The terms are as follow: **Strategic management**, the **agency theory** and **competitive advantage**.
Second, the paper examines the competitiveness of the agency theory in strategic management amidst other competing theories in strategic management.

This is necessary to establish in this discussion whether or not the agency theory has a much better added value in strategic management than the other competing theories. The other competing theories include: profit-maximizing theory, the resource based theory, the survival based theory, the human resource based theory, the agency theory and the contingency theory. Finally, the discussion will shed light on what organizations need to adapt theoretically, if they have to enjoy competitive advantage both locally and internationally.

Historical development of strategic management

Strategic management can be traced back to 1950s and 1960s and the most influential pioneers were Alfred D. Chandler, Philip Selznick, Igor Ansoff and Peter Drucker. Chandler recognized the importance of co-coordinating the various aspects of management under one all-encompassing stragegy.He stressed the importance of taking a long term perspective when looking to the future. This is the view that is considered especially at the strategy formulation in designing a mission statement and the vision for the firm. In 1962 he developed a ground breaking design 'Strategy and structure' where he showed that a long term co-ordinated strategy was necessary to give a company structure, direction and focus. He concludes that structure follows strategy which is indeed embraced in strategic management. Philip Selznick in 1957 came up with the idea of matching the organization's internal factors with external environmental factors now called the SWOT analysis. These are tools of analysis used in environmental analysis during strategy formulation.Igor Ansoff built on Chandler's work by developing a strategy grid that compared market penetration strategies, product development strategies, market development strategies and horizontal and vertical integration and diversification strategies.

In 1965 he came up with the gap analysis where he says that we must understand the gap between where we are currently and where we would like to be, and then develop what he called gap reducing actions. His contribution also leads to the SWOT analysis in the environmental analysis in strategic management. Peter Drucker a guru of management stressed the importance of management by objectives (MBO). It is therefore from this that at the strategy formulation level of strategic management objectives are crafted.

Overview of strategic management theory

Raduan C. et al (2009) contends that strategic management is the process and approach of specifying an organization's objectives, developing policies and plans to achieve and attain these objectives and allocating resources so as to implement the policies and plans. Among the theories that form the foundation of strategic management include; profit maximizing and competition –based theory, the resource based theory, the survival based theory, the human resource based theory, the agency theory and the contingency theory. The profit maximizing and competition based theory was based on the notion that business organization's main objective is to maximize long term profit and developing sustainable competitive advantage over rivals in the external market place.The resource-based theory hinges on the premise that the source of firms competitive advantage lies in their internal resources as opposed to their positioning in the external environment (Barney,J., 2001). This theory predicts that specific types of resources owned and controlled by firms have the impetus to generate competitive advantage and superior firm performance (Ainuddin et al, 2007). The survival-based theory centers on the premise that firms need to always adapt to its competitive environment for it to survive.

The human resource-based theory emphasizes the importance of the human element in the strategic development of firms. The agency theory is the mother of the theory as this theory builds on the human element as a source of the organization's competitiveness.The contingency theory draws the idea that there is no one or single best way or approach to manage organizations. It recommends that organizations should develop managerial strategy based on the situation and condition they are experiencing. (Ainuddin et al 2007).

Finally, the agency theory which I have given precedence in this paper stresses the underlying important relationship between the shareholders or owners and the agents or managers in ensuring the success of the organization.

In the perspective of the agency theory, the paper has included the boards of directors as principals and by extension agents in the fact they represent the interest of the shareholders and by extension focused on the hierarchies of strategic formulation using various managers at each level as agents parse of the principals.The agency theory proves superior to other theories of strategic management since they all depend on the agents in the entire process of strategic management in achieving organizational success. Ackermann et al 2004 contends that the Agency theory is indeed the critical element in strategy formulation since for all organizations the nature of strategy will be most contingently influenced by the agents who constitute the chief executives. He adds that these agent's personal skills and personality highly influence the nature of strategic planning. Ackermann further says that most important outcomes of strategy making for organizations is that of developing a way of better managing the link between the competing demands of different stakeholders. He concludes that stakeholders determine the ability of an organization to achieve its aspirations. Much as the above discussed theories do affect strategy formulation, implementation and evaluation, strategy formulation makes much use of the agency theory over other theories.

Competitive Advantage

This is a condition which enables a firm to operate in more efficient or otherwise higher-quality manner than the companies it competes with and which results in benefits accruing to that company (Wheelen et al 1995). It can also be defined as superiority gained by a firm when it can provide the same value as its competitors but with more benefits (Porter 1985). A firm can achieve this through giving customers more benefits, the same at lower cost, access to cheaper raw materials, better staff, cheaper labour, better brand recognition and proprietary technology. Porter identified two basic types of competitive advantage: cost advantage and differentiation advantage. In the former competitive advantage exists when the firm benefits as compétititors but at a lower cost. In the latter a firm delivers benefits that exceed those of competing products. Porter concludes that a competitive advantage enables the firm to create superior value for its customers and superior profits for itself. This paper observes that it is through the ability of the CEO who is the agent of the firm to creatively co-ordinate the firm's resources with good strategic management that competitive advantage is achieved.

The Agency Theory

Agency theory is a management approach where one individual (the agent) acts on behalf of another (the principal) and is supposed to advance the principal's goals Jean et al 2002. The agent therefore advances both the principals' interests and his own interests in the organization. A balance of these interests should be merged in order to arrive at the corporate objectives of the organization through the agent because he/she is in charge of the vast resources of the organization. Laffort & Martimost (97) contends that the agency theory of strategic Management is so crucial since the action chosen by a particular individual (the agent) affects not only one, but several other parties (the principals). Hence the agents' role in strategic formulation and the overall strategic management process cannot be underestimated. They say that the firm is often characterized as a nexus of both explicit and implicit contracts linking the management and its different stakeholders, including claimholders, workers, unions, customers, suppliers and the state among others. The Agency Theory holds the view that there should be proper synergy between the management and its stakeholders in order to work towards a common goal.
The Agency Theory has also been described as the central approach to managerial behavior.

Ross (1987) says that the Agency Theory is used in the managerial literature as a theoretical framework for structure and managing contract which is among the emerging issues in strategic management. It therefore explains the behavior of principals and agents relationships in performance contracting in management. The agency theory also gets a lot of support from Alchian and Demsetz 2002, Jensen and Meckling 1996 as a framework for strategic management as they say that this theory focuses on accountability by correction for opportunistic behavior that can result from exploiting asymmetric information- one part has an economy of knowledge about something which the other part doesn't have. Moreover the principal-agent theory as agent theory is also called has been applied extensively to a range of contractual relationships between organizations, boards, directors and managers and employees in organizations.(Bogart 1995, Dharwadhar, George and Brandes 2000,Lee and O'Neill2003) They further say that in this theory the principal chooses to contract with an agent for reasons of cost and expertise. The former therefore decides that their firm lacks the expertise or resources required to produce and that the cost of hiring or developing that expertise in-house exceeds the costs associated with contracting for the expertise. The principal and the agent therefore agree on the terms of the contract.

Bernheim and Whinston (1986) provide an additional insight into agency theory in particular relevance to stakeholders' theory where they distinguish between delegated and intrinsic agency. They say that delegated common agency arises when several parties voluntarily and independently bestow the right to make certain decisions upon a single (common) agent. Also intrinsic common agency arises instead when an individual is naturally that is not voluntarily and not independently endowed with the right to make a particular decision affecting other parties who may in turn attempt to influence that decision. They therefore give prominence to the agency theory in the theories of strategic management. They say that intrinsic common agency in agency theory resembles the relationship found between many stakeholders and managers because communities do not choose to entrust decisions to firm managers (agents) but find themselves subject to these managers decision- making activities. In response, communities often attempt to influence these managers' resource allocations which affect the whole process of strategic management within a firm. It is on this premise that I observe that the agency theory should be embraced in strategy formulation where the principals should always co-operate with the agents in formulating the organization's mission, vision and the objectives. All that is done at the strategy formulation to strategy evaluation and control should carry the hopes, aspirations and the values of the principals, the agents and all other stakeholders of the firm.

Mintzberg H, (2003)Joseph L, (2004) James B. Q, (2003), contends that strategies emanate from the agency theory as it is the agents who are judged with the responsibility of strategic formulation by other stakeholders who have direct control over the firm. R. Gibbons (2004) calls the agency theory the simplest possible theory of strategic Management; one boss (or principal) and one worker (or 'Agent'). In his response he says that the agency theory of strategic management rests on the firm's shareholders as the principal and the CEO to be the agent but it is on this context that he says that one can enrich this modality in analyzing a chain of command in organizations. It is therefore on this basis that he says we can talk about a principal, a supervisor and an Agent in the chain of command. I want to observe that it is from his contribution to this theory that I carefully note that in strategy formulation the Agency theory gives us strategy formulation hierarchy that is done at four major levels in the chain of command: corporate strategy, strategic business units level, tactical level and finally the operational level where each one in charge of every level of strategy formulation is an agent.

At the corporate strategy level which is the top most strategy formulation level in an organization it normally deals with strategic to questions such as: ‘ in which businesses should we compete?’ and ‘how does being in this business create synergy and/or add to the competitive advantage of the corporation as a whole? “At this top level therefore the chief executive of the firm and the firm’s board of directors form the Agents of formulating corporate strategy. At the strategic Business level (SBU) the SBU’s managers or branch managers of the firm as agents based on the Agency theory become agents of the top management and formulates strategy at branch levels that are in line with the corporate strategies of the firm. Thus their strategies are derived from broader corporate strategies.

At the functional (departmental levels using the Agency theory of strategy management) the functional heads of departments become agents of strategic Management representing the chief executive of the firm and the branch executive at the strategic business units. However, these agent’ formulation of strategies is guided by the corporate strategy generally and by the SBU strategies particularly.

Finally, the operational strategy level that was emphasized by Peter Drucker (1954) in his theory of management by objectives (MBO) says that at this level, the strategies formulated are very narrow in focus and deals with day to day operational activities. He further says that operational level strategies are informed by corporate level strategies.

For a firm to gain competitive advantage, it takes the efforts of all the agents at these levels of strategy formulation to advise the CEO who is the chief agent on matters relating to cost leadership and differentiation that are the best tenets of sustaining competitive advantage. These agents’ sound management skills in regard to resources apportioned to their deparments also enhances synegy that leads to competitive advantage.

Minitzberg (1994) contends that strategic planning is essentially by agents as planners and therefore as strategists they should make their greatest contribution around the strategy formulation process rather than being inside it. They should supply the formal analyses or hard data that strategy thinking requires as long as they do it to broaden the consideration of issues rather than to discover the one right answer to the strategic formulation.
He adds that planners again he calls them principals, based on this agency theory should give the agents good compensation that commensurate with the tasks assigned to them in order to motivate the agents to achieve the goals of the firm optimally.

Mintzberg also says that using the managers as agents to strategic planning and more particularly to strategy formulation should have a committing style to engage employees of a firm in a journey that will help shape that cause of the organizations. It is therefore worth noting that the principals should agree with the agents on the best modes of compensation and them (principals) carefully recruit a competent agent who will mobilize other employees in achieving the corporate objectives of the firm.

Critiques of Agency Theory

Laffont (2002) criticizes the agency theory saying that it only shows a relationship between owners and managers and it provides deception and misappropriation of funds by the agent. This, he adds constitute a perfect example of the moral hazard problems that are an endemic feature of principal-agent complexities. He substantiates this saying these were some of the moral obligations that were violated at Enron Company in the US which led to the loss of billions by the owners. The agents were busy working for their own interests leaving other stakeholders as outsiders. Laffont concludes that in a standard business corporation it is very difficult for shareholders to exercise effective control of management interests between managers and owners.

The shareholders have a moral obligation to ensure that their firm is run competently for it to gain competitive advantage, have a duty to hire the best skilled managers and given in the modern management where performance contracts are embraced they should specify through consensus with the managers of their firms what their target should be. Buchaman 1996 criticizes the agency theory arguing that the agents embraced by the agency theory in strategic critic management makes decision, that best fits them thus they are self-interested championing their own interests. He adds that the agents again may end up with the conflicts of interest that give rise to agency risks. This view is shared by Shankmann (1999) who says that Agency theory leads to agency costs which could be high expenses to the organization.The paper holds the view that the payment in terms of salaries and bonuses to the agents is not in futility but is a matter of compensation for work that is being done thus they deserve good compensation for their efforts in keeping the firm competitive over others.

James Dow, Clara C. Raposo (2001) in their paper, uses the agency theory to study the active role of the chief executive in the formulation of the corporate strategy, these scholars say; that of much interest, the agent (CEO) should play a key role in defining the parameters of the organization problem. They argue that CEOs will have an incentive to propose difficult and ambitions strategies. They say the effect arises because in equilibrium, the agent may be overcompensated in the sense that the participation constraint is not binding in determining his compensation and the agent can exploit this by proposing ambitious corporate strategies, thereby influencing the parameters of the constraints in the agency theory problem. This may make the organization to flop because the agent's or the CEO's strategies could be very ambitious thus not well understood and embrace by other stakeholders inside or outside the firm. I therefore note that the agent's role in strategy formulation should be checked by the responsible authority to ensure that they are in line with the organization's set up.

Agency Theory in Practice in Strategic Management

The agency theory tends to take precedence against other strategic management theories.
Krueger (2004) in his paper in strategic management and management by objectives says that the plethora of strategic management is the agency theory in practice at all levels of the strategic management process. He contends that starting from the corporate strategy to operational strategy the objectives designed at all these levels must be supervised by the agents or managers for the organization to achieve its objectives management by objectives which observes that organization must formulate objectives at all strategic hierarchy levels cited by Henry et al (2006) stresses that for these objectives to be achieved there has to be collaborative efforts between the managers as agents and subordinates. Strategic management programs require top managers to provide clear and visible support to the program without that support of the manager as the agent the synthesis between the individual and the organization goals does not develop.

Krueger (2004) observes that strategy formulation relies upon a team approach that flows from the corporate level to the functional level of the firm. The process relies on input from all levels of management (top to bottom and bottom up). The paper observes here that at the stage of strategy formulation the chief executive should as the agent not be single minded but should involve other stakeholders and agents of strategy formulation at all levels of the organization. The CEO as the agent should therefore embrace synergy by searching for information resulting in an evaluation of the task to be carried out (strategy formulation) and secondly he proposes a strategy to the board (principals), for their agreement and then carries out the agreed task (strategy implementation) in order to gain competitive advantage.

Conclusion

In conclusion therefore that the Agency theory of strategic management proves to be superior than any other theory of strategic management when it comes to strategy formulation hierarchy. This is in the light that at each level of the strategic formulation hierarchy, there has to be an agent charged with the responsibility of representing other stakeholders at other levels. It is therefore prudent to note that there should be synergy using the Agency theory and proper understanding between the principal and the Agent for the organization to achieve its objectives efficiently and effectively. Hambrick and Finkl Stein (1987) in discussing the role of the agent (CEO) discretion in firm performance and they conclude that strategic leadership of an agent (CEO) is pivotal to the success or failure of a firm. Thus in conclusion the agency theory should be embraced particularly at the strategy formulation level of strategic management and generally to the overall process of strategic Management to enhance the organizational competitive performance..

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