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Agency Theory: Review and Evidence

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Abstract: Every month, there are headlines concerning scams on famous online sites. Due to the ease with which scams may be spread, they have become one of the most popular crimes worldwide, inflicting significant emotional, financial, and psychological consequences on millions of people. Despite their significant and pervasive influence, we seem to know very little about why some people fall prey to scams while others remain immune to the strategies used by scammers to entice potential victims. For example, research on the impact of demographic traits (e.g., age) as well as psychological variables (e.g., risk-taking) on individuals' vulnerability to scams has yielded inconsistent results. Even little is known about how the type or character of a scam influences a person's susceptibility. Gaining a better knowledge of these issues is essential for developing preventive programs and lowering the occurrence of victimization. We highlight potential interesting directions, present knowledge gaps, and the necessity for decision scientists to solve this crucial challenge.
Keywords: scam, agency theory, financial scams, cyber fraud, fraud awareness.

I. INTRODUCTION

Knowledge of fraud symptoms and causes is critical in preventing and detecting fraud. The fraud occurred in three ways: lack of awareness of fraudulent behaviour , awareness combined with rationalisation to avoid negative affect or emotion (individual's intuition supports committing fraud), or awareness combined with other thoughts (individual's intuition unclear).

While the pandemic brought out the best in many individuals, such as those who took meals to elderly neighbours, stitched masks, and risked their lives to care for infected patients, it also provided chances for lawbreakers.

For instance, Health care scammers took advantage of slack standards imposed by federal agencies and private insurers, allowing patients to be treated without having to visit hospitals or clinics. It charged 354 persons in various illicit schemes totalling almost $6 billion in losses. Some were charged for clinic visits that never happened, while others fake profiles of officers charging a huge sum.

In 2020, Google announced that it has stopped 126 million COVID-19-related phishing attacks in a single week. This was the company's most aggressive and extensive phishing attack in history (Kumaran & Lugani, 2020). Millions of additional COVID-19 frauds were circulating around the world, including those requesting donations, offering COVID-19 treatments, or promising money reimbursements. However, the magnitude of COVID-19 scams has only served to highlight the major problem such scammers pose. Scam stories appear in the popular media on a weekly basis, and scams have become one of the most common crimes worldwide. According to one report, the financial cost of fraud to the global economy is over $5 trillion per year (Gee & Button, 2019), which is about 50% greater than the 2019 estimate U.S budget of about $3.5 trillion.

Knowing the core causes of fraud can assist detect and prevent it (Wuerges & Borba, 2014), allowing you to control your fraud risk exposure. Management fraud is a decisional, behavioural, cognitive, social, or ethical issue. Previous research has linked management fraud to a number of theoretical frameworks, including agency theory, a fraud-triangle theory, a theory of planned behaviour, a rational choice theory, a prospect theory, a differential association theory, a general stain theory, and corporate ethics theory. According to a European Commission (2020) survey, 79% of scam victims suffered emotionally, while just 24% suffered monetarily. Knowing Frauds better involves knowing it's theories better, further in this paper we will be getting a deep understanding of Agency Theory, it's relationships, it's problems and how to reduce them.

II. AGENCY THEORY

Agency theory is a principle used to describe and overcome problems in the interaction between business owners and their agents. That relationship is most typically between shareholders, as principals, and firm executives, as agents.

In general terms, an agency relationship is any relationship between two parties in which one, the agent, represents the other, the principle, in day-to-day transactions. The agent has been hired by the principal or principals to provide a service on their behalf.

Agents are given decision-making authority by principals. Because the agent makes numerous financial decisions affecting the principal, disagreements, and even divisions in priorities and interests, might occur. The interests of a principle and an agent are not necessarily aligned, according to agency theory. This is also known as the principal-agent issue.

An agent, by definition, uses the resources of a principal. The principal has given money but has little or no day-to-day involvement. The agent makes the choice, but bears little or no risk because any losses are borne by the principal.

Financial planners and portfolio managers act as agents for their principals and are responsible for their assets. A lessee may be responsible for the protection and safekeeping of assets that do not belong to them. Despite the fact that the lessee is responsible for the assets, the lessee is less interested in protecting the products than the actual owners.

III. AGENCY THEORY RELATIONSHIPS

When it comes to business and the concept of agency theory, there are numerous types of interactions that are inextricably linked and are fraught with conflict.

The following are some of the most intricate and interconnected commercial connections that involve a principal-agent relationship and qualify under the agency theory.

1) *Shareholders and Executives of the Company:* As previously stated, the primary represents the shareholder. It is because the shareholder invests in the business of an executive, and the executive is in charge of making decisions that affect the shareholder's investment. A negative relationship will develop if the corporate CEO acts badly and affects the value of the shareholder's stock. A positive link will build, on the other side, if the corporate executive acts ethically, resulting in some sort of financial boost in the shareholder's stock.
2) *Fund Manager and Investor:* The investor is the primary in this scenario since they are handing a portion of their income to the fund manager to allocate on their behalf. If the fund manager invests in volatile equities and produces a lower-than-expected return for the investor, a negative connection develops. In contrast, if the fund manager goes above and above and makes a profit that exceeds expectations, the investor praises the fund manager, and there is a positive correlation.
3) *The Board of Directors and the CEO:* The principal represents the board of directors further up the hierarchy since the CEO decides their financial position and standing. If the CEO makes a bad financial decision that causes the organisation to get into debt, the board of directors is more likely to vote against him in the next election. In contrast, if the CEO introduces a new business sector that provides exceptional market innovation, they will be praised by the board of directors and will most likely remain in power for years to come. The relationships mentioned above represent the concept of agency theory. The whole investigation of the topic is comprised of all of the encounters and disagreements experienced by both the principle and agent.

IV. AGENCY THEORY PROBLEMS AND IT'S REDUCTION METHODS

Agency theory deals with disagreements that originate primarily from two factors: a difference in aims or a difference in risk aversion.

For example, firm executives may want to grow a business into new, high-risk markets in order to increase short-term profitability and remuneration. This, however, may offer an unjustifiable risk to shareholders, who are mainly concerned with long-term earnings growth and share price appreciation.

Another important issue frequently addressed by agency theory is conflicting risk tolerance levels between a principal and an agent. Shareholders at a bank, for example, may argue that management has set the bar too low for loan approvals, putting the bank at too big a risk of default.

To elaborate, the following are the primary reasons of agency problems:

1) When there is a conflict of interest between the principal and the agent
2) When the agent makes decisions on behalf of the principal that are not in the best interests of all parties involved
3) The agent may work independently of the principal to obtain a previously agreed-upon incentive or bonus.
4) Breach of confidentiality concerning the principal's personal and financial information
5) Insider trading based on the principal's information
6) When the principal disregards the recommendations of the agent.

Given the existence of power/trust allocation, it is not surprising that there is an entire theory that investigates the relationship and exchanges between a principal and a subordinate.

Several proponents of agency theory have provided methods for resolving disagreements between agents and principles. This is referred to as "reducing agency loss." The amount that the principal claims was lost as a result of the agent acting against the principal's interests is referred to as agency loss.

Among these tactics is the provision of incentives to corporate executives in order to maximise the earnings of their principals. The stock options granted to firm executives are based on agency theory. These incentives are designed to improve the interaction between principals and agents. Other practises include connecting CEO pay to shareholder returns in part. These are some applications of agency theory in corporate governance.

Concerns have been raised that management will jeopardise long-term corporate growth in order to boost short-term profits and their personal remuneration. This is frequently seen in budget planning, as management reduces estimates in annual budgets to ensure that they achieve performance targets. These concerns have resulted in yet another compensation structure in which CEO pay is partially postponed and set based on long-term objectives. These answers are found in other agency relationships. One example is performance-based remuneration.

The amount that the principal claims was lost as a result of the agent acting against the principal's interests is referred to as agency loss. Offering incentives to corporate managers to maximise the profits of their principals is one of the most effective techniques for resolving disputes between agents and principals. Stock options granted to executives are based on agency theory and aim to optimise the interaction between principals and agents. Other practises include connecting CEO pay to shareholder returns in part.

V. AGENCY THEORY CASE STUDY

Gerard and Weber (2015) investigated a $30 million fraud case using an agency theory perspective to find fraud indicators. They discovered abnormal frequency of form 4 stock option (statement of changes in beneficial ownership) filings with the SEC in 2003 followed by an instant sale of the same number of shares (23 times out of 36 total filings). They proposed that an executive who promptly disposes of ownership rights after being awarded them should be considered a fraud warning flag (Gerard & Weber, 2015). They claimed that agency theory mechanisms such as stock options can be utilised to align management's self-interest with the interests of shareholders while minimising information asymmetry and fraud risk (Gerard & Weber, 2015).

Similarly, Ndofor, Wesley, and Priem (2015) examined the relationship between the level of complexity (industry and firm-level) of information asymmetry between top managers and shareholders and the likelihood of fraudulent financial reporting by top managers using incentive tools (CEO stock options) and control tools (audit committee monitoring). Ndofor, Wesley, and Priem (2015) examined 453 matched pairs of fraud-identified and non-fraud-identified enterprises from the Government Accountability Office's (GAO) 2006 report to Congress. They used conditional logistic regression to investigate the relationship between restatement of earnings due to fraud (the dependent variable) and the independent variables of company diversification index, industry complexity (the amount of heterogeneity present), the number of unexercised stock options owned by a CEO, and the number of audit committee meetings.

Previous research has revealed that the complexity level (industry and firm level) of information asymmetry increases the chance of financial fraud (Ndofor, Wesley, & Priem, 2015). Ndofor, Wesley, and Priem (2015) discovered that when industry information complexity is high, CEO stock options increase the likelihood of fraud, whereas aggressive audit committee monitoring decreases the likelihood of fraud (Ndofor, Wesley, & Priem, 2015). They emphasised the role of information asymmetry in allowing CEOs to engage in fraudulent financial reporting, as well as the importance of incentive tools (such as CEO stock options) and control tools (such as audit committee monitoring) in aligning CEO interests with shareholders and reducing moral hazard.

VI. CONCLUSION

Scams are a multifaceted and dynamic issue. Scammers target people from various walks of life, from all over the world, and with ever-changing strategies and lures. Given that millions of people are scammed each year, there is an urgent need to discover what elements make people more vulnerable to scam solicitations and, more importantly, what preventive measures may be implemented to relieve this problem. Most, if not all, of the advice available has not been evaluated, and it does not appear to work, as evidenced by the growing number of victims. Psychologists, as well as other behavioural scientists, have the knowledge and training to address this issue.

Despite the significant knowledge gathered from the studies described here, there is still plenty of potential for a wide range of additional research to be carried out. First, there is an increasing need for theoretical frameworks that include cognitive abilities, neurological insights, and personality research in order to advance knowledge of scam vulnerability. Furthermore, empirical researchers must increase the external validity of their work and devise methods for conducting more realistic and natural field studies (e.g., Ebner et al., 2018). Furthermore, because little is known about how to reduce scam compliance, there is an urgent need to conduct research in this area so that decision aids and other tools to reduce scam compliance can be developed.

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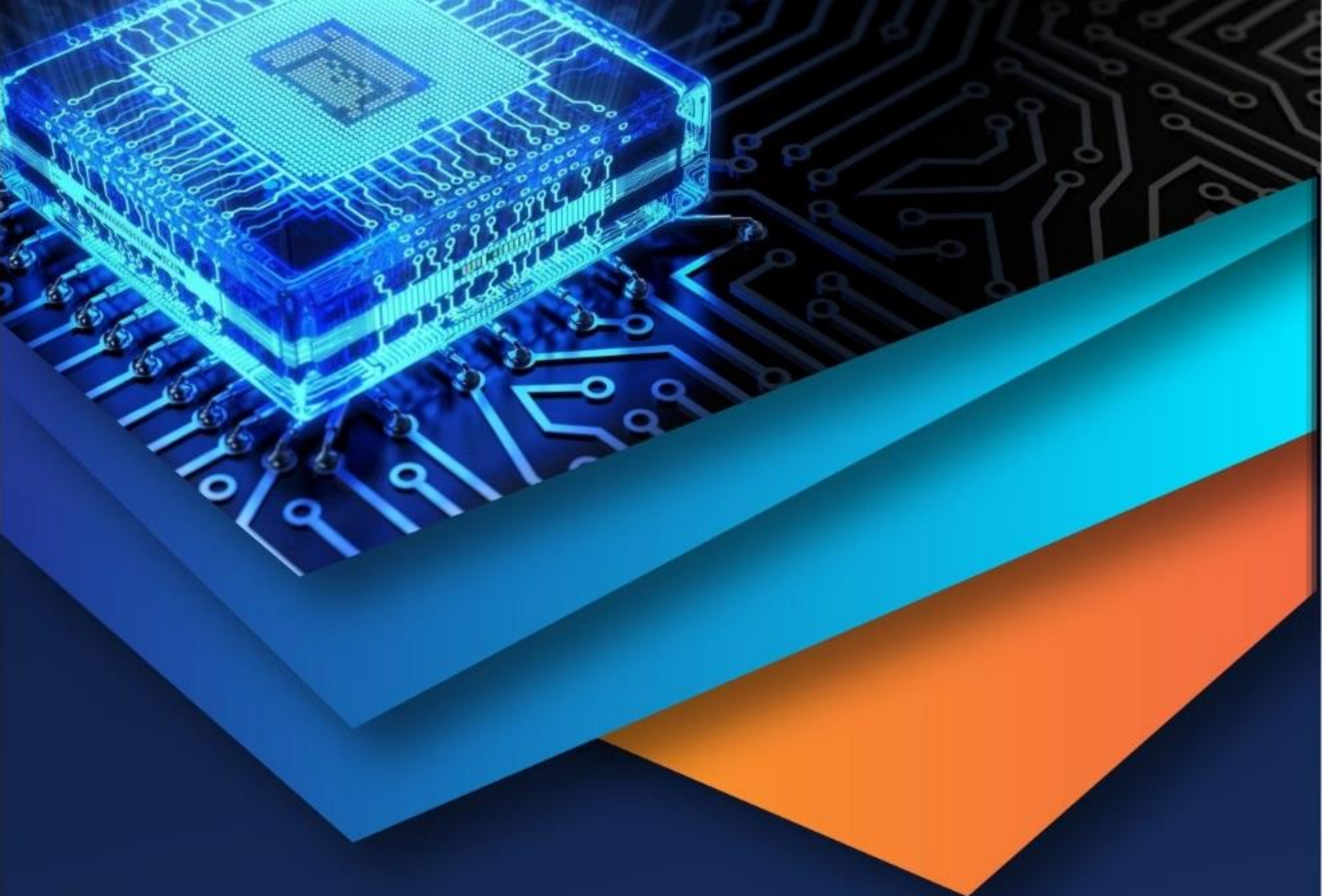

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