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Review Article

Agency Costs in the Context of Financial Markets: Concept, Types, and Economic Consequences: A Literature Review

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Abstract

This literature review aims to scrutinize and elucidate the intricate theoretical and applied framework surrounding the pervasive issue of agency costs, specifically within the dynamic milieu of financial markets. The analysis delves into the foundational concept of agency costs, meticulously examining their distinct typologies, their multifaceted interpretation by market participants, and their profound economic ramifications. The genesis of this principal-agent problem is inextricably linked to the defining characteristic of the modern corporation: the separation of ownership from control. This fundamental division creates a inherent conflict of interest, wherein management (the agent) may prioritize personal goals-such as excessive perquisite consumption, empire building, or shirking-over the paramount objective of maximizing shareholder wealth (the principal). This divergence is critically intensified by pervasive information asymmetry, where managers inherently possess superior knowledge about the firm's true performance and prospects compared to dispersed owners. The theoretical underpinnings of this study are firmly rooted in the seminal contributions of Berle and Means, who first identified the implications of separated ownership and control, and Jensen and Meckling, who formally defined agency costs. The review systematically identifies and categorizes the principal manifestations of agency costs, framing them according to their association with the specific behavioral incentives and cultural-institutional characteristics of both the contracting parties and their broader economic environment. Two predominant patterns are rigorously delineated: first, the classical vertical conflict between corporate management and all shareholders, and second, the horizontal conflict between controlling shareholders (who often exert significant influence over management) and minority shareholders, who are vulnerable to expropriation through tunneling or unfair related-party transactions. For each archetype, the synthesis critically analyzes the empirical findings of previous scholarly work concerning their distinct economic consequences, which range from direct wealth transfers and suboptimal investment decisions to broader macroeconomic impacts like reduced market efficiency and impeded capital formation. Furthermore, the review proactively explores unresolved research particularly in the context of evolving market structures, regulatory landscapes, and global corporate governance norms.

Keywords

Agency Costs, Agency Theory, Financial Markets, Controlling Shareholders, Minority Shareholders, Corporate Governance, Economic Consequences, Market Inefficiency

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1. Introduction

With reference to economic literature, Agency Costs (AC) origins are attributed to the "separation of ownership and control" hypothesis formulated by Berle & Means [3]. In their work, The Modern Corporation and Private Property, the two scholars argued that shareholders in American corporations were unable to manage the firm independently due to its significant growth in size and complex requirements. This, in turn, highlighted the necessity of hiring professional managers possessing specific skills to run the corporation. However, given the divergence of interests between shareholders and management, a situation of corporate mismanagement emerged. As the management is involved in day-to-day operations, it possesses more information than the shareholders, enabling it to exploit this informational advantage-a consequence of the information asymmetry that arises between the two parties. Agency costs are internal expenses that occur when the management of a company makes decisions that may not align with the interests of the shareholders [3]. These costs arise due to conflicts of interest between the shareholders and the management of the company [13]. Researchers agree that agency costs are a reality and that management decisions may not always prioritize the shareholders' best interests without incurring these costs [8]. These costs cannot be completely avoided due to the contractual relationship between the management and shareholders [7].

The agency problem arises from the conflict between the goals of shareholders and the goals of the management, as the management may not always act in the best interests of the shareholders [18]. This view was supported by the framework of agency theory and its analyses, where conflicts of interest usually occur due to the separation of ownership from management. The management of the firm, as responsible for the business of the firm on behalf of shareholders and creditors, tends to focus on maximizing its personal benefits rather than giving priority to the objectives of the firm, thus deviating from the principle of shareholders and creditors in maximizing their wealth. This caused shareholders and creditors to find their wealth and interests at risk, which prompted them to search for a formula to supervise management's actions to continue to carry out its duties to achieve the objectives of the firm through a pre-determined contract between the firm's management, shareholders and creditors [1]. This led to shareholders bearing costs to maintain their assets, known in accounting literature as agency costs.

In general, it is established in the corporate governance literature that agency problems lead to agency costs; agency conflicts take different forms such as those between shareholders and the management of the firm or type I (PA), between controlling and minority shareholders or type II (PP) or between shareholders and creditors (principal-principal problem, type III) [1, 10].

For defining the research problem, we started from the agency theory, which suggests that the firm is a meeting point for a number of contractual relationships, each party to the contractual relationship has interests that may differ from the interests of the other party.

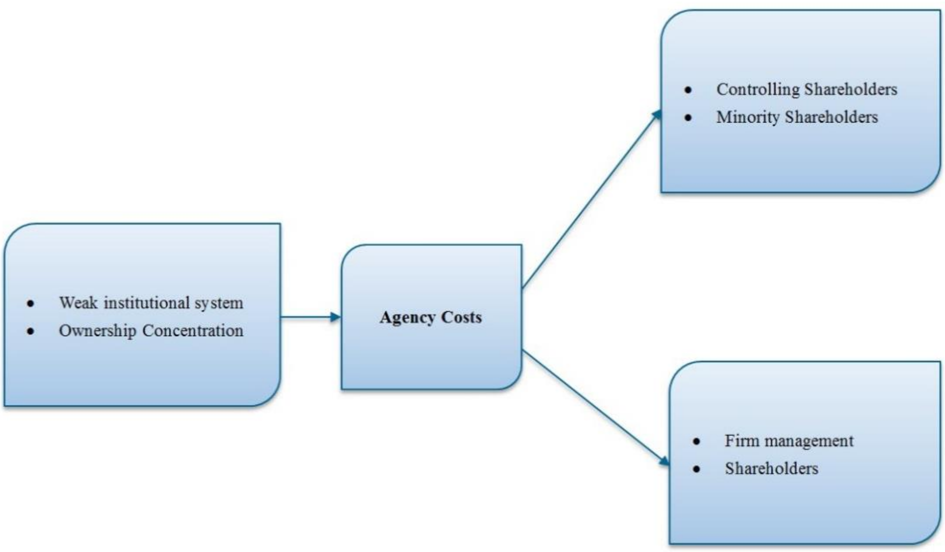

Figure 1. *An illustration of the emergence of agency costs.*

The firm management bears the responsibility for preparing financial reports. Based on this information presented in the financial reports which are used by investors, creditors, and other stakeholders to make decisions about the firm. Therefore, it is possible to use the information contained in those financial reports to judge the existence of agency problems between those parties. To address these issues, we review the literature and provide an analysis of agency costs in three stages. First, we examine the concept of agency costs. Next, we discuss the types of agency costs and their explaining. Then, we discuss the economic consequences of agency costs in two groups: (1) firm management and shareholders (2) controlling and minority shareholders. The importance of this study is represented by supporting previous studies regarding the concept of agency costs and developing theoretical literature in this field in emerging economies. in addition to the scarcity of previous studies regarding determining the existence of agency costs, especially in light of the scarcity of studies that addressed the research topic in developing countries, according to the researcher's knowledge.

The structure of the research paper is as follows: Section Two discusses the important literature on agency costs and their main factors. Section Three defines the research methodology. Section Four highlights the main results of the research paper and discussion. Finally, Section Five concludes the paper.

2. Literature Review

Jensen & Meckling identified three main types of agency costs: supervision costs, compliance costs, and residual loss. Supervision costs are the expenses incurred by the principal to monitor the agent's actions and behavior. This includes costs related to measuring, observing, and establishing compensation and bonus policies for the management. Compliance costs, on the other hand, are the costs borne by the agent to ensure that their actions do not harm the interests of the principal. Residual loss refers to the difference in actions that the agent takes as compared to what they would have done if they were the principal [7].

Mirshekary & Wise [20] further categorized agency costs into total costs and residual loss. Total costs encompass supervision and compliance costs. Governance mechanisms, such as control activities by management and audit committees, help mitigate residual losses. The relationship between the principal and agent extends beyond just the management of the facility and shareholders, but also includes relationships among shareholders, controlling shareholders, and minority shareholders. The levels of agency conflicts between the management of a company and its shareholders differ based on various economic, social, and political factors within the business environment, which can vary from country to country [22]. When comparing developed economies like Anglo-American countries with emerging economies, it is clear that the agency conflicts between management and shareholders in the former do not directly apply to the latter. In emerging economies, the separation of ownership from management does not adequately explain the agency problem due to weak shareholder protection and a significant concentration of ownership among families or the government instead of widespread distribution [4].

Emerging economies are known for two main factors: high ownership concentration and inadequate investor protection. The concentrated ownership in these economies often leads to disputes among shareholders, particularly due to the lack of proper protection for investors. Majority shareholders may take advantage of these circumstances to benefit themselves, disregarding the interests of minority shareholders [14]. According to a study by Li & Song, agency conflicts among shareholders in emerging economies are defined as "a conflict of interest between groups of shareholders in a company, especially between majority and minority shareholders [12].

These conflicts result in agency costs, which stem from the unique characteristics of emerging economies as they try to address the traditional conflicts between shareholders and management in these settings [6].

According to LaRiviere, et al., conflict among shareholders plays a significant role in shaping corporate governance dynamics [11]. When ownership of a company is concentrated, conflicts between shareholders can intensify if there are no effective external governance mechanisms in place [5].

These conflicts typically involve a subgroup of shareholders who control the majority of the company and use their voting power to prioritize their own interests over those of the minority shareholders [2, 9].

Young, et al. analysis delineates the fundamental distinctions between two primary agency problems within corporate governance structures: the conflict between firm management and shareholders, and the conflict between controlling and minority shareholders [24].

Table 1. *Agency disputes between firm management and the controlling and minority shareholders.*

Terms	Firm Management & Shareholders	Controlling & Minority shareholders
Objective	Between shareholders, whether they are in concentrated or dispersed ownership, and the management of the entity.	Between controlling and minority shareholders. And strategies that benefit controlling shareholders at the expense of minority shareholders.
Institutional minority protection	Strategies that benefit the management of an entrenched entity at the expense of shareholders.	Formal institutional protection is often absent, corrupt, or non-coercive. Informal rules typically favor the interests of shareholders over minority shareholders.
Market Control	Formal constraints (such as judicial reviews and courts)	No corporate governance mechanism

Terms	Firm Management & Shareholders	Controlling & Minority shareholders
	place a ceiling on potential expropriation by dominant shareholders. Informal norms generally aim to maximize shareholder wealth.	
Ownership Types	Concentrated: Owning 5% to 20% of equity. Insider ownership: Owning 5% of equity.	Concentrated: More than 50% of equity, shaped like a pyramid. Where cash flow is greater than equity.
Board of Directors	A legal and social institution with a legitimate duty to protect the interests of shareholders.	In emerging economies, the board of directors often has to establish institutional legitimacy and is therefore ineffective.
Top Management Team	They are either recruited through the corporate ladder or recruited externally after extensive search and vetting of qualifications. They are monitored internally by the board of directors and externally by the managerial labor market.	Usually, family members or associates. They are primarily monitored through family consensus or self-organization and adherence to "gentlemen's agreements."

The previous table discuss shows that agency costs can be categorized into two types: the first type involves the relationship between shareholders and management, while the second type involves the relationship between controlling shareholders and minority shareholders. These types have unique characteristics and arise in different situations, such as ownership structure, institutional environment, legal safeguards, and corporate governance practices. Agency conflicts of the first type typically occur in environments with limited shareholder protection, ineffective boards of directors, and a concentrated ownership structure.

In such cases, shareholders' interests are safeguarded by legal and social institutions with a fiduciary responsibility. These conditions are commonly found in emerging economies, where the institutional and economic framework provides the groundwork for such agency costs to arise. On the other hand, advanced economies are characterized by a more widely dispersed ownership structure and robust legal protections for minority shareholders. This creates the conditions for agency costs of the first type to emerge in these economies.

In comparison to developed and emerging markets, emerging markets are more influenced by managerial decisions than developed markets. Companies in emerging markets often manage their resources inefficiently, which directly impacts the company's performance. This inefficiency is why agency costs differ between these markets. So, the solution to reducing agency issues lies in the company's supervisory system. Good corporate governance practices can help mitigate conflicts of interest between shareholders and company management [15, 23].

Early research on the economic implications of agency costs has been conducted in various studies, focusing on both types of agency costs. Sari explored the correlation between agency costs and financial distress in Indonesia, finding that higher agency costs increase the likelihood of firms facing financial distress [21]. Similarly, Rashid et al. investigated the link between agency costs and firm performance in China, determining that agency costs are associated with decreased firm performance [19]. These findings align with Nuhu et al. 's study in Nigeria, which attributed the lower performance to the opportunistic behavior of firm management prioritizing their interests over the firm's overall goals [16].

Additionally, Obayagbona & Ogbeide studied the relationship between agency costs and dividends in Nigeria, concluding that higher agency costs result in lower dividends [17].

Young, et al. also found that conflicts between controlling and minority shareholders can have negative impacts on organizations. These include inefficient use of capital and lower quality of life. Many supposedly independent companies in developing countries are actually run informally as business groups. They make strategic decisions based on factors at both the country and company levels. This can lead to less-than-ideal choices in governance structures and potential mistreatment of minority shareholders. The main consequences of these conflicts are increased monitoring and interconnection costs, as well as challenges in organizational strategy and competitiveness. The various roles of controlling and minority shareholders in governance and their potential for misuse result in higher control costs in firms operating in emerging economies due to several factors. These factors include complex corporate structures that make it challenging to define and measure contract terms, the ability of controlling shareholders to bypass traditional control mechanisms like the board of directors, and lower informational content in stock prices leading to limited control effectiveness of capital markets. These conflicts impact organizational performance and competitiveness by distorting the firm's strategy. In emerging economies with underdeveloped legal and regulatory frameworks, detrimental actions such as appointing unqualified individuals to key positions, engaging in transactions at unfair prices with related parties, pursuing self-serving agendas like excessive diversification, and underinvesting in innovation are likely to occur [24].

3. Methodology

This paper utilizes secondary data as evidence, which was gathered from various articles in the field of accounting and finance.

The selection process involved reviewing 22 major accounting journals and ranking them based on their focus. The top 12 journals in Scops were chosen for further analysis: Academy of management review (AMR), American economic review (AER), Journal of Financial Economics (JFE), International Journal of Managerial Finance (IJMF), Business and Finance (JAABF), Corporate Ownership & Control (COC), Solid State Technology (SST), Corporate Governance: An International Review (CGIR), Pacific-Basin Finance Journal (PBFJ), Journal of business ethics (JBE), Journal of Management Studies (JMS), Asian Economic and Financial Review (AEFR), Journal of Risk and Financial Management (JRFM).

Articles on agency costs were systematically selected by examining titles, abstracts, and keywords provided by the authors, resulting in a list of 23 articles published between 1976 and 2023.

The paper offers a summary of previous research on agency costs, noting the significant increase in research on this topic in recent years.

Due to the vast amount of literature available, the focus is primarily on key studies that define and interpret agency costs, particularly those published in reputable academic journals.

The analysis of the literature is organized along two primary dimensions: the distribution of articles by their source publication and their classification by central research topic.

First, The Journal of Risk and Financial Management was the sole publication that contributed two articles, making it the most frequently cited source in this sample. The remaining journals, such as Amity Journal of Finance, Asian Economic and Financial Review, and Solid-State Technology, among others, each contributed one article, indicating a broad engagement with the topic across various academic and regional platforms.

Furthermore, the reviewed literature was systematically categorized into three principal thematic areas based on content. The most prominent theme, addressed by 14 articles, was "Agency Cost Types and Explanation in Financial Markets." This indicates that the primary focus of existing research is on identifying, classifying, and elucidating the mechanisms through which these costs manifest within market structures. The two other themes, "Agency Costs Concept" and "Agency Cost Economic Consequences," were equally represented, with 5 articles each. This distribution suggests that while the foundational concept and its final outcomes are well-covered, the predominant scholarly effort is dedicated to understanding the specific typologies and operational dynamics of agency costs in a financial context.

4. Discussion

This paper primarily uses agency theory as its main theoretical framework. Previous studies published in journals have identified two main points. In the past, research focused on factors like managerial behavior, and ownership structure. However, recent studies have delved into corporate governance mechanisms, shareholder conflicts, multiple controlling shareholders, International Financial Reporting Standards (IFRS), shareholder protection, conflicts between controlling and minority shareholders, disclosure quality, liquidity, social responsibility, financial performance, financial distress, and types of financial markets. These studies have raised concerns about the reliability of executive management appointments in relation to unethical financial behavior. These findings offer valuable insights for researchers, policymakers, and professionals, highlighting areas that require further exploration in emerging market research. This field has experienced significant growth, with the highest number of research papers published in 2020, most of which were conducted in the United States, China, Australia, Brazil, the United Kingdom, Vietnam, Nigeria, Indonesia, New Zealand, and India. Furthermore, current research on agency costs in emerging economies lacks a comprehensive analysis. Recent literature reviews have emphasized the evolving nature of work behavior, stressing the influence of culture, social trends, and new management practices.

Recent research findings (2020-2023) highlight key issues in the field being studied. These include the lack of examination on the benefits received by management and how these benefits are paid out. Moreover, gaps in the existing literature have been identified, such as the absence of studies on stock-based compensation, Chief Executive Officer (CEO) compensation, audit committee effectiveness, and reporting on conflicts of interest among independent directors. Additionally, there is a need for more organized research on agency costs. Connecting agency costs, earnings management, and corporate governance in future studies can offer valuable insights to policymakers and those involved in corporate governance on how to effectively regulate them. This section will delve into three main ideas: the concept of agency costs, their significance in financial markets, the influence of different financial market types on them, and the economic implications they carry.

4.1. Agency Costs Concept

Agency costs are the expenses that the principal has to bear due to the difference in performance between the agent and the standard expected performance. This difference in performance can lead to risks of deviation from the principal's perspective, as the agent has been granted certain rights and privileges under the agency relationship.

4.2. Agency Cost Types and Explaining in Financial Markets

When looking at agency cost types in financial markets, we can understand them through the interactions between the management of a company and its shareholders. These interactions create a series of contractual relationships that can lead to disputes over agency issues. It is important to not only identify the parties involved in the agency relationship, but also to understand the behaviors of the individuals and the environment in which they operate. The information asymmetry between the management and shareholders can be attributed in essence to the emergence of an expectation gap between the two parties that widens and narrows according to the differences in the culture adopted by each party, as this pre-existing culture affects the attitude towards the expected behavior, which in turn affects the intention that directly affects the behavior, and it also varies from country to country in that it constitutes a pressure factor for performing or not performing that expected behavior. The role of the environment must be noted in this context, as management tendencies cannot be explained as depending on the invested effort based on attitudes and standards only, but rather extends beyond that to the expected behavioral control factors in terms of possessing the necessary resources and opportunities to make management qualified to possess those tendencies in terms of the required information, skills and capabilities derived from the environment, time and opportunity. Accordingly, the expectation gap can be linked to the agency cost representing the information contained in the contract concluded between shareholders and the management of the facility as a criterion for assessing the extent to which the management of the facility represents the interests of shareholders, and is evaluated in terms of: the relative benefit obtained from including that information in the contract and the extent to which it represents the interests of individuals related to the facility. Agency disputes between minority and controlling shareholders can also be attributed to the existence of a concentration of ownership for a group of shareholders within a larger group that enables them to violate the principle of equal treatment for all shareholders by monopolizing participation in decisions related to fundamental changes in the facility through their control of the right to effective participation and voting in the meetings of the general assembly of shareholders, which in turn prevents the protection of minority shareholders from the influence or abuse of major shareholders controlling the board of directors and executive management, especially if the management of the facility is part of that group.

4.3. Agency Cost Economic Consequences

For the first type: The increase in the level of agency costs can be linked to the possibility of financial distress, as establishments facing financial difficulties have an increased level of conflict of interest between the establishment's management and shareholders, as management seeks to take measures that will maintain its continuity in its job positions at the expense of the interests of shareholders, which in turn leads to an increase in the level of direct costs of control and interconnection. The existence of financial difficulties may also prevent the establishment from accessing external sources of financing on favorable terms, which in turn increases financing costs that may result from suboptimal decisions. Financial distress may also lead to an increase in the risks associated with the establishment, which may sometimes lead to its liquidation, which makes shareholders more conservative in monitoring management to ensure that it is operating in a manner consistent with their interests. As for the link between the level of agency costs between the management of the facility and shareholders and the performance of the facility, the management of the facility limits the direction of funds to monitoring the work of management instead of directing them to investments in the long-term operational activities of the facility that benefit the facility as a whole. On the other hand, the negative impact of agency costs on the market value makes it less valued in the market due to concerns related to corporate governance and management. As for dividend distributions, the increase in the level of agency costs between the management of the facility and shareholders can affect the reduction of dividend distributions, especially in light of the management of the facility enjoying broad decision-making authority, as it prefers to keep a larger percentage of profits within the company to finance investments that serve its interests more than the interests of shareholders on the one hand. In addition, shareholders, with the high level of agency conflicts, prefer to transfer the funds allocated for dividend distributions to agency cost solutions channels such as management bonuses, and the low level of investment attraction can reduce the level of dividend distributions to current shareholders.

As for the second type; controlling shareholders can influence management decisions and policies in ways that may not be in the best interest of the entity, such as mergers and acquisitions that may increase their wealth, which leads to an inefficient allocation of resources, as funds are used to promote the interests of controlling shareholders instead of investing in projects that benefit the entity as a whole. This may have an impact on minority shareholders' reluctance to invest in entities with controlling shareholders, which may affect the entity's ability to obtain capital. This in turn leads to a reduction in the level of investor confidence in the market, which affects share prices and reduces the market value of the entity. Other consequences may be added, such as the entity's exploitation of transactions with related parties in the practice of earnings management based on accrual for the purpose of transferring resources to controlling shareholders at the expense of minority shareholders, especially in light of the presence of weak external and internal corporate governance mechanisms that do not guarantee the protection of those investors, in addition to the strict implementation of instructions and decisions that serve its interests, or both.

5. Conclusions

In this paper, we review the literature that explores the definition, patterns, and interpretation of agency costs in the context of financial markets and their economic implications. While the effects of agency costs have been extensively researched over the past two decades, we find several areas where the results are inconclusive and further research is needed. We first compare the definitions although there is no consensus on the definition of agency costs, the principles on which they are based provide important guidelines for developing a unified definition. We then identify the types of agency costs. The research finds that agency costs come in two types, each of which is closely related to the behavioral and cultural characteristics of both the environment and the parties to the agency (firm management, controlling shareholders, and minority shareholders). Finally, the research on the economic implications of agency costs is extensive. These findings may be due to multiple interpretations; the economic implications of agency costs between firm management and shareholders are mainly due to management's desire to remain in office, increase financing costs, and managerial rewards. While the economic implications of agency costs between controlling and minority shareholders are mainly due to the opacity of corporate structure and the weak implementation of internal and external governance mechanisms. In general, many research opportunities are noted to provide more information on agency costs and their implications in the accounting field. Such research is believed to be essential to fully understand agency costs.

Abbreviations

IFRS	International Financial Reporting Standards
CEO	Chief Executive Officer
AC	Agency Costs
PA	Agency Conflicts Between Shareholders and the Management of the Firm
PP	Agency Conflicts Between Controlling and Minority Shareholders

Author Contributions

Alaa Kafa is the sole author. The author read and approved the final manuscript.

Conflicts of Interest

The author declares no conflicts of interest.

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