On Applying Agency Theory in Historical Accounting Research

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Accounting theory and accounting history have largely evolved as two independent fields of study. Accounting research is closely allied with contemporary models in economics and finance, which emphasize rigor in logical construction and statistical analyses. Studies in accounting history, in contrast, apply economic theory very infrequently, and are predominantly descriptive. There has been little communication between accountants and historians, though a tremendous synergistic potential exists. The importance of combining historical and statistical approaches in advancing economic theory and the complementary nature of the two approaches have long been emphasized by scholars such as Keynes [1890] and Schumpeter [1954].

Accounting is concerned with information flows and their organization, which are central to business operations, managerial decision-making, and the nature and efficiency of capital markets. Hence, the development of accounting is embedded in issues relating to the development of the markets and corporation. Tools of historical scholarship are therefore uniquely suited to incorporating contextual factors and path dependencies in evaluating accounting theory.

Accounting theory also has the potential to enrich our understanding of business history. As Lamoreaux, Raff, and Temin [1997, p. 77] suggest, historians would benefit from turning to economic theory "both for useful ideas and for the light a coherent perspective sheds on an otherwise untidy past." This essay provides an illustration of potential synergies in combining historical and theoretical research in accounting. We focus on the use of agency

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models of capital markets relationships, which are the cornerstone of contemporary accounting research.

Current mainstream accounting research is based extensively on economic models of agency that represent the operating company (firm) manager as "agent" and the individual investor as "principal." This principal-agent model has also been implicitly adopted in the regulation of accountancy, which focuses on the needs and welfare of a diverse group of individual investors who entrust their wealth to the control of managers.

In this paper, we challenge this traditional characterization of capital markets agency relationships in an accounting context. In particular, we focus on the role played by fund managers and other managers of capital who aggregate the wealth of individuals and make investment decisions on their behalf. We perform an historical analysis of the nature of control and influence (de facto property rights) relationships as they existed at the turn of the century, when the corporate economy was still in its infancy, and compare these relationships with those that have evolved among individual investors, fund managers, and firm managers over the past two decades. These two periods in the evolution of the American corporate economy are especially interesting because they signify two eras in which money managers, fund managers, and other managers of capital have played important roles in capital markets.

While our analysis takes into account fundamental differences in context across the two time periods we study, some interesting similarities are also apparent. We find that, like the money managers and bankers at the turn of the century, fund managers and other professional investment managers of today play a fundamental part in transforming the nature, structure, and valuation of property rights in capital markets. Their role, therefore, goes well beyond their traditional characterization as flow-through entities or financial intermediaries. We suggest an expanded framework of capital markets agency relationships in which investment managers are represented as agents of individual investors and principals of firm managers as a richer basis for framing and conducting accounting research, and in policy deliberations.

Our approach in this paper may be viewed as answering increasing calls for the adoption of a theoretical basis for conducting historical research [Temin, 1991; Baskin and Miranti, 1997]. We concur with the view of Douglas North [June 1994, p. 359] when he states: "Economic History is about the performance of economies through time. The objective of research in the field is not only to shed new light on the economic past, but also to contribute to economic theory by providing an analytical framework that will enable us to understand economic change."

Agency Research in Accounting

While the issue of separation of ownership from the control of property had been commented upon by Adam Smith [1976], Veblen [1923], and the Pujo Committee [1913], among others, the classic work of Berle and Means,

The Modern Corporation and Private Property [1932] has had a pivotal impact on accounting research and regulation.[1] Combining legal and economic perspectives, Berle and Means put forth a provocative thesis that the separation of the risk-bearing functions of ownership and the control function of management created conditions in which professional managers could take actions to the detriment of the owner and to their own personal gain. One consequence of this, they argued, was the urgent need for new and reliable channels of communication in order to protect shareholder interests by enabling them to judge managerial performance in their role as stewards of corporate resources.

The Berle and Means' view, coming as it did on the heels of the Crash of 1929 found favor with securities regulators looking for answers. The New York Stock Exchange (NYSE) was quick to implement several of their recommendations, and in 1933, the NYSE in conjunction with the American Institute of Accountants began to promulgate accounting standards for companies that were listed on the NYSE. This may have been a case of "too little too late" for the accounting profession, as it did not stem the public pressure for governmental intervention.[2] The Berle and Means thesis became the foundation for the passage of the Securities Acts of 1933 and 1934, which established legal responsibilities in connection with the agency relationship between shareholders and managers. One important outcome of these acts was that accounting reports containing information about the financial conditions and results of operations had to be made available by managers of companies interested in accessing public securities markets.

The Berle and Means [1932] work became the foundation for subsequent capital markets agency models in accounting. In particular, Jensen and Meckling [1976] synthesized earlier works by Berle and Means with the property rights and contracting literature developed by Coase [1937, 1960], and Alchian and Demsetz [1972]. They defined the firm as a "legal fiction" that may be characterized as a "nexus of contracts." Their analysis focuses on the agency relationship between shareholders of a firm (principals) and managers (agents). The principals contract with the agent to perform some services on the principal's behalf. These contracts require the agent to exert effort and make decisions. The agent is assumed to maximize his utility, which is a function of both pecuniary and nonpecuniary costs and benefits. In the process, the manager has incentives to take value-reducing or opportunistic actions such as overconsuming perks, shirking, or stealing. With competition and rational expectations in capital markets, such behavior on the part of managers reduces the value of the firm. This reduction in firm value is termed "agency cost." Contracts between shareholders and managers are written in

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[1] The 1983 *Journal of Law and Economics* symposium celebrating the 50th anniversary of the publication of Berle and Means [1932] provides an overview of the enduring influence of this work.

[2] Historical studies of the development of accounting include Miranti [1989], and Previts and Merino [1979].

order to reduce agency cost, and thereby, the deadweight loss in firm value as a result of the separation of ownership from control.

Accounting is considered to play an important role as an integral part of the contracts that define a firm. For example, lending arrangements between a firm and its creditors often contain several accounting based covenants. Accounting-based bonus plans are frequently a component of executive compensation plans. Accounting measures are commonly used in the performance evaluation of a firm's cost and profit centers. Watts and Zimmerman argue [1986, p. 196]: "if accounting is an important part of the firm's contracting process and agency costs (and hence, firm value and/or managers' compensation) vary with different contracts, accounting procedures have the potential to affect firm value and/or the manager's compensation." This rationale has given rise to several hypotheses regarding the role of accounting information in market valuation of firms and managers' use of accounting discretion. Parallel to these theoretical developments, methodological innovations in finance like the capital asset pricing models (CAPM) made it possible for researchers to subject the hypotheses derived above to statistical empirical tests.

The hypothesis that accounting reports are demanded to monitor the relationship between managers and shareholders is termed the stewardship concept and has been used by accounting historians to explain the existence of accounting [e.g., Yamey, 1962]. The principal-agent model has also generated other hypotheses relating to accounting method choice, rationales for accounting regulation and informativeness of accounting reports. The implications of the manager-shareholder agency relationship for contract design have been studied using analytical models. This literature [e.g., Ross, 1973, 1974; Wilson, 1968; Spence and Zeckhauser, 1971; Mirrlees, 1974, 1976; Stiglitz, 1974, 1975; Holmstrom, 1979; and Antle, 1982, 1984] addresses the principal's problem that the agent or manager will shirk and not take actions that will be in the best interests of the principal. The problem arises because the principal cannot observe the agent's actions. Therefore, the optimal contract between the principal and the agent will provide for the agent to share in the outcome of his actions. The focus on designing these contracts is to provide the appropriate incentives to the agent and optimal risk-sharing between the principal and the agent. This normative agency literature has evolved parallel to the positive agency literature derived from the works of Berle and Means [1932] and Jensen and Meckling [1976]. These analytical models also provide intuition regarding the role of accounting information in principal-agent relationships. In order to preserve the mathematical tractability of their analysis, these models have portrayed extremely simplistic situations and have been based on several unrealistic assumptions.[3]

The contracting role of accounting has largely been viewed in the context of simple agency models of the shareholder-manager relationship. Accounting researchers have used formal management compensation plans and

[3] Baiman [1982] provides a good overview of this literature.

firm debt contracts to generate and test hypotheses about managers' choice of accounting procedures and the stock price effects of these choices [e.g., Zmijewski and Hagerman 1981; Healy, 1985; DeAngelo, 1986, 1988; Jones 1991; Gaver, Gaver, and Austin, 1995; Holthausen, Larcker, and Sloan 1995].

The agency paradigm and developments relating to the CAPM and the efficient markets hypothesis have also influenced accounting regulation. Accounting researchers in this tradition have supported the efforts of accounting regulators by analyzing the implications of these economic models for disclosure regulation. The Financial Accounting Standards Board (FASB), its predecessor, the Accounting Principles Board (APB), and the Securities and Exchange Commission (SEC) have utilized studies such as Beaver [1973], Beaver and Demski [1974], Benston [1969, 1973], etc. as the basis of regulating the practice of accountancy.

The principal-agent literature has thus had a tremendous impact on accounting research and regulation. Yet, this research has been narrowly focused, and has been predominantly based on analytical or statistical approaches employing large standardized databases. Such exclusive reliance on a narrow basis is inappropriate in advancing knowledge in an interdisciplinary subject like accounting, which exists within a complex interplay of political, social and economic settings. Strikingly absent from contemporary accounting research is a modeling or even an understanding of these contextual factors.

Historical scholarship in uniquely suited to bridging this void by providing the necessary tools to understand factors that have contributed to economic change. A few studies have applied contemporary agency theory and related models in information economics to historic events or periods. Watts and Zimmerman [1983] used a principal-agent setting from which to argue that auditors' reputation served as a bond for independence even in early merchant guilds. De Long [1991] investigated the role of the House of Morgan in the early corporate economy in America, suggesting that the need to resolve principal-agent problems engendered by the corporate form of organization results in the creation of institutions that would not exist in a perfectly competitive world. He argued that J.P. Morgan served the interests of individual investors and did not behave in a self-serving manner because of the need to preserve the vast amount of reputational capital at stake. Ramirez [1995] used contemporary finance methodology to provide an empirical evaluation supporting the proposition that J.P. Morgan and Company resolved the principal-agent problem by alleviating informational asymmetries between investors and managers. He portrayed J.P. Morgan as a financial intermediary, who facilitated a smoother functioning of the primary agency relationship between individual shareholders and managers.

These studies are primarily concerned with applying contemporary agency and related economic models to historical time periods. The issue of how relevant these models are in the context of particular time periods in business history has however not been addressed. In this essay, we use historical research in a manner that is fundamentally different from the studies described

above. Rather than apply the existing stylized model directly to the past, we provide a dynamic assessment of the descriptive validity of the model. Our analysis focuses on the turn of the century, when the corporate economy was still developing, and on the past quarter century which has witnessed the tremendous rise of the institutional investor. We demonstrate the limitations of characterizing a direct and simple principal-agent relationship between individual shareholders and firm managers in capital markets that are dominated by the presence of these institutional investors.

Capital Markets Relationships in the Early Corporate Economy

An analysis of the evolution of agency relationships in capital markets is an important perspective from which the development of the corporation and its environment may be addressed. Agency theory provides a particularly useful lens to study the past with a view to understanding the role of accounting information in the development of markets and organizations. Historical evidence thus obtained may be utilized to sharpen the focus of contemporary models. The approach also has the advantage that economic models developed by contemporary researchers are not applied in a mechanistic manner to study the past, thus lessening the dangers of presentmindedness [Previts and Bricker 1994].

America's drive to industrialism initiated by the development of railroads in the second half of the eighteenth century gave impetus to the growth of the corporate form of organization [Chandler, Bruchey, and Galambos, 1968]. Until the 1880s, however, the typical manufacturing company was small and closely held and largely served local markets, existing merely as extended versions of sole proprietorships or partnerships. Ownership and management in these cases were either substantially the same or were closely related. External financial reporting was therefore considered unnecessary and even unwise. A corporation had the right to privacy regarding its financial information, just as any private citizen did. The regulation of accountancy during this period, as reflected in state corporation laws, also reflected this sentiment against public disclosure. These state laws generally required two sets of reports: one submitted to public authorities, which were considered to be confidential, and the other, summarized financial information submitted to stockholders, but not to the public at large [Hawkins, 1963].

In the 1880s large industrial combines started to emerge in the United States. The American economy was fast changing from a primarily undifferentiated, agrarian, local economy into a differentiated, urban, industrialized one. It was also experiencing enormous growth. While in the 1850s, the industrial output of the U.S. was far below that of England, by 1894 the value of American output almost equaled the combined output of the United Kingdom, France, and Germany, and by World War I, America was producing more than one-third of the world's industrial goods [Chandler, Bruchey, and Galambos, 1968]. Such enormous growth made structural changes inevitable, and gave impetus to the development of a corporate economy. The integration of

ownership and control that was inherent in the nineteenth century firm and even early closely-held corporations gave way to their separation. The development of railroads further hastened the growth of the corporate economy by expanding the possibilities for commerce.

Such enormous expansion within a relatively short span of time required the deployment of huge amounts of capital. Capital markets, as we know them today, did not exist. Investment bankers of this time like J.P. Morgan played a central role in filling the need for capital to fuel this expansion [De Long, 1991] due to their ability to mobilize large amounts of capital.

The combinations and merger movement of the late nineteenth century resulted in the formation of several publicly held corporations. In the absence of adequate financial information or public disclosures from these corporations, investors bought their securities primarily on the basis of their confidence and trust in the investment firms marketing the securities. The investment bankers' involvement constituted a stamp of quality and an implicit guarantee of the security [De Long, 1991]. Corporate managers also depended on these investment bankers to raise capital and make a market for the industrial securities of their firms.

There were thus two tiers of capital markets agency relationships during this early corporate economy: one between individual investors and investment bankers and the other between investment bankers and industrial firms. The Berle and Means world of powerful, concentrated managers who directly controlled the wealth of individual investors was not yet in place. Individual investors were effectively investing in the reputation of the investment bankers, who they believed had information to make good investment decisions.

Financial reporting in this era was rarely thought necessary, prudent, or even demanded [Hawkins, 1963]. The meager financial statements that did exist were completely inadequate for purposes of individual investor valuation of securities. The accounting profession was still in its infancy. There was no established body of accounting theory, and the lack of uniformity in accounting practices rendered financial statements inadequate as a basis for comparative evaluation of firms. Auditing practices were still considered unusual. The function of public accountants and their reports was grossly misunderstood, and most accountants "neither could nor desired to modify management's desire for corporate secrecy" [Hawkins, 1963, p. 145].

Financial relationships in capital markets were made possible therefore by the structure of property rights. Investors during this period expected regular dividends from the corporations, and as long as they received these dividends did not care about financial statements. The nature of control and influence relationships that existed at this time also made it possible for the organization and financing of corporations even with the absence of structured capital markets, adequate information flows, securities regulations and a general social acceptance of the corporate form of organization.

Investment bankers were at the center of these control and influence relationships, as is well-documented in business history research. These

bankers, particularly J.P. Morgan, were involved initially with railroad financing. They acted as managers of large underwriting syndicates which agreed to purchase stocks, convertible bonds and other securities not purchased by the railroad corporation in an offering, as sole underwriters, or as direct subscribers of securities through private placements [Chandler and Tedlow, 1985]. These activities, of central importance in an economic system with relatively undeveloped capital markets, increased the bankers' control over the railroad industry. The system worked on faith, reputation, and character of these bankers, all of which were essential factors in the early development of corporations. During the economic depression of the 1890s, the industry went through a series of reorganizations, again financed by the investment bankers. These required raising of cash through the issue of new securities, realigning fixed charges by exchanging new securities for the old, and the creation of voting trusts which were vested with full corporate authority by the shareholders. The voting trusts were controlled by investment bankers who used them as vehicles to wield significant control over the railroads. The trusts served to separate the voting and ownership rights inherent in common stocks.

The merger movement that started with the railroads spread to other industrial concerns in the late nineteenth century, resulting in a number of large publicly owned manufacturing companies. Some well known companies of today, like General Electric, American Telephone and Telegraphs, Federal Steel, United States Steel, and International Harvester were organized at the turn of the century. The need for capital and the fragmentation of the industry (particularly in the case of AT&T), resulted in a close relationship between the company and its bankers. The bankers fostered combinations in industrial concerns with the purpose of bringing the market under control. For example, by 1900, Standard Oil through a series of horizontal and vertical combinations that were orchestrated by Morgan, controlled 90% of the domestic industry [Galambos and Pratt, 1988]. In the restructuring of eleven major firms of the steel industry into the United States Steel Corporation, the first billion-dollar company, investment bankers once again were central. The underwriting circular issued in this connection noted that "the entire Plan of Organization and Management of the United States Steel Corporation shall be determined by J.P. Morgan and company" [Chandler and Tedlow, 1985, p. 282]. J.P. Morgan orchestrated the creation and financing of U.S. Steel, hand picked the manager, obtained a 200% return on funds advanced during the merger, and received huge fees.

The means for financing corporations were concentrated in a few hands. These bankers became important investment agents at the turn of the century. In early capital markets, there existed agency relationships between a comparatively small number (from today's perspective) of large corporations, and a relatively small group of investment managers and industrial firm managers, who in turn had a fiduciary relationship with the individual investors whose resources they mobilized. The Berle and Means thesis ignores the vital role of these investment managers. In analyzing the corporation, Berle and Means did

not address the role of bankers and underwriters as agents of capitalism and therefore did not adequately portray property control relationships.

There were, of course, several vociferous critics of big business and money managers [e.g., Brandeis, 1914]. The Pujo hearings on the "money trust" reported in 1913 that there was "a high degree of financial concentration ...and a close alliance between the heads of a few New York city banks and the principal users and suppliers of capital" [Carroso, 1973]. De Long [1991, p. 217] asserts that "[t]he forty-five employees of Morgan and Company approved and vetoed proposed top managers, decided what securities they would underwrite, and thus implicitly decided what securities would be issued and what lines of business should receive additional capital."

The control over investor resources was effected through representation on corporate boards, controlling individual savings in life insurance companies and banks, and by creating a syndicate system, which consisted of various techniques of originating, underwriting, and distributing new securities. In the 1920s, other forms of institutional investment, particularly investment trusts, evolved. The absence of regulation separating commercial and investment banking as we have today, together with a healthy U.S. economy stimulated the rapid growth of these trusts.[4] Small investors invested in these trusts, which in turn invested in portfolios of securities of industrial firms. The market values of the securities of the trusts themselves were typically far greater than the sum of the values of the property that these trusts owned, consisting solely of common and preferred stocks and debentures, mortgages, bonds, and cash. It is apparent that in early capital markets a premium was paid for financial entrepreneurship.

The involvement of investment bankers in the early corporate economy went far beyond their contemporary economic conceptualization as "financial intermediation." Berle and Means did not address this pattern of property control and influence that characterized early capital markets in arguing that the balance of power had shifted entirely in favor of the professional corporate manager. Their failure to address institutionalized forms of corporate control limits the descriptive validity of their analysis in the context of the early American corporate economy. There did not exist a direct agency relationship between individual investors and corporate managers. Investment bankers and trust managers as agents of individual investors proved to be important monitoring agents against opportunistic behavior by corporate management [Carosso, 1973]. Agency models that do not consider these two tiers of relationships do not accurately portray capital markets relationships in early American markets.

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[4] By 1927, Wall Street investment trusts sold $400 million of securities, and by the fall of 1929, total assets of these trust were estimated to exceed $8 billion, an elevenfold increase [Galbraith, 1955].

Capital Markets Relationships in Contemporary Capital Markets

It has been suggested that we are returning to an era of financial capitalism [Hawley, 1995]. Investment companies today play an important role in the management of capital, as individual investors are increasingly employing professional capital managers. As of 1992, more than half of the common stock outstanding in the United States, amounting to over $2 trillion, was owned by pension funds, mutual funds, etc., compared with 40% in 1980, and less than 15% in 1950.[5] Institutions account for about 80% of all trading activity. The average New York Stock Exchange transaction now exceeds 2,000 shares, which is nearly six times the figure for 1974, and half the daily trading volume takes place in blocks of 10,000 shares or more. Meanwhile, individual investors' direct holdings of common stock represent only 16% of their financial assets, down from 44% in the late 1960s, and transactions of less than 100 shares have fallen to less than 2% of total volume. Bernstein [1992] suggests that "individuals who buy and sell for their own account are a disappearing breed."

To be sure, there are fundamental differences between the early and modern corporate economies. Following the stock market crash of 1929, regulatory measures like the Glass-Steagall Act restricted investment activities of banks. The federal government through the newly created Securities and Exchange Commission (SEC) played a direct role in requiring fuller, more reliable and more useful disclosures by the managers of industrial firms. The SEC supported the efforts of the American Institute of Certified Public Accountants, and accounting rules called "generally accepted accounting principles" were promulgated. Since this period there has been a constant pressure on the part of firm managers to improve the quality of their accounting disclosures. The measures separating investment and commercial banking and enhanced regulation of corporate disclosures encouraged individual investor participation directly in capital markets. For a few decades after the Great Crash of 1929, the emergence of a retail market for securities rendered the Berle and Means model most closely representative of capital markets relationships as they existed.

During the prosperous period following World War II, however, a number of nonbanking and nondepository institutions such as insurance companies, pension funds, and mutual funds became important securities holders.[6] As reported in *The Economist* [1990], American private investors reduced the net value of their equity holdings by about $550 billion between the end of 1983 and the end of 1989, which is about 40% of their portfolios in 1983. "Were these trends to continue, the last American to hold shares directly would sell his last one in the year 2003" [*The Economist*, 1990].

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[5] Statistics on institutional holdings and trading are contained in Bernstein [1992].

[6] The phrase "pension fund socialism" has been employed to characterize the extent of institutionalized capital.

The growing economic importance of contemporary investment managers has increased their property control capabilities. Many large pension funds like Calpers have defined and structured shareholder activism programs.[7] There are several highly publicized instances of shareholder activism. In 1990, shareholders targeted ITT for excessive executive compensation. Pressures from institutional shareholders resulted in the ouster of chief executives at several companies such as General Motors, American Express, IBM, Westinghouse Electric, Apple Computer, Eli Lilly, Kodak, Scott Paper, and Borden. Pension funds are also directly involved in corporate governance through board representation, and in regulatory areas. In 1992, the SEC, as a result of pressure from institutional investors, adopted new regulations virtually eliminating restrictions on communication among shareholders of a company. Mutual funds have been less prominently involved in corporate governance.[8] However, investment companies like mutual funds have a huge amount of economic power.[9]

Capital market structures have also evolved in a manner favoring institutional investors. Trading is now conducted virtually round the clock in after-hours electronic trading accessible only to institutional investors. Large institutional investors can now trade block shares off the floor. Further, some privately placed securities (under Rule 144A) may be traded only among institutional investors in private transactions. These measures "further the development of a two-tier stock market" [Torres, 1992].

In today's American economy, institutions exert enormous control over the property of individual investors and act as their agents in making decisions regarding investing in operating companies.[10] By investing in a mutual fund rather than in an operating company, an individual investor has property and information rights against the investment fund and not against the operating company. The investment fund in turn has these rights against the operating company. This fundamental role of funds is ignored when they are viewed within the traditional principal-agent framework that represents operating company managers as agents of investors.

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[7] See Wahal [1994] for a description of some of the larger programs and the process of activism.

[8] Researchers have argued that this has been a consequence of U.S. Securities laws that are designed to promote market liquidity rather than good governance [Bhide, 1993].

[9] At the end of June 1994, mutual funds controlled more than $2 trillion, up more than 100% in just 3 years [Henriques, 1994].

[10] While our analysis focuses on the U.S economy, the property control capabilities exerted by investment managers in the U.S. is echoed in many other countries like Germany, Japan, and South Africa. For a discussion of capital markets relationships in these countries, see Prouse [1995], Barr et al. [1995], and Walter [1993].

Conclusion

Our analysis suggests that the simple principal-agent model that is the basis for much of contemporary accounting research and regulation is not descriptive of markets in which there is a high proportion of institutional investors. A two-tier setting that would represent investment managers as agents of individual investors and principals of corporate managers would provide a more accurate portrayal of property control agency relationships in these markets.

While we recognize that there are potentially several agency relationships among different capital market participants,[11] we consider that the elaboration that we suggest is directly useful in accounting theory, practice, and regulation. Our analysis suggests a need for broadening the scope of agency research in accounting. The two-tier model more clearly illuminates contracting and financial reporting issues involving investors, fund managers, and corporate managers, and would enable us to raise and consider theoretical issues that we have not yet done. The agency model also provides some unique perspectives on the development of accounting thought, which is grounded in the evolution of capital markets agency relationships. Researchers in accounting history and accounting theory have a lot to say to one another.

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[11] As discussed in McCraw [1984] and Miranti [1990].

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