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# Interpreting Agency Theory Through Greiner Growth Model: Regulatory Mechanism Reduces Agency Costs for Modern Chinese Enterprises

Drake Keyang Zhou[1,a], Aaron Weixu Sun[2], Joseph Yuanlong Zhang[3]

[1,2,3] *Warwick Business School, University of Warwick, Coventry, CV4 7AL, United Kingdom*
[a]*Email: keyang.zhou.1@warwick.ac.uk*

**ABSTRACT**
In Chinese organizations, the principal often delegates power to the agent, but their different interests will bring conflicts and contradictions. This phenomenon is the source of the agency problem. With the development of academic research, besides Principal-Agent Conflicts, Principal-Principal Conflicts and Principal-Creditor Conflicts also exist in the organization. When faced with complicated agency problems, only by understanding its causes can the organization better respond to them. The Greiner Growth Model, which describes the stages of organizational development, is a good starting point for analyzing the origin of agency problems. Based on this model, this paper discovers the importance of regulatory mechanisms in the process of solving agency problems and proposes solutions to three types of agency problems respectively, emphasizing the critical position of regulatory mechanisms in modern Chinese enterprises.

***Keywords:*** *Agency theory, Organizational development cycle, Regulatory mechanism, Agency cost*

## 1. INTRODUCTION

The core content of agency theory is the agency problem and its solution [23]. Early research has shown that in a joint-stock company, individuals or groups hold company ownership in the form of stocks, and these shareholders (principals) delegate the authority to managers (agents) [39]. However, an obvious problem at this time is that these managers often work for themselves instead of considering the interests of the principals, so there will be conflicts between shareholders and the managers.

With the changes of the times, the agency problem no longer exists only between the principal and the agent but transcends and covers a series of stakeholders such as creditors, major shareholders, and minor shareholders. Recent scholars have divided the agency problem into the following three categories [3]

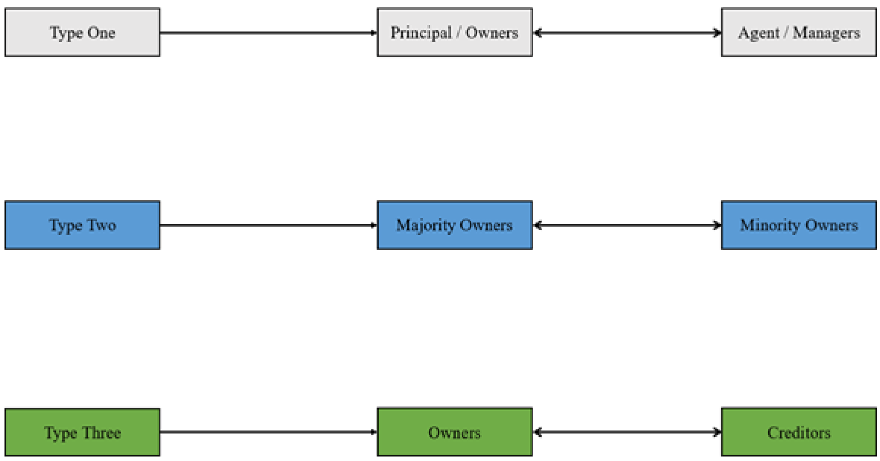


**Figure 1**. Types of Agency Problem

In the context of contemporary China, Principal-Agent Conflicts (PAC) and Principal–Principal Conflicts (PPC) coexist, and under certain circumstances, both may be dominant [4]. When faced with different types of agency problems, the Greiner Growth Model (GGM) can help Chinese entrepreneurs understand the reasons for agency problems at different stages of the organization. This model helps managers use revolutionary solutions to solve various problems that arise at different stages of the organization's growth [22]. The answer to the agency problem may be identified through these solutions.

The second part below is a literature review that focuses on previous studies on agency theory and discussing the causes of agency problems at different stages from the perspective of GGM, and realizing the importance of regulatory mechanisms. The third section discusses the effectiveness of the regulatory mechanism in the organizational context. The fourth section puts forward specific suggestions for the organization to alleviate or solve the agency problem based on the content of previous sections. The last two parts will discuss the prospects and draw a conclusion.

## 2. LITERATURE REVIEW

### *2.1. Agency problems within the organization*

#### *2.1.1. Definition of Agency Problems*

The agency problem first appeared in the form of PAC. The owner delegates the task of managing the company to managers, hoping that they can work for the owner's interests. However, managers are more interested in maximizing their own compensation [3]. Later, scholars defined PPC as the majority owners make decisions which is beneficial to their interests, thus hinders the interests of minority owners [8]. When owners try to invest in high-risk projects, creditors can only get a fixed income when the project is successful. If the project fails, the creditors will be forced to share part of the loss. Principal-Creditor Conflicts (PCC) will appear at this time [3].

#### *2.1.2. Leading Causes of Agency Problems*

As shown in Figure 2, the asymmetry of internal corporate information is a typical reason for agency problems [6]. Nevertheless, there is more than one reason for agency problems, and these causes lead to different types of agency problems. For example, adverse selection and moral hazard caused by information asymmetry may bring PAC to the organization [39]. PPC is mainly caused by the imbalance of power in the process of decision-making and income distribution. Large shareholders enjoy higher voting rights in the company, and they have priority in the distribution of company earnings, and minority shareholders can only obey the orders of majority shareholders. The difference in risk preferences between owners and creditors and the attention of creditors paid to their interest income has led to the emergence of PCC in the organization [3].

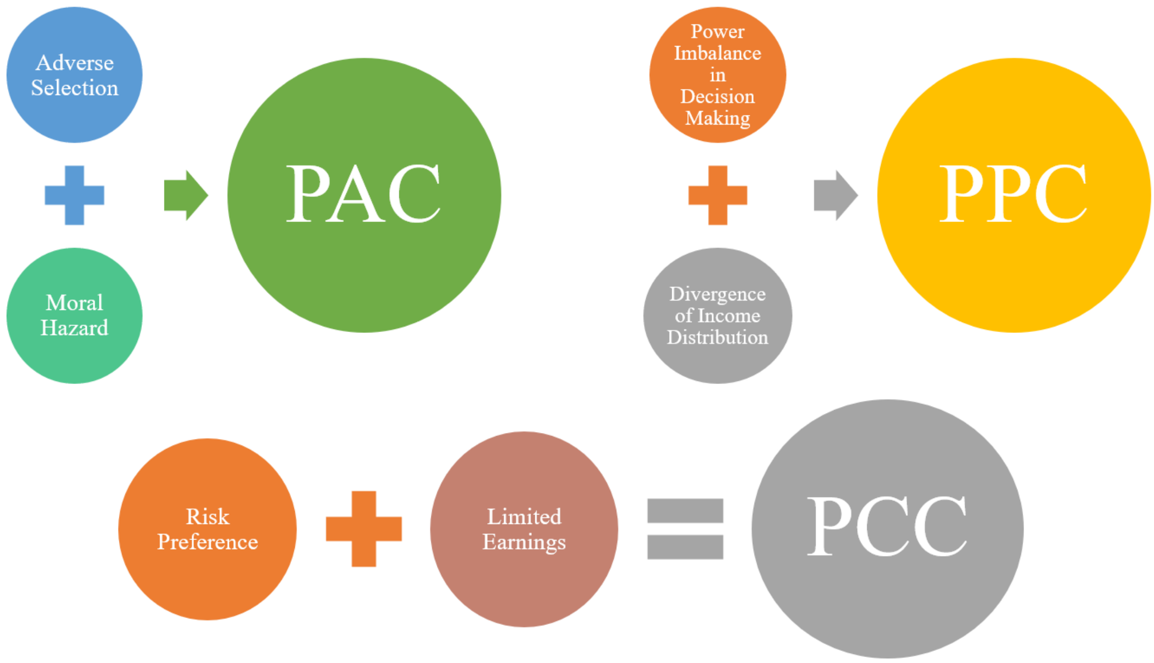


**Figure 2**. Causes of Different Types of Agency Problems


**Figure 3**. Elements of Agency Cost

### 2.2. Agency Cost

Agency cost is the internal cost caused by the inconsistency of interests between stakeholders. It consists of the principal's monitoring cost, the agent's bonding cost and the residual loss (Figure 3) [23]. The cost of maintaining the board of directors and the cost of recruitment or training for managers are the monitoring costs for owners [8]. The agent needs to bear the bonding cost incurred by the establishment and operation of the system according to the company's institution [23]. The residual loss caused by the conflict between other stakeholders' decisions and the owner's wealth maximization is the last part of the agency cost [29].

According to current empirical research, if organizations need to reduce agency costs, increasing the ownership of the board of directors would be an effective method [30]. The increase in management ownership leads to a reduction in monitoring costs, reducing total agency costs [3]. The current methods for reducing agent costs mainly focus on decreasing monitoring costs, but it is not enough to focus on only one aspect. A review of the current literature shows that the agency problem within the organization is no longer limited to the PAC format. Many factors cause different types of agency problems. The following review of literature related to GGM will interpret these factors from the perspective of organizational development.

### 2.3. Understanding Agency Theory from the Perspective of Greiner Growth Model

In the start-up phase of a corporate, the values that drive the development of the business are those of the founder, the primary efforts of the organization are focused on developing a commercially viable product and management style is mainly direct supervision, at this stage, the organization has a high level of uncertainty, and the level of forwarding plan is low [26].

However, from a long-term organizational perspective, according to Lippitt and Schmidt, during the process of organizational developments, after the initial founding and survival phases, the organization expands, and the hierarchy of positions increases, at which point how it is organized and how its discipline is accepted and enforced will become a significant management challenge for the organization to maintain long-term stability [9]. According to GGM (Figure 4), during the creativity phase of organizational growth, as the company grows, the burden on managers becomes heavier and formal systems and disciplined processes are needed to strengthen management, giving rise to leadership crisis [19].

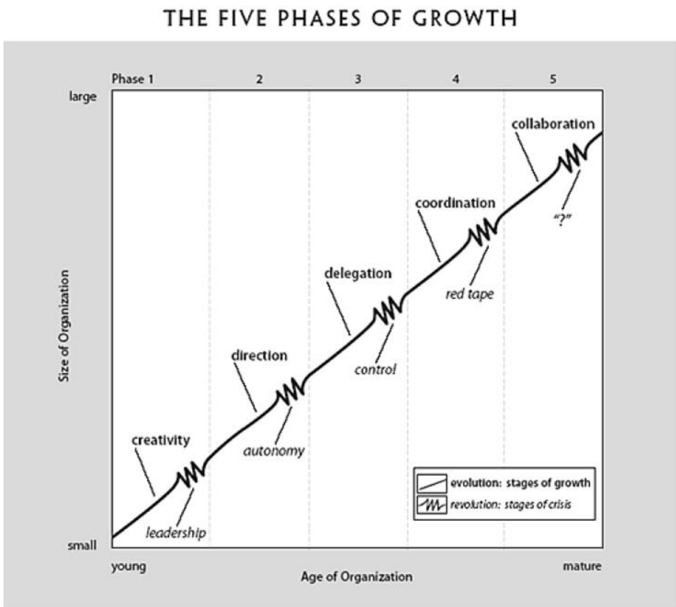


**Figure 4**. The Greiner Growth Model

For these reasons, the company owner often adopts the method of hiring professional managers to manage the company to improve the management level and maintain control over the organization. At this point, a principal-agent relationship is formed between the hired professional manager and the founder of the company, and at the expense of hiring an agent, the principal needs to spend the agency cost to solve the crisis of leadership. However, according to the principal-agent theory, because the interests of the principal and the agent do not coincide, there may be opportunistic behavior of the agent, which to the detriment of the principal's human interests. To gain short-term benefits, agents may focus more on short-term interests in organizational management, such as milking behavior [35], to the detriment of the agent's long-term interests.

Furthermore, according to GGM, in the process of transitioning from the "direction" stage to the "delegation" stage, as the organization continues to develop, senior managers have delegated authority to lower-level managers, and this delegation diminishes the control of senior managers and further amplifies the PAC, creating a crisis of control. At the same time, senior management's lack of control over minority owners and creditors will also make the organization more prone to decision-making differences and different risk preferences, exacerbating PPC and PCC. GGM also suggests that as the organization grows, the control system will gradually become inappropriate and outdated. Increasing management ownership to reduce monitoring costs does not guarantee to reduce the organization's long-term agency costs, so organizations urgently need new methods to respond to agency problems. Therefore, for contemporary Chinese companies, it is necessary to design a mechanism to ensure that the company is effectively managed by professional managers while protecting the interests of shareholders.

## 3. METHODS OF REGULATORY MECHANISMS

According to Agency theory, the sharing of residual income can effectively coordinate the interests of principals and agents and motivate agents to produce excellent performance [23]. According to the GGM, the effective coordination of incentives between principals and agents in organizational growth is a great challenge to solve the agency problem in the process of organizational growth. The incentive mechanism, evaluation mechanism and constraint mechanism are three crucial mechanisms to alleviate the principal-agent problem, and those mechanisms have practical implications for solving the principal-agent problem.

### *3.1. Incentive Mechanism*

From the incentive point of view, an equity incentive plan can be an effective form of incentive for agents. By granting professional managers partial equity, they will consider their interests as shareholders when making decisions, rather than only from the perspective of the professional manager.

Firstly, equity incentives can motivate management to work in the best interests of shareholders, reduce moral hazard behavior of agents and motivate agents, thus increasing their efficiency and reducing agency costs [34]. Secondly, equity incentives can avoid management's tendency to avoid risk, thus encouraging management to invest in high-risk projects for higher potential benefits [32].

From the human resource perspective, equity incentives can optimize the firm's compensation structure, which helps it attract and retain talented people and maintain a stable management team, helping it grow steadily in the long term [37].

Moreover, according to Singh and Davidson, the stronger the incentive is given to the agent, the more the agent cares about the correctness of the decision [27]. The more the agent insists on his viewpoint, the higher the possibility of rejecting the principal's order. Equity incentives reinforce the relationship between executive compensation and firm performance, thereby reducing their dependence on the controlling shareholder and giving them more autonomy in the firm's management. Equity incentives are also a valuable tool to moderate PPC.

For these reasons, equity incentives help align managers' interests with those of shareholders in the long term, thus reducing agency conflicts in the firm [27]. Thus, incentives play an important role in sustaining the growth of an organization in the long run, and effective incentives are essential in mitigating agency problems and reducing agency costs.

### *3.2. Evaluation Mechanism*

In parallel to incentive mechanisms, evaluation mechanisms are also an essential method of monitoring agents, and Lasher suggests that the monitoring of agents' performance is the core measure for effective management of corporate agency problems [36]. Modern corporations generally operate with a separation of ownership and control, and an effective way to reduce agency costs and safeguard shareholders' rights is to link corporate performance to managerial compensation. Therefore, principals should design effective evaluation mechanisms to appraise agents.

Relative Performance Evaluation (RPE) is a comparatively objective way of evaluating agents. RPE reduces the risk of agent performance pay by adjusting the industry or market trends in a company's performance metric by referring to the performance of other agents in the same industry or market when evaluating the level of agent effort [2]. According to Aggarlwal and Samwick, managerial compensation is more correlated with firm performance in highly competitive industries than in relatively less competitive ones. RPE can strengthen the principal-agent contract by increasing the agent's incentives to outperform competitors [31]. RPE allows the principal to effectively compare its performance with that of its competitors in the industry and thus assesses the agent's performance with greater credibility and validity. Therefore, an effective evaluation mechanism has a positive effect on solving agency problems.

### *3.3. Constraint Mechanism*

Firstly, an effective internal control mechanism would better help the principal control the agent, prevent the agent from abusing his power and protect the interests of the shareholders. According to Doyle et al., the reliability of financial reporting can be improved by improving internal control, which can protect the interests of shareholders and investors [13]. Listed companies with high internal audit costs are more likely to hire high-quality external auditors to manage agency problems. This phenomenon implies that when a firm's internal management mechanism is not effective in reducing agency costs, the firm will seek a high-quality external audit [17]. Therefore, improving internal control and establishing internal constraining mechanisms can help the firm reduce agency costs and alleviate agency problems.

Secondly, external controls over the work of managers can also be a helpful tool for preventing agency problems. The principal can use the external audit to assess the veracity and objectivity of the corporate financial reports. Accurate financial reporting guarantees the fairness of the corporate performance results and serves an essential purpose in assessing whether the company's management has manipulated internal audit results for personal gain [7]. In addition, the market price of a company's stock, which is an essential indicator of the company's operations, is also an essential factor in assessing the work outcomes of professional managers. Therefore the assessment of a company's stock price is also a constraint on agents [20].

Furthermore, the law is also an essential external constraint for principal-agent problems. Better investment laws ensure a favorable corporate governance environment, allowing companies to pay out more cash dividends, and these laws may be effective in mitigating PPC between large and small shareholders [38]. Through internal constraints and external constraints, a comprehensive constraint mechanism can be formed against the agent to safeguard the agent's behavior in line with the principal's interests, thus better assisting the principal in regulation. A well-regulated mechanism facilitates a rigorous and comprehensive internal control mechanism, allowing the company's management to be less exposed to external influences in its decision-making, hence serving to moderate PCC.

In summary, establishing effective incentive, evaluation and restraint mechanisms in an organization can help the organization maintain sustained growth, alleviate principal-agent conflicts, reduce agency costs and, in the long term, protect the economic interests of shareholders as well as increase the remuneration income of agents. Therefore, this paper proposes the following three responses to deal with the three agency problems respectively.

## 4. ORGANIZATION’S RESPONSE TO AGENCY PROBLEMS

### *4.1. Principal-Agent Conflicts: Motivate and Restrain Managers*

One approach to addressing the PAC issue is to motivate managers/agents. According to the classic agency theory [15], managers are more likely to be motivated to behave by the philosophy of optimizing the interests of their clients if they feel their interests are compatible with those of their clients. Managerial rewards vary from individual to person, which may include monetary benefits and reputation or status within the company. As suggested by Jensen and Meckling, many businesses consider offering managers high wages and stock options and connecting managers' earnings to company success as the preferred solution [23]. Existing research also backs up the efficacy of incentive-based contracts and revenue tied to efficiency [28]. Executive compensation can influence the course of corporate strategy at various stages of organizational growth. For example, the prospect of companies pursuing early internationalization strategies is negatively related to the CEO's secured cash compensation and positively related to the CEO's equity-based compensation, and this relationship will grow with the CEO's tenure [12]. There are some drawbacks to this measure. While it is possible to transform managers into principals by providing them with equity partially, this does not alter the fundamental nature of the principal-agent relationship. Moreover, managers also risk buying and selling stocks for their benefit through private inside information [33]. In this case, a close examination of executive compensation, timely information disclosure, and shareholder oversight are needed.

Another way to solve PAC is to use internal or external restraint mechanisms to monitor and restrain the actions of managers. The focus of limiting managers' behaviors is to strengthen the corporate governance system. Board, remuneration, shareholders, and auditing are things to consider when deciding on a corporate governance mechanism. Board structure, committee composition, board policies, payment for performance, non-performance-based pay, contact and transparency, shareholder rights, audit procedures, and audit of specific factors. In terms of the Chinese management scenario, research shows that Chinese state-owned enterprises have a unique institutional background: their governance is based on state involvement and market incentives. The Chinese Communist Party's leadership and the public ownership policy have a significant positive impact on governance. Improved corporate governance is also aided by state-owned companies' mixed-ownership reform and independent directors with technical backgrounds. Of course, the governance model of Chinese state-owned companies, such as the compensation system for independent directors, needs to be improved. Besides, external constraint structures, such as credit risk rankings, have also been shown to contribute to the improvement of corporate governance [25], and constraint from external is beneficial in the resolution of PAC.

### *4.2. Principal-Principal Conflict: Make Supervision more effective*

The root of Principal-Principal Conflict, also known as the Type 2 agency issue, is found in the centralized ownership structure: dominant shareholders use their controlling role to pursue their interests at the expense of other small shareholders. Concentrated ownership structure can be divided into the Controlled Structure (CS) and controlling-minority ownership structure (CMS), while CMS can be divided into a pyramid, cross-holding, and dual-clash shares [16]. Tunnelling is a term used by researchers to describe controlling shareholders' embezzlement of other shareholders. On the other hand, tunnelling appears to be widespread in both developed and emerging market countries [14].

The concentration of equity and the reluctance of non-controlling shareholders to challenge the power of majority shareholders may harm corporate governance and the board of directors' efficiency. The mitigation of PPC necessitates improving both internal and external oversight of controlling shareholders. Institutional investors should play a critical role in external oversight. They have a vested interest in overseeing the controlling owners while also compensating for the shortcomings of shareholders and other supervisors [1]. The media, the legal system, and the Securities Regulatory Commission can all help at the same time. Regarding internal governance, the board of directors, supervisors, and managers can all play an active role. Among them, the independent director system is a frequently used measure. The corporation does not employ independent directors in any other capacity. Even though independent directors are members of the board of directors, their priorities are distinct from those of the ordinary board of directors. According to studies conducted in various countries and regions, increasing the number of independent directors will help to mitigate the PPC problem [18].

The unique board structure of Chinese state-owned enterprises and directors appointed by non-controlling shareholders can effectively alleviate the PPC problem. The China Securities Regulatory Commission's strategy of increasing board of director independence also has had a positive effect. Independent directors have a significant impact on reducing state-owned enterprise shareholders' tunnelling activity [21].

### *4.3. Principal-Creditor Conflicts: Utilize Synergy of Internal Regulatory Mechanism and External Control*

In order to avoid a large gap between creditors' income and that of the owner, and to prevent excessive differences in risk preference between owners and creditors, Chinese organizations can reduce agency costs brought by PCC through the decline in the residual loss in terms of both internal and external aspects. From the internal incentive mechanism perspective, providing financial rewards to managers based on the organization's profit or allowing managers to buy stocks are essential ways to solve PAC [20]. When the organization faces PCC, these approaches also have reference significance. The goal of incentives is to allow different entities to achieve the convergence of interests. Shareholders can provide creditors with economic returns or shares linked to organizational performance to incentivize them so that creditors' income is not only derived from a limited amount of interest, and the stocks held by creditors can also allow them to generate ideas to constrain the owner's financing decisions autonomously. From the organization's internal constraint mechanism, centralized ownership is an effective way to prevent agency problems. When the ownership of managers increases, their interests gradually coincide with those of shareholders, so their behavior will add value to owners [5]. The behavior of creditors also follows similar patterns. Concentrating part of the ownership on the creditors is a feasible way to reduce residual loss within the organization.

From an external perspective, as mentioned earlier, one of the measures to prevent agency problems caused by PAC is to control the manager's work through a constraint mechanism effectively. Control from the external party is also crucial when the owner's risk preference is too high and PCC appears. A reasonable response at this time may be a regular assessment of the company's financial status through a well-known domestic audit agency like Shu Lun Pan CPAs. Research by some scholars has demonstrated that accurate financial reports are essential to determine whether an agent works for his interests [7]. From the creditor's perspective, the external audit report may allow creditors to be aware of the owner's risk preference and their strategic choices on time, thereby forming an external force that restricts the owner.

Based on the previous content, this paper proposes Organizational Regulatory Mechanism Model (Figure 5) to help contemporary Chinese companies reduce agency costs. When faced with three different types of agency problems, organizations can respond through regulatory mechanisms. The experience gained from the incentive mechanism, evaluation mechanism and constraint mechanism provides a new way for organizations to solve agency problems and reduce agency costs. Setting up financial rewards related to organizational performance for agents or creditors, allowing them to purchase company stocks, and conducting objective evaluations through RPE can enable the principal to implement more efficient supervision and reduce monitoring costs. Moreover, when agents or creditors obtain ownership of the organization through stocks, they and the principal will gradually form a convergence of interests, thereby forming internal constraints. Combined with the control of external audit institutions, the residual loss of the principal caused by the decision of the agent or creditor will be reduced. The integration of interests will also make the principal trust the agent more, reducing the bonding cost. GGM revealed that contemporary Chinese companies lack flexibility in handling agency problems. Establishing and improving a regulatory mechanism is the most effective way to overcome this dilemma and reduce agency costs.

## 5. FUTURE PROSPECTS

According to the recommendations in this article, contemporary Chinese organizations should play an integrated function of incentive, evaluation, and constraint mechanism, focusing on enhancing the independence of the board of directors and the role of outside directors, strengthening corporate governance skills, and resolving agency problems. Many Chinese companies have indeed referenced these practices in their past practices [25]. At the same time, Chinese companies combine their characteristics, such as obedience to party leadership and mixed ownership changes, to find solutions that suit their characteristics to mitigate PAC, PPC, and PCC.

This paper believes that the following points need to be further studied in the future.

Firstly, previous studies on Chinese companies have primarily concentrated on state-owned firms, while private firms and international firms in China have received less attention. The similarities and features of agency problems in businesses with various ownerships should be investigated further. The unique strategies used by businesses with different ownerships to deal with agency problems are also worth exploring further.

Secondly, many measures aimed at strengthening corporate governance, such as increasing the board of directors' independence, are aimed at publicly traded corporations. China's small and medium-sized businesses, as well as unicorns, receive relatively little recognition.

Moreover, existing research lacks the research that puts the agency problem under the background of different stages of enterprise development. Through different enterprise life cycle theories, such as GGM, it is also necessary to further explore the agency problem.

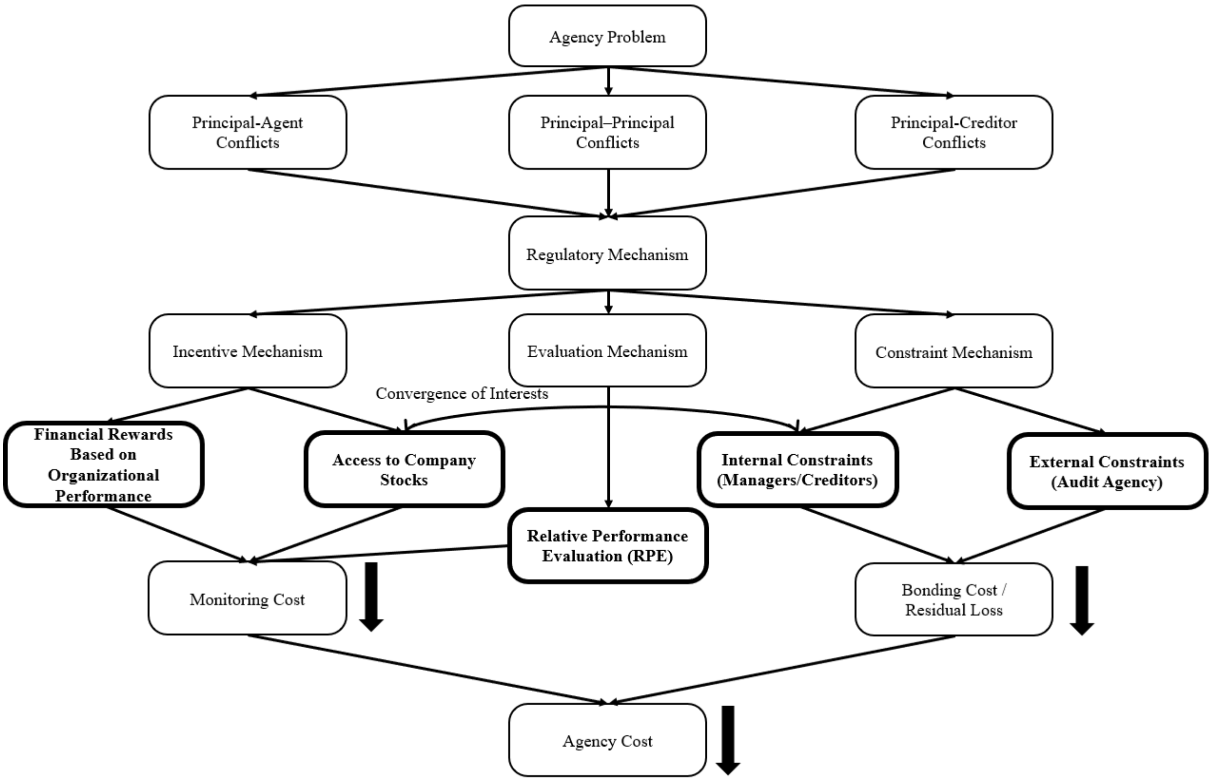


**Figure 5**. Organizational Regulatory Mechanism Model

## 6. CONCLUSION

The agency problem is a dilemma that contemporary Chinese organizations cannot ignore. It no longer exists only in the form of PAC in enterprises, and this kind of problem arising from the conflicting interests of stakeholders will also bring agency costs to the organization. After analyzing the characteristics of different stages of organizational development through GGM, this paper discovers the crucial roles played by the three regulatory mechanisms of incentive mechanism, evaluation mechanism, and restraint mechanism in the life cycle of the organization, and based on these mechanisms, three responses for contemporary Chinese organizations are proposed to deal with different types of agency problems. However, due to the limitations mentioned in the previous section, the theoretical framework of this paper may need further revision.

## AUTHORS' CONTRIBUTIONS

Keyang contributed to the idea of this research;

Keyang made important contributions to the analysis and preparation of the paper;

Keyang, Weixu and Yuanlong conducted literature analysis and wrote the paper;

Weixu and Yuanlong helped with the analysis through constructive discussions.

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