

Agency and Stewardship: A Comprehensive Guide

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Introduction to Agency and Stewardship

The concepts of **Agency** and **Stewardship** represent two foundational, yet fundamentally contrasting, perspectives within organizational theory, corporate governance, and behavioral economics, defining the relationship between those who own resources (the principal) and those who manage them (the agent or steward). Agency theory, rooted deeply in economics, posits that human beings are primarily motivated by self-interest and utility maximization, creating an inherent conflict when one party delegates decision-making authority to another. This delegation establishes the classic principal-agent dynamic, a situation rife with potential for goal misalignment and information asymmetry. Conversely, Stewardship theory offers a socio-psychological lens, suggesting that under specific conditions, managers (stewards) are intrinsically motivated to serve the best interests of the organization and its principals, viewing organizational success as the primary pathway to their own satisfaction and reputation enhancement. Understanding the distinctions between these two frameworks is crucial for designing effective governance structures, incentive systems, and organizational cultures that aim to optimize performance and align disparate interests within complex corporate structures.

The initial challenge addressed by both theories is the problem of delegated authority. When an owner (shareholder or principal) cannot directly manage an asset or operation, they hire a manager (CEO or agent) to act on their behalf. In the context of **Agency Theory**, this separation of ownership and control immediately introduces friction because the agent possesses specialized knowledge--information asymmetry--and may prioritize personal objectives, such as increased leisure, higher salaries, or reduced risk exposure, over the principal's objective of maximizing profit or shareholder value. This divergence necessitates costly mechanisms--known as agency costs--to monitor the agent's behavior, bond the agent to the principal's interests, or absorb the residual loss resulting from imperfect alignment.

Stewardship Theory bypasses this assumption of endemic self-interest, painting a picture of managers as good stewards who view the organization as an extension of themselves. This framework suggests that when managers are treated with trust and empowered by the organizational structure, they exhibit collective, pro-organizational behavior. The steward's utility function is maximized not by extracting personal wealth at the expense of the firm, but by achieving the firm's objectives, thereby securing intrinsic rewards like self-actualization, respect, and successful institutional performance. These two frameworks thus provide a powerful dichotomy: one emphasizing control, contracting, and external incentives to manage opportunistic behavior, and the other prioritizing trust, empowerment, and intrinsic motivation to harness altruistic or collective behavior.

Theoretical Foundations of Agency Theory

Agency Theory, formalized prominently by economists Michael C. Jensen and William H. Meckling in 1976, is grounded in neoclassical economics and the assumption of **Homo Economicus**--the rational, self-interested actor. The theory views the firm as a nexus of contracts, where relationships are structured to minimize transaction costs and manage inevitable conflicts arising from contractual incompleteness. The fundamental premise is that if monitoring systems are not put in place, agents will shirk responsibilities or utilize organizational resources for non-value-maximizing activities. This perspective shifts the focus of governance from defining what managers should do to defining how to ensure managers actually do what is expected, given their inherent motivation to pursue personal gain.

Central to the agency framework is the concept of **Agency Costs**, which represent the financial burdens borne by the principal to mitigate the risks associated with the agency relationship. These costs are categorized into three major components. First, **Monitoring Costs** include expenditures on auditing, creating detailed operating budgets, installing internal control systems, and compensating the Board of Directors for oversight duties. Second, **Bonding Costs** are incurred by the agent to assure the principal that they will adhere to the contract, such as agreeing to restrictive covenants or meeting minimum share ownership requirements. Finally, **Residual Loss** accounts for the unavoidable decline in wealth that occurs because it is economically infeasible to perfectly align the interests of the principal and the agent; some level of sub-optimal decision-making is always tolerated because the cost of perfect monitoring would exceed the benefit derived from it.

A critical element underpinning agency theory is the difference in risk preferences between principals (shareholders) and agents (managers). Shareholders typically hold diversified portfolios and are therefore willing to embrace higher levels of risk in pursuit of higher returns. Managers, however, often have most of their human and financial capital tied up in the firm, making them inherently more risk-averse. This divergence means that managers may reject positive net present value projects that are perceived as too risky, preferring instead stable, lower-return strategies that protect their employment and reputation, directly conflicting with the principal's goal of maximizing firm value. Agency theory thus provides the justification for complex compensation schemes designed specifically to force managers to internalize the risks associated with shareholder value creation.

The Core Conflict: Divergence of Interests

The divergence of interests manifests primarily through two related but distinct problems: **Adverse Selection** and **Moral Hazard**. Adverse selection occurs before the contract is executed, when the principal cannot perfectly discern the true competence, intentions, or integrity of the prospective

agent. The principal risks selecting an agent who is fundamentally unsuited for the role or who possesses hidden agendas that will undermine organizational goals. This information asymmetry makes the selection process imperfect and costly, requiring extensive vetting and signaling mechanisms.

The second, and often more pervasive, conflict is **Moral Hazard**, which arises after the contract is signed. This refers to the agent's tendency to exert less effort or engage in opportunistic behavior when their actions are unobservable or difficult to verify by the principal. Examples of moral hazard include management using company funds for excessive perquisites (e.g., luxury corporate jets, lavish offices), engaging in empire-building activities that increase managerial power but not necessarily shareholder value, or manipulating financial reporting to meet short-term performance targets required for bonuses. These actions directly drain organizational resources and distort strategic decision-making away from long-term value creation.

Furthermore, the conflict extends beyond simple shirking to fundamental strategic choices. Agents often have shorter time horizons than principals. A CEO focused on securing a large bonus tied to annual results may prioritize short-term cost cutting or revenue boosting measures, even if those decisions compromise long-term investments in research and development, capital expenditure, or employee training. This misalignment in time horizons can lead to the systematic destruction of intrinsic firm value over time, necessitating incentive structures, such as long-term restricted stock units or multi-year performance vesting schedules, designed to compel the agent to think like a long-term owner. The inherent difficulty in crafting contracts that perfectly anticipate every possible future contingency ensures that this residual conflict remains a persistent feature of the principal-agent relationship.

Mechanisms for Mitigating Agency Costs

To counteract the potential for opportunistic behavior predicted by Agency Theory, organizations employ a wide array of governance mechanisms aimed at monitoring, incentivizing, and restricting agent activities. The most fundamental monitoring mechanism is the structure and independence of the **Board of Directors**. An effective board, particularly one dominated by independent, outside directors, is presumed to serve as a robust check on management power, ensuring strategic decisions align with shareholder interests. This external oversight is complemented by internal controls, such as rigorous internal audit functions and formalized reporting structures designed to enhance transparency and accountability throughout the hierarchy.

Beyond direct monitoring, the primary tool for mitigating agency costs is the design of effective **Incentive Alignment Systems**. Since agents are assumed to be motivated by financial gain, compensation packages are structured to make the agent's personal wealth contingent upon the principal's success. This involves shifting compensation away from fixed salaries toward

performance-based pay, including stock options, restricted stock grants, and bonuses tied to key performance indicators (KPIs) like earnings per share (EPS) or total shareholder return (TSR). The goal is to transform the manager into a quasi-owner, internalizing the consequences of their decisions. However, poorly designed incentives can backfire, encouraging excessive risk-taking or fraudulent behavior to achieve targets, necessitating careful calibration and clawback provisions.

Finally, external market forces and regulatory environments serve as powerful secondary mechanisms. The **Market for Corporate Control**, where underperforming firms are susceptible to hostile takeovers, acts as a disciplinary threat, motivating managers to maximize value or risk losing their positions. Furthermore, government regulations, such as the requirements for external auditing and financial disclosure mandated by legislation like the Sarbanes-Oxley Act, reduce information asymmetry and impose severe penalties for breaches of fiduciary duty. These bonding and regulatory mechanisms are essential for establishing a baseline level of trust and accountability that reduces the required investment in internal monitoring efforts, although they never fully eliminate the costs associated with managing self-interest.

Introducing Stewardship Theory

Stewardship Theory emerged as a critical counterpoint to the pessimistic view of human nature inherent in Agency Theory. Developed largely by scholars such as Donaldson and Davis in the 1990s, this theory posits that managers are not necessarily opportunistic individuals driven solely by financial self-interest, but rather **Stewards** who are motivated by organizational success, achievement, and respect. This framework draws on psychological and sociological principles, assuming that managers possess a strong need for competence, achievement, and identification with the organization they serve.

The core tenet of Stewardship Theory is that the utility of the steward is maximized when the principal's utility is maximized. Unlike the agent who views the principal's objectives as an external constraint to be managed, the steward integrates the principal's objectives into their own definition of success. This intrinsic motivation means that stewards are inherently trustworthy, prioritizing the organization's long-term health and reputation over short-term personal gain. Consequently, the organization benefits from significantly reduced monitoring costs, as the need for extensive controls and complex incentive contracts diminishes when managers are assumed to be acting in good faith.

Stewardship Theory suggests that the structures and controls recommended by Agency Theory--such as strictly separated CEO and Board Chair roles, or highly fragmented boards--can actually be detrimental. Overly restrictive controls signal distrust, which can demotivate the steward, potentially leading to a self-fulfilling prophecy of opportunistic behavior. Instead, stewardship requires structures that facilitate and empower the manager, fostering a cohesive and trusting

environment. This often includes combining the CEO and Board Chair roles to allow for unity of command and decisive leadership, and fostering a corporate culture built on high levels of organizational commitment and collective responsibility.

Psychological and Sociological Drivers of Stewardship

The behavior of a steward is driven by specific psychological and sociological factors that contrast sharply with the external incentives emphasized by Agency Theory. Psychologically, stewards exhibit high levels of **Organizational Identification** and commitment. They derive their sense of worth and accomplishment from the high performance and reputation of the organization itself. This means that the reward for the steward is often intrinsic--the satisfaction of a job well done, the fulfillment of responsibility, and the social approval gained from colleagues and the community, rather than merely the size of the annual bonus.

Sociologically, stewardship is heavily influenced by the organizational culture and structure. Collectivist cultures, where group cohesion and shared goals are prioritized over individual achievement, are fertile ground for stewardship behavior. In such environments, the manager's reputation and social standing within the firm and the broader industry are tied directly to the firm's success. The fear of social sanction or damage to one's professional standing due to poor organizational performance becomes a more powerful motivator than the fear of a reduced bonus payment. This social contract encourages reciprocal trust and cooperation, transforming the relationship from a contractual obligation into a moral one.

Key structural facilitators of stewardship include **Empowerment** and **Involvement**. When principals provide managers with autonomy, trust their judgment, and involve them deeply in strategic formulation, managers are more likely to internalize the organization's goals and respond with increased dedication and performance. Conversely, highly bureaucratic, controlling structures typical of the agency model can undermine the steward's sense of autonomy and responsibility, crowding out intrinsic motivation and potentially forcing the manager back into the narrow, self-interested calculus predicted by agency theorists. Therefore, the choice of governance structure is not neutral; it actively shapes the type of managerial behavior that emerges.

Comparative Analysis: Assumptions and Outcomes

The fundamental differences between Agency and Stewardship theories stem from their opposing assumptions about human nature, leading to drastically different prescriptions for organizational governance. Agency Theory assumes the manager (agent) is a **Self-serving Individualist** motivated by economic rewards, prone to shirking, and requiring tight control. Stewardship Theory assumes the manager (steward) is a **Pro-organizational Collectivist** motivated by intrinsic achievement and identification, and thrives under conditions of trust and empowerment. This core

divergence informs everything from compensation design to board structure.

In terms of organizational structure, Agency Theory advocates for governance mechanisms that separate power to prevent misuse, such as separating the roles of CEO and Board Chair, implementing rigorous internal monitoring, and relying on external, market-based controls. Stewardship Theory, conversely, argues for structures that consolidate power and facilitate decisive action, often supporting the duality of the CEO/Chair role to ensure unified vision and rapid execution. The agency model seeks efficiency through contractual clarity and minimized opportunism, whereas the stewardship model seeks efficiency through maximized trust, commitment, and reduced monitoring overhead.

The predicted outcomes of these models also differ significantly. An organization governed strictly by Agency principles may achieve contractual compliance and reduced overt fraud, but often at the expense of managerial initiative, creativity, and commitment, leading to high transaction costs. An organization governed by Stewardship principles, assuming the managerial pool is indeed composed of stewards, benefits from high managerial commitment, innovative decision-making, and lower governance costs, potentially leading to superior long-term performance. However, the stewardship model is vulnerable to failure if the initial assumption of managerial integrity proves false, as the lack of controls provides an easy avenue for exploitation.

Practical Applications and Organizational Governance

In contemporary organizational practice, few firms rely exclusively on one theory; instead, most employ a **Hybrid Governance Model** that integrates elements of both Agency and Stewardship perspectives. For highly standardized roles or in situations where information asymmetry is extreme and the potential for financial manipulation is high (e.g., procurement, treasury), tight agency controls, audits, and performance metrics are essential. Conversely, in areas requiring high creativity, long-term strategic vision (e.g., R&D, innovation labs), or where managers have significant specialized knowledge, stewardship approaches emphasizing trust, autonomy, and intrinsic rewards are far more effective at motivating high performance and commitment.

The relevance of Stewardship Theory is particularly pronounced in sectors where financial incentives are secondary drivers, such as non-profit organizations, public sector entities, and family-owned businesses. In these contexts, managers are often motivated by the mission, social impact, or legacy preservation, making the assumptions of intrinsic motivation and collective success highly applicable. For example, a non-profit director is more likely to be driven by the organization's charitable outcomes (stewardship) than by maximizing their personal salary (agency). This validates the theory's assertion that motivation is context-dependent and not universally self-serving.

Ultimately, the ongoing discourse between Agency and Stewardship theories highlights the

complexity of human motivation in organizations. Modern governance is increasingly moving toward a more nuanced, behaviorally informed approach that recognizes that managers are neither purely opportunistic agents nor perfectly altruistic stewards, but rather complex individuals whose behaviors are shaped by the interactions between their personal psychological makeup and the organizational structures and cultures they inhabit. Effective governance thus requires a careful diagnosis of the specific context, risk profile, and motivational drivers present to select the optimal blend of control (agency) and empowerment (stewardship) mechanisms to secure long-term organizational value.

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