

## **Detailed transcript for section 2.2.1 Walk the talk...**

Hello, in this section, we will discuss the usefulness of accountancy professionals in society by investigating the “agency theory triangle”.

So, what is this triangle “thing” all about?

The Agency Theory Triangle clearly shows that no entity functions in isolation.

It also indicate that there are FOUR (4) parties involved in building this triangle.

Who are these parties?

They are:

1.The entity itself;

2.The owners of the entity;

3. Management of the entity;

and 4.Regulation to protect society

What do you think a triangle looks like?

It looks something like this:

Cool, so now we know who the involved parties are, and we also know that a triangle has three sides.

So who goes where on the triangle?

In the centre, we place the entity itself.

The entity can fall into either the private sector, or the public sector of our economy.

What do we mean by the private and public sector?

A private sector entity could do business as an owner managed business, a partnership, a private company or a public company.

One of your commercial law modules (CLA1503 or CLA1501) deals with the advantages, disadvantages, the differences and requirements for these business types.

So, if you have not yet dealt with this – don't worry it will still come.  
And the public sector?

A public sector entity forms part of government's activities aimed at service delivery to the residents of the country.

Interestingly, the public sector is involved in about a third of all economic transactions in South Africa.

So who did we put in the centre again?

The entity itself!

Who do we then place on the bottom left corner of the triangle?

Here, we have the owners of the entity.

In the private sector, the owners are the individuals who invested money in the business.

The owners could be a single individual trading as a sole owner, two to twenty individuals trading as a partnership, or any number of individuals and entities that hold a combined interest in a company.

In the public sector, government is the "goalkeeper" with all the activity aimed at service delivery as well as the effective functioning of the State.

Who do we then place on the bottom right corner of the triangle?

Here, we have the management of the entity.

"Management" refers to the individuals and structures responsible for running the business, by making decisions and overseeing activities.

So what do we have so far?

We have now placed the entity, owners and the management on the triangle.

Who is then missing?

Society...

At the top, sits Regulation to protect society.

What is regulation?

Well, it refers to all the rules and regulation that apply to the entity and those involved with it.

Some of the rules and regulation will have their origins in laws, and others in a corporate governance code.

This is now what the complete agency theory triangle looks like.

But how does this Agency Theory Triangle then work, and how does it relate to accountancy professionals?

Well, it applies when the owners of an entity are not also the management thereof.

When an entity is small, and the owners are involved in the day-to-day running thereof, the owners are fully aware of the performance of it and they themselves take important decisions that affect the entity.

Let's look at an example.

If you have your own small business and is the only employee at it, are you then managing the business yourself?

Yes you are!

Will you make decisions that are damaging to your own business?

No you won't.

Why not?

Because it's your business, you are managing it and it is your own money that you are managing.

However, when an entity becomes bigger, like in large companies, most owners of the entity are not part of the management.

Let's think about it...

I have R1 million cash in my bank account. (Laugh) – NOT! - I wish.  
But let's pretend I do.

I now decide to buy shares in Edgars, at a price of R200 per share.

How many shares did I buy?

I bought 5000 shares.

What do these shares now do for me?

Well, they are hopefully going to make me some money in the form of dividends, or later capital growth, but for now – they make me an “owner”.

Do I work at Edgars?

No I don't.

I work on a fulltime basis at UNISA and therefore I am an owner of the company but not part of the management.

Who then manages Edgars?

The management of the company!

If they, for example badly managed the finances of the company and make bad decisions, I will get less dividends and capital growth in my investment.

Can you see that my success in my investment is dependent on the management?

So what have we now established?

We have established that the agency theory applies when the owners of an entity are not equal to the management.

We have also established that management is then acting as the “agents” for the owners.

But the fact that management acts as the agents brings with certain problems.

What are they?

Think back to my example of the shares I supposedly bought in Edgars.

These shares make me an owner.

Remember I do not work there and therefore I am an owner of the company, but NOT part of the management.

Who will then manage my investment, and make sure I make MONEY?

Well...

The other owners and I will have to appoint managers as our agents to run Edgars on a day-to-day basis.

This means that we have less information than the managers about the decisions that they take as part of the day-to-day business activities.

This is referred to as “information asymmetry”.

Management may also have their own self-interests in mind when they make business decisions.

And remember, I am not there to be part of these decisions.

So management of Edgars may make business decisions that are to their OWN advantage while MY interest in the company is undermined.

So now we can see that there are problems when the owners of an entity are not part of management.

But where does that leave us?

Luckily for us, the clever people have come up with some ideas on how we can mitigate the agency problems by making use of various structures in an entity.

Unfortunately most things in life cost money.

And for use to make use of various entity structures will cost us money.

This cost is referred to as an agency cost.

Examples of agency costs are:

- Board of directors;
  - Annual financial statements;
  - External audits;
  - Management accounting practices;
  - Tax practices;
- and
- Internal audit functions

Let's look at the first agency cost - the board of directors.

Before we can look at what a board of directors refers to let's first look at what is meant by a director.

A director forms part of the board of directors and is a person from a group of managers who leads or supervises a particular area of a company.

Note the word "group of managers" used in the definition of a director.

That is why we refer to the term, board of directors, because a board of directors is a body of elected or appointed "members" who jointly oversee the activities of a company.

I also want you to know that a board of directors consists out of a combination of non-executive directors and executive directors.

What is a non-executive director?

It is a director which is not involved in the running of the business on a full-time basis.

So what is an executive director then?

It's a director which is employed full time by the entity.

So, now we know what is meant by the terms director, board of directors, non-executive directors and executive directors.

How does this knowledge now fit in with the agency theory?

Well, directors are regarded as "Agents" of owners.

For this reason, directors are regarded to be in a “fiduciary” relationship with the owners of an entity.

What is a “fiduciary” relationship?

A fiduciary relationship means that owners trust the directors to act in accordance with the interests of the owners.

Such a fiduciary relationship requires that directors use THEIR competence solely for the benefit of the company’s owners.

Directors should therefore NEVER place their own interests first.

What have we learnt so far?

We have learnt that the owners of an entity can make use of a board of directors to mitigate agency problems.

We have also learnt that appointing a board of directors will lead to an agency cost.

The next agency cost that we have is the ‘annual financial statement’.

What on earth are ‘annual financial statements’?

They are yearly reports prepared by management, that presents information to the owners, about the financial performance of the entity for the PERIOD covered, and its financial POSITION as at a specific date.

So now we know that a board of directors and annual financial statements are 2 examples of agency costs.

Let’s look at another...

External audit!

What is an external audit?

An external audit is an investigation by an independent auditor on an entities annual financial statements, to assure the owners of the entity, that the annual financial statements present all material aspects of the entity’s performance, and financial position, in line with accounting and legal requirements.

Cool, so now we also know that external audit is an agency cost.

Let's look at three more examples of agency costs...

Management accounting practices, tax practices and the internal audit function.

What is a management accounting practice?

A management accounting practice is a method that management uses to measure the entities performance information.

What do you think is an example of a management accounting practice?

A cash budget!

The second last agency cost that we will look at is tax practices...

What are tax practices?

Tax practices are "things" that results in the compliance with the law while the interests of the owners are also taken into account.

An example of a tax practice will be a tax return.

The last agency cost that we will look at is...

The internal audit function.

We know what external audit is.

But what is internal audit?

An internal audit function forms part of the controls of an entity to ensure that the ENTITY meets its objectives as set by the owners.

We have now learnt about 6 agency costs which may mitigate agency problems.

It is also important for you to remember, that most of the requirements that result in Agency Costs, are contained in regulation, such as:

- The Public Service Act;
- The Public Finance Management Act;
- and
- Very important - The Companies Act.

For example...



A company's Memorandum of Incorporation (otherwise referred to as a MOI) is enforced by the companies act.

The MOI sets out the rights, duties and relationships of shareholders, directors and officers of the company.

The MOI should therefore, adhere to requirements in the Companies Act.

Have you ever heard about "The King Report on Governance for South Africa"?

It's also known as the King III?

Well the King III plays a very important role in business, especially for listed companies.

The King III:

- is applicable to all entities in South Africa;
- and
- contains principles of best practices for corporate governance, as well as related recommendations.

But remember...

There is no legal requirement on an entity to comply with the King III.

However, an entity has to explain each non-compliance in its annual financial report.

But believe me...

It's super cool to comply!

Let's quickly recap.

We have determined that the owners of an entity often do not manage the entity themselves.

We also learnt that owners rely on managers and, in the case of a company, directors to manage the entity on their behalf.

Directors and managers are therefore required to act as agents of the owners.

And that as agent, directors and managers may act in their own interests rather than in the interests of the owners.

The result...

The “agency problems”.

Agency Costs are then used to protect owners from the self-serving behaviour of their managers and directors who create “agency problems”.

And that these structures include. • board of directors;

- annual financial statements;
  - external audit;
  - management accounting practices;
  - tax practices;
- and
- internal audit.

So, who are these individuals that implement “agency cost” structures?

And why do owners and society trust these individuals to implement these costs?

Well, this is exactly where your own role as a future accountancy professional will fit in.

As a future accountancy professional you will be implementing the “agency cost” structures!

But why will owners and society trust you as an accountancy professional to play a role in mitigating “agency problems”?

The answer lies in the fact that you will be an accountancy professional.

However, in order for you to be regarded as a professional, you will have to comply with the distinguishing characteristics of a professional.

We have now come to the end of our discussion of this section.

See you in the next section to find out more on the distinguishing characteristics that you will need to become a professional.

But for now – please go to the classroom reflection in section 2.2.2 for instructions on how to complete assignment 2.