AGENCY THEORY RELATED TO TRUSTWORTHY PROFIT SHARING IN SUPPRESSING THE ADVERSE SELECTION PROBLEM

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Abstract: This study aims to determine how agency theory is related to the trustworthy profit sharing in suppressing the adverse selection problem. This research is a qualitative research. The type of research that researchers use is library research. Library research is a form of research carried out by collecting various kinds of references which are the main source for conducting research, references which are the primary sources in this research are articles published in journals, and other written articles. The results of this study explain that when the company divides the ownership structure and also the management of the company, there will be problems in it, the problem that arises is that there is an agency problem. Agency problems are divided into two forms, namely moral hazard and also adverse selection. One way to solve this problem is to apply the concept of a trustworthy profit sharing.

Keywords: Agency theory, adverse selection, profit sharing, trust.
INTRODUCTION

At present, economic development requires very active contributions and roles from company owner and management. Good company management will enhance the company’s image and its development. One thing that can help a company growing is capital. Discussing about budgeting capital is the same as talking about investment activities in order to determine the direction of the company related to the investment form, the company needs a certain mechanism or procedure to track all the investment processes, starting from the analysis and selection of several alternatives, in order to take a decision in making an investment (Ariawan, 2014). However, in the process of making the decision is not always easy to run in accordance with the company’s requirements, and sometimes some problems will arise in the mid of process. One of many problems in which companies often encounter is managers fail to make effective use of all available information to make decisions (Nayang, 2015). The failure has an impact on the continuity of the company. The most obvious result of this failure is a company may suffer multiple losses. In most cases the failure caused by the manager’s behavior. He insisted on his initial decision. Even if he received a great deal of information, his decision would indicate a loss for the company.

The failure of manager to make decisions within the company often results in a great loss to company. To explain this kind of phenomenon, it can be explained by agency theory. This theory explains that in the company’s decision-making, manager plays a very important role. On the other hand, in most cases manager’s decisions
are based on his own interests, not interest of the company. Due to the emergence of manager’s personal interests, this will lead to information asymmetry or unequal between manager and company owner (Sari and Wirakusuma, 2016). In this case, the agency theory explains that the problems between the owner (as principal) and the manager (as agent) are caused by the unequal goals of both parties. The main problem is that, it is difficult for the principal or the owner to know and check all the activities performed by the agent within the scope of his responsibility to manage the company. The inability and ignorance of the principal to see the agent’s overall performance in the company will lead to the emergence of potential fraud by the agent. The fraud in question is the dishonest operation of the company by the agent. Another problem that arises is the different risk sharing due to the different risks faced by the principal and the agent. (Kurniaawansyah, Kurniato, & Rizqi, 2018).

This phenomenon usually leads to what is commonly referred to as adverse selection. Adverse selection is usually interpreted as the company owner’s failure to receive clear information or unclear what the manager is doing, whether it is about decision-making, policy, and the actions he made. On the other hand, the information obtained by managers will also create opportunities for managers to commit negligence in performing their duties. This adverse selection condition allows managers to know more information that is very important to the company. This information can be in the form of the company’s current state as well as the company’s future prospects. The manager’s knowledge about the company even exceeds the information that the owner of the company should have. As matter of facts the information
should reach the hands of the company owner, unfortunately the information is not communicated properly. This is due to the manager’s attitude. He puts personal interests first and sacrifices the company’s interests (Bintang, Susbiyani, and Syahfrudin, 2020)

The problem that is often faced by companies is related to differences in interests this occurs as the effect from the structure of company ownership that does not work as expected results, this happen because the company’s internal equity structure indirectly promotes performance and able to develop the company by itself, especially with this type of company’s equity structure will lead to minimize agency problems. (Sugama, 2018) The phenomena of agency problems have had a very unfavorable impact on the company, and agency issues should be handled properly to reduce the losses faced by the company. One way to manage this agency problem is to provide appropriate part and take the corresponding risk between the two parties i.e. the principal and the agent. The proportional share is appropriate due to the agent’s selfish behavior with respect to the company’s interests (Melinda and others, 2019) The share of dividing portion can also utilize profit sharing methods in its implementation.

From an institutional point of view, the meaning of profit sharing is a form of cooperation agreement or contract when conducting business activities. In carrying out these business activities, two or more parties have reached an agreement or a deal on the profit sharing mechanism on amount of profits obtained (Wahab, 2016). According to the English dictionary the term of profit sharing detailed as profit and loss sharing, which can be interpreted as the act of sharing profits and losses shared by both parties. This kind of profit
and loss sharing is a form of profit sharing between the company manager, that is, the manager and the company owner or those who provide funds for the company’s sustainable development. In the implementation of this profit sharing system, it is very important to determine the proportion of profit sharing that both parties will receive. These two parties are the investor or the provider of funds and company manager. In determining the profit sharing ratio between the two parties, there are several aspects need to pay attention, including the proportion of funds that must be included in the cooperation, and other aspect is the business data and how the business results are done. It is paramount to pay proper attention of these aspects in order to get rid some of disputes between two parties that signing the cooperation agreement (Hutagalung, 2017).

The concept of profit sharing is totally different from the concept of interest in the conventional system. Profit sharing can be described as: First, the investor with capital or funds invests his wealth in the company. Secondly, the manager will use a fund-raising system to manage these funds. After the funds is raised, the manager invests or allocates the funds to important industries or business projects that able to bring benefits to the company, it should noted that all processes must observe Sharia law compliance in every aspect. Third, after the two parties reach an agreement on the contents of contract including the form of cooperation, on the amount of funds that must be issued, and on the profit sharing ratio obtained during the cooperation period, and for how long the company agreement will take effect (Fathimah, 2017). Preferably to company to carry out this profit-sharing system in order to maintain the values of honesty and
transparency, it is because the profit-sharing system is very practical under the existing conditions, and it has proven that the profit sharing is reasonable in the system. If there is a loss, it will be shared all together. Judging from this mechanism, it will eventually lead to justice for both sides, and neither side will feel deceived or oppressed by the other side (Natalia, Dzulkirom and Rahayu, 2014). Based on the description from the above problem, researcher interested in conducting research to understand how agency theory is relates to reliable profit sharing in curbing adverse selection problems. The focus of this research is how reliable profit sharing could be a solution to agency problems.

LITERATURE REVIEW

Agency Theory

Agency theory is a theory that tries to describe the relationship between principal and agent. The principal is the party that provides authorization or power to the agent. The principal indirectly grants or entrusts the agent with responsibility, which can be in the form of decision-making (Anton, 2010). Agency theory is the formal relationship between the principal and the agent, or any party interested in the budgeting process. The focus of this theory is to design a mechanism, and also to measure the achievements and rewards given to manager by principal in order to motivate them to take affirmative actions and provide benefits to the company (Raharjo, 2007).

On the discussion of agency theory, a manager is an agent who is assigned the responsibility of managing the company by the
principal or manager. During the discussion on agency theory, several issues emerged, including: First, the owner of the company in this case is the principal and the manager as an agent; the second is the problem between the manager and the creditor; the third is the problem between the company owner and the manager and the creditor. Agency theory believes that in the operation of a company, if the company’s ownership function and management function are separated, it will lead to agency conflicts within the company. The cause or reason for the conflict between company owner and manager is related to the decision to seek funds to develop the company. The problem that may arise is how to decide how to use the funds that have been obtained. If there is a difference in decision-making between the company’s owner and the manager, then the use of these funds will often cause problems because of the difference in the direction in which the funds are used for investment. This is because usually more complete information is only available to manager, which makes manager always put themselves above the company’s interests (Ardianingsih and Ardiyan, 2010).

The agency theory from the perspective of financial management explains the relationship related to agency, that is, the relationship between the separation of ownership and management of the company. This separation related to company management and ownership occurs because the company owner or capital owner takes action based on portfolio verification to manage the company by entrusting the responsibility and power of decision-making to the manager, especially the funds related to management. In fact, if the company does not perform well or does not achieve prosperity, the
Agency theory can be used not only in companies, but also in the public sector. In the implementation of the public sector, it will affect the country and the people. The country in this situation is reflected in its central government status. Another concern is the relationship and networking between the central and local government. The implementation of agency theory in the public sector can be seen from the role of the central government and the community. In addition, what can be seen is the role of the central government in issuing orders and authorizing local government. On the other hand, local government is accountable to the central government. The accountability system implemented by local
government is inseparable from the goal of the central government, which is the well-being of the people.

The application of agency theory in the public sector can also be seen from its application in budgeting. The budget is prepared by the local government according to the needs of the region. Like a budgetting in infrastructure or other. Additionally, local government has to prepare and to provide the results of budget to the central government for follow-up. After the budget is approved by the central government, the local government will manage it in accordance with the approved budget draft after receiving the funds. In the end, the local government must delegate the responsibility for the budget that has been spent and realized to the central government (Zelmiyanti, 2016).

**Agency Problem**

The agency problem arises because one party is more concerned about their own personal interests (Maharani, 2008). On the other hand, a more selfish tendency could lead to self-interest and affect the behavior. This selfish nature will only guide a person’s actions based on how to achieve personal interests. The theoretical agency problem explains the problems that arise when the principal or in this case the capital owner appoints or authorizes an agent to carry out activities, in companies for instance. The problem arises because the agent does not get a share of the income from his job in managing the company. On the other hand, the problem with the relationship between the principal and the agent is that the information received by the principal is unsatisfactory. additionally, agency problems might appear in various forms, including problems evolving from excessive
use of company funds to provide convenience for managers or agents, and other problems. The other problem that might arise is that the manager retains the company’s profits and other frauds that may cause the company to lose (Arifin, 2007). The term related to principal-agent arises due to the existence of information asymmetry, which is not only related to the activities of the management company, but also related to the information held by the agent.

According to Islam, the form of cooperative relationship must be based on the concept of trust. This is because cooperation is a form of economic mutual interaction between two people who sign a cooperative contract through the bond of God. This indirectly explains that when the two parties, the capital owner and the manager or agent, cooperate, the two parties share the tasks and duty they have and are entrusted to them by God. If the two parties implementing the cooperation agreement are not trustworthy in performing their duties, the agency problem that Islam believes will arise (Sa’diyah and Huda, 2018). There are some cases in history where agency problems have been pointed out. That is, a 1996 report by the Islamic Banking Association pointed out that agency problems were pointed out in both mudharabah and musharakah financing models, and only the the concepts of mudharabah and musharakah are only used for no more than 20% of the total return on investment used by Islamic banks worldwide (Khoiruddin and Noekent, 2011). On the other hand, there are several ways to overcome agency problems, including providing incentives and monitoring the work performed by the agent and for this case is the manager. Monitoring is very essential, because by monitoring the principal, it is easy to obtain information related to all
the activities performed by the agent. Hence, monitoring is paramount because it can detect signs of agent dishonesty and fraud. Another point of view also shows that, in order to reduce the risk of agency problems, the principal in this case should restrict acts directly related to the agent (Lubis, 2016).

**Adverse Selection**

Adverse selection is a form of imbalance and different information held by manager and people within the company compared with company owner or investor. Additionally, this imbalance information may lead to the exploitation of profits related to company information, which may lead to losses for company owner or investor (Ardiansyah, 2014). The discussion of adverse selection is inseparable from the discussion of the agency problem, because the agency problem is caused by the information asymmetry between the principal and the agent. Information asymmetry is a form in which one party between the principal and the agent has information that does not belong to the other party. Adverse selection is a form of information asymmetry. In addition, another form of information asymmetry also includes moral hazards (Chandra, 2015). To further explain, the emergence of adverse selection is due to the failure of the principal and agent to explain in details the different visions and perspectives among them (Manziliati, 2011).

One of many obstacles faced by the company is the constraints brought by information asymmetry by which the principal and the agent cooperate within company, as the result of this problem is adverse selection, this condition is very unfavorable for the company, especially for the capital owner. In its application, the adverse
selection environment will provide managers with a very wide range of opportunities to manipulate, to hide and to disguise all forms of information known to the company’s owner or investor. This condition makes investor uncertain about the company run by the manager. Ultimately, the most serious impact of this behavior is that investors are unwilling to buy stocks or make capital contributions in the form of funds (Yanti, Asnawi, and Simanjuntak, 2018). Another view explains that such adverse selection will lead to market failure. However, from an economic point of view, the existence of adverse selection is considered very important. This is because the existence of adverse selection will lead to the loss of profits that producers and consumers may obtain in exchange or buying and selling transactions. The most obvious example of adverse selection in the field of economics is the sale of goods in different quality levels at one price. This is because the seller has no idea about the quality of the goods they sell to consumers. Discussions about adverse selection are always related to the escalation of commitments. It could be seen that from the agent and at the same time as manager has different interests from the company’s owner, and there is a tendency to ignore the company’s interests, this will indirectly lead to an escalation of the manager’s commitment (Yani, Rohadiah, and Azmi, 2019).

**Profit Sharing**

Profit sharing can be explained as a form of agreement agreed between capital owner and managers based on will and free choice rather than coercive factors (Wahyuningsih, 2011). In the approved profit-sharing agreement, there is a reasonable profit-sharing proportion, which later is called the profit-sharing ratio. In terms of
the percentage of possible actual productivity results, the face value of the received profit share can only be known after the existence of the fund that have been resulted, and the profit share ratio is determined according to the agreement of the parties to the cooperation. The size of the ratio is usually affected by the consideration of the contributions of the parties to the cooperation and the level of risk that may occur. The agreement related to the profit-sharing ratio should consider several aspects, namely: First, share on partnership which is something real and measurable. Second, is expected return and third is expected risk (Yahya and Agunggunanto, 2011).

From the perspective of Islamic banking, the concept of profit sharing will find another term or form of profit sharing, the term coined to the most widely known for profit sharing is al-musharakah and al-mudharabah. Al-Musharakah is a cooperation agreement between two or more parties for a specific business, in which each party provides funds and agrees to share profits and risks according to the agreement. Al-mudharabah in other hand comes from the word dharab, which means walking or beating. Technically speaking, al-mudharabah is business cooperation between two people, in which one party (shohibul maal) provides all the capital and the other party becomes the manager. The operating profit is distributed according to the contract, the loss is borne by the fund owner, as long as it is not caused by the operator’s negligence. If losses are caused by the manager’s fraud or negligence, the manager must be responsible for the loss (Susana and Prasetyanti, 2011).
Trust

Amanah or trust is something that is entrusted to be used correctly according to the wishes of the principal. Amanah in the economic context points out that all resources belong to God, and human beings are those who are entrusted and given the sacred mission assigned to him (Kalbarini and Suprayogi, 2014). Amanah is every religious obligation or burden upon mankind in relation to worldly life and after life affairs. In the linguistic sense, amanah derives from Arabic, which means safe, honest or trustworthy. And according to the Great Indonesian Dictionary, trust is something that is handed over to others; it is loyal and trustworthy. Amanah is a trust given to someone to be fulfilled to whom people due. A trustworthy person is someone who can perform assigned tasks. Trust plays an important role in personal relationship. Trustworthy attitudes and behaviors can form positive relationships between individual and group. Trust is the foundation of social and national life. Amanah is a social bond that builds solidarity in the community and aims to form cooperation between individuals. Without trust, the life of society and the country will be harmed. For instance, many criminal acts or conflicts are caused by untrustworthy performance of duties and behaviors (Agung and Husni, 2016).

RESEARCH METHOD

This research is qualitative research and the researcher based his study on the library research (Riyansyah, 2017). Library research is a kind of research conducted by collecting various reference materials. These reference materials are the main sources of research.
The main sources of this research are articles published in journals and other written articles.

RESULT AND DISCUSSION

A. Trustworthy Profit Sharing as a Solution to the Agency Problem

Company as a profit-oriented organization will always strive for profit as much as possible. The main purpose of a company is to increase the value of the company and increase the prosperity of the owners or shareholders. Manager pays attention to the interests of the owner when operating the company. On the other hand, company manager is also interested in maximizing his own welfare. The combination of the interests of these parties often creates agency problems. According to agency theory, companies that separate management functions from ownership functions will be vulnerable to agency conflicts. The reasons for conflicts between managers and shareholders include decisions related to the following: first, financing decision, and second, decision making related to how investing the funds obtained. The company’s equity structure includes (1) management equity and (2) institutional equity. In some cases, the problem that will arise is information asymmetry, this problem caused by information that is not owned by either party between the two parties that carry out cooperative activities. Information asymmetry can be divided into two forms: adverse selection and moral hazard.

In fact, the main problem that might arise in one company, seen from the agency theory approach is that the principal or capital owner does not have adequate information related to the company’s
management activities carried out by the manager, as result it will cause suspicion of the manager. On the other hand, the problem also lies with the agent. In this case, the manager is the person who has the right and authority to make decisions to manage fund of company. This is a problem occur because manager tends to care more about himself than the company’s interests. In addition, this problem arises because manager is not properly motivated based on his work for the company. This is what triggers the fraud by the agent and for this case is the manager in charge.

Phenomena or problems related to agency problems can be seen practically in the banking industry, especially those related to cooperation contracts or profit-sharing oriented. Profit-sharing contract banking is often referred to as mudharabah, unfortunately its implementation is not ideal because Indonesian Islamic banks are not yet ready to finance in the form of mudharabah plan. This is due to the lack of competent human resources, especially in mastering the Islamic economy and the Islamic Economic Law and jurisprudence. The lack of competent human resources in the Islamic banking industry is also behind the reason why nearly 60% of the human resources in the Islamic banking industry came from conventional banking. This is based on the data prepared by the Islamic Banking Council of the Central Bank of Indonesia (BI). About 90% of the workers in the Syaria’ah banking industry have no economic education background in the Shariah law, this issue has also become more complicated and will increase the information gap if an agreement or cooperation is reached between Islamic banks and customers. In fact, as a result many Islamic banks in Indonesia are
unwilling to deal with or pay attention to the cooperation agreement. This is reflected in the situation in the field, indicating that the cooperation agreement, especially mudharabah has not yet made any major contribution to the development of the Indonesian Islamic Bank’s assets (Risal, 2019).

The other problem experienced by the banking industry is the existence of information asymmetry, where information asymmetry is caused by the difference in information obtained by Islamic banks as capital owners and customers as managers. This phenomenon occurs because customers who are managers are actually more aware of the sustainability of the business they are currently operating. This is the reason for the problem between two parties, for that reason lead to major deviations (Sriwahyuni, Haryono, and Wahyuni, 74-86) In the practice of profit sharing of Islamic banks or mudharabah practice there are several systemic risks have emerged due to agency problems, including: First, the client as a manager did not use the funds provided in accordance with the agreed regulations stated in the contract. Second, the negligence and human error caused by the customer deliberately; Third, the profits obtained are deliberately concealed by customers, and many cases customers show dishonesty and fraud in the information about the profits obtained.

To overcome this problem, several solutions can be provided, for the principal, in this case is the capital owner should establish a strict rules to limit the activities of manager who attempt to commit fraud and may cause losses to the company. Another solution is to cooperate in details, especially the proportional distribution of profits between capital owner and agent as manager. In addition, the
principal, who is the capital owner in this case, must use risk management as a solution to the problems caused by agency problems. For that reason, the implementation of risk management started by screening agent or customer cautiously, and by reviewing and in-depth observation of the concept or project funded by the principal. This kind of risk management is also related to the skills of the agent or manager and their understanding of market conditions, knowledge of business risks and, most importantly, the knowledge related to conducting sustainable business. Other concern pertaining to risk management, in this case is reputation and trustworthiness of the agent should be known properly by ensuring his individual record, or in the form of educational background records passed by the agent.

In order to reduce the loss caused by this agency problem and provide a solution that is beneficial to both parties, the principal could do wa’ad, that is, the agent is willing to provide the lowest profit sharing from every profit obtained, this is in order to minimize the fraud of agent (Rafidah, 2017). The application of this profit sharing must also be supported by trustworthiness of both parties based on the agreement. In this case, the concept of trust is very important, because the virtue of trust will give born and cause to act honestly, openness, and trustworthy at all times. The virtue of trust will make a person always remember God as Provider and Bestower of sustenance for all His servants. By remembering God all the time, a person will be protected from bad behavior, in this case by deceiving the company and both parties. The virtue of this trust will always keep a person away from bad behaviors that may undermine moral and relegate the degree of humanity in the civil society and even before God Almighty.
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The solution provided by the researcher could be seen from the chart below:

CONCLUSION

At present, the company’s development is inseparable from various problems. The problems that encountered by many enterprises, especially those companies with separation of management rights and ownership, usually have differences between the owner and the manager who is responsible for management. The problem arises due to the lack of information obtained by one of the
parties, which leads to the possibility of fraud by the agent. Another problem is the owner’s ignorance of what the agent is doing. This problem is often referred to as adverse selection. In order to overcome these problems, they should have a setting of clear profit sharing ratio between the two parties, the owner can make binding rules for the agent when the agent’s activities may threaten or even damage the company survival.

REFERENCES


