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Agency Relationships and Governance Mechanisms in Service Delivery: A Theoretical Analysis[1]

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Abstract

The general topic of service quality has been widely studied in literature on marketing. Considered as a whole, researchers have focused on issues concerning the structure of service quality (e.g., SERVQUAL dimensions) and underlying psychological processes (e.g., role conflict, job stress) that impact delivery. While extant studies have added to our understanding of service quality, one notable gap in the literature concerns the lack of attention to *agency relationships* and *governance mechanisms* that affect delivery. For example, unless appropriate governance mechanisms or safeguards are in place, agents may *under-provide* or *over-provide* services, thereby adversely affecting quality. Given the widespread prevalence of agency relationships, the objective of this paper is to provide a focused discussion of agency problems and to specify how firms can deploy appropriate governance mechanisms to aid in the delivery of service quality.

I. Introduction

The general area of service quality has received considerable attention in the marketing discipline. Up until the early and mid-1990's, the central focus of these studies was two-fold. First, researchers generated an impressive body of literature on the *structure* of the service quality construct by studying scale development, measurement, dimensionality, validity, and generalizability issues among others (Babukus and Boller, 1992; Babakus and Mangold, 1992). Second, a number of studies explored how individual level *psychological constructs* such as role conflict, role ambiguity, role stress, job burnout, and empowerment (Boulding et al., 1993; Cronin and Taylor, 1992) affected delivery. In recent years, the emphasis of the field has shifted somewhat with researchers focusing on behavioral and financial consequences of service quality.

While extant research has furthered our understanding of service delivery in a number of ways, one important gap in the literature remains unaddressed. Specifically, relatively less attention has been directed at understanding agency relationships that may serve as failure points by impacting quality negatively. An agency relationship is established whenever a principal hires an agent to do some work on the principal's behalf (Fama, 1980; Jensen and Meckling, 1983). The central problem in an agency relationship stems from information asymmetry or a situation where one party to the exchange such as the agent has more information than the principal (Bergen, Dutta, and Walker, 1992). In these situations, monitoring the agent becomes difficult and expensive and the agent may dilute quality.

Agency problems manifest themselves on a regular basis in service settings. For example, Mills (1990) observes that principals (i.e., patients and management) "are often unable to determine whether the tests and treatments of physicians are appropriate" (p. 35) which, in turn, affects service quality. A similar point is illustrated by a story involving Sears, a leading retailer in North America which provided unnecessary service to its customers (*Wall Street Journal*; October 2, 1992). Since auto-repair service is an experience good (Biehal, 1983; Nelson, 1974), customers (principals) who authorized all estimates prepared by Sears' mechanics (agents) did not know whether estimates were inflated or not. According to agency theory, Sears' agents (mechanics) engaged in *moral hazard* (i.e., opportunistic behavior) in order to earn high commissions because

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principals (Sears' management and final customers) could not effectively monitor agents (mechanics). Consequently, service quality at Sears was adversely affected by an inefficient monitoring system based on output control (i.e., commissions). Sears subsequently shifted from "the incentive compensation system that paid employees solely on the basis of amount of repairs customers authorized" to "a program based on quality instead of quantity" (*Wall Street Journal*; June 23, 1992, p. B1).

Mechanisms such as compensation systems are governance modes that can ameliorate agency problems. The general resolution of the agency problem involves the deployment of both ex-ante and ex-post governance mechanisms (Bergen, Dutta, and Walker, 1992). Ex-ante governance mechanisms such as screening, training, etc. of service providers address the adverse selection problem while ex-post strategies such as appropriate compensation schemes can ameliorate the moral hazard problem in service delivery.

While the agency relationship between managers and service providers is readily apparent, there is another level of agency relationship involving the final customer as the principal and the company's brand (and managers) as the agent. Since services are characterized by *information asymmetry* or a situation where "buyers (unlike sellers) are not fully informed about product quality" (Rao and Bergen 1992, p. 413), management has an incentive to signal a firm's reputation (Bloom and Reve, 1990; Fombrun and Shanley, 1990) to the final buyer by using quality cues (e.g., *price, warranties, certification, investment in firm specific assets, price premiums*; Bloom and Reve, 1990; Klein and Leffler, 1981; Shapiro, 1983). By reducing information asymmetry (through signals of quality), service companies attempt to manage agency relationships with the final buyer.

If customers use signals such as brand names to choose a service company, there is no guarantee that promised service will actually be delivered unless managers govern their agency relationship with service providers. For example, service quality can be compromised if an individual agent decides to behave opportunistically and dilute quality. To sum it up, delivery of desired quality levels in the marketplace is contingent upon the deployment and use of governance mechanisms that can manage multiple agency relationships involving: 1) companies and service providers, and 2) companies and customers.

Despite the need to study agency problems little conceptual effort has been directed at researching agency relationships and governance mechanisms in service delivery. For a long time, researchers have called for studying internal processes concerning service delivery, but have lagged behind in developing appropriate conceptual approaches for studying such problems. Given this well articulated need for more studies relating to internal processes, why has the field been slow to answer such calls? One reason may be the lack of attention to appropriate theory for guiding research in this area.

In the light of the preceding discussion, the objective of this paper is to provide a detailed theoretical analysis of multiple agency relationships and governance mechanisms in service delivery. It is hoped that this study will close a major "gap" in our understanding by moving away from the extant "black box" attitude that neglects agency problems in service delivery.

This paper is organized as follows. First, I describe the nature of services and discuss how agency relationships manifest themselves at *two* levels (i.e., company-final customer, and company-service provider) in a company. This is followed by the delineation and description of a set of governance mechanisms that can ameliorate such agency problems. Finally, I comment upon the implications of this study for service marketers and describe the scope for further research.

II. The Nature of Services and Levels of Agency Relationships

Information asymmetry

There is near unanimous agreement among scholars in *marketing* (Lovelock, 1983; Zeithaml, 1981), *organization theory* (Bowen and Jones, 1986) and *operations/strategic management* (Nayyar, 1990, 1992, 1993), that *intangibility* is *the* critical goods-services distinction from which all other differences emerge" (Zeithaml, Parasuraman, and Berry, 1985; p. 33). Intangibility

refers to a situation where services "cannot be seen, felt, tasted, or touched in the same manner as goods" (Zeithaml, Parasuraman, and Berry, 1985, p. 33). Since services are performances which cannot be easily evaluated, one party to the transaction (the service provider) usually possesses more information than others (management and final customer). Owing to information asymmetry, customers cannot *a-priori* evaluate a company's service, while management lacks objective criteria to evaluate service providers. These evaluation problems are a direct consequence of intangibility or information asymmetry between service providers, agents, and other entities such as managers and customers (Bowen and Jones, 1986). Note that in the context of a performance evaluation problem, information asymmetry is also termed performance ambiguity. For the purpose of this paper we will use the terms information asymmetry and performance ambiguity interchangeably.

Jones (1990) notes that information asymmetry or performance ambiguity "is particularly prevalent when the goods or services being purchased are intrinsically complex, and their quality can only be *evaluated after* purchase" (p. 24). The presence of performance ambiguity in the "client-firm interface" (Mills and Turk 1986) leads to agency (principal-agent) problems because "one party (the principal) engages another party (the agent) to undertake actions on his behalf in situations of information asymmetry" (Clark and McGuiness, 1987; p. 8).

Information asymmetry gives rise to *two* principal-agent levels in a service encounter, i.e., between the company and the final customer, and between the company and service providers. Information asymmetry presents difficulties for customers to evaluate a service even after consumption (Siehl, Bowen and Pearson, 1992), thereby providing management with an incentive to reduce information asymmetry for gaining competitive advantage (Nayyar, 1990). Furthermore, information asymmetry also makes it difficult (i.e., costly) for management to monitor and control service providers (Anderson and Oliver, 1987; Eisenhardt, 1985). Specifically, management may have "limited direct control" over the "quality of service that is delivered", because "when employees are delivering intangible services", "they are essentially acting alone (Bowen and Schneider, 1988; p. 65).

To sum it up, by incorporating the concept of information asymmetry, researchers can explicitly focus on two levels of agency problems that are found in service companies.

II (a). Agency Relationship between Company and Final Customers and Related Governance Mechanisms

As Bergen, Dutta, and Walker (1992) note, the "ultimate customer (principal) can be viewed as engaged in an agency relationship" with the company (agent) because services are performances (Holmstrom, 1985) which cannot be easily evaluated. Typically, sellers have more information than buyers (information asymmetry) about the true quality of the service. This information asymmetry can lead to "moral hazard", because the company may exert less than complete effort in providing the service, or it may overprovide the service. Though customers (principals) attempt to reduce this information asymmetry by relying on "word-of-mouth" communications (Biehal, 1983; Murray, 1991) or by "purchasing" cheap information on the agent (company) from institutions (e.g., surrogate customers: Solomon, 1986; consumer reports: Hill and Jones, 1992), management has an incentive to reduce information asymmetry for the final buyer by using signals.

There are three main reasons for firms to signal quality and reduce customers' adverse selection risks. *First*, service customers "seek risk-reducing" information because of the "intangible, ephemeral, and experiential nature of services" (Murray, 1991, p. 20) in order to make better choices (Stigler, 1961). In fact, as Fombrun and Shanley (1990) observe, "the more informational asymmetry and ambiguity characterize the interactions between management and stakeholders (customers), the more likely the latter are to search for information" (p. 235). Consequently, "service firms can develop competitive advantage by exploiting the potential buyer's incentives to lower information acquisition costs when buying services" (Nayyar, 1990; p. 513). Companies attempt to reduce information asymmetry by providing customers with surrogate barometers of quality (Akerlof, 1970). These surrogates may be considered as *signals* and defined as "marketer-controlled easy-to-acquire informational cues, extrinsic to the products themselves, that consumers use to form inferences about the quality or value of those products" (Bloom and Reve, 1990; p.

59). More technically, using an agency theory perspective, Cooper (1992) comments upon the function of signals as follows:

> *In many markets, one agent has private information that could help others in making their decisions. The uninformed agents would usually adjust their actions to suit their environment better if they could learn the private information before making choices. Because of this potential to change actions, sharing the private information could benefit the more informed agents or society as a whole. One method of disclosing private information is signaling (p. 431; emphases added).*

Second, by reducing information asymmetry, service companies prevent market failure and contribute to social good. For instance, some service companies may exploit information asymmetry to their advantage (by engaging in moral hazard) and supply low quality services. These firms may earn supernormal profits (because of low production costs), which provide no incentive to honest firms for staying in business. In the extreme case, "it is quite possible to have the bad driving out the not-so-bad driving out the medium driving out the not-so-good driving out the good in such a sequence of events that no market exits at all" (Akerlof, 1970; p. 490). This has been termed the "lemons" problem Akerlof (1970).

Finally, service firms which earn a good reputation by reducing performance ambiguity can successfully diversify into related services (Nayyar, 1990) by legitimately transferring their reputation to new services. According to Nayyar (1990), "a firm that diversifies into services that its existing customers may buy could create a competitive advantage, since it could potentially exploit the favorable attention in the information asymmetry distribution faced by potential buyers when they consider buying the new service offered by the firm" (p. 516).

Governance mechanisms

The general strategy to solve customer's agency problems is called signaling. Signaling strategies which firms may use to reduce information asymmetry for the final buyer are of two types, i.e., *direct* and *indirect* (Nayyar, 1990). Direct quality signals assure the buyer of a minimal level of performance by reducing information asymmetry. The most widely mentioned signals are guarantees and certification. Guarantees shift the risk of purchase from the buyer to the seller and ensure some level of quality (Akerlof, 1970). According to Hill and Jones (1992), some services are inherently difficult for buyers to evaluate prior to purchase. The existence of information asymmetry presents customers "with a difficult agency problem" because "the consumer is vulnerable to opportunistic action on the part of management and the agency problem is solved by the *ex-ante* introduction of a warranty into the contracting scheme" (p. 139). The use of warranty as an information asymmetry reduction mechanism has also been suggested by Allen (1984), Grossman (1981), and Wiener (1985).

Though some authors (Bergen, Dutta, and Walker, 1992) suggest that the efficacy of guarantees is limited because of customers' proclivities to behave opportunistically (e.g., by falsifying a claim), service marketers (Hart, Schleisinger, and Maher, 1992) have stressed the power of unconditional service guarantees. More importantly, service guarantees offered to final buyers also act as a vehicle for communicating quality levels to employees. Furthermore, the presence of an unconditional guarantee like "customer satisfaction" provides management with objective criteria for monitoring boundary spanners (frequency with which guarantees are invoked), whose behavior is typically difficult to observe.

Service guarantees serve to reduce the "gap" (Zeithaml, Parasuraman, and Berry, 1988) between management and boundary spanners about quality perceptions. In other words, by offering guarantees, management attempts to solve not only the agency problem with final customers but also the agency problem with service providers. Service guarantees therefore differ from product guarantees which are directed solely at the final buyer and are attempts to solve only one level of agency problems (between management and the final buyer). In this vein, Nayyar's (1990) observation that "warranties covering services are impossible to administer since failure to perform a social interaction is generally indeterminable" (p. 514), ignores the potential of service guarantees to solve the agency problem between management and service providers.

Certification, which indicates the "attainment of levels of proficiency", also reduces quality uncertainty (Akerlof, 1970; p. 500). According to Akerlof (1970), "the high school diploma, the baccalaureate degree, the Ph.D., and even the Nobel Prize, to some extent, serve this function of certification" (p. 500). By prominently stressing the qualifications of their professors, universities seem to reduce performance ambiguity for freshmen.

Indirect quality signals serve to reduce information asymmetry for the final buyer by stressing a firm's reputation. Klein and Leffler (1981) suggest two such signals, i.e., *price premiums* and *firm-specific capital investments.* Firms can signal high quality by charging prices above the market price (i.e., charging a price premium). However, if these firms cheat on quality, a potential stream of future profits would be lost. According to Klein and Leffler (1981), "this price premium stream can be thought of as protection money paid by consumers to induce contract performance" (p. 624). Thus, when firms do not deliver the promised level of quality, customers may withdraw this deposit, causing the firm to go out of business. Price premiums indirectly reduce information asymmetry for buyers by promising quality. A firm charging price premiums have every incentive to maintain the quality of its services and reap future profits which are held hostage in view of possible quality dilution.

Firm specific capital investments yield only "small direct consumer services… relative to cost" (Klein and Leffler, 1981; p. 627). For instance, expensive advertising for services characterized by high levels of information asymmetry does not necessarily reveal relevant information (1974). As an illustration, hospitals' advertisements do not detail the surgical procedure for patients with heart problems. On the other hand, the purpose of expensive and "non-informative" advertising (Nelson, 1974) is to signal a company's reputation to the final buyer and to reduce information asymmetry.

Firms making company specific investments trade off "increased consumer service value with decreased salvage value" (Klein and Leffler, 1981; p. 627). According to these authors, "the expenditures on brand name capital assets are similar to collateral that a firm loses if it supplies output of less than anticipated quality (p. 627). Examples of firm specific capital investments are *logos and expensive signs, ornate settings like expensive carpets and upholstery which yield no direct service, human entrepreneurial skills and idiosyncratic knowledge, expensive advertising, and celebrity advertising* (Klein and Leffler, 1981; Rubin, 1990).

Interestingly, it has been recognized that the use of ornate settings or "elaborate servicescapes" (Bitner, 1992) is an attempt to make the service ambience physiologically pleasant for the customer (Bitner, 1992). However, agency theory suggests that ornate settings in hospitals are signals of reputation which management uses to solve the agency problems with patients. In other words, patients realize that hospitals have sunk a lot of money into these expensive investments (e.g., ornate settings). Consequently, firms cannot possible cheat on quality.

In a study on the relationship between reputation effects and price premiums, Rao and Bergen (1992) found out that reputable sellers could not command price premiums. One possible explanation for this finding is that these sellers did not make commensurate investments in firm specific assets. As Klein and Leffler (1981) note, firms may command price premiums only when commensurate investments have been made in firm specific assets. In other words, buyers may not pay high prices to "seemingly" reputable agents who do not make collateral investments, fearing a "rip-off" (Dejong, Forsythe, and Lundholm, 1985).

Though a number of signaling strategies have been suggested in the literature (e.g., warranties, certification, investments), existing theory does not comment upon the relative importance of these signals for solving agency problems. Echoing this point, Rao and Bergen (1992) note that "future research will be required to suggest which of these many devices is most appropriate for a given situation" (p. 421). There is some discussion in literature on strategic management (Nayyar, 1990) that firms may focus more on indirect signals of quality (e.g., reputations) than on warranties and certification. As Nayyar (1990) notes, "certification, too, is so widely prevalent as to make it of no consequence in consumer choice behavior" (p. 514). Perhaps companies realize that reputation is an idiosyncratic asset (Rashid, 1988) which cannot be easily duplicated by competitors.

II (b). Agency relationship Between Company and Service Providers and Related Governance Mechanisms

Service is finally delivered to customers by boundary spanning employees (Aldrich and Herker, 1977). When performance ambiguity is high, management (principal) cannot completely and costlessly monitor the actions of service providers (agents). Due to incomplete monitoring, service providers may engage in moral hazard (opportunistic behavior) and oversupply or undersupply the service, thereby adversely affecting service quality. Moral hazard is a typical problem when services are high in credence properties (e.g., medical care and education; Darby and Karni, 1973). For instance, Swedlow et al. (1992) note that "MRI (Magnetic Resonance Imaging) scans (were) medically inappropriate 38% more often when ordered by self-referring physicians, suggesting increased rates of use in this group" (p. 1506). In a similar vein, Gomez-Mezia and Balkan (1992) observe that "in a university setting, principals face a classical agency problem with respect to faculty" and that "information asymmetries between faculty and administrators (principals) create steep agency costs for the latter if they attempt to directly monitor faculty behavior" (p. 923). Furthermore, most professors in universities have a lot of freedom in designing courses and conducting research. There is a possibility that a professor may engage in moral hazard by putting in less effort into teaching and research than into consulting. University administrators face therefore the classic agency problem of preventing "faculty members (agents) from taking advantage of their privileged and nonprogrammable position" (Gomez-Mezia and Balkan, 1992; p. 924).

Governance mechanisms

Management solves the agency problem with boundary spanning employees by using various types of control mechanisms (i.e., output and behavior controls: Eisenhardt, 1985; Ouchi, 1980). One approach to managing such information asymmetry entails the resolution of *adverse selection* or *hidden action* problems (Bergen, Dutta, and Walker, 1992).

According to the adverse selection model, managerial strategies depend on the extent to which agent's actions can be costlessly observed. In general, when management can observe the behavior of boundary spanners easily, behavior control strategies (e.g., hourly pay systems) are suggested. This method of control is suitable for services characterized by low information asymmetry (e.g., grocery stores, where a sales clerk's actions are routinized). On the other hand, agency theory recommends the use of output control (e.g., commissions) when employee behavior cannot be costlessly observed. However, for highly intangible services (e.g., medical care and education), a commission system may be inappropriate because it places little emphasis on customer satisfaction (Anderson and Oliver, 1987). Accordingly, management uses complex compensation systems for aligning the interests of service providers with those of the company. For instance, Gomez-Mezia and Balkan (1992) note that university administrators often tie a professor's compensation to the number of quality journal articles he or she publishes. Likewise, hospitals may link the bonuses of physicians to "patient satisfaction" scores (Dranove and White, 1987).

It should be noted that applications of agency theory in marketing have concentrated rather narrowly on "salesperson's compensation" issues (John and Weitz, 1989; Lal and Staelin, 1986; Oliver and Weitz, 1991). Practically no attention has been directed at *ex-ante* strategies which management can use (e.g., rigorous screening of employees) to prevent *ex-post* contractual problems (e.g., shirking by service providers). In agency theory parlance, *hidden information or adverse selection* strategies (e.g., screening, socialization, and training: Bergen, Dutta, and Walker, 1992) have not been researched. For intangible services, management often uses rigorous screening procedures to ensure that service providers' subsequent performances are congruent with company objectives. For example, university professors at the entry level are selected through a rigorous process which involves several rounds of screening (preliminary screening, initial interview, campus visits and presentations and careful consideration of reference letters). By following this extended search procedure, universities try to discover as much "hidden information" as they can on a candidate prior to his or her selection. Another example of how service companies rigorously select and train service providers is provided by an illustration in the Wall Street Journal (January 25, 1993):

> *Kaiser Permanente, a health maintenance organization… is often cited as a model health plan for managed competition. It recruits doctors through an evaluation process that includes a rigorous review of training and credentials and hires them as probationary employees for three years. At the end of that period, doctors are voted in as full-fledged members by their peers, based on advanced training, perceptions of competence as such factors as rapport with patients and staff (p. A12).*

Note that although Gomez-Mezia and Balkan (1992) correctly view the relationship between administrators and professors as an agency problem, they focus only on "compensation". In other words, though "hidden action" or moral hazard problems have been addressed in the literature, "hidden information" issues have received less attention. In the context of services, it is imperative to research both "hidden action" and "hidden information" models.

The findings from agency studies on salesforce compensation plans (Oliver and Weitz, 1991) are relevant to service organizations. However, some clarifications are in order. In the salesforce literature, the exogenous concept of environmental uncertainty determines subsequent compensation plans (e.g., salary or commissions) for boundary spanners. Environmental uncertainty is often operationalized as uncertainty in the relationship between effort expended and sales (results) (Oliver and Weitz, 1991). John and Weitz (1989) measure uncertainty of "product sales" as an indicator of environmental uncertainty. The focus on "sales" inevitably excludes any consideration of services as salespeople may overprovide services in order to earn high commissions, thereby affecting customer satisfaction and service quality. The Sears situation discussed earlier vividly illustrates the adverse effect of "commission" systems on service quality. According to agency theory, the use of output control systems for salespeople is less effective when environmental uncertainty is high, because agents are assumed to be "risk averse". Being risk averse, agents facing a highly uncertain environment will not opt for a commission system. In other words, they are better off with some assured compensation (e.g., salary). In sum, agency theory predicts that when environmental uncertainty is high, salary based systems are effective because of the "risk averse" nature of agents. On the other hand, when environmental uncertainty is low, salary is also the dominant compensation mode because an agent's behavior can easily be observed (by management).

The findings from compensation schemes for salespeople is directly applicable to service settings although it is important to recognize that "risk aversion" plays no part in determining compensation of service providers. For instance, when information asymmetry is low, management can easily observe an agent's behavior and a 'salary' system is recommended. When information asymmetry is high, output based systems are inadequate because agents may engage in 'moral hazard' and overprovide or underprovide services to final customers. Hence, when information asymmetry is high, service providers may be compensated with 'salary' not because they are 'risk averse', but because they may provide poor service to the final customer. Furthermore, when information asymmetry is high, a complex compensation system for agents which incorporates notions of service quality and customer satisfaction may also be used. In any case, output control systems are clearly inappropriate in a service setting because they can compromise service quality – a point recognized by Anderson and Oliver (1987).

In sum, managerial strategies for solving the agency problem with service providers should include elements from both the "hidden action or moral hazard" and the "hidden information or adverse selection" models. Perhaps less attention has been paid to "hidden information" strategies because they have traditionally been considered outside the domain of "agency" theory (Eisenhardt, 1985). As such, the incorporation of "hidden information" models into agency theory in recent studies (Bergen, Dutta, and Walker, 1992) is a welcome trend.

Interdependencies between agency relationships

Although agency relationships in a service organization exist at two levels, they are interdependent. Management solves the agency relationship with final customers by using signals of reputation. Reputation is defined as "a set of attributes ascribed to a firm, inferred from the firm's past actions" (Weigelt and Camerer, 1988; p. 443). Service firms assure customers of quality by stressing reputations. Klein and Leffler (1981) argue that investments in firm specific assets are

essentially reputation building activities which serve to assure buyers about quality. In other words, by compromising on quality, these firms risk the appropriation of future quasi-rents (Klein, Crawford, and Alchain, 1978). Rashid (1988) articulates this point well by noting that "when significant amounts of money are invested, the businessman tells that he plans to stay for some time to come… in the long run the only way to stay is by pleasing customers… this requires providing them with the goods they really want… *this long-term dependence of producers on customers is perhaps the most effective guarantee of quality*" (p. 248; emphasis added).

According to Camerer and Vepsalainen (1988), managers have an incentive to maintain the reputation of their firms. The owner-manager has an incentive to maintain his firm's reputation so as to increase its salvage value. On the other hand, in the case of firms where ownership and control are separated, "managers are continuously 'selling' the firm to new owners through capital markets… managers who erode the firm's reputation are depreciating an intangible asset and are vulnerable to market discipline like takeover attempts" (p. 118).

Maintaining a firm's reputation solves the agency problem between management and the final customer because reputation is essentially an information asymmetry reduction strategy. On the other hand, service is actually delivered by a distant boundary spanner who may act in his or her self interest and compromise on quality. Management is therefore faced with a problem of safeguarding its reputation because it is involved in a second agency relationship with the service provider. In this sense, the two agency levels appear to be inter-related. In other words, the greater the use of reputation by a management for reducing performance ambiguity for the final customer is, the greater the need to monitor service providers appears to be. Klein and Leffler (1981) discuss this problem in the context of a franchisor-franchise relationship:

> *The existence of independent competitive retailers that do not have any ownership stake in this firm specific asset and yet can significantly influence the quality of the final product supplied to consumers creates a severe quality-cheating problem for the manufacturer. Manufacturers may protect their trademarks by imposing constraints on the retailer competitive process including entry restrictions, exclusive territorial grants, minimum resale price maintenance, and advertising restrictions that will assure quality by creating a sufficiently valuable premium stream for retailers" (Klein and Leffler, 1981; p. 633).*

In a similar vein, Brickley and Dark (1987) argue that "a major problem facing companies with valuable names is controlling the action of agents throughout the organization to assure the continued value of that trademark" (p. 403). An example of how reputation effects can be compromised in a service setting because of agency problems between management and service providers is illustrated by Dejong, Forsythe, and Lundholm (1985). These authors explicitly model reputation effects in studying a principal-agent problem in the stock market. The findings of this study indicate that "while there is evidence of reputation effects in these markets seemingly reputable agents are often able to use opportunities for false advertising to their advantage and 'rip-off' principals" (p. 809). To sum it up, reputation effects alone do not guarantee quality because "the presence of moral hazard does indeed lead to the provision of nonoptimal levels of services in an agency relationship (between management and the service provider) (Dejong, Forsythe, and Lundholm, 1985, p. 819).

The notion of multiple agency relationships, their interrelated nature, and the impact of governance mechanisms on service delivery are depicted in Figure 1. Panel A of the figure depicts the simplest possible agency relationship between a single principal and a single agent. For example, when a patient (principal) obtains service from an independent physician (agent), such a relationship is established. From the principal's standpoint, the two main agency problems that need to be governed are as follows: i) adverse selection, and ii) moral hazard. Efforts undertaken by the patient to pre-qualify an independent physician such as screening, word-of-mouth referrals from other patients, etc., constitute governance mechanisms for resolving the adverse selection problem. Moral hazard or hidden action problems may come up after the patient has begun visiting the physician on a regular basis. Governance mechanisms that ameliorate moral hazard may have to do with the length of the doctor-patient relationship and the building up of trust. As such, doctor-patient relationships are often sticky because principals having resolved adverse selection and

moral hazard problems do not wish to grapple with additional uncertainty by switching to a new physician. In this setting, using compensation as a governance mechanism appears less relevant given institutionalized compensation practices.

Next, consider panels B and C of Figure 1 that depict multiple agency relationships. The key idea is that multiple agency relationships are i) interdependent, and ii) need to governed simultaneously in order to yield optimal quality outcomes. In Panel B, consider a situation where McDonald's as the franchiser (principal) deals with the individual franchisee (agent). McDonalds faces both adverse selection and moral hazard problems because individual franchisees that are far removed from headquarters may dilute delivered quality. These problems are managed in several ways. In addition to instituting governance mechanisms like pre-qualification and training of franchisees, McDonald's also employs District Sales Managers (DSM's) who undertake field visits to monitor individual franchisees. Hence, the DSM is a principal in his or her relationship with the franchisee and is an agent of McDonalds. To deliver optimal levels of quality, McDonald's has to craft appropriate governance safeguards at the level of the DSM also, e.g., through pre-qualification and compensation mechanisms. However, in governing the relationship with DSM's (Level 1), agency relationships at another level (Level 2) may also be affected. For example, if the DSM is compensated on the basis of sales, he or she, in turn, may impose additional burden on franchisees by imposing unattainable sales goals on them. As a consequence, individual franchisees can get de-motivated and may switch to competition.

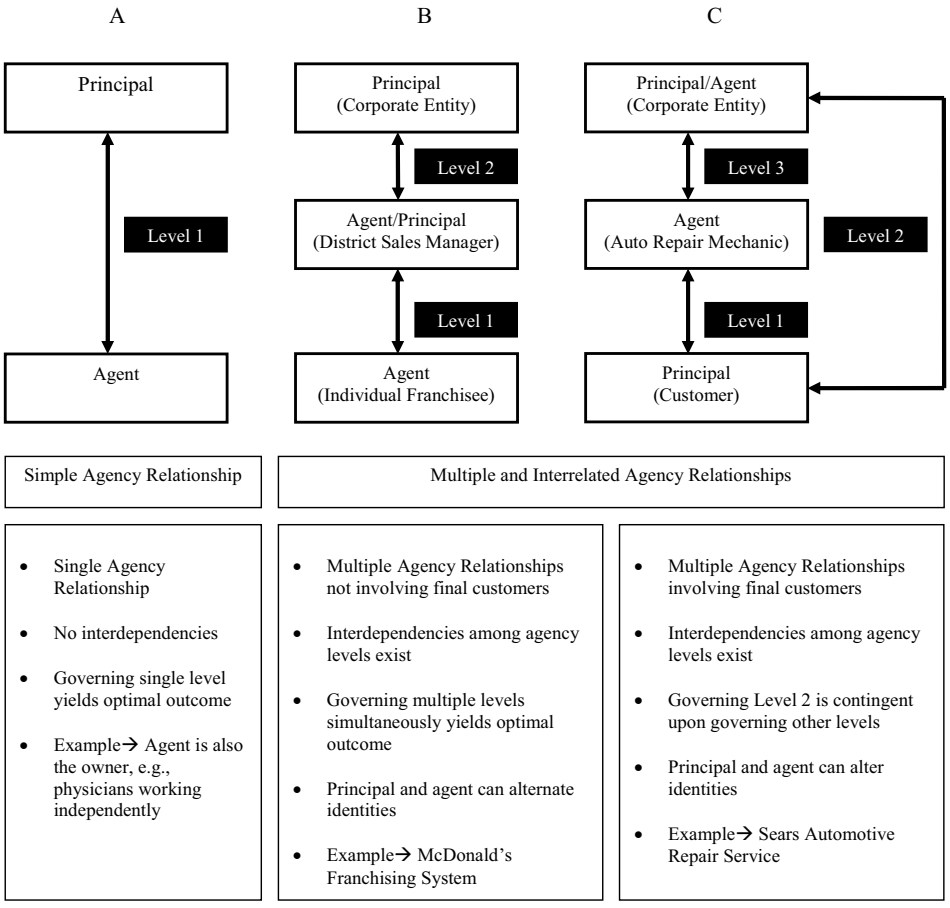

Fig. 1. Simple and Interdependent Agency Relationships in Service Delivery

Panel C depicts a situation described earlier. Typically, automotive repair chains such as Firestone, Midas, Goodyear, Sears, etc. invest considerable resources in promoting their brand. Brand image, in turn, acts as a quality signal and governs customers' adverse selection concerns. In general, other things being equal, customers are more likely to choose a brand that is widely advertised and has a national presence. However, governing this level of agency relationship (Level 2) is contingent upon how other agency relationships are managed. In the simplest case, promise quality at level 2 may be diluted if management has not solved the agency relationship with mechanics or managers who are directly involved in providing the service (Level 3). In sum, optimal delivery of service quality entails i) the crafting of appropriate governance mechanisms, and ii) the resolution of interdependency problems.

III. Implications And Scope For Further Research

It was argued at the outset that agency problems in service delivery have not received any systematic attention in marketing. This gap in the services literature is surprising because most service arrangements in today's society are agency relationships. Specifically, in keeping with the transition from an agrarian economy to industrial one, role specialization has engendered the modern agency problem. To address this shortcoming, we used agency theory to study multiple levels of agency relationships and specified appropriate governance mechanisms. This study has implications for managers and researchers.

Managerial implications

Managers should realize that service quality involves more than a smile or a handshake. Quality is the result of a process which starts within the organization. Service organizations are characterized by the presence of agency relationships where parties often have divergent interests. The successful resolution of agency problems at different levels within an organization is the *sine-qua-non* for achieving quality.

Despite the obvious importance of understanding agency relationships, prescriptions from extant research can be summarized in the following sentence: *These are the dimensions of quality, now manage your internal activities in accordance with these dimensions to that you achieve that elusive mantra for profitability – quality.* In sum, no systematic understanding exists in the literature on how managers should manage agency relationships in which they are involved. For instance, the Sears example discussed earlier is a classic case of mismanagement of an agency relationship where two principals (Sears' management and the final customer) and an agent (Sears' mechanics) were locked in an inefficient arrangement that compromised quality.

By viewing monitoring and control systems through the powerful lens of agency theory, managers can be better equipped to solve these problems. First, by classifying their service along the dimensions of information asymmetry, managers will be sensitized to the relative importance of monitoring problems. Second, the recognition of agency problems may help management to transmit signals to final customers. For example, management may realize that it cannot charge premium prices for its service without making appropriate investments in improving the ambience of the service setting. Quality conscious customers will perceive these specific investments as "collaterals" for price premiums. Advertising strategies which stress the company's reputation may also send powerful quality signals to customers. Furthermore, if guarantees are widespread, management can gain competitive advantage by introducing unconditional guarantees. Third, appreciation of agency problems may motivate management to design appropriate compensation schemes for service providers. For example, a dentist's compensation may be tied to patient satisfaction scores. In this way, management can dovetail its monitoring of service providers with its objective of providing superior quality.

Scope for further research

An obvious avenue for future research is to formulate empirically testable hypotheses in the context of extant theory. Researchers may also incorporate "organizational culture" concepts (Deshpande and Webster, 1989; Deshpande, Farley, and Webster, 1993) to better understand

agency problems. Attention to culture issues is desirable because shared ideas and beliefs can minimize the divergent interests of parties involved in an agency relationship. For example, researchers can empirically determine the relative importance of agency strategies and organizational culture in delivering service quality. The results of such an empirical study may directly impinge upon the debate in *marketing* and *organization behavior* about the narrow focus of agency theory on human opportunism. There is some empirical evidence in literature on marketing (Heide and John, 1992) which suggests that innate human values like trust and norms may act as safeguards against human opportunism. In fact, in some organizations, culture may be the most important determinant of service quality.

Finally, the conceptual framework offered in this study can be extended to better understand various "forms" of service organizations. For instance, the health care industry has different types of organizational forms, e.g., *fee-for-service, autonomous physicians, health maintenance organizations, referral networks.* In the fee-for-service form, the agency arrangement between a doctor and his or her patient is rendered efficient because principals develop close relationships with agents. This relationship assures the doctor of continued loyalty and future business. On the other hand, health maintenance organizations manage agency relationships with doctors through various compensation schemes and socialization strategies. In this vein, we may note that the relationship between a customer and a "surrogate customer" (e.g., expert services like stock-analysts) is not a principal-agent relationship. By employing a surrogate customer, the buyer attempts to obtain cheap information on *the* agent, i.e., on the company where he or she desires to buy the service. To sum it up, many forms of service delivery in today's business environment can be studied by using principles derived from agency theory.

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