AGENCY THEORY'S ANSWER TO THE MAKE OR BUY DECISION OF VERTICALLY INTEGRATING THE SALES FUNCTION

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Vertical integration of the selling function addresses the issues surrounding the decision to utilize a direct sales force or outside agents. The desire to control the sales function is an important citerion in the establishment of viable industrial sales strategy. agency theory provides an alternative approach to the sales alternative decision. This article integrates the benefits of agency theory with the sales force determination process.

INTRODUCTION

In many industries, administering and compensating the sales force represents a substantial portion of marketing costs (Churchill et al., 1990, p. 12-13). In fact, U.S. firms spend over $140 billion annually on personal selling—more than is spent on any other promotional method (Kotler, 1991, p. 650). The magnitude of these costs, coupled with a need for increased sales productivity, has forced management to review strategic decisions regarding the sales function. Among these strategic decisions, the strategic implications involved in the decision to fill a sales district with outside agents (OA) or a direct sales force (DS) has received increased attention (Anderson, 1985; Anderson and Weitz, 1986; Hlavacek and McCuistion, 1983; Narus, Reddy, and Pinchak, 1984; Ruhuke, 1966).

Traditionally, when the decision to employ a direct sales force is made it becomes a difficult one to change (Stern and Sturdivant, 1987). Management is reluctant to deviate from the use of a DS when problems arise; opting instead to manipulate training and compensation variables (Anderson, 1985). However, an increased emphasis on greater sales productivity is forcing firms to review their DS decision and reconsider the use of OA's. The sales growth experienced by OA's is evidence of this trend. From 1977 to 1982, OA's sales increased over 62% and now account for more than $67 billion in sales (Boone and Kurtz, 1989, p. 454; Rosenbloom, 1987, p. 38).

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Despite the important, strategic implications of the OA/DS decision, little attention has been focused upon developing the needed guidelines to facilitate management decision making in this regard. Few empirical studies have addressed the issue and a review of the literature revealed only one attempt to comprehensively model the OA/DS decision (see: Anderson, 1985; Anderson and Weitz, 1986). For the most part, managers have to rely on past experience or antidotal "rules-of-thumb" that are often contradictory.

The purpose of this manuscript is to begin the development of theoretically-driven guidelines for the OA/DS decision. A hypothesized model of the OA/DS decision is developed based primarily upon agency theory, a general approach that can be applied to problems of cooperative effort and contractual relationships (Bergen, Dutta, and Walker, 1992). At the most basic level, the OA/DS decision can be compared to a make or buy situation. The decision to pursue vertical integration of the sales function by utilizing a direct sales force represents a make decision, while the use of outside agents represents a buy decision. Each choice represents a need for different degrees of cooperative effort and contracts. As such, agency theory constructs should offer a more comprehensive explanation of the OA/DS decision.

The first section of this manuscript reviews the relevant marketing literature which addresses the "pros" and "cons" of vertical integration of the selling function. That is, the relative advantages and disadvantages of using a direct sales force or outside agents are discussed. The second section presents an overview of agency theory concepts. The third section presents a framework for the OA/DS decision and corresponding propositions based upon an integration of the marketing literature and agency theory.

OA/DS LITERATURE REVIEW

The marketing literature that does address the OA/DS decision is usually conflicting and nonempirical. While sales and marketing management texts do describe and define the two alternatives, little is done in the way of clarifying the choice issue. This review divides the literature into two parts: (1) arguments advocating the use of OA's and (2) arguments advocating the use of a DS.

Arguments Advocating the Use of OA's

Outside agents (also called manufacturers' agents or manufacturers' representatives) do not take title to goods and they usually perform only a few functions for the manufacturer. Their main function is to facilitate the exchange process, and, for their effort earn a commission. OA's usually represent two or more manufacturers of complementary lines. Additionally, most OA's are small businesses with a few highly skilled salespeople. They are utilized by small manufacturers that can not afford to maintain a sales force and by large manufacturers to open new territories or fill territories that can not justify the use of a full time sales force (Kotler, 1991, p. 552).

Since OA's are independent businesses whose survival depends upon good performance (i.e. sales), they must be comprised of highly successful salespeople in order to remain in business (Anderson, 1985). Additionally, by combining various complementary product lines, OA's are able to offer customers a wider variety of selection (Kotler, 1991, p. 552). Customers may prefer to buy the needed complementary products from one vendor as opposed to numerous single sources. OA's are more cost effective since they can spread the costs of a sales call over their entire line of products.

The OA's central position between the manufacturer and customer allow them to serve as an effective information link between the two groups. They are able to supply the customer with information concerning new products and they are able to supply the manufacturer with valuable information concerning market acceptance of their products (Boone and Kurtz, 1989, pp. 443-444). Additionally, OA's are unlikely to transfer and this continuity adds to stronger customer relationships. This stability relieves the manufacturer of the burden associated with DS transfers (Anderson, 1985).

The cost of deploying a DS in new territories may be prohibitive for some manufacturers. New territories are risky and may not prove profitable. For these reasons, the use of OA's to perform the pioneering exploration of new territories is more cost effective (Boone and Kurtz, 1989, p. 454). Additionally, small or newly organized manufacturers may not possess the needed capital or sales force to adequately distribute their product. OA's present these manufacturers with an immediate, ready-made sales force at virtually no fixed costs (Anderson, 1985; Boone and Kurtz, 1989, p. 454).

Arguments Advocating the Use of a DS

The amount of control afforded the manufacturer surrounds most arguments for the use of a DS. When the manufacturer uses OA's it looses some degree of control over the marketing of its product (Peter and Donnelly, 1992, p. 189). Since a DS is under the direct supervision of the firm, more control over the marketing of the firm's product is maintained. A variation of the control theme is the importance placed upon performing non-selling activities. OA's are paid a commission on their sales, and, as a result, may be less motivated to perform the needed non-selling activities—opting instead to focus on the immediate returns generated from sales (Anderson, 1985). OA's receive their payoff at the completion of a sale, and, as a result, are interested in quick, immediate sales. Thus, OA's may opt to focus their energy on products with short selling cycles while neglecting products with long selling cycles (Anderson, 1985).

Plausible arguments for the use of OA's or DS's are presented in the marketing literature. The difficulty lies in an inability to assess the relative importance of each factor. Anderson (1985) argues that a "comprehensive framework is needed to develop hypotheses as to when a district would be served by reps and when by company salespeople (p. 237)." A framework that the author believes is useful for this purpose is agency theory.

AGENCY THEORY OVERVIEW

Agency theory has been applied to a wide spectrum of disciplines, including: accounting (Demski and Feltham, 1978), economics (Spence, 1975; Spence and Zeckhauser 1971), finance (Fama, 1980), political science (Mitnick, 1975), organizational behavior (Eisenhardt, 1985), sales management (Basu et al,. 1985; Eisenhardt ,1985), and sociology (Eccles, 1985; White, 1985). Despite its widespread adoption, agency theory continues to generate considerable controversy. Its proponents argue that "the foundation for a powerful theory of organizations is being put into place (Jensen, 1983, p. 324)." However, its detractors call it "trivial, dehumanizing, and even dangerous (Perrow, 1986, p. 235)." Regardless of the controversy, agency theory "provides a unique, realistic, and empirically testable perspective on problems of cooperative effort (Eisenhardt, 1989, p. 72)."

It has been argued that agency relationships should pervade marketing since marketing is an exchange process, and agency relationships are a significant component of exchange relationships (Arrow, 1985; Bergen et. al., 1992). In its simplest form, an "agency relationship is present whenever one party (the principal) depends on another party (the agent) to undertake some action on the principal's behalf (Bergen et. al., 1992, p. 1)." Therefore, all contractual or employment arrangements are representative of a form of agency relationships.

Agency theory uses the metaphor of a contract to describe the principal-agent relationship. Given the differing characteristics of the parties involved as well as the fact that environmental uncertainty and information costs make it difficult for the principal to monitor the agent, agency theory focusses on determining the most efficient contract to govern the relationship (Anderson and Oliver, 1987; Bergen et. al., 1992). This contract is the one that most efficiently aligns the goals of the agent with those of the principal. By focussing on an efficient alignment of goals, this perspective extends the previous efficiency theories of contingency and transaction costs through an emphasis on information, risk and uncertainty, and the political view of organizations (Eisenhardt, 1988; Kurland, 1991). Efficiency is defined in terms of the principal. In other words, the focus is on determining the contract that is most beneficial to the principal (who is assumed to be the dominant party), not on maximizing the joint utility of the both parties per se (Bergen et. al., 1992).

Two agency problems occur when cooperating parties have different goals and levels of risk aversion (Bergen et. al., 1992; Eisenhardt, 1988). Both of these problems represent distinct agency models in the literature. The first occurs before the two parties decide to contract and is referred to as the problem of "hidden information". In this situation, the principal is aware of the particular characteristics required to perform the task to be contracted. However, the principal: (1) needs to find out if potential agents have the characteristics the principal seeks and (2) must decide on a strategy for uncovering this information. The second problem occurs after the two parties enter a relationship and is referred to as the problem of "hidden action". In this situation the principal: (1) must decide how to evaluate and reward the agent's performance to motivate the agent to act for the principal's goals and (2) decide on an information strategy to ease this performance evaluation process.

Hidden Information Model. The basic problem in the hidden information model is that the principal does not possess full information concerning the ability of the agent to perform the necessary tasks. Therefore, the principal must choose an information-gathering strategy that will illuminate the agent's true characteristics. Information-gathering strategies may be viewed on a continuum. On the one end, the principal would disregard the costs of gathering information concerning the agent. The objective here is to ascertain with certainty the agent's true characteristics before entering a relationship. On the other end of the continuum, the principal would not engage in pre-employment information gathering, opting instead to let the agent's performance on the job determine whether an appropriate agent has been selected.

There are different costs associated with each of these two contradictory information-gathering strategies. In the first strategy, the costs associated with attempting to gather complete pre-employment information will increase the costs of the hiring process. In the second strategy, the principal may hire the wrong agent due to a lack of information. The costs accrued in this situation may result from losses due to poor performance. Therefore, the principal is faced with the trade off between the costs of gathering pre-employment information to increase the odds of selecting the appropriate agent and the potential losses associated with selecting the wrong agent (Bergen et. al., 1992).

Hidden Action Model. As mentioned above, the basic problems in the hidden action model are that the principal: (1) must decide how to evaluate and reward the agent's performance to motivate the agent to act for the principal's goals and (2) decide on an information strategy to ease this performance evaluation process. However, three assumptions about principals and agents help to compound these problems. First, both principal and agent are assumed to be motivated by self-interest and a desire to maximize their utility. Second, the principal must make decisions under conditions of incomplete information concerning the agent. The agent possesses the information the principal desires, but self-interest makes the agent reluctant to share this information. The third assumption is that factors other than agent effort, including environmental uncertainty, will have an impact upon realized outcomes (Bergen et. al., 1992). This assumption serves to highlight the potential problems that occur when the agent and principal posses different levels of risk aversion. As a result, the contract must take into account the risk preferences of the two parties.

Since the two parties are self-serving, with incompatible goals and risk preferences, that which is best for the principal is considered costly for the agent. These factors, combined with the principal's lack of information concerning the agent's behavior, creates the opportunity for moral hazard. Moral hazard refers to the failure on the agent's part to put forth the agreed upon effort or when the agent engages in activities designed to evade responsibility (Holmstrom, 1979).

To avoid moral hazard, the principal can pursue two strategies. First the principal can invest in information systems that reveal the true actions or behavior of the agent and then reward the agent based upon this information. The problem here is similar to the problem gathering pre-employment information, the costs associated with gathering the information can be high. The second option is for the principal to evaluate and reward the agent based upon realized outcomes. The problem here is that factors other than agent effort may affect realized outcomes, resulting in higher levels of risk aversion on the part of the agent. Higher levels of agent risk aversion increases the principals costs. Therefore, the principal is faced with the trade off between the costs of shifting the risk to the agent and the costs associated with agent cheating or moral hazard.

AN AGENCY THEORETIC MODEL OF SALES FORCE INTEGRATION

In this section of the manuscript propositions concerning when OA's or DS's are used to perform the selling function in a district are developed. These propositions are based on an integration of agency theory and the sales and marketing management literature. Figure 1 presents the agency theory framework for a DS decision. The following paragraphs serve to highlight and explain this framework. The explicit assumption is that an OA decision would be exactly opposite from the DS decision. In other words, to model the OA decision the signs in Figure 1 would be reversed.

Managerial Control

The first variable to examine is that of managerial control. As can be seen in Figure 1, the desire by management to control the selling function is positively related to the use of a direct sales force. The first factor of concern is goal congruence or goal compatibility. One problem that agency theory attempts to resolve occurs when the goals of the principal and agent conflict (goal incongruence). In order to insure that its objectives are being met (goal congruence), management may desire more control over the selling function and thus the agent (Eisenhardt, 1989).

> **P 1:** Management's desire for goal compatibility increases the likelihood of using a direct sales force.

However, the goal conflict assumption may be relaxed to illustrate cases of lower goal incongruence. This leads to the second factor of a strong organization culture. For example, Ouchi (1979) presented the case of a highly socialized or clan-oriented firm. In these type situations, (i.e., when a strong clan-oriented culture exists), management's desire to control the selling function may increase due to a desire to keep operations "in the family".

> **P 2:** A strong organization culture increases the likelihood of using a direct sales force.

The third factor of concern under managerial control is that of performing non-selling tasks. Since OA's are paid a commission on their sales, they may be less motivated to perform the needed non-selling activities—opting instead to focus on the immediate returns generated from sales (Anderson, 1985). However, if non-selling activities such as paperwork, attending trade shows, services, etc. are important, then management may desire more control over the selling function and thus the agent.

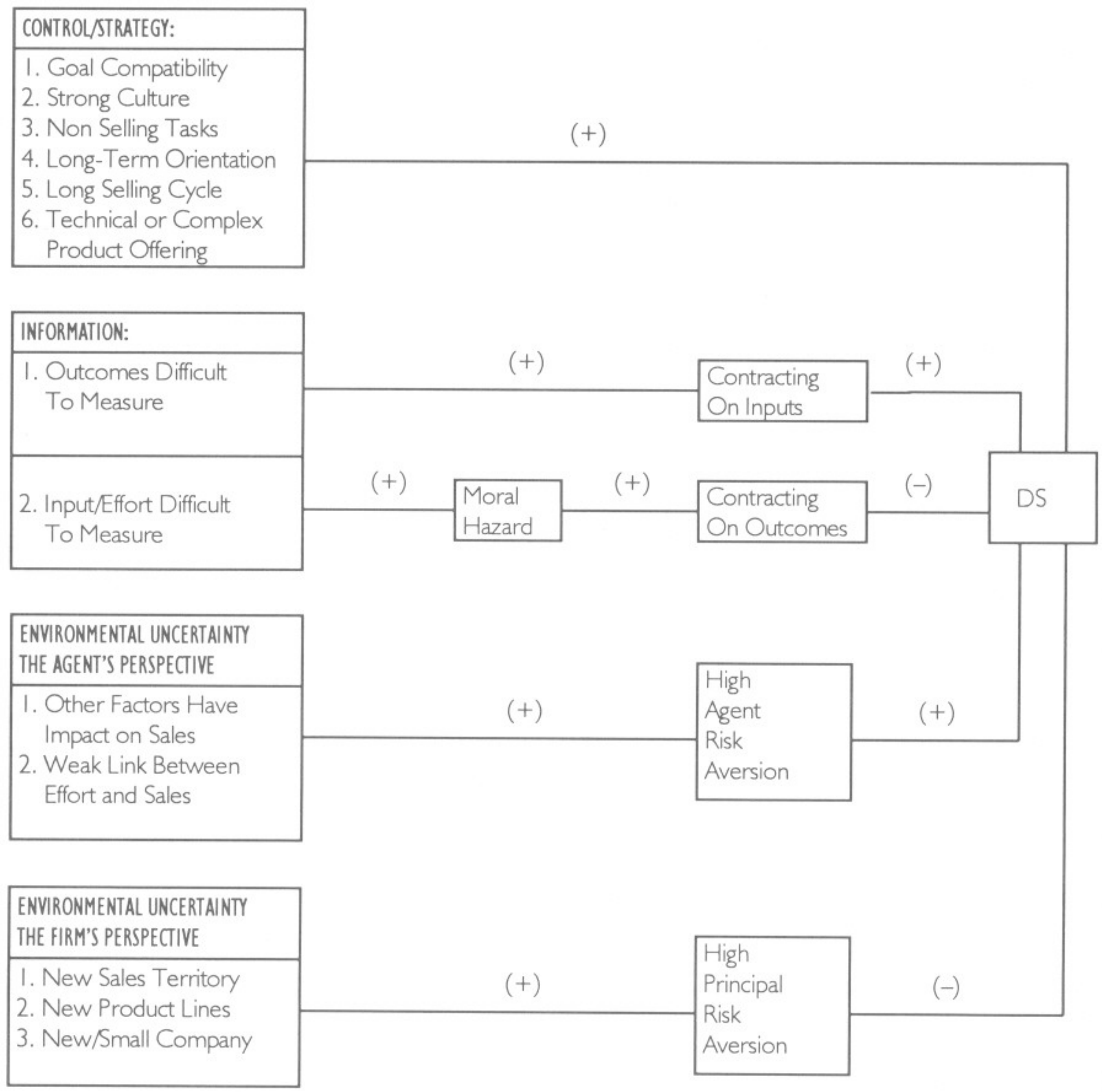
> **P 3:** The need to perform non-selling activities increases the likelihood of using a direct sales force.

Instilling a long-term orientation is the fourth factor under managerial control. Since OA's are interested in immediate payoffs, they may be less interested in performing the needed activities (ie. cultivating new accounts, cultivating small accounts with growth potential, customer service) that ensure long-term success and future profitability for the manufacturer. Again, if these activities are important, they will lead management to desire greater control of the selling function.

> **P 4:** The need to instill a long-term orientation increases the likelihood of using a direct sales force.

A related topic to instilling a long-term orientation is the length of the selling cycle or the amount of time

FIGURE 1
AGENCY THEORY FRAMEWORK FOR A DS DECISION



between effort and final outcome. As mentioned earlier, OA's are interested in immediate sales and, as such, may neglect those products with a long selling cycle. Therefore, products with a long selling cycle increase management's desire to control the sells process.

P 5: Products with longer selling cycles are more likely to be sold through a direct sales force.

The last factor under managerial control is the technicality or complexity of the product offering. Highly technical or complex products may require special selling efforts such as demonstration, installation, and continued support services. Each of these factors require personnel that have been adequately trained to perform these tasks. Therefore, highly technical or complex products will increase management's desire to control the selling function.

P 6: Highly technical or complex products are more likely to be sold through a direct sales force.

Information

The second variable in the agency theory framework is that of information. The first information problem occurs when realized outcomes are difficult to measure. Without competent outcome measures, it is difficult for the principal to determine how well selling activities were performed. In these situations, the principal must rely upon input measures such as the amount of effort expended. It would be most difficult for the principal to gather these input measures from OA's. However, an employment contract gives the principal legitimate authority to gather this type information if a direct sales force is used.

> **P 7:** Difficulty in assessing sales performance based upon realized outcomes increases the likelihood of using a direct sales force.

As discussed in the earlier presentation of agency theory, one problem that agency theory attempts to resolve occurs when it is difficult or expensive for the principal to verify what the agent is actually doing (lack of information) (Eisenhardt, 1989). Given the principal's lack of information concerning the agent's behavior, (i.e., the amount of input or effort expended), the opportunity for moral hazard arises. Moral hazard refers to the failure on the agent's part to put forth the agreed upon effort (Holmstrom, 1979). If inputs or effort are difficult to measure, then the principal may contract on the outcomes of the agent's behavior.

> **P 8:** Difficulty in assessing sales performance based upon inputs decreases the likelihood of using a direct sales force.

Environmental Uncertainty From The Agent's Perspective

Performance outcomes may be a function of several factors other than agent effort (for example: government policies, economic climate, competitor actions, technological change, etc.) (Eisenhardt, 1989). Agency theory assumes that agents are self-interested, rational, and risk averse (Kurland, 1991). As the amount of uncertainty within the environment increases, the cost of transferring the risk to the agent also increases. Higher incentives are needed in order to motivate the agent to accept the added risk.

> **P 9:** The impact on sales of environmental factors increases the likelihood of using a direct sales force.

Basu et al. (1985) stress that uncertainty may take the form of a weak link between effort and sales performance. If a weak link exists between effort and outcomes, then the use of OA's will be inefficient. This is due to the fact that OA's are considered unwilling to exert effort without an immediate and certain payoff (Anderson 1985).

> **P10:** A weak relationship between agent effort and sales increases the likelihood of using a direct sales force.

Environmental Uncertainty From The Firm's Perspective

The preceding discussion of risk aversion may also be applied to the principal. Agency theory also assumes that principals are self-interested, rational, and risk averse (Kurland, 1991). As the principal's level of risk aversion increases, the attractiveness of passing the risk to the agent (using OA's) increases. The first factor to examine is that of new sales territories. In these situations, the probability of success is uncertain. Therefore, new sales territories lead to higher risk aversion on the part of the principal and a desire to shift this risk to the agent.

> **P11:** Entering a new sales territory decreases the likelihood of using a direct sales force.

The same argument can be made for new product lines. The principal is uncertain as to the market acceptance of the new product. Additionally, the principal may not have developed the required knowledge necessary to sell the new product. As a result, the probability of success is uncertain. Therefore, new product lines lead to higher risk aversion on the part of the principal and a desire to shift this risk to the agent.

> **P12:** New product lines decrease the likelihood of using a direct sales force.

New and smaller firms may not have established themselves as viable concerns. In these situations, the firm is very risk averse with a strong desire to shift the risk to the agent.

> **P13:** New or smaller firms decrease the likelihood of using a direct sales force.

IMPLICATIONS

The likelihood of using a direct sales force as opposed to an outside agent increases as: (1) the desire to control the selling function increases; (2) the difficulty in

TABLE 1

KEY VARIABLES	DS	OA
DESIRED LEVEL OF CONTROL		
1. Goal Compatibility		
--Can company objectives be met by outside agents?	No	Yes
--Do potential outside agents exist with company cultures similar to that of the company?	No	Yes
--Do potential outside agents carry products of other companies that may damage the company's image?	Yes	No
--Is close coordination with agent needed?	Yes	No
2. Strong Culture		
--Is there company-wide agreement concerning goals and objectives?	Yes	No
--Good employee attitudes toward company?	Yes	No
--Employee moral:	High	Low
3. Non-Selling Tasks		
--Is accurate and timely paperwork mandatory?	Yes	No
--Product requires a presence at trade shows?	Yes	No
--Market research activities performed in the field?	Yes	No
4. Long-Term Orientation		
--Small accounts exist with growth potential?	Yes	No
--Cold-calling required?	Yes	No
--Many repeat buyers?	Yes	No
--Do new products need to be promoted in the field?	Yes	No
5. Long Selling Cycle		
--Is the buying decision:	Involved	Simple
--Is a team effort required?	Yes	No
--Multiple calls required to close sale?	Yes	No
6. Technical or Complex Product Offering		
--Are product demonstrations required?	Yes	No
--Is special product knowledge required?	Yes	No
--Do customers require training on the use of product?	Yes	No
INFORMATION		
1. Realized Outcomes Difficult to Measure		
--Is there a wide variety of factors affecting realized outcome measures?	Yes	No
--Can you separate company contribution from agent contribution based upon outcome measures?	No	Yes
2. Input/Effort Difficult to Measure		
--Accurate measures of customer contacts available?	Yes	No
ENVIRONMENTAL UNCERTAINTY FROM THE AGENT'S PERSPECTIVE		
1. Other Factors Have Impact On Sales		
--Degree of industry regulation:	High	Low
--Technological changes occur:	Often	Seldom
--Degree of competition in the industry:	High	Low
2. Weak Link Between Effort And Sales		
--Size of advertising budget:	Large	Small
--Discounts, rebates, or incentives offered?	Yes	No
ENVIRONMENTAL UNCERTAINTY FROM THE PRINCIPAL'S PERSPECTIVE		
1. New Sales Territory		
--Geographic dispersion of potential accounts:	Narrow	Wide
--Forecasted growth potential:	Large	Small
--Proximity to existing sales territories:	Near	Far
2. New Product Lines		
--Forecasted market acceptance:	High	Low
--Does new product line fit existing lines?	Yes	No
3. New/Small Company		
--Capital exist to maintain a direct sales force?	Yes	No
--Company experiencing growth?	Yes	No

gathering outcome measures increases; (3) environmental uncertainty increases an agent's level of risk aversion; and (4) environmental uncertainty decreases the company's level of risk aversion. Table 1 presents a series of questions for assessing the implications of these four factors. If the response to a given question is in the right-hand column, then the implication is for an increased potential of using outside agents. If the response to a given question is in the left-hand column, then the implication is for an increased potential of using a direct sales force.

A quick run-down of the questions in Table 1 will indicate that there may not be a clear-cut answer each time. Factors such as type of product or industry will clearly influence the outcome. Additionally, the same weight may not be given to each of the four variables by all firms. For example, a firm that truly desires to control the selling function will place more emphasis on this variable relative to the other three when making a decision. Or, a firm worried about environmental uncertainty and possessing a high level of risk aversion will place move emphasis on reducing risk as opposed to the other three variables.

CONCLUSION

This manuscript illustrated the compatibility of agency theory with the normative prescriptions offered by the sales and marketing management literature. As Eisenhardt (1989) points out, agency theory provides researchers with an unique, realistic, and empirically testable perspective to apply to problems of cooperative effort. Since channel relationships represent the epitome of cooperative effort, the agency theory perspective may offer a more comprehensive view for channel decisions in general. For example, the cooperative nature of just-in-time and sole sourceing relationships appear ripe for agency theory applications.

Future research should focus on empirically testing the framework developed within this manuscript. The risk aversion variable must be realistically operationalized. This may prove particularly difficult since perceptions and tolerance of risk may vary greatly between individuals. Additionally, attempts to increase the robustness of the agency framework by integrating complementary perspectives should be undertaken.

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