The agent thus acquires certain obligations with respect to the principal by virtue of the economic relationship established between them.

- The mechanism for articulating this relationship takes the form of a contract between the principal and the agent. Accordingly the firm is understood as a nexus of contracts between principals and agents.

- An agency relationship arises whenever there are two or more individuals who have differing goals and interests and one of them holds a position of dominance over the others, so that the others are obliged in such a way to achieve the objectives of the person who is in the dominant position.

- The paradigmatic case of an agency relationship in firms is the relationship between shareholders and managers. The managers are agents of the shareholders, and the shareholders assume that the principle guiding the managers' actions will be that of implementing whatever policies increase the value of the firm.

- The principal's problem is to decide on the optimal way to compensate the agent. It is generally assumed in these models that the principal can dictate the terms of the contract, subject only to the constraint that the compensation offered must equal or exceed the agent's next best known alternative.

- The value of the reservation utility is simply stipulated in the model. Agents will not accept contracts with expected values below the stipulated reservation utility. The principal's goal is to develop a compensation scheme that attracts a capable agent, and that most efficiently motivates the agent to do her best to deliver the level of service desired.

- Economists working on this problem point out that this compensation decisions becomes a difficult exercise when certain complicating, but common conditions hold. These conditions are goal incongruity, uncertainty, information assymetry, and agent risk aversion.

- Goal incongruity in principal-agent models refers to the fact that the agent's preferences regarding the performance of the service do not match the principal's preferences. The agent is not sufficiently motivated by the satisfaction of a job well done. She must be induced to provide the type and level of service the principal desires.

- Uncertainty refers to the fact that the observable outcome of the agent's work is not a perfect measure of the input. The observable outcome is a product of the agent's skill and effort, combined with factors beyond the agent's control.

- Information asymmetry refers to the fact that the agent has better information about her abilities, preferences, and level of effort than does the principal. As a result, the principal cannot easily identify the best-suited agents, and cannot easily link compensation to agent