Principal agent conflict

2. Explain several dimensions of the shareholder-principal conflict with manager-agents known as the principal-agent problem. To mitigate agency problems between senior executives and shareholders, should the compensation committee of the board devote more to executive salary and bonus (cash compensation) or more to long-term incentives? Why? What role does each type of pay play in motivating managers? There are several dimensions to the principal-agent conflict.

Principal-Agent Relationships exist whenever one person or party works in the interests of another party. The owner (the principal) hires and often delegates decision-making authority to professional managers (the agent) to perform tasks on his behalf. The challenge for the principal is to create anenvironmentin which the agent has incentives to align their interests with those of the principal. The principal typically creates incentives for agents to act as the principal wants.

The principal-agent conflict acerbates when the incentive system creates a conflict of interest, the principal cannot ensure the agent is performing exactly the way the principal would like and due to the intrinsic unobserved managerial effort and the presence of random disturbances in team production. The lack of information shared between the two makes it impossible and expensive for the principal to monitor the decisions and performance of the agent.

The agent usually has less to lose than the principal; therefore they often seek acceptable levels of profit and shareholder wealth while pursuing their own self interests. The uncertainty and risk includes the principal not knowing the extent to which the contract has been satisfied and they end up

paying agency costs. To mitigate agency problems between senior executives and shareholders, the compensation committee should devote more to executive salary and bonuses (cash compensation); dependant on the level of cooperation between the executives and the board.

If the board is able to secure the cooperation of the executives through higher salary and bonus, such action is acceptable. In addition, if the board can set up a system of monitoring the executives so that the executives make the effort required to further shareholder interests. Monitoring improves executive performance and can be combined with cooperation. If long term incentive schemes are used then there is isk that the organization may not make profits or the financial outcomes on which the incentives are based may not take place. When negotiating with managerial talent, the high risk of incentives keeps reputed managers away from the company. Top managers want to be certain of the compensation they will receive. Incentives are supposed to motivate managers to make more efforts, takeresponsibility, and achieve more. However, the insecurity of incentives reduces themotivationof managers.

They feel insecure when the bulk of their compensation is incentive based. The role of higher executive salary and bonuses are to provide security to the top managers and motivate them. Overall, executive salary and bonuses based on negotiation with board members should reduce shareholder-manager conflict. There should be cooperation between the board members and the executives. A mechanism for monitoring executive performance will go a long way in improving the alignment of executive action with shareholder interest.