Principal agent theory

Business

1. Introduction One of the major problems that businesses face while setting prices and outputs in a bid to maximize their profits arises in key decision making where the owners of the business and those who are in control or the managers are divorced. This makes it difficult for the owners to monitor the managers or controllers who manage their businesses on their behalf. The mystery lies in the question on how the owners or shareholders of a particular business will ascertain that the decisions that the managers make day in day out are geared towards maximizing the value of the shareholders. It is common knowledge that when shareholders hire solicitors or managers to manage businesses on their behalf, monitoring their diligence and their efforts to undertake the assigned task becomes almost impossible. Shareholders can only monitor profits but not the manager’s behavior and in cases where monitoring manager’s behavior is possible the shareholders do not have enough expertise to evaluate this behavior.

Therefore, most of what these managers do remains a mystery for shareholders since the managers have access to some unique expertise and information that is alien to the shareholders and this is why they are hired as managers. Though anyone can be able to follow the revenues of the firm, it would take a lot of detailed knowledge and expertise to make a certain estimate of the actual revenue the firm could have generated if the managers had done things differently. 2. The Principal Agent Problem This deficit in information between these two parties described above is what is commonly referred to as the Principal Agent problem. To be much more precise the Principal Agent problem is a kind of a theoretical explanation that describes the situation explored above.

The shareholder in this case becomes the principal whereas the manager(s) become the agents hired to perform managerial tasks on behalf of the principal(s). The agent(s) has some utility function that in some sense is very different from that of the principal. The principal faces the problem of ensuring that the agent performs the assigned task precisely according to his expectation. The agent's performance and decisions are expensive and almost impossible to monitor since the incentives of both parties may differ. If both parties were to have perfect information the incentive on the agent's part might be to act differently which could possibly translate to managers making decisions that are undesirable.

This in effect could lead to inefficiency economically. The problems above hence can be categorized into adverse selection and moral hazard. 2. 1. Moral Hazard Moral hazard can be described as a situation where holders of asymmetric information, not to mention that the accuracy of this information cannot be challenged or monitored, bear the incentive to act differently from what their principals expect.

This could be in a dishonest manner which denies the principal full benefits. 2. 2. Adverse Selection Adverse selection on the other hand results from cases where asymmetric information may lead to the sale of poor quality goods and services which are far from what the shareholders had intended or expect. The principle agent problem is mostly realized when ownership and management are divorced and the egocentric wishes of the managers drive them to behave towards achieving their own interests other than those of their shareholders. A problem hence arises in design monitoring or monitoring incentives that will discourage the management from working towards achieving the shareholders interests.

In this regard the principal knows that working directly on his own without relying on agents proves less effective than acting through agents. The principle therefore has to construct some incentive schemes to try and get the agent to act though not fully but partly parallel to the interests of the principal. The problem here therefore lies in designing mechanisms or a mechanism that serves to induce the agents to behave according to the interests of the principal. Generally unless the principal employs some very costly monitoring measures, may be through training the board of trustee to equip them with expertise in monitoring of managerial behavior, it is not easy to completely eliminate this problem. The managers in the long run will be tempted to pursue their personal goals. However, it is not possible for them to ignore profits since they risk facing the sack if they register poor performance.

The degree of how much the agents might want to pursue their own personal benefits at the expense of the firm's profits depends on a variety of factors with the degree of competition in addition to the possibility that a management that is more profit oriented taking over being major motivators. In the light of the principle agent problem this paper is going to explore the possibility of two of the major corporation in the United States that could have possibly suffered from this problem and ended up collapsing during the 2008 financial crisis. These two companies includeEnronand the Lehmann brothers. 3.

The Principal Agent Theory and the Collapse of Enron Corporation 3. 1. Back Ground of the Enron Corporation The Principal Agent theory is very much applicable to the scandal that hit the Enron Corporation the year 2001 which led to its collapse after it was declared bankrupt. Just to give a brief background, Enron was the leading and very successful corporation that used to distribute and transmit natural gas as well as electricity through out the whole of the United States. In 2001 its accounting practices were put in the limelight leading to the discovery that Jeffrey Skilling (C. E.

O.) in cahoots with the company's accounting firms had been for years fudging numbers. Jeffrey Skilling had a way of making the company's financial losses and other operations disappear in a processes that they labeled mark-market accounting. For instance the company would set up assets like power plants and then its management would proceed to register profits in their books even before it made a single cent from it. If the revenue from the asset registered a loss the company would transfer the losses to the corporations off books instead of taking the losses hence they went unreported.

Since the shareholders could not monitor the behavior of its managers it could not detect any discrepancies since after monitoring the documentations they suggested that the company was still making profits. This is a very clear evidence of Principle agent problem. Only the managers knew that the company was headed to its down fall whereas the shareholders, employees and the general public were oblivious of this fact. Enron hence went down taking a lot of victims down with it. The scandal cost a lot of people their jobs leading losses that amounted to millions of dollars.

In addition to this many employees went without their pension, savings and college fund for their kids. This was the consequence that resulted from lack of financial accountability and management. 3. 2. Implications of Poor Management in Enron Corporation The collapse of Enron was mostly credited to the poor operations of its department of operations management. The functions of the operation management department in any corporation is setting up of accounts as well as notifying the utilities, verification of invoice formatting, testing the algorithms of these invoices, working with customers in setting up agent agreements as well as reporting the customers requirements.

However the operations department's functions in Enron were very limited and were no where close to the ones identified above. Other departments which entirely had no cnnections to the operations management had been assigned the responsibilities of the operational management listed above with some of them being; the energy asset management, commodity management, financial management, capital management and operation facility management. It was very clear that though all these departments were executive they lacked systematic vision, integration, control, responsibility and creativity. The operations management department failed in creation of a corporate atmosphere and culture in the corporation which also had adverse effects on Enron having in mind that this was one of the corporation's major functions. In this way the department was unable to uphold the principal's ethical values and integrity in addition to failing in competence and accountability.

Looking at the situation from a superficial level the motives and attitudes that formed the background for the downfall of Enron appear as very simple. The greed of some individuals and the collective stakeholders permitted the existence of an atmosphere dominated by corporate arrogance. As Enron's reputation grew through out the global environment its internal culture started to fail drastically which proves that competition increases the temptation of agents wanting to pursue their own interests as mentioned above. Jeffrey skilling had eventually established a Performance Review Committee which conducted the highest employee ranking countrywide. The review system was supposed to be based on the values of Enron's values of ' Respect, Integrity, Communication and Excellence' (RICE).

Eventually the company's associates concluded that performance of the employees could only be measured by the amount of profits that the employees could generate. This motivated employees especially the top ones to make shady deals in order to secure top ranking and remain part of the organization. Jeffrey Skilling's division would annually replace 15 percent of the company's work force in respect to the above. The result for this was fierce competition internally which in turn caused short term results to prevail at the expense of long term ones. Paranoia as a vice flourished within Enron promoting the number of highly confidential and restricted trade contracts to increase.

Secrecy hence became a rule that was generally acceptable in most of the contracts and disclosures among Enron's executive management. Deals especially in the department of finance ware hurriedly executed regardless of whether they conformed to strategic goals of the organization in addition to its rules that governed risk management. This brings out evidence that Enron's collapse and bankruptcy or the problem that led to it did not exclusively lie in the dockets of financial practices. If all the internal processes in Enron were to be analyzed then the popular belief on the issue of accounting practices cannot be entirely blamed for devastating Enron's employees and shareholders. 3.

3. Application of the Principal Agent Problem in regard to the collapse of Enron With this kind of information on Enron it is clearly possible to connect its downfall with the principal agent problem where by if the principle was well equipped with expertise in monitoring the behavior of the company's agents existence of moral hazards that led to the company's downfall could have been intercepted. Enron seemed a strong corporation equipped with a powerful management and a hierarchy that was clear but its internal organization had a lot of short comings due to the greed and the incompetence of the corporation's agent . In this respect it is so obvious that the operations management failed in provision and advancement of an environment of positive control hence did not make any contributions in shaping the ethical integrity, values and managerial philosophies of Enron's principal(s) in addition to failing in accountability. Hence the corporate principles in regard to their formulation and communication that the operations management at Enron employed in did not in any way comply with the principals initial values. The evaluation systems that Skilling resulted to which were harsh and strict played a major role in perverting the principals values and ethical basis of RICE converting them to profit gaining methods that paid no attention to the method employed .

Employees were left to engage in practices that were questionable receiving rewards for boosting the organizations income regardless of the means that they used. 4. The Lehmann Brothers and Mortgage CrisisAs it has been highlighted in the former parts of the paper, the Principle- Agent problem that is experienced in many economic units mainly arises due to the fact that the management and the ownership in the company have been placed in different individuals and sectors. As a matter of fact, the management and the stakeholders of the company are two different stakeholders in the company who are most likely to have very different roles in the company hence having slightly differing roles. It is due to this fact that it is important to take note of the fact that the managers and the shareholders at Lehmann Brothers had very different interests just as is the case with other companies in the globe today.

As a result of this fact, it is true to indicate that the difference of interest between the management at Lehmann Brothers and the shareholders can be cited as the most conspicuous reason behind the massive fall of one of the largest bank in the United States during the economic crisis that ended during last year of 2010. It is important to take note of the fact that the economic crisis that hit the world economy during the years 2007 upto 2010 still remains as the worst economic crisis that ever hit the world economy from when the Great Depression hit in the years between 1930 and 1940. The shortfall in the liquidity of the banking system in the United States is the main reason that is given behind the economic crisis. As will be further indicated in the paper, the financial crisis led to key businesses such as the banking sector falling, major declines in the consumer wealth, financial commitments given to the governments and most notably the overall decline in the economic activities. 4. 1.

Lehmann Brothers and the 2008 Economic Crisis The economic crisis that is in discussion led the Lehmann Brothers into filling for bankruptcy in the last quarter of 2008. By the time, the bankruptcy that was filled by Lehmann Brothers went on to becoming the largest in history with a recording of assets which by far exceeded those that had been reported for Enron and WorldCom which had earlier on been thought to be the heaviest firms to ever record heavy amounts of bankruptcy. The collapse of the bank was mainly accorded as being responsible for a figure of 10 million of the market capitalization that had resulted from the equity markets globally. The economic crisis that was brought about by the United State’s housing market was a very notable force in the life of the Lehmann Brothers since it had been capable of effectively surviving the all the other economic crisis points that had swept away other economic players. It is most notable that the Lehmann Brothers was capable of surviving the railroad bankruptcies, the Great Depression that was present during the 1930s, both the First and Second World War economic crisis, the collapse of the long term capital management and the Russian debt fault that was highly experienced during 1998. The 2008 economic crisis though proved to be a tough hurdle to be easily jumped by the Lehmann Brothers as it had done in other cases.

4. 2. Application of the Principal Agent theory to the Collapse of Lehmann Brothers Corporation The main reason that can be offered as to why Lehmann Brothers did not survive the economic crisis that was hitting the world during the period can be attributed to the problems that were rising

due to the principle agent theory in the company. Lehmann Brothers sets an example of a company whose management and ownership have been strictly divided among two different parties and segments. Due to this factor, it is expected that the interests that are attributed to the owners of the company or the shareholders are very different when compared to the interest that the management of the company had in mind. The acquisition of mortgage lenders into the bank was the main reason as to why Lehmann Brothers was facing problems during this particular time in its history.

It was very clear though that the incorporation of the mortgage lenders into the bank had already been highlighted by the owners of the bank as a potential for problems that the bank could face in the future. The chief Financial Officer of the company came out bravely to affirm to the investors in the bank that the risks that the bank was facing by adding more home delinquencies had been contained by the bank hence they could not hatch the problems that had been feared by the bank owners. The earnings of the firm were therefore under safe management by the bank's management team according to the Chief Financial officer who had assured the shareholders of the company that the management was doing the best to ensure that the earnings of the bank had not been interfered with totally by the home delinquencies. As a matter of fact, the Chief Financial Officer who had been entrusted by the shareholders made the wrong decision by informing the owners of the company that the difficulties that were being experienced by the subprime market could not spread into the housing market and therefore any fears about the mortgage lenders that had been incorporated into the bank had not to be an issue at all. In the long run it was very apparent that the fears that the shareholders were having about the returns for the company came to pass and in a very heavy and fast wave. The managers had been entrusted by the investors or the owners of the company that they would make the right decisions on their behalf while minding the interests of the owners.

This was not the case as in the long run, it ended up that the exact fears that the owners of the banks were foreseeing really ended up being the main reason for the down fall of the company. Signs that the interests of the principals were not being considered began coming into realization. The stock of the Lehmann Brothers fell sharply in the year 2007 in August. This was as a result of the failure of the failure of the funds from two Bear Stearns. This sharp fall of eth company's that was being experienced as early as 2007 resulted into the management reducing the jobs that were related to mortgage and even went ahead to shut down the segment of the bank that was responsible for BNC.

This had been the wish of the owners of the company from the word go but the management had been trusted on using its own effective means of ensuring that the economic crisis resulting form the mortgage sector did not affect the company. Although the management of Lehmann Brothers seemed to be realizing that the wishes of the owners of the company were more important hence reducing the rate at which it was investing in the mortgage related businesses, Lehmann Brothers still remained to be a major player ion the housing market in the United States. This was mostly notable when the firm became the company that wrote the highest number of securities backed by mortgages more than any other bank in the United

States at the time that the housing market was already indicating all the signs that problems were looming ahead. This move led Lehmann Brothers into accumulating portfolio that was amounting to $85 billion, an amount that was actually four times more than the value of its share equity. During the fourth quarter of the year 2007 when the company's management had the final chance to lower down the rate at which it had invested in the mortgage portfolio, its stock rebounded.

At this point the management was still adamant on following their wishes at the expense of the company's owners. It was not long before failure came glaring at the faces of the managers as they had failed completely in dealing with the problem tat the owners of the company had allocated to them. By this, it meant that the Lehmann Brothers was going to have to plunge into the financial mess that had already seen other companies close down. The downfall that could not be avoided by Lehmann Brothers as has been clearly illustrated in the part above was by all means as a result of the problem brought about by the principal Agent theory in the company. 5.

Solution to the Principal Agent Problem As has already been critically analyzed in the rest of the paper, the principal agent theory mainly faces the sole problem of ensuring that the managers and the owners of the company share an interest or even interests. Aligning the interests of the managers and the shareholders in the company is therefore the very first strategy that ought to be used in the company to ensure that issue like the one that has been discussed that faced the two companies is avoided. This can be achieved by ensuring that the managers in the company have a part in the share of values in the company. As a mater of fact, by ensuring that the managers are also part of the shareholders in the companies means that they form part of the ownership and hence they are bound to make more sober decisions about the company that they also own and run. The other remedy that could be used would be to ensure that the rate of profits that is accrued by the company is directly put in the employee’s salary. By doing this kind of thing, it would mean that a certain per cent age of the employee’s salary is pegged on the amount of profits that the company generates at the end of the financial year.

As was the case in the Lehmann Brothers, the motivation for the managers to make profits for the company did not exists at all and it is no wonder that despite the many opportunities that they had to change the strategy off operation were not followed at all. Finally, the other main way that the company can use to prevent having a case as similar to that of the Lehmann Brothers is by having the employees being rewarded according to the profits that they make in their respective departments. This ensures that the employees are all committed towards ensuring that the company makes optimal level of profits just as is the case with the wish of the shareholders of the company or the owners. 6. Conclusion The problem that is brought about by the Principal Agent theory is by all means not an issue to be ignored totally in a business of any nature and level.

The Lehmann Brothers and Enron are perfect examples that indicate that no matter how stabilized a company is, the agreement between the owner’s and manager’s interests is of very huge importance. The two have to merge and it can not therefore be said that one of them has to bend into accepting the interest of the other party. Without having this, a company is bound to fall because the owners of the company may have all the interest communicated to the management although the final implementation is exclusively dependent on the management team. As has been highlighted in the previous section, the only way to ensuring that the management follows exclusively the interest of the owners which is to basically see that the success of the company is realized, accommodating the management and the employees in enjoying the results of the profits and also accommodating them in ownership are the only feasible manner to ensure that principal agent does not come in as a problem to a company.