Agent – principal conflict

[Business](), [Company]()

Principal – agent conflict arise because managers & shareholders view the role of the corporation differently. Investors see corporation as investment vehicles. Shareholders want corporate managers to work diligently and efficiently towards the simple goal of maximizing the value of their ownership stake. However, the relationship between the managers of a corporation and its owners is complex. The principle of self-interested behavior tells that people, including managers and stockholders, work in their own financial self interest.

This is considered the main source of divergence between a manager’s and an owner’sgoals. Each wishes to maximize wealth and benefits, often at the expense of the other party. The modern corporation separates ownership and control giving rise to the principal-agent relationship. However, this separation gives managers an opportunity to work in their own self-interest. There are six different types of agency conflicts briefed below. Major source of manager-owner conflict is a behavior called shirking.

Shirking is not putting forth the best effort to help stockholders realize the largest return possible. Perhaps managers are spending too much time enjoying perks and creating an opportunity cost of not working on projects and day-to-day operations. Whatever the reason, stockholders’ value decreases each time an opportunity for firm improvement is lost to shirking managers. Further, managers have different time horizons than the shareholders. The executives concerns largely on their tenure with the corporation, whereas shareholders concerns with value of infinite series of future cash flows.

Another source of manager-owner conflict occurs when managers and employees hold unique skills necessary for business operations. The abilities and skills held by employees are collectively known as human capital. Just like investment capital, it defines what a company is capable of and often creates an important vehicle through which a company may compete in the market. When employees of a firm become specialists over time, their skills become non-diversifiable. We know that diversification is a good thing, but specialty creates what is known as non-diversifibility of human capital.

One of the major sources of manager-owner goal divergence is found in the perquisites a manager enjoys as being a decision-maker in the organization. Perks are those aspects of the company that bring value to a manager but are not a part of the manager's compensation package. Perks include club membership, company cars, and plush workingenvironment. Excessively taking advantage of these perks erodes the value of the firm because they represent real costs to stockholders. The overinvestment problem occurs when managers creating assets for the firm at the expenses of shareholders without creating value for them.

However, managers choose not to make NPV investments in order to increase company's cash holding, creating larger cash buffer to avoid future cash short fall. This is underinvestment problem. Correcting overvalued stock would destroying shareholder value rather than creating it, although the financial results are misrepresented. It become worse if manages have been compensated with stock options. There are three common ways to reduce the conflicts. Which are contracting, incentives and monitoring. Although

none of this method eliminates the agency problem, it however reduces the conflict.

Contracting: It is difficult method to enforce executive assignment or guidelines since managers have to respond to the opportunity arises & also to make the decisions about future course during uncertainties. Without discretion over decision it would not be possible. Incentives: It is more promising method; however agent principal conflict arises because the two parties have different incentives. Equity based compensation combined with overvalued equity can create more problem than resolves. Monitoring: It can be effective in limiting excess perquisite consumption, the poor use of company assets and time horizon problem.

It is less effective in dealing with the shirking or effort problem. The separation of ownership of a firm and its control allows investors to investmoneyin multiple companies without having to concentrate on how each firm is actually run. This allows for diversification of assets by the investor to minimize risking all of his/her wealth. However, this separation creates agency problems which erode some of the value of being able to own a company but not having to spend the time to manage it. This value lost is often the result of managers taking too much liberty with perks and of shirking responsibilities.