

Good example of
report on agency
problems and the
ways in which it could
be solve...

[Business](#), [Company](#)



The Concept of Agency Problems

In the field of business and financial management, when a principal hires or appoints any agent to carry out or perform some sort of duty, this activity gives a rise to an agency relationship. An agency problem, known as a conflict of interest, comes to existence when there is a clash of interest between the needs of the agent and the demands of the principal.

A conflict of interest or an agency problem is said to be inherent in any kind of relationship where one party is obliged to act in the best interests of counterparty. The major concern in such kind of relationship is that an agent, who is expected to make decisions in best interests to serve the principal, is motivated naturally by self-interest. This way, his own best interests may differ from those of his principal. Theoretically, agency problem is known with a name of principal-agent problem .

In corporate finance, a conflict of interest usually refers to the agency problem between a company's management and its stockholders (shareholders). The manager, acting as an agent to the company's principals or shareholders, is required to make decisions that could maximize shareholder wealth or increase stockholder value. However, it is in the agent's (manager's) best self-interest to maximize/increase his own wealth . A potential agency problem is more likely to occur between stockholders and managers when the manager possesses minority stake (less than 100%) of the company's total common stock outstanding. Managers may make only those decisions that have a potential to conflict with the shareholders' best interests. For instance, managers may grow their company to a certain extent that it is able to escape any kind of hostile takeover attempt to

maximize their job security. However, in many cases, a hostile takeover could be in the best interests of shareholders .

How Shareholders and Financial Markets Can Ensure Managers Maximize Wealth?

While it is not completely possible to reduce or even eliminate the conflict of interest or agency problem, the manager of the company can still be motivated to act in the best interests of shareholders. This objective could be achieved through implementation of such incentives as well as initiatives like direct intervention by shareholders, threat of being fired, the threat of hostile takeovers and performance-based compensation.

The major objective of almost every organization is to enhance the shareholders' wealth. In a true and broader sense, such a maximization pertains to the premise that financial decisions should be taken in a manner that shareholders could receive highest returns in the form of dividend payments and maximize the market price of outstanding shares. This concept is known as Net Present worth Maximization or Value Maximization on which all financial decisions are based.

There are primarily four policy mechanisms or initiatives for shareholders and financial markets to motivate financial managers to act in their best interests. These include direct intervention by stockholders, threat of being fired, threat of hostile takeovers and managerial compensation . These initiatives are elaborated in general detail as follows:

Direct Intervention by Stockholders

These days, the majority of a publicly traded company's outstanding stock is owned by large institutional investors like mutual funds and pension management institutions. As such, these large institutions, as shareholders, can exert their powerful influence on organization's managers and the firm's operations to act and make decisions in their best interests.

Threat of Being Fired

In case, if shareholders are unhappy or discontented with managerial performance of the existing management, they may influence the current board of directors to change the existing management. Alternatively, shareholders have the power to re-elect new board of directors having a potential to accomplish the wealth maximization task.

Threat of Hostile Takeovers

If a stock price for every outstanding share in the market deteriorates because of inability of the existing management to run the organizational operations effectively, shareholders or competitors may take a controlling (majority) interest in the publicly traded company and replace the existing management by bringing-in their own managers .

Managerial Compensation

This form of program to motivate managers for acting in the best interests of shareholders should always be constructed not only to retain competent managers, but to align their interests with those of shareholders as much as possible. Such a program is typically implemented by accompanying

manager's annual salary with a performance-based bonuses and ownership of company shares.

Generally, if Employee Stock Ownership Plan (ESOP) is implemented, company's shares are distributed typically to managers either in the form of performance shares in which managers receives a certain number of shares, as bonuses, based on the overall performance of the public organization.

Another form of ESOP is to reward high-performing managers through executive stock options where managers are allowed to buy shares at some future date and a specific price. With the use of various stock option initiatives stated in this section, managers' interests are aligned closely to the shareholders interest as they themselves will become the owners to the public organization.

Why Is This Important and Are There Any Associated Problems

In above sections, it was discussed that how agency problems arise and what policy measures could be considered so that the shareholders and financial markets could align the managerial activity to their interests. Here, the reasons for which the shareholder wealth maximization is important for managers of publicly traded businesses. When managers of public businesses try to maximize the wealth of their shareholders, they are actually attempting to increase the stock price from which shareholders derive capital gains.

As the price per share increases, any investor holding the company's stock witnesses a maximization of his wealth. As per share price increases, the firm's value also increases leading to a dramatic maximization of the net

worth of the investors who own the stock. In Corporate Sense, Wealth Maximization is known to be the maximization of a market price per share. Generally, market price is considered to be an indicator of company's progress, financial prosperity, profit generating capacity and operational productivity as well as it reflects the prospects of a publicly traded company as a " Performance Index" .

Measurement of Shareholder Wealth

In financial management, the fundamental principle is the maximization of shareholders wealth which is measured on the basis of economic value depending upon cash flow streams and not profitability. Economic Value, corporate finance, is defined as the net present value of future cash flows (FCF) generated by making a feasible business decision and is discounted at an appropriate rate which reflects the degree or involvement of associated risk.

2. Market Value of Shares

The future cash flow (FCF) is anticipated for the net present value of the market price of every outstanding share. As wealth of each shareholder is equal to the per share market price held by investors, any increase in the market price would lead to a maximization of shareholder's wealth.

Depending upon the above two concepts, it is clear that managers should attempt to maximize the shareholder wealth because the public business needs to have a sufficient financial flexibility to raise capital from the secondary market to finance its business operations. In the event when shareholder wealth is deteriorated in any form, investors will lose confidence

into the business and will refrain from extending any kind of financial and non-financial support to the public organization.

In such an event, not only the business will find it difficult to raise capital but the liquidity strength of the business will greatly harmed also. If the shareholder wealth maximization is not pursued strategically as a long-term goal, the public business will need to borrow from the debt market at a higher rate of return which will expose the company more to an interest rate risk and its risk of default (counterparty risk) will rise drastically. Very soon, the business will find very exhausting to raise capital from debt as well as equity markets and will find it cumbersome to materialize its corporate objectives.

Problems with Shareholder Wealth Maximization

However, since this world is a platform of possibilities, even though managers pursue the goal of maximizing the shareholder wealth, yet they face numerous obstacles as well problems while doing so. This is so because since shareholders make decisions in their own best interests, a potential agency problem arises between the creditors of the publicly traded business and its shareholders. For instance, managers could borrow money from lenders (creditors) to repurchase a portion of outstanding shares to reduce the public company's share base and maximize earnings or returns made available to each shareholder. When shareholders benefit, it is the creditors group who will become seriously concerned about the managerial performance given the increase in debt levels having a strong influence over future cash flows (FCF) .

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