Agency conflicts

Business, Company

The genius of public corporations teems from their capacity to allow efficient sharing or spreading of risk among many investors, who appoint a professional manager run the company on the behalf of shareholders. However, the public corporation has a key weakness - namely, the conflicts of Interest between managers and shareholders. The separation of the company ownership and control, which Is especially prevalent where corporate ownership Is highly diffused, gives rise to possible conflicts between shareholders and managers.

In theory, shareholders elect the board of directors of the company, which in turn ire's managers to run the company for the Interests of shareholders. Managers are supposed to be agents working for their principals, that Is, shareholders, who are the real owners of the company. In a public company with diffused ownership, the board of directors is entrusted with the vital tasks of monitoring the management and safeguarding the interests of shareholders. Unfortunately, with diffused ownership, few shareholders have strong enough incentive to incur the costs of monitoring management themselves when the benefits from such monitoring accrue to all shareholders alike. The benefits are shared, but not the costs. When company ownership is highly diffused, this " free-rider" problem discourages shareholder activism. As a result, the interests of managers and shareholders are often allowed to diverge. With an ineffective and unmotivated board of directors, shareholders are basically left without effective recourse to control managerial self-dealings.

Recognition of this key weakness of the public corporation can be traced at least as far back as to Adam Smith's Wealth of Nations (1 776), which stated:

The directors of such Joint-stocks companies, however, being the managers rather of other people'smoneythan of their own, it cannot well be the partners of a private cooperator frequently watch over their own.... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

Agency theory in a formal sense originated in the early asses, but the concepts behind it have a long and varied history. Among the influences are property-rights theories, organization economics, contract law, and politicalphilosophy, including the works of Locke and Hobbes. Some noteworthy scholars involved in agency theory's roommate period in the asses included Airmen Lucian, Harold Demesne, S. A. Ross and the famous paper " Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure. " of Michael Jensen and William Neckline.

In an ideal situation the manager (or entrepreneur) and the investors sign a contract that specifies how the manager will use the funds and also how the investment returns will be divided between the manager and the investors. If the two sides can write a complete contract that specifies exactly what the manager will do under each of all possible future unforeseen events, there will be no room for any inflicts of interest or managerial discretion. Thus, under a complete contract, there will be no agency problem. However, it is practically impossible to foresee all future contingencies and write a complete contract.

This means that the manager and the investors will have to set up the control rights to make decisions under those contingencies that are not specifically covered by the contract. Because the outside investors may be neither qualified nor interested in making business decisions, or if there will be too many of investors, the manager often ends up acquiring most of this residual control right. The investors supply funds to the company but are not involved in the company's daily decision making. As a result, many public companies come to have " strong managers and weak shareholders. The agency problem refers to the possible conflicts of interest between self - interested managers as agents and shareholders of the firm, who are the principals. In the described circumstances the manager will end up with residual control rights to allocate investors' funds, and sometimes the disclosure of investment channels may not be clear and full. So the investors are not longer assured of achieving fair returns on their funds, in other words the agency problem lies in a loss of trust for the manager by the shareholders of the company.

In the following paper examples of the agency problem, proposed ways of solving and controlling methods and their analysis will be presented and discussed. Chapter 1 . Prerequisites of the agency problem and different approaches to solving it 1. 1 . How we detect an agency problem Agency theory suggests that the firm can be viewed as a combination of different relationships - some of them well and others can be loosely defined - between resource holders. The primary agency relationship in business is between stockholders and managers.

The relationships are not necessarily harmonious; indeed, the agency theory is concerned with so-called agency conflicts, or conflicts of interest between agents and principals. This has implications for, among other things, corporate governance and business ethics. When the agency problem occurs sustain an effective agency relationship, those will be discussed a bit later. So what can be signals for managerial self-interested behavior? Sometimes, the manager simply steals investors' funds.

Alternatively, the manager may use a more pesticides scheme, setting up an independent company that he owns and diverting to it the main company's cash and assets through transfer pricing. For example, the manager can sell the main company's output to the company he owns at below market prices, or buy the output of the company he owns at above market prices. Some oil companies are known to sell oil to manager-owned trading companies at below market prices and not always bother to collect the bills.

Self- interested managers may also waste funds by undertaking unprofitable projects that benefit themselves but not investors. For example, managers may allocate funds the ay to take over other companies and overpay for the targets if it serves their private interests. Needless to say, this type of investment will destroy shareholders' value. What is more, the same managers may take anti-takeover measures for their own company in order to secure their personal Job and perpetuate private benefits.

In the same vein, managers may resist any attempts to be replaced even if shareholders' interests will be better served by their resignation. These managerial entrenchment efforts are clear signs of the agency problem. One of the clearest signals for the existence of the agency problem can be management of free cash-flow. High level of free cash-flows are usually presented in companies on a maturity stage of life cycle, with a low level of growth, so those free cash? flows are supposed to be distributed as dividends or should be invested in some projects, both of the actions can probably increase the firm's value.

But there are a few important incentives for managers to retain cash flows. First, cash reserves provide corporate managers with a measure of independence from the capital markets, insulating them from external scrutiny and discipline. This will make life easier for managers. Second, growing the size of the company via retention of cash tends to have the effect of raising managerial compensation. As is well known, executive compensation depends as much on the size of the company as on its profitability, if not more.

Third, senior executives can boost their social and political power and prestige by increasing the size of their company. Executives presiding over large companies are likely to enjoy greater social prominence and visibility than those running small companies. Also, the company's size itself can be a way of satisfying the executive ego. Consequently, managers of those companies either sit n a huge bunch of money, or bound to invest in a lot of not so successful projects or to take over some other firms in attempt to diversify and not to pay dividends or at least too high dividends.

In the contrast in high-growth industries, such as biotechnology, financial services, and pharmaceuticals, where companies internally generate funds, which fall short of profitable investment opportunities, managers are less likely to waste funds in unprofitable projects. After all, managers in these industries need to have a " good reputation", as they must repeatedly come back to capital markets for funding. Once the managers of a company are known for wasting funds for private benefits, external funding for the company may dry up quickly.

The managers in these industries thus have an incentive to serve the interests of outside undertaking their " good" investment projects. Generally, the heart of the agency problem is the conflicts of interest between managers and the outside investors over the disposition of free cash-flows, so in the following part I would like to present different approaches on how owners of the firm can hedge and maintain managers of the firm to lower the risk of agency problem ND, subsequently, agency costs. 1. 2.

Remedies of agency problem Obviously, it is a matter of vital importance for shareholders to control the agency problem; otherwise, they may not be able to get their money back. It is also important for society as a whole to solve the agency problem, since the agency problem leads to waste of scarce resources, hampers capital market functions, and retards economic growth. Several main governance mechanisms exist to manage or completely remove an agency problem: 1. Board of directors 2. Incentive contracts 3. Concentrated ownership 4. Debt 5.

Overseas stock listings 6. Market for corporate control (takeovers) In most of the countries, shareholders have the right to elect the board of directors, which is legally charged with representing the interests of shareholders. If the board of directors remains independent of management, it can serve as an effective mechanism for curbing the agency problem. For example, studies showed that the appointment of outside directors is associated with a higher turnover rate of Coos following poor firm performances, thus curbing managerial entrenchment.

In the same vein, in a study of corporate governance in the United Kingdom, Daddy and McConnell report that the board of directors is more likely to appoint an outside CEO after an increase in outsiders' representation on the board. But due to the diffused ownership structure of the public company, management often gets to choose board members who are likely to be friendly to management. The structure and legal charge of corporate boards vary greatly across countries.

In Germany, for instance, the corporate board is not legally charged with representing the interests of shareholders. Rather, it is charged with looking after the interests of stakeholders (e. G. , workers, creditors, etc.) in general, not Just hardliners. In Germany, there are two-tier boards consisting of supervisory and management boards. Based on the German extermination system, the law requires that workers be represented on the supervisory board. Likewise, some U. S. Companies have labor union representatives on their boards, although it is not legally mandated.

In the United Kingdom, the majority of public companies voluntarily abide by the Code of Best Practice on corporate governance recommended by the Catbird Committee. The code recommends that there should be at least three outside directors and that the board chairman and the CEO should be different individuals in USA there are a lot of examples of CEO and chairman being the same individual, what is in author's opinion, can be one of the most crucial factors of top-managerial frauds).

Apart from outside directors, separation of the chairman and CEO positions can further enhance the independence of the board of directors. In Japan, most welfare of the keiretsu to which the company belongs. As previously discussed, managers capture residual control rights and thus have enormous discretion over how to run the company. But they own relatively little of the equity of the company they manage. To the extent that managers do not own equity shares, they do not have cash flow rights.

Although managers run the company at their own discretion, they may not significantly benefit from the profit generated from their efforts and expertise. In the end of sees researches showed that the pay of American executives changes only by about $3 per every $1, 000 change of shareholder wealth; executive pay is nearly insensitive to changes in shareholder wealth. This situation implies that managers may not be very interested in the minimization of shareholder wealth. This " gap" between managerial control rights and cash flow rights may enlarge the agency problem.

When professional managers have small equity positions of their own in a company with diffused ownership, they have both power and a motive to engage in self-dealings. Aware of this situation, many companies provide managers with incentive contracts, such as stocks and stock options, in order to reduce this gap and align better the interests of managers with investors'. With the grant of stocks or stock options, managers can be given an incentive to run the company in such a way that enhances shareholder wealth as well as their own.

Against this backdrop, incentive contracts for senior executives have become common among public companies in the United States. As will be shown in the second chapter of the paper, however, senior executives can abuse incentive contracts by artificially manipulating accounting numbers, sometimes with the connivance of auditors (for example, Arthur Andersen's involvement's with the Enron debacle), or by altering investment policies so that they can reap enormous personal benefits.

It is thus important for the board of directors to set up an independent compensation committee that can carefully design incentive contracts for executives and regularly monitor their actions, and these incentives contracts should be composed in accordance to the characteristics of firm's operational activity, as will be demonstrated in the third part of the chapter. An effective way to mitigate an agency problem is to concentrate shareholdings. If one or a few large investors own significant portions of the company, they will have a strong incentive to monitor management.

For example, if an investor owns 51 percent of the company, he or she can definitely control the management (he can easily hire or fire managers) and will make sure that shareholders' rights are respected in the conduct of the company's affairs. With concentrated ownership and high stakes, the free-rider problem afflicting small, atomistic shareholders dissipates. In the United States and the United Kingdom, concentrated ownership of a public company is relatively rare. Elsewhere in the world, however, concentrated ownership is regularly implemented.

In Germany, for example, commercial banks, insurance and other companies, even families often own significant blocks of company stock. Similarly, extensive cross-holdings of equities among keiretsu member companies and main banks are commonplace in Japan. Also in France, cross-holdings and " core" investors are common. In Asia and Latin America, many companies are controlled by founders or theirfamilymembers. In China, the government is often the controlling ownership has a positive effect on a company's performance and value, examples of Japan and Germany.

This suggests that large shareholders indeed play a significant governance role. Of particular interest here is the effect of managerial equity holdings. Previous studies suggest that there can be a nonlinear relationship between managerial ownership share and firm value and performance. Specifically, as the managerial ownership share increases, firm value may initially increase, since he interests of managers and outside investors become better aligned (thus reducing agency costs).

But if the managerial ownership share exceeds a certain point, firm value may actually start to decline as managers become more entrenched. With larger shareholdings, for example, managers may be able to more effectively resist takeover bids and extract larger private benefits at the expense of outside investors. If the managerial ownership share continues to rise, however, the alignment effect may become dominant again. When managers are large shareholders, they do not want to rob themselves. To summarize, there can be an interim range" of managerial ownership share over which the entrenchment effect is dominant.

Studies showed (Merck, Shellfire, and Vishnu) that the " entrenchment effect" is roughly dominant over the range of managerial ownership between 5 percent and 25 percent, whereas the " alignment effect" is dominant for the ownership shares less than 5 percent and exceeding 25 percent. A relationship between managerial ownership and firm value is likely to vary across countries. Although managers have discretion over how much of a dividend to pay to shareholders, debt does not allow such managerial discretion.

If managers fail to pay interest and principal to creditors, the company can be forced into bankruptcy and its managers may lose their Jobs. Borrowing and the subsequent obligation to make interest payments on time can have a major disciplinary effect on managers, motivating them to curb private perks and wasteful investments and trim bloated organizations. In fact, debt can serve as a substitute for dividends by forcing managers to disgorge free cash flow to outside investors rather than wasting it.

For firms with free cash flows, debt can be a stronger mechanism than stocks for credibly bonding managers to release cash flows to investors. Excessive debt, however, can create its own problem. In turbulent economic conditions, equities can buffer the company againstadversity. Managers can pare down or skip dividend payments until the situation improves. With debt, however, managers do not have such flexibility and the company's survival can be threatened. Excessive debt may also induce the risk-averse managers to forgo profitable but risky investment projects, causing an underinvestment problem.

For this reason, debt may not be such a desirable governance mechanism for young companies with few cash reserves or tangible assets. In addition, companies can misuse debt tofinancecorporate empire building. Companies domiciled in countries with weak investor protection, such as Italy, Korea, and Russia, can bond themselves credibly to better investor protection by listing their stocks in countries with strong investor protection, such as the United States and the United Kingdom.

In other words, foreign firms with weak governance mechanisms can opt to outsource a superior corporate governance regime available decision to list its stock on the New York Stock Exchange (NYSE). Since the level of shareholder protection afforded by the U. S. Securities Exchange Commission (SEC) and the NYSE is much higher than that provided in Italy, the action will be interpreted as signaling the company's commitment to shareholder rights. Then, investors both in Italy and abroad will be more willing to provide capital to the company and value the company shares more.

Generally speaking, the beneficial effects from U. S. Listings will be greater for firms from countries with weaker governance mechanisms. Studies confirm the effects of cross-border listings. Specifically, Dodge, Karol, and Stall (2002) report that foreign firms listed in the United States are valued more Han those from the same countries that are not listed in the United States. They argue that firms listed in the United States can take better advantage of growth opportunities and that controlling shareholders cannot extract as many private benefits.

It is pointed out, however, that foreign firms in mature industries with limited growth opportunities are not very likely to seek U. S. Listings, even though these firms face more serious agency problems than firms with growth opportunities that are more likely to seek U. S. Listings. In other words, firms with more serious problems are less likely to seek the remedies. Suppose a company continually performs poorly and all of its internal governance mechanisms fail to correct the problem. This situation may prompt an outsider (another company or investor) to mount a takeover bid.

In a hostile takeover attempt, the bidder typically makes a tender offer to the target shareholders at a price substantially exceeding the prevailing share price. The target shareholders thus have an opportunity to sell their shares at a substantial premium. If the bid is successful, the bidder will acquire the control rights of the target and restructure the company. Following a successful takeover, the bidder often replaces the management team, divests some assets or divisions, and trims employment in effort to enhance efficiency.

If these efforts are successful, the combined market value of the acquirer and target companies will become higher than the sum of stand-alone values of the two companies, reflecting the synergies created. The market for corporate control, if it exists, can have a disciplinary effect on managers and enhance company efficiency. In the United States and the United Kingdom, hostile takeovers can serve as a rustic governance mechanism of the last resort. Under the potential threat of takeover, managers cannot take their control of the company for granted. In many other countries, however, hostile takeovers are quite rare.

This is so partly because of concentrated ownership in these countries and partly because of cultural values and political environments disapproving hostile corporate takeovers. But even in these countries, the incidence of corporate takeovers has been gradually increasing. This can be due, in part, to the spreading of equitycultureand the opening and deregulation of capital markets. In Germany, for instance, takeovers are carried out through transfer of block holdings. In Japan, as in Germany, inter firm cross-holdings of equities are loosening, creating capital market conditions that are more conducive to takeover activities.

To the extent that companies with poor investment opportunities and excess cash initiate takeovers, it is a symptom, rather than a cure, 1. 3. Different approach for different types of companies In the Journal of Financial and Strategic Decisions Robert L. Lippies wrote an article named " Agency conflicts, managerial compensation and firm variance", where e described different situations where one type of managerial compensation would be more effective than others as a solution for an agency problem.

The recent literature on agency conflicts between managers and shareholders is characterized by studies that test whether the implementation of incentive compensation schemes mitigate the manager-shareholder conflict. While these studies present evidence that incentives do influence managerial decision-making, no dominant class of incentives has been found. This finding is consistent with evidence that suggests firms must compensate according to their particular characteristics.

The article of Robert Lippies will consider incentive compensation in relation to the manager's ability to increase the risk of future cash flows. In this context the relationship between compensation, risk taking, and managerial behavior can be evaluated. I would like to introduce some of his findings with short arguments. 1. Managers who receive a large portion of their total compensation in fixed wages will make efforts to reduce the variance of future cash flows. 2. Managers who receive a large portion of their total compensation in the form of fixed wages will have interests aligned to those of bondholders.

Both wage and bond payoffs are negatively affected by increased dispersion because any values beyond these fixed claims are of no concern. This result implies that the interests of the manager and the bondholder become increasingly aligned as the manager's fixed wage increases. In the case of the pure fixed wage earner or pure bondholder, minimizing variance increases expected utility. Specifically, in this scenario, bondholders and wage earners have interests that are naturally aligned, and that is in direct conflict with the manager's role as an agent for the shareholders.

The manager should consider bondholders interests to the extent that they impact the value of the firm but there should not be a direct alignment of interest between the manager and bondholders because this would violate the agency agreement between the shareholders and the manager and ultimately lower the value of common equity. Thus, the incentive compensation scheme must encourage the fulfillment of the principal-agent relationship. 3. Managers who receive a large portion of their total compensation in equity-related securities will make efforts to increase the variance of future cash flows. Managers who receive a large portion of their total compensation in equity-related securities will have interests aligned to those of shareholders. If the manager has significant control over the dispersion of firm values, the compensation scheme should reflect this fact by providing a lower fixed wage and more equity-related rewards. Of course, when the firm compensate its manager by equity-related reward, there is always a threat that the manager will manipulate with a price of shares, those manipulations may harm the real market value of the firm and may even lead to the firm's edge.

If, however, the manager has little control over the dispersion, a different type of remuneration package should be developed which limits the manager's exposure to risk which is beyond his control. 5. Managers of earning high wages will choose to hold larger amounts of the firm's equity-related securities. Assuming that a manager receives a wage, in case of high level of variance the manager should hold enough stock to offset any potential loss in wages.

For example, if a firm is subject to large dispersions in value over which the manager has no control, the manager could hedge against a possible loss in wages by holding an mount of stock proportional to his wage claim. This wealth allocation would allow him to offset his potential loss of wages with potential capital gains. 6. Managers of stable firms who have little control over the dispersion of future cash flows and who earn high wages should receive fewer equity-related rewards from the firm.

Clearly, if a manager has a little control over a firm's cash-flows, there is no need to connect his reward to the particular indexes of the firm, but as far as the firm is stable and has a lot of cash, it can allow high wage for its manager, what in turn is expected to be fair reward for the manger to prevent him from wrong-doings. 7. Firms which provide their managers with the ability to increase the dispersion of future cash flows should include more equity related rewards in the manager's compensation system. 8.

The existence of compensation in the form of stock options lowers the incentive of managers to expropriate wealth from shareholders and increases the incentive to expropriate wealth from bondholders. While prior research has focused on managerial compensation and its motivational qualities; this model suggests that firm-specific characteristics relating o the propensity for firm variance and the degree of control that the manager has over this variance should be the fundamental determinants of managerial reward.

In the second chapter of my paper various examples of agency problem will be presented, also how different aforementioned solutions were implemented for these examples will be analyzed and discussed. Chapter 2. Practical examples of agency problem's solution 2. 1. Good intentions usually backfire Executive loans. In the asses and early asses, loans by companies to executives with low interest rates and " forgiveness" often served as a form of compensation. Before ewe loans were banned in 2002, more than 30 percent of the 1500 largest US firms disclosed cash loans to executives in their regulatory filings, sum totaled $4. Billion, with the average loan being about $11 million. Half of these companies, charged no interest on executive loans, and half charged below market rates, and in either case the loans were often " forgiven". An estimated $1 billion of the loans extended before 2002 (when they were banned) will eventually be forgiven, either while the executives are still at their companies or when they leave. For executives in companies that went bankrupt during the informational genealogy bubble collapse (when in the most of cases value of Internet-based or oriented companies could have been created by adding e- in front of their names or . Mom after), when investors lost of billions of dollars, this was very useful. According to the Financial Times, executives at the 25 largest US public firms that went bankrupt between January 2001 and August 2001 sold almost $3 billion worth of their companies' stock during that time and two preceding years as the collective shares fell by at least 75 percent, 25 had executives sell a total of "$23 billion before their stocks plummeted".

Large loans to executives were involved in more than a couple of these companies, one of the most notable being World. World loaned (directly or indirectly) hundreds of millions of dollars? approximately 20 percent of the cash on the firm's balance sheet? to its CEO Bernard Beers to help him pay off margin debt in his personal brokerage account. The loans were both unsecured and about half the normal interest rate a brokerage firm would have charged.

World filed for bankruptcy a few months after the last loans were made. As a reaction to these scandals and clear frauds by top-management of huge impasses, the Serbians-Solely Act was passed in mid-2002 to improve financial disclosures from corporations and prevent accounting fraud, but also involved executive compensation. It banned loans by companies to directors and executives, also included the return of executive stock sale profit if overstating earnings will be revealed.

Enron's compensation and performance management system was designed to retain and reward its most valuable employees, the system contributed to a dysfunctional corporate culture that became obsessed with short-term earnings to maximize bonuses. Employees constantly tried to start deals, often disregarding the laity of cash flow or profits, in order to get a better rating for their performance review, such actions helped ensure deal-makers and executives received large cash bonuses and stock options. The company was constantly emphasizing its stock price.

Management was compensated extensively using stock options. This policy of stock option awards caused management to create expectations of rapid growth in efforts to give the appearance of reported earnings to meet Wall Street's expectations. At budget meetings, target earnings were developed on the basis " What earnings do you need to keep our stock price up? And that number would be used, even if it was not feasible. At December 31, 2000, Enron had 96 million shares outstanding as stock option plans (approximately 13% of common shares outstanding).

Enron's proxy statement stated that, within three years, these awards were expected to be exercised. Using Enron's January 2001 stock price of $83. 13 and the directors' beneficial ownership reported in the 2001 proxy, the value of director stock ownership was $659 million for the chairman of Enron Kenneth Lay, and $174 million for the CEO Jeffrey Killing. Employees had large expense accounts and many executives were paid moieties twice as much as competitors. In 1998, the top 200 highest-paid employees received $193 million from salaries, bonuses, and stock.

Two years later, in 2000 the figure Jumped to $1. 4 billion. As we all know Enron had gone bankrupt on November 30, 2001, before that the price of Enron's share fell to 0, 61 $, yet Just in the beginning of the year the CEO promised 2001 will be " their easiest year". All in all we can conclude that pay-for-performance policy in combination with excessive stock- options for top-management result in shadowy deals and non-deliberated decisions on all levels of the company.