2 THE AGENCY PROBLEM IN CORPORATIONS

In traditional (neoclassical) approach corporation is treated as single entity, it is often called holistic approach. That is one of the feature of a sole proprietorship. Owner–managers have no conflicts of interest. In big companies we almost always have the separation of owners and managers. Financial manager should work in the best interests of the owners by taking actions that increase the value of the company. However, we’ve also seen that in large corporations ownership can be spread over a huge number of stockholders. If we assume that stockholders buy stock because they seek to gain financially, then the answer is obvious: good decisions increase the value of the stock, and poor decisions decrease the value of the stock. Given our observations, it follows that the financial manager acts in the shareholders’ best interests by making decisions that increase the value of the stock. The goal of financial management is to maximize the current value per share of the existing stock.

The separation of stockholders and management has few advantages. It allows share ownership to change without interfering with the operation of the business. It allows the company to hire professional managers. This dispersion of ownership means that managers, not owners can control the firm, and it brings problems if the managers’ and owners’ objectives are not the same and if management really act in the best interests of the owners. The goal of maximizing the value of the stock avoids the problems associated with the different goals. There is no ambiguity in the criterion, and there is no short-run versus long-run issue. We explicitly mean that our goal is to maximize the current stock value. By this we mean that they are only entitled to what is left after employees, suppliers, and creditors (and anyone else with a legitimate claim) are paid their due. If any of these groups go unpaid, the stockholders get nothing. Because the goal of financial management is to maximize the value of the stock, we need to learn how to identify those investments and financing arrangements that favorably impact the value of the stock. We could say that
corporate finance is the study of the relationship between business decisions and the value of the stock in the business.

2.1.1 Agency Problem

The connection between owners and managers is called an principal-agent problem and the conflict is called an agency relationship. Such a relationship exists whenever someone (the principal) hires another (the agent) to represent his interests. The shareholders are the principals; the managers are their agents. Shareholders want management to increase the value of the firm, but managers may have their own axes to grind or nests to feather. Agency costs are incurred when (1) managers do not attempt to maximize firm value and (2) shareholders incur costs to monitor the managers and influence their actions. More generally, the term agency costs refers to the costs of the conflict of interest between stockholders and management. Of course, there are no costs when the shareholders are also the managers.

Agency costs can be indirect or direct. An indirect agency cost is a lost opportunity, such as the one we have just described. Direct agency costs come in two forms. The first type is a corporate expenditure that benefits management but costs the stockholders. Perhaps the purchase of a luxurious and unneeded corporate jet would fall under this heading. The second type of direct agency cost is an expense that arises from the need to monitor management actions. Paying outside auditors to assess the accuracy of financial statement information could be one example.

2.1.2 The goals of financial management

Assuming that we restrict ourselves to for-profit businesses, the goal of financial management is to make money or add value for the owners. This goal is a little vague, of course, so we examine some different ways of formulating it in order to come up with a more precise definition. Such a definition is important because it leads to an objective basis for making and evaluating financial decisions.
If we were to consider possible financial goals, we might come up with some ideas like the following:

- Survive.
- Avoid financial distress and bankruptcy.
- Beat the competition.
- Maximize sales or market share.
- Minimize costs.
- Maximize profits.
- Maintain steady earnings growth.

What would be the management goal if they have no control at all? One of main answer comes from outside mainstream economy. It is the idea that managers prefer the company to be bigger than more profitable. So managers left to themselves would tend to maximize the amount of resources over which they have control or, more generally, corporate power or wealth. This goal could lead to an overemphasis on corporate size or growth. Our discussion indicates that management may tend to overemphasize organizational survival to protect job security. Also, management may dislike outside interference, so independence and corporate self-sufficiency may be important goals.

### 2.1.3 Do Managers Act in the Stockholders’ Interests?

Principal–agent problems would be easier to resolve if everyone had the same information. That is rarely the case in finance. Managers, shareholders, and lenders may all have different information about the value of a real or financial asset, and it may be many years before all the information is revealed. Financial managers need to recognize these information asymmetries and find ways to reassure investors that there are no nasty surprises on the way. Whether managers will, in fact, act in the best interests of stockholders depends on two factors. First, how closely are management goals aligned with stockholder goals? This question relates to the way managers are compensated. Second, can management be replaced if they do not pursue stockholder goals? This issue relates to control of the firm. As we will
discuss, there are a number of reasons to think that, even in the largest firms, management has a significant incentive to act in the interests of stockholders.

2.1.3.1 Managerial Compensation

Management will frequently have a significant economic incentive to increase share value for two reasons. First, managerial compensation, particularly at the top, is usually tied to financial performance in general and oftentimes to share value in particular. For example, managers are frequently given the option to buy stock at a bargain price. The more the stock is worth, the more valuable is this option. In fact, options are increasingly being used to motivate employees of all types, not just top management.

The second incentive managers have relates to job prospects. Better performers within the firm will tend to get promoted. More generally, those managers who are successful in pursuing stockholder goals will be in greater demand in the labor market and thus command higher salaries. In fact, managers who are successful in pursuing stockholder goals can reap enormous rewards.

2.1.3.2 Control of the Firm

Control of the firm ultimately rests with stockholders. They elect the board of directors, who, in turn, hire and fire management. An important mechanism by which unhappy stockholders can act to replace existing management is called a proxy fight. A proxy is the authority to vote someone else’s stock. A proxy fight develops when a group solicits proxies in order to replace the existing board, and thereby replace existing management.

Another way that management can be replaced is by takeover. Those firms that are poorly managed are more attractive as acquisitions than well-managed firms because a greater profit potential exists. Thus, avoiding a takeover by another firm gives management another incentive to act in the stockholders’ interests.
2.1.4 Stakeholders

Management and stockholders are not the only parties with an interest in the firm’s decisions. Employees, customers, suppliers, and even the government all have a financial interest in the firm. Taken together, these various groups are called stakeholders in the firm. In general, a stakeholder is someone other than a stockholder or creditor who potentially has a claim on the cash flows of the firm. Such groups will also attempt to exert control over the firm, perhaps to the detriment of the owners.