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Agency Problems: Managers VS Shareholders Goals

Agency Problems: Agency problems are conflicts of interest that arise when one party, the agent, is entrusted with acting on behalf of another party, the principal, but the agent has different goals than the principal. In the context of corporations, agency problems can arise between managers and shareholders.

In large companies, there is a divorce between management and ownership. The decision-taking authority in a company lies in the hands of managers. Shareholders as owners of a company are the principals and managers are their agents. Thus, there is a principal-agent relationship between shareholders and managers. In theory, managers should act in the best interests of shareholders; that is, their actions and decisions should lead to the shareholders' wealth maximization (SWM). In practice, managers may not necessarily act in the best interest of shareholders, and they may pursue their own personal goals. Managers may maximize their own wealth (in the form of high salaries and perks) at the cost of shareholders, or may play safe and create satisfactory wealth for shareholders than the maximum. They may avoid taking high investment and financing risks that may otherwise be needed to maximize shareholders' wealth. Such 'satisfing' behaviour of managers will frustrate the objective of SWM as a normative guide. It is in the interests of managers that the firm survives in the long run. Managers also wish to enjoy independence and freedom from outside interference, control and monitoring. Thus, their actions are very likely to be directed towards the goals of survival and self-sufficiency. Further, a company is complex organization consisting of multiple stakeholders such as employees, debt-holders, consumers, suppliers, government and society. Managers in practice may, thus, perceive their role as reconciling conflicting objectives of stakeholders. This stakeholders' view of managers' role may compromise with the objective of SWM.

Shareholders continuously monitor modern companies that would help them to restrict managers' freedom to act in their own self-interest at the cost of shareholders. Employees, creditors, customers and government also keep an eye on managers' activities. Thus, the possibility of managers pursuing exclusively their own personal goals is reduced. Managers can survive only when they are successful; and they are successful when they manage the company better than someone else. Every group connected with the company will, however, evaluate management success from the point of view of the fulfillment of its own objective. The survival of management will be threatened if the objective of any of these groups remains unfulfilled. In reality, the wealth of shareholders in the long run could be maximized only when customers and employees, along with other stakeholders of a firm, are fully satisfied. The wealth maximization objective may be generally in harmony with the interests of the various groups such as owners, employees, creditors and society, and thus, it may be consistent with the management objective of survival. There can, however, still arise situations where a conflict may occur between the shareholders' and managers' goals. Finance theory prescribes that under such situations, shareholders wealth maximization goal should have precedent over the goals of other stakeholders.

The conflict between the interests of shareholders and managers is referred to as agency problem and it results into agency costs. Agency costs include the less than optimum share value for shareholders and costs incurred by them to monitor the actions of managers and control their behaviour. The agency problems vanish when managers own the company. Thus, one way to mitigate the agency problems is to give ownership rights through stock options to managers. Shareholders can also offer attractive monetary and non-monetary incentives to managers to act in their interests. A close monitoring by other stakeholders, board of directors and outside analysts also may help in reducing the agency problems. In more capitalistic societies such as USA and UK, the takeovers and acquisitions are used as means of disciplining managers.

There are a number of other ways to reduce agency problems, including:

- Aligning managers' incentives with shareholders' interests. This can be done by linking managers' compensation to the company's financial performance, or by giving shareholders more say in the appointment and dismissal of managers.
- Implementing corporate governance mechanisms, such as independent boards of directors and audit committees, to monitor the performance of managers and hold them accountable for their decisions.
- Creating a culture of transparency and accountability within the company. This can be done by encouraging employees to report wrongdoing and by ensuring that managers are held to high ethical standards.

It is important to note that it is impossible to eliminate agency problems entirely. However, by taking the steps outlined above, companies can reduce the risk of agency problems and protect the interests of their shareholders.

Examples of agency problems:

- A manager may approve a risky new project that is likely to benefit the manager's own career, even though the project is not in the best interests of the company.
- A manager may award themselves a large bonus, even though the company is not performing well financially.
- A manager may cover up a fraud scandal to avoid job loss or damage to their reputation.