Agency and Conflicts of Interest

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WHAT'S COVERED

In this lesson, you will learn how to identify the nature of agency conflicts and the associated costs for an organization. Specifically, this lesson will cover:

1. Defining Agency Conflicts

The agency view of the corporation posits that the decision rights (control) of the corporation are entrusted to the manager to act in shareholders' and other stakeholders' interests. Because of this separation, corporate governance includes controls intended to align managers' incentives with those of shareholders and other stakeholders.

The principal-agent problem or agency dilemma, developed in economic theory, concerns the difficulties in motivating one party, the **agent**, to act on behalf of another party, the **principal**. The two parties have different interests and it is difficult to ensure that the agent is always acting in the best interest of the principal. Conflicts of interest may arise.

HINT

Decision rights (control) of the corporation are entrusted to the managers.

While managers control the corporation and make strategic decisions, **shareholders** are owners, and bondholders are creditors. While all three parties have an interest–whether direct or indirect–in the financial performance of the corporation, each of the three parties has different rights and rewards, such as voting rights and forms of financial return.

Shareholders, managers, and bondholders have different objectives. Stockholders have an incentive to take riskier projects than bondholders do, as bondholders are more interested in strategies that will increase the chances of getting their investment back. Shareholders also prefer that the company pay more out in **dividends** than bondholders would like. Managers may also be shareholders and reap the profits of more risky strategies or may prefer risk-averse empire-building projects.

TERMS TO KNOW

Agent

One who acts for, or in the place of, another (the principal) by authority from him; one entrusted with the business of another; a substitute; a deputy; a factor.

Principal

One who directs another (the agent) to act on one´s behalf.

Shareholder

One who owns shares of stock.

Dividend

A pro rata payment of money by a company to its shareholders, usually made periodically (e.g., quarterly or annually).

2. Conflicts Between Managers and Shareholders

The term "agency costs" refers to instances when an agent's behavior has deviated from a principal's interest. In this case, the principal would be the shareholder. These types of costs mainly arise because of contracting costs, or because individual managers might only possess partial control of corporation behavior. They also arise when managers have personal objectives that are different from the goal of maximizing shareholder profit.

Typically, the CEO and other top executives are responsible for making decisions about high-level policy and strategy. Shareholders, on the other hand, are individuals or institutions that legally own shares of stock in a corporation. Typically, these people have the right to sell those shares, to vote on directors nominated by various boards, and many other privileges. This being said, shareholders usually concede most of their control rights to managers.

While attempting to benefit shareholders, managers often encounter conflicts of interest. For instance:

- A manager might engage in self-dealing, entering into transactions that benefit themselves over shareholders.
- Managers might also purchase other companies to expand individual power, or spend money on wasteful pet projects, instead of working to maximize the value of corporation stock.
- Venturing onto fraud, managers may even manipulate financial figures to optimize bonuses and stock price-related benefits.

Another important goal is to evaluate whether a corporate governance system hampers or improves the efficiency of an organization. Research of this type is particularly focused on how corporate governance impacts the welfare of shareholders. After the recent instances of accounting fraud, there is renewed public interest in how corporations practice governance and accurate accounting.
Advocates of governance typically encourage corporations to respect shareholder rights, and to help shareholders learn how and where to exercise those rights. Disclosure and transparency are intertwined with these goals.

BIG IDEA

The chief goal of current corporate governance is to eliminate instances when shareholders have conflicts of interest with one another.

3. Conflicts of Interest Between Shareholders and Bondholders

The deviation from the principals' interests by the agent is called "agency costs," which are often described as existing between managers and shareholders, but conflicts of interest can also exist between shareholders and bondholders.

The shareholders are individuals or institutions that legally own shares of stock in the corporation, while the bondholders are the firm's creditors. The two parties have different relationships to the company, accompanied by different rights and financial returns.

- Stockholders have an incentive to take riskier projects than bondholders do, as bondholders are more interested in strategies that will increase the chances of getting their investment back.
- Shareholders also prefer that the company pay more out in dividends than bondholders would like.
- Shareholders have voting rights at general meetings, while bondholders do not.
- If there is no profit, the shareholder does not receive a dividend, while interest is paid to debenture-holders regardless of whether or not a profit has been made.

Other conflicts of interest can stem from the fact that **bonds** often have a defined term, or **maturity**, after which the bond is redeemed, whereas stocks may be outstanding indefinitely but can also be sold at any point. Because bondholders know this, they may create ex-ante contracts prohibiting the management from taking on very risky projects that might arise, or they may raise the interest rate demanded, increasing the cost of capital for the company.

EXAMPLE Loan covenants can be put in place to control the risk profile of a loan, requiring the borrower to fulfill certain conditions or forbidding the borrower from undertaking certain actions as a condition of the loan. This can negatively impact the shareholders. Conversely, shareholder preferences–as, for example, riskier strategies for growth–can adversely impact bondholders.

TERMS TO KNOW

Bond
A documentary obligation to pay a sum or to perform a contract; a debenture.

Maturity
Date when payment is due.

SUMMARY

In this lesson, you learned that agents and principals can have different and sometimes competing interests. Corporate governance attempts to mitigate such **agency conflicts** by balancing the incentives of managers against those of shareholders and other stakeholders such as bondholders. **Conflicts between managers and shareholders** create "agency costs" that good corporate governance can minimize. **Conflicts of interest between shareholders and bondholders** can also occur, especially with respect to risk and the payment of dividends.

Best of luck in your learning!

Source: THIS TUTORIAL HAS BEEN ADAPTED FROM "BOUNDLESS FINANCE" PROVIDED BY LUMEN

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