Agency Problem

In a corporation, the principals would be the shareholders and the agents would be the managers. The shareholders want the managers to run the company in a way that maximizes shareholder value. The managers, on the other hand, may want to run the company in a way that maximizes the managers' own personal power or wealth, even if it lowers the market value of the company.

According to C.P. Jones, "Agency problem is the potential conflict between principals (shareholders) and agents (managers).

According to Brigham, "An agency problem is a potential conflict of interests that can arise between a principal and an agent."

According to Van Horne, "Agency theory is a branch of economics relating to the behavior of principals (such as owners) and their agents (such as managers).

Agency problem can be categorized in the following way:

1. Managers Vs. Owners
2. Senior management Vs. Junior management
3. Creditors Vs. Owners
4. Owners Vs. Other parties.

Resolve the agency problem

The agency problem can be minimized by the following ways:

1. **Markets forces**
    a. Performance-based compensation plans
    b. Direct intervention by shareholders
    c. The threat of firing
    d. The threat of takeover
2. **Agency Costs**
    a. Monitoring costs
    b. Bonding costs
    c. Opportunity costs
    d. Structuring costs

Market Forces:

The market forces are direct intervention by shareholders, and the threat of takeover. These forces are discussed below.

Direct Intervention by Shareholders: Major Shareholder's particularly large institutional investors such as mutual funds, life insurance companies, and pension funds can exercise considerable influence over most firms' operations. They exert pressure on management to perform. When necessary they exercise their voting rights as stockholders to replace underperforming management.

Threat of takeover: Another market force is that threat of takeover by another firm that believes it can enhance the target firm's value to restricting its management, Operations and financing. The constant threat of takeover tends to motivate management to act in the best interest of the firm's owners.

Agency Costs:

Agency costs are internal costs incurred from asymmetric (unequal) information or conflicts of interest between principals and agents in an organization.

Monitoring costs: When the principals attempt to monitor or restrict the actions of agents, they incur monitoring costs For example, the board of directors at a company acts on behalf of shareholders to monitor and restrict the activities of management to ensure behavior that maximizes shareholder value. The cost of having a board of directors is therefore, at least to some extent, considered an agency monitoring cost. Costs associated with issuing financial statements and employee stock options are also monitoring costs.

Bonding costs: An agent may commit to contractual obligations that limit or restrict the agent's activity. For example, a manager may agree to stay with a company even if the company is acquired. The manager must forego other potential employment opportunities. Consider that implicit cost an agency bonding cost.

Opportunity costs: Opportunity costs are attributable to the difficulties typically shown by large organizations in responding to new opportunities. The firm's necessary organizational structure, decision hierarchy, and control mechanisms may cause profitable opportunities to be forgone as a result of managements in ability to seize upon them quickly.

Structuring costs: Structuring Expenditure topically involve managerial compensation that provides financial incentives for actions consistent with share price maximization. Popular incentive package include:

- ✓ Performance Share, Share of stocks given to management as a result of meting stated performance goals, typically measured in terms of return; and
- ✓ Cash bonuses, bonus money tied to achievement of certain performance goal in a fashion similar to performance share.

Question: What is mean by "Perfect capital market"? What role dose the perfect capital market assumption plays in functional theory.

A market in which there are never any arbitrage opportunities. A market is said to be a perfect capital market if holds the following assumptions.

1. All investors are efficient investors, who want to target points on the efficient frontier.
2. All investors are price takers
3. Investors can borrow or lend any amount of money at the risk free rate of return
4. All investors have homogeneous expectations.
5. All investors have the same one-period time horizon such as one month, six months, or one year.
6. All investments are infinitely divisible and perfectly liquid.
7. There is no tax
8. There are no transaction costs.
9. There is no inflation or any change in interest rates, or inflation is fully anticipated.
10. The quantities of all assets are given and fixed.

Now a days the financial decision making have a fairly common coverage of theories and models. In addition to such Nobel winning theories as the Portfolio Theory, The M&M Irrelevance Theorems, The Capital Asset Pricing model, and the Option Pricing Models, other theoretical works such as The efficient market theory, the Dividend Discount Model, the Arbitrage Pricing Theory, and the theories about agency costs and information signaling are common in the field of modern financial decision making.

Typically we say that all theories are based on a set of assumptions and they may be sometimes very crucial and unrealistic also. Assumptions holds under the perfect capital market are found to be the bench mark or in most of the chases the fundamental pillars for the development of other financial theories. So at the end we can say that perfect capital market assumptions are the guided principles based on which most of the finance theories were developed.