

Part 11. Corporate Control

The Agency Problem

Sam Mahoney, the owner of Sam's Flower Shop, has never had any problem with his managers. Why? Well, Sam's Flower Shop is pretty small and Sam is the only manager! If it's not in the best interest of Sam (the owner), then Sam (the manager) won't do it.

With larger companies, the situation is different. The owners of the company cannot run every aspect of the business and will need to hire managers to do it for them. This kind of relationship is called a **principal-agent relationship**: the owner (the principal) hires the manager (the agent) to do something for him – in this case, run the company. In principal-agent relationships problems can arise if the principal and the agent do not have exactly the same goals. For example, the owner of the company wants to maximize the profits of the company. However, while the managers of the company certainly want higher profits, they also want higher pay, more benefits and better job security, items that may not be consistent with maximizing profits. Because of this, the agent may not run the company in the way the principal wants. When an agent has an incentive to behave in a way that is not in the best interests of the principal, we call this an **agency problem**.

What is the Goal of a Firm?

Companies are business ventures, that is, they are ways of increasing the wealth of their owners. Sometimes it is said that the goal of a business is to maximize the wealth of the shareholders, but large corporations, who know very little about their many shareholders, need a more tangible goal. The part of the shareholders wealth that is directly influenced by the company is the value of the shares of that company. Since the values of the shares depend on the profitability of the company, we say that the goal of a business is to maximize its profits over the lifetime of the business.

Often people talk as if firms have competing goals, they can satisfy their customers, or their employees, or their shareholders. While the goal of the company is to maximize shareholder wealth, this is not inconsistent with working to satisfy the customers and employees. If your customers are satisfied they will buy your products, which will increase profits for the shareholders. If your employees are satisfied there will be higher productivity, which will increase profits for the shareholders. A good firm will take care of the customers and employees, but a company that is keeping its customers and workers happy, but is not making any money for the owners, is not a successful company.

Finally, it is important to remember that when we say businesses maximize their profits, we mean that they maximize their profits over the lifetime of the company, not in any one particular year. Management could easily raise profits in one year, say by selling off all the assets of the company, but this would have the cost of eliminating profits in future years. This would not be in the interest of shareholders!

Solving the Agency Problem

Agency problems can be quite severe in large public corporations. General Motors has a huge number of shareholders. There is no way all the shareholders could get together to tell GM management how to run the company, and given the potential costs and benefits it wouldn't be worth their time if they could. Because of this, the management has complete control over the policies followed at GM. This is a situation where there is almost a complete separation of ownership and control, which leads again to an agency problem. How do the shareholders of GM make sure that the management of GM runs the company in their best interest?

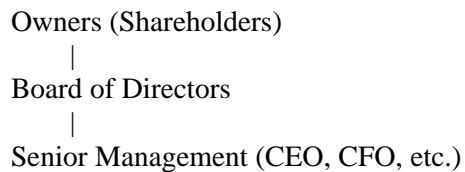
There are three types of solutions to the agency problem: watching the managers, changing the incentives for managers, and relying on market forces to discipline managers.

1) Watching the Managers

One solution to the agency problem is for the owners to hire someone to watch the managers. The watchers are there to see that management is following the wishes of the owners; working hard to maximize profits and reporting honestly to the shareholders.

Board of Directors

The Board of Directors is a level in-between the shareholders and senior management.



The Board of Directors generally consists of 7 to 15 directors. They are elected by shareholders and are responsible for the big picture. Running the company is still the responsibility of the management team; the Board is responsible for seeing that the company is being run in the interest of shareholders. One of the important roles of the Board (done by a subcommittee called the compensation committee) is to determine how much the top managers in the company get paid.

Most Boards consist of a mix of insiders and outsiders. Insiders, such as the CEO or CFO of the company are known as internal directors. Internal directors are valuable since they have a good understanding of the operations of the company; however, since part of their job is to make sure that management is doing their job, there is an obvious conflict of interest. External directors are outsiders; often senior managers from other companies (although not from companies in the same industry – you wouldn't want to give away company secrets to competitors). While they do not have the same detailed knowledge as internal directors, they have greater independence. Most boards consist of a mix of internal and external directors, but it is important a large fraction of the board consist of outsiders.

Who watches the watchers?

The Board's job is to watch management to make sure they do their job. But who watches the Board to make sure they do *their* job? Adding a Board of Directors doesn't get rid of the agency problem, it just changes it. Now shareholders need to watch the directors.

Management that wants to be free of the control of shareholders can try to co-opt the board (convince it to work for the interests of management rather than shareholders.) To do this, it can offer to increase the salaries of the Directors and offer nice benefits. A company based in Cleveland could hold its winter board meetings in Hawaii.

One of the reasons for this problem is that managers and shareholders gain different amounts from lobbying the Board. For managers, getting the Board on their side can mean hundreds of thousands of dollars in compensation. For an investor with a thousand dollars of stock, it is just not worthwhile to make sure that the Board is doing their job. Institutional investors may be one way of evening the sides. Institutional investors are large investors, such as pension funds or banks, who can make million dollar investments in a company. Because they have so much money at stake, they have a good reason to watch the Board closely. In this way, institutional investors can protect the interests of smaller shareholders.

Auditors

Auditors are responsible for checking the financial records of the company to make sure that everything has been reported properly. This includes correcting mistakes, but also insuring that things have been reported honestly, that employees are not trying to hide things from management, that management is not trying to hide things from shareholders, and that the company is complying with laws and regulations.

Large companies will have internal auditors. While effective in providing information to management, they obviously are not independent from management. Public companies are also required to have external audits, using outside accounting companies to verify that their financial numbers have been correctly calculated and reported.

However, just as with Boards of Directors, auditors may become too closely tied to management. Most large accounting companies also get substantial business from consulting. A company may decide to go elsewhere for consulting or auditing if it doesn't get favorable treatment from its auditors.

2) Changing the Incentives for Managers

What we would like to do is to change the incentives for managers so that their only goal is to maximize the value of the company. One way to do this might be to offer bonuses to managers based on the earnings of the company. This way, managers would be dedicated to maximizing earnings. The problem is that this gives managers an incentive to produce short-run earnings growth at the cost of long-run earnings. We could make bonuses based on subjective measures of performance, but the judges of performance would have to be the Board of Directors, and so we have the same problem as before.

Another approach is to use stock options. Stock options give a person the right to buy a certain amount of stock at a fixed price. For example, the CEO might have the right to buy 100,000 shares of stock at the current price of \$50. If the performance of the company improves, and the stock price rises to \$60, then the CEO would earn \$1 million (the difference in the prices multiplied by the number of shares). The CEO now has an incentive to increase the value of the company, which matches the goal of the shareholders.

There are a couple of problems with stock options. Management may be able to manipulate the stock price in the short run, allowing them to earn millions while not maximizing the long-term value for the shareholders. Another problem is that there may be changes in the value of the company that are not reflective of managerial performance. Bad managers may be rewarded by a general increase in prices in the stock market while good managers may be punished if stock prices fall.

3) Market Forces

Another solution to the agency problem is to allow the market to “weed out” inefficient companies. Say that a company’s management team is running the company unprofitably while paying themselves large salaries and getting excessive benefits. If we were outside investors, we could take advantage of this by buying the company, firing the current managers, and bringing in our own management team. This can be a potent force to encourage managers to manage efficiently.

However, the costs of a buyout can be high. The new owners may need to issue large amounts of debt in order to purchase the company, which leaves the company in the difficult position of having to generate a steady flow of cash to service the debt. It can also be very difficult to buy a company, particularly if management opposes the buyout. If the hurdles to buying a company are too high, market forces will be ineffective in disciplining manager behavior.