Answer on Question #51387, Economics, Finance

When do companies incur the agency costs? Support your answer by giving an example.

Explanation:

A feature of the modern company's ownership structure is dispersal of capital, the degree of which varies by country and areas of activity. This dispersal allows attracting a significant amount of capital. Practice shows that the corporation (stock form of organization) can take projects requiring the level of technology that is not available to companies in other forms. The realization of these benefits of raising capital requires transmission owner's daily functions, operational control over the assets of the professionals - financial managers (agents).

The agency relationship is the ratio of the two participants, one of the which (customer) transfers to another (the agent) his functions. Principal - the owner, the head, on whose behalf the agent acts. In financial management agency relationship or relationship "principal-agent" arise, when capital owners (principals) delegate investment and financial decision-making to its managers (agents). Managers are rewarded for achieving the goals set by the principal. The interests of the principal and the agent may not coincide.

Agency costs represent the difference between the actual evaluation of the company and the potential, hypothetical its value, which would have existed in a better world, where the interests of managers and owners completely would coincide.

Managers can be encouraged to act for the benefit of shareholders through incentives, restrictions and penalties. In this regard, there are three major categories of agency costs: 1) the cost of overseeing the activities of managers, such as the costs of the audit; 2) the costs of establishing the organizational structure, limiting the possibility of undesirable behavior of managers, such as the introduction of the board of the foreign investors; 3) opportunity costs arising in cases where shareholders established rules limit the actions of managers, contrary to the goal of increasing shareholder wealth. The increase in agency costs is acceptable as long as it is as a result of the measure is covered by earnings growth.

Stimulation of managers is more profitable and preferably than the full control of their actions. In addition to controlling managers encouraged to act in the interests of shareholders, the following mechanisms: 1) the system of incentives based on performance indicators and efficiency of the enterprise in the form of options to acquire shares of the company or, more effectively, in the form of premium of shares; 2) direct intervention by shareholders coming into contact with the management company or the proposal, which must be put to the vote at the annual meeting of shareholders; 3) the threat of dismissal if its proponents gain the required number of votes of the shareholders; 4) the threat of buying a controlling stake in the new investor, who usually replaces manual.

Thus, we can conclude, that the agency costs are legal and contractual costs, which should protect the rights of shareholders, bondholders, and managers, when between these

participants occurs the conflict of the interests. The result of organizational conflicts may be decisions that affect the value of the company.

Shareholders, for example, may benefit from the additional issue of bonds if the company at the same time refuses the low-risk projects in favor of projects with greater risk. If the latter is successful, shareholders will receive additional profit. However, owners wishing to buy bonds in the past, with the additional risk of falls, which they did not foresee when buying bonds, and, therefore, increases the likelihood of bankruptcy. Bondholders anticipate the possibility of such a development and require agreement to protect their rights.

Such agreements give rise to two types of costs: first, it is the cost of monitoring compliance according to the agreements; secondly, these agreements limit the flexibility of management, blocking some of the activities that could increase the company's market value. These costs are borne by the shareholders in the form of reduced market value of the shares.

In general, we can assume that this kind of agency costs will be higher, the greater the level of debt. If the debt is low, bondholders would be considered relatively secure investments and reduce their demands. The higher the debt, the more reliable guarantees they will require. Therefore, the agency costs affect the value of the company about the same as the costs of bankruptcy. The higher the debt, the higher the level of agency costs on the value of the company. For any positive value of debt, the agency costs will reduce the market value of the company. Therefore, the agency costs reduce the optimal level of debt capital structure compared with a situation where they do not exist.

We can consider the agency conflict between shareholders and creditors. Lenders are entitled to part of the income of the company (in the amount of interest and repayments of principal), as well as assets of the company in the event of bankruptcy. However, control over the decisions that affect the profitability and riskiness of the firm's assets, by shareholders acting through the managers of the firm.

Lenders are cutting tools of the company at interest rates which, depends on the following factors: 1) the riskiness of assets available to the company; 2) the expected riskiness of future additional assets; 3) the existing capital structure of the firm; 4) the expected future decisions affecting the capital structure of the firm. These are the primary factors that determine the riskiness of the cash flows of the company and, therefore, the reliability of its debt; given these factors, lenders define their values required yield.

Assume, that the shareholders acting through managers, forcing the firm to undertake the implementation of a major new project, the level of risk that is higher than expected by creditors of the firm. Increased risk will increase the required return on debt of the company, which in turn leads to a decrease in the market value of outstanding debt. If this is a risky capital investment is successful, all this benefits will go to the shareholders of the company as a lender's return are fixed and correspond to the original, lower level of risk. However, in case of failure of the project to bondholders will have to take some losses. From the perspective of shareholders, such investments are a winning deal, which obviously can not satisfy creditors.

It should be noted that in most cases, actions aimed to maximizing the overall value of the firm (the market value of its debt and equity), and maximize the price of its shares. However, it may be a situation where the total value of the firm is reduced, and the price of its shares soaring. Such a situation may arise if the value of the borrowed capital firms reduced, but often lost in this way the cost is transferred to the shareholders of the company. In this case, the total value of a company can be reduced even with an increase in stock prices.

From the above it follows that, in order to better serve the shareholders of their companies, managers need to play fair with creditors, comply with the terms of loan agreements. Managers are agents and shareholders, and creditors of firms should be a balance between the interests of these two groups of holders of securities. Likewise, the actions of managers who aim to exploit the wealth of other interested parties (stakeholders) - employees, customers, suppliers and the public, in view of the existing restrictions and sanctions ultimately will hurt the shareholders of the company.

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