Exploratory Note 5
Agency – Theory and Implications

## INTRODUCTION

In economics and finance, self-interest is typically taken for granted as the driver of individual judgment, decision-making, and behavior. In much of the literature, this primacy of self-interest is viewed positively. Consider, for instance, Adam Smith's invisible hand which gives a type of moral backing to market-based systems or our conversation from last week regarding financial market equilibrium which requires the existence of large numbers of self-interested participants to seek out and exploit instances of mispricing and, by doing so, eliminate them and restore equilibrium. But, when it comes to the relationship between principals and agents, the literature takes a markedly different turn and presents us with something known as the agency dilemma or problem.

## THE AGENCY DILEMMA

In order to understand the agency dilemma, you need to know the difference between a principal and an agent, in an economic setting. Who can define these terms?

Are principals and agents always privy to the exact same information? Why does this matter?

Are principals and agents always going to have the same goals? Consider both moral hazard and conflicts of interest, among other things.

## IMPLICATIONS FOR BUSINESS

The agency dilemma yields a great deal of frustration for business people in a number of areas. In this section of the note, we consider just a few (most of which are strictly internal to the firm): executive compensation and perquisites; mergers and acquisitions (M&A) and long-term investment decisions; and IPO underpricing (external).

### *Executive Compensation and Perquisites*

How might the interests of managers (agents) and owners (principals) conflict when it comes to executive compensation and perquisites?

According to the literature, how might owners be able to better align the interests of managers with their own? Consider both ownership and the use of leverage.

What are the implications of this for early-stage firms?

Are there downsides to making managers shareholders?

***Mergers and Acquisitions (M&A) and Other Long-Term Investment Decisions***

How might the interests of managers (agents) and owners (principals) conflict when it comes to M&A and other long-term investment decisions?

According to the literature, how might owners be able to better align the interests of managers with their own? Again, be sure to consider both ownership and the use of leverage.

What are the implications of this for early-stage firms?

***IPO Underpricing (An External Issue)***

Does anyone know what the typical first-day performance is for an IPO?

If you are a shareholder of a firm (principal) that has experienced a typical IPO, should you be happy or unhappy? Why?

Why might investment banks (agents) tend to systematically underprice IPOs?

Why might owners underreact to IPO underpricing?

**SELF-INTEREST: INNATE OR LEARNED?**

Though economics and finance are certainly rooted in self-interest, it is worth asking a question: is the self-interested behavior so frequently pointed to in business due to innate human qualities (or, perhaps, a lack thereof) or is it learned?

Is there room for altruism or fairness in business? Why or why not? What if it comes at the expense of the principals?

**CONCLUSIONS**

Right, wrong, or indifferent, financiers concern themselves with matters of agency and their mitigation—and, given much of the historical record, probably for good reason. For entrepreneurs, it is important to recognize that informational asymmetries exist which give investors more-than-adequate reason for pause. Through contracting, signaling, or other mechanisms, overcoming this natural source of distrust is critical to success for many organizations.