Business finance 101

Week 5

AGENCY PROBLEM AND SHAREHOLDER WEALTH MAXIMAZATION

Understandung the raltionship btween shareholdadera and mangers

Agency theory - Agency theory explains the relationship between two parties where one party, known as the agent, represents the interests of another party, the principal

**Key Assumptions:**

* Individuals act in their own self-interest, which can lead to conflicts between the agent and principal.
* Agents have access to more information than principals, which can create information asymmetry.

TYPES OF PRINCIPAL – AGENT RELATIONSHIPS

1. Shareholders and managerment
2. Investors and fund managers i.e Bernie Madoff ponzi scheme

STRATEGIES TO MITIGATE AGENCY THEORY

1. **Contracts:** Detailed contractual agreements that outline performance evaluation, incentives, and compensation help align the interests of managers and shareholders.
2. **Restrictions:** Imposing specific restrictions on managerial power can reduce the potential for agency problems.
3. **Evaluations:** Regular performance evaluations ensure that agents are working in the best interest of the principals. Rewards or sanctions can be applied based on performance.
4. **Bonuses:** Offering incentives and bonuses aligns the interests of agents with those of the principals, encouraging decisions that maximize shareholder value.
5. **Transparency:** Open communication and transparency between agents and principals help reduce conflicts and promote trust.

Shareholders wealth maximization principle

The primary goal of a financial manager is to maxomine the shareholder wealth .

For public companies – firms stock

For private companies – market value

**Key Points:**

* Managers must balance short-term gains with long-term strategic goals to maximize the value of the firm.
* The risk-return trade-off is a critical consideration in making decisions that affect shareholder wealth.
* Financial managers must consider both the immediate impact on profitability and the long-term sustainability of their decisions.

Risk to Return trade off -- In finance, the risk-return trade-off refers to the principle that potential returns on investments increase with an increase in risk

Example - Investing in research and development may involve high upfront costs and risks, but it could lead to significant long-term profit

SOURCES OF FINANCE

Internal -  Funds generated from within the business itself.

And

external source of finance - Funds obtained from outside the business, often requiring agreements with third parties like banks, investors, or other institutions.

sources of finance refer to the various ways that a business can obtain funds to meet its operational needs, invest in new projects, or expand its activities