1.31 Alternative Business Objectives and the Principal-Agent Problem: 10-minute Pack

AQA 7136 · Calculators not allowed · about 10 minutes

Total Marks

Name: _____ Date: ____ / ____ / _____

Answer all questions. Write full sentences for the scenario question and the extended evaluate question.

1 Executive pay and alignment: explain how linking executive pay to firm performance might reduce the principal-agent problem, and give one limitation of pay-based incentives in fully aligning managers with shareholder interests.

(Total for Question 1 is 3 marks)

2 Principal-agent problem in a listed UK firm: define the problem and give one typical example of conflicting interests between shareholders and managers.

(Total for Question 2 is 2 marks)

3 Sales volume maximisation (maximising units sold) as an objective: explain a manager's motive and one likely effect on average cost compared with profit maximisation.

(Total for Question 3 is 2 marks)

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Mark scheme · 1.31 Alternative Business Objectives and the Principal-Agent Problem: 10-minute Pack

Question 1

explains mechanism: tying pay to performance (share options, bonuses linked to profitability or share price) gives managers a direct financial stake in shareholder outcomes, incentivising decisions that increase shareholder value **M1**

develops: use of long-term equity awards can encourage managers to focus on sustainable value creation rather than short-term earnings manipulation **A1**

limitation: incentive schemes can encourage short-term manipulation, misreporting, or risky behaviour to hit targets, and may not perfectly align incentives if performance measures are imperfect **B1**

Answer: Linking pay to performance incentivises managers to increase shareholder value through bonuses and share-based rewards, but such schemes can encourage short-term manipulation or risky projects and may rely on imperfect performance metrics.

Question 2

definition: the principal-agent problem occurs when agents (managers) make decisions that do not fully align with the objectives of principals (shareholders) who hired them **B1**

example: managers may prefer to grow the firm and increase their power or perks, even if this reduces short-run shareholder returns **B1**

Answer: The principal-agent problem is the conflict when managers act in their own interests rather than shareholders interests; for example managers may pursue empire-building that reduces shareholder returns.

Question 3

reason: managers may aim to maximise units sold to achieve economies of scale, secure market dominance, or meet managers targets based on volume **B1**

effect on average cost: output above the profit-maximising level may lower average cost through greater scale, reducing unit costs **B1**

Answer: Managers aiming to maximise units sold may do so to gain economies of scale and market share; this often increases output above the profit-maximising level, lowering average cost.

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