ECO.MIC29 Alternative Business Objectives and the Principal-Agent Problem

AQA 7136 · Calculators not allowed · about 60 minutes

Total Marks

Name: ______________________________ Date: ____ / ____ / ______

Answer all questions. Write full sentences for the scenario question and the extended evaluate question. Timed guidance: about 40 minutes on the short and scenario items, 20 minutes on the essay.

1 Divorce of ownership from control in modern firms: define the concept and explain why it arises in large UK public limited companies.

(Total for Question 1 is 2 marks)

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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)

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3 Sales revenue maximisation as an alternative objective: explain why a manager might target sales revenue and state one likely effect on price compared with the profit-maximising outcome.

(Total for Question 3 is 2 marks)

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4 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 4 is 2 marks)

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5 Satisficing behaviour by managers: define satisficing in the context of a public limited company and give one reason a manager might satisfice rather than maximise profit.

(Total for Question 5 is 2 marks)

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6 Non-profit objectives: explain why some managers may prioritise firm growth or organisational size even when profits could be higher at a smaller scale, naming one internal incentive that supports this choice.

(Total for Question 6 is 2 marks)

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7 Compare sales revenue maximisation and sales volume maximisation: state one clear difference in how each objective is likely to affect output level and one difference in how each is likely to affect price, relative to profit maximisation.

(Total for Question 7 is 3 marks)

8 Scenario: A UK supermarket chain, Greenfield Grocers, sets a policy that store managers receive promotion and store-incentive pay based strictly on the number of transactions per month and on market share in each town. Greenfield also deliberately reduces some product prices below competitors to attract customers, accepting thinner margins. Identify which alternative objective Greenfield is most likely pursuing and explain, in one paragraph, whether Greenfield's chosen output level is likely to be above or below the profit-maximising output level. Explain your reasoning.

(Total for Question 8 is 3 marks)

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9 Monitoring and control costs: explain one reason why shareholders cannot perfectly monitor managers in a large multinational company and state one type of cost that results from imperfect monitoring.

(Total for Question 9 is 2 marks)

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10 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 10 is 3 marks)

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11 Non-pecuniary manager motives: state two non-financial reasons a manager might avoid profit maximisation, each briefly explained, in the context of a UK public company.

(Total for Question 11 is 2 marks)

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12 In the context of UK public limited companies where ownership is often dispersed, evaluate whether shareholders can ever fully control managerial behaviour. In your answer, consider mechanisms shareholders use to influence managers, why these mechanisms may fail or be limited, the role of regulation and markets, and conclude with a supported judgement. Draw on concepts such as the principal-agent problem, agency costs, executive incentives, monitoring, and takeover discipline. You may include brief diagrams or a labelled list to support your analysis, but spend most time on explanation and evaluation.

Evaluate the view that shareholders can fully control managerial behaviour in large public limited companies.

(Total for Question 12 is 15 marks)

Mark scheme · ECO.MIC29 Alternative Business Objectives and the Principal-Agent Problem

Question 1

- **B1** definition: ownership and control are separated when shareholders legally own the firm but day-to-day decisions are taken by professional managers or directors
- **B1** explanation: arises because share ownership is widely dispersed in large public companies, so individual shareholders lack the time or information to run the firm and appoint managers to do so
- **Answer: Ownership and control are separated when shareholders own the firm while managers run it; this arises in large public companies where shares are dispersed and professional managers run daily operations.**

Question 2

- **B1** 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
- **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

- **B1** reason: managers may target sales revenue to increase market share, meet turnover-related bonuses, or improve perceived firm size and stability
- **B1** effect on price: price is likely to be lower than the profit-maximising price to boost revenue and sales, other things equal
- **Answer: Managers may target sales revenue to grow market share or receive turnover-linked incentives; this tends to lead to a lower price than profit maximisation would set.**

Question 4

- **B1** 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
- **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.**

Question 5

- **B1** definition: satisficing is choosing an outcome that is acceptable or good enough to meet multiple stakeholders objectives rather than the single goal of profit maximisation
- **B1** reason: managers may satisfice because they value job security, a stable predictable income, and avoiding the risk and effort required to chase maximum profit
- **Answer: Satisficing is settling for an acceptable level of performance across several objectives rather than maximising profit, often chosen because managers prefer job security and lower risk.**

Question 6

- **B1** reason: growth can increase managers influence, job security and perceived success, and larger firms may offer higher prestige and personal benefits to managers
- **B1** internal incentive: bonuses or career progression linked to growth or market share rather than to profit alone
- **Answer: Managers may prioritise growth for greater influence, job security and prestige; internal incentives include bonuses or promotion tied to market share or turnover growth.**

Question 7

- **B1** output: sales volume maximisation focuses on maximizing units sold, so output is likely to be higher than the profit-maximising level; sales revenue maximisation may increase output but could be less extreme depending on price elasticity
- **B1** price: sales revenue maximisation often targets a price that maximises total revenue (which may be lower than profit-maximising price), while sales volume maximisation typically uses lower prices to maximise units sold
- **B1** distinctive point: sales revenue maximisation may tolerate higher marginal costs if total revenue rises, whereas volume maximisation aims explicitly to expand quantity even if margins shrink
- **Answer: Volume maximisation usually raises output above the profit-maximising level more clearly than revenue maximisation; both tend to reduce price relative to profit maximisation, but revenue maximisers pick the price to maximise total revenue while volume maximisers push price down to maximise units.**

Question 8

- **B1** identifies sales volume maximisation (maximising units or number of transactions) as the objective, supported by incentives tied to transactions and market share
- **B1** explains direction of output: output is likely to be above the profit-maximising level because managers accept lower prices to increase transactions and market share
- **B1** links reasoning: lower prices to attract more customers increase quantity sold but reduce per-unit margin, so the firm operates at higher output than the profit-maximising point where MR=MC
- **Answer: Greenfield is pursuing sales volume maximisation; its output is likely above the profit-maximising level because managers accept lower prices to increase transactions and market share, raising quantity sold while reducing margins.**

Question 9

- **B1** reason: shareholders are numerous and dispersed, often lack detailed firm-specific information and cannot observe day-to-day managerial decisions
- **B1** cost: leads to agency costs such as expenditure on monitoring, auditing, or lost profit from managers pursuing private benefits rather than shareholder value
- **Answer: Shareholders cannot perfectly monitor managers because they are dispersed and lack detailed information about daily decisions; this causes agency costs, such as spending on monitoring and auditing or losses from managers pursuing private benefits.**

Question 10

- **M1** 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
- **A1** develops: use of long-term equity awards can encourage managers to focus on sustainable value creation rather than short-term earnings manipulation
- **B1** 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
- **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 11

- **B1** reason 1: job security, explained as managers preferring stable but lower profit outcomes that reduce the risk of takeover or dismissal
- **B1** reason 2: personal utility from power or prestige, explained as managers valuing the status and influence of running a larger organisation even if it reduces profits
- **Answer: Two non-financial motives: job security, since stable acceptable results reduce the risk of dismissal or takeover; and power or prestige, where managers value running a larger organisation even if it lowers profit.**

Question 12

- **Level 1** (1-5): Basic statements about shareholder attempts to control managers with limited development. May describe one or two mechanisms such as monitoring or pay, with little analysis of their effectiveness or limitations.
- **Level 2** (6-10): Clear explanation of several mechanisms shareholders use to influence managers, such as executive pay, board oversight, shareholder votes and takeover threat, with analysis of how these can align interests and some consideration of agency costs and practical limits.
- **Level 3** (11-15): A well-developed balanced evaluation that weighs evidence for and against the claim shareholders can fully control managers, discusses why control is often partial (monitoring costs, information asymmetry, short-termism from incentives, collective action problems), considers regulatory and market discipline, and reaches a supported judgement.
- **Indicative content:**
  - Mechanisms by which shareholders attempt control: appointing and dismissing boards, AGM votes, executive pay tied to performance, activist shareholders, takeover threat and market for corporate control, disclosure and reporting requirements.
  - Ways these mechanisms can succeed: performance-related pay aligns incentives, active monitoring by institutional investors can influence strategy, takeover threat disciplines underperformance, legal/regulatory duties of directors constrain opportunism.
  - Limitations and reasons control is incomplete: dispersed ownership causes collective action problems and weak monitoring incentives, information asymmetry leaves managers with informational advantage, monitoring and contracting are costly leading to agency costs, incentives can create perverse outcomes like short-termism or risk-shifting.
  - Empirical and practical points: institutional investors vary in activism; regulatory changes can increase transparency but cannot remove asymmetric information; boards may be captured or lack independence.
  - Evaluation angles: magnitude and time frame matter, complete control may be infeasible but partial alignment can be achieved; trade-offs between tight control and managerial autonomy for long-term strategy; supported judgement on whether 'fully control' is realistic given costs and governance mechanisms.