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# The Relevance of Agency Conflicts in Small and Medium Enterprises

**Presenter**

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# Introduction

- Issues in Sourcing Finance face by Early stage firms or start-up ventures.
- Lack of collateral assets, potential agency problems and information asymmetries
- Sources of finance for start-up entrepreneurs (Berger & Udell, 1998)
- High-growth potentials and pre-tested service or produce (Kerins, Smith & Smith, 2004)

# Introduction

- Agency conflicts and information asymmetry in SMEs (Jensen & Meckling, 1976).
- Conceal the financial prospects and circumstances of the venture from the principals (Emery, Finnerty, & Stowe, 2004)
- Types of Agency conflicts
- Conflicts between outside and inside capitalists (Hand, Lloyd, & Rogow, 1982)

# Literature Review and Propositions

- SME administration in Initial phases
- Sophisticated firm structure with the growth of SME.
- Organizational sophistication and external financing
- Separation of managerial control and ownership with SMEs' complication.
- **Consequences of Separation** (Berle & Means, 1932; Fama & Jensen, 1985; Jensen & Meckling, 1976).

# Literature Review and Propositions

- Non-owner managers could work in their own best interest due to different priorities like power, personal prestige, firm's valuation ratio, market share, risk taking, sales revenue, growth maximization and other related factors.
- Debt capital providers and managers
- Cultural factors, local disclosure requirements, and legal status of the SME
- Moral hazard and Adverse selection (Suzuki & Lacktorin, 1999).

# Debt Maturity Structure

- Problem of underinvestment in SMEs (Myers, 1977).
- Problem of risk-shifting and asset substitution
- Problem of free cash flow or overinvestment
- **Optimum policy for debt maturity** (Lopez-Gracia & Mestre-Barberá, 2015).

# Debt Overhang

- Managers or owners in SMEs who obtain loan renounce positive NPV investments.
- Debt contracting in the present to invest current opportunities can cause an underinvestment issue in the future.
- This agency problem can be mitigated with the reduction in debt maturity as before the investment is made, the debt will be matured
- *H1: Underinvestment agency problem in SMEs is likely to be mitigated by reducing the debt maturity.*

# Risk-shifting or Asset Substitution

- SME debt holders try to invest in risky projects instead of low risk ventures at the expense of lender.
- Most of the risk burden has to face by creditor
- Short-term debt financing will also allow the creditor to monitor the risk-taking behavior (Jun & Jen, 2003).
- *H2: Risk-shifting agency problem in SMEs is likely to be mitigated by aligning the economic life of assets to debt maturity.*

# Free cash flow Problem

- Separation of management and ownership
- Misusing the available free cash flows by investing them in unsuccessful ventures
- Less control structures and concentrated ownership
- Contrary views (Kaplan, 1999; Hart & Moore, 1995)
- *H3: Overinvestment agency problem in SMEs is likely to be mitigated by increasing the debt maturity.*

# Demand for Audit

- Efficient auditing can mitigate the potential agency conflicts as it acts as monitoring mechanism (Niskanen, Karjalainen, & Niskanen, 2010).
- Small and medium enterprise are also willing to have their accounts audit even in an informal setting (Kaur & Kurt, 2008).
- Firm-specific incentives (contracting and agency costs)
- Benefits of voluntary external auditing.
- SMEs should carry out an audit regardless of their size. (Mustapha, Yaen, & Ismail, 2015).
- H4: Potential agency conflicts in SMEs are likely to be mitigated through voluntary demand for external auditing.

# Discussion and Conclusion

- Agency conflicts in small firms.
- Agency conflicts in medium firms.
- Utilization of independent directors on board, activism of institutional investors, better compensation plans or higher interest rates
- underinvestment (debt-overhang) problem, asset substitution (risk-shifting) problem and overinvestment (free cash flow) problem
- External auditors to mitigate agency conflicts
- Improve the corporate governance structures in SMEs
- Effective monitoring by creditors will improve the level of collateral, long product history, credit history and disclosure policies.

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