**Ans No3**

**Goal of Firm**

**1. Profit Maximization Approach:**

Profit maximization approach about the behavior of the firm is one of the most fundamental assumptions of traditional neo-classical economic theory.

The attempt of the entrepreneur to maximize profit is regarded as the rational behavior of the entrepreneur. Just as the rational behavior in the case of firms is profit maximization, profit is basic to the philosophy of the free enterprise system. Adam Smith saw profit as the device which transforms the selfishness of mankind into channels of useful service.

**2. Long Term Survival:**

According to Rothschild, main objective of a firm is to obtain the stage of long-run survival. A firm having this aim is always reviewed cautiously and all of its decisions are safety oriented. Such firms do not like to reap larger profits in short-run but prefer lower profits in the long-run.

**3. Baumol’s Sale Maximization Objective:**

Prof. Baumol has put forward sales maximization as an alternative goal to profit maximization. He offers several justifications of sales maximization as a goal of the firm. Here, sales maximization means maximization of the money value of sales. The objective of a firm is one of constrained maximization where the firm maximizes total revenue subject to a minimum profit constraint. According to Prof. Baumol it is the better evaluator of performance of the firm than the traditional profit maximization model.

**4. Maris’s Model of the Managerial Enterprise:**

Marris has developed a model of managerial discretion. In Marris’ model the goal of the firm is the maximization of the balanced rate of growth of the firm, i.e., the maximization of the rate of growth of demand for the product of the firm and of the growth of its capital supply.

**In pursuing this maximum balanced growth rate, the firm has two limitations:**

(I) A constraint set by the available managerial team and its skills.

(ii) Secondly, financial constraint set by the desire of the managers to achieve maximum job security.

In short, the rationale for this goal is that by jointly maximizing the rate of growth of demand and capital, the managers maximize their own utility as well as of the utility of the owners. Their utility maximization is reflected in increased salary, power, and prestige. Hence, they are motivated to pursue such policies maximizing these things.

**5. The Behavioral Theory of the Firm:**

Model of Satisfying Behavior: Prof. Simon gave an early statement of the behavioral theory of the firm in 1955. This theory was subsequently elaborated by Cryert and March. This theory focusses on the decision-making process of the large multi-product firm under uncertainty in imperfect market. The firm is not treated as a single goal, single decision unit, but as a multi-goal, multi-decision organizational coalition. The firm is regarded as a coalition of different groups which relate to its activity in various ways.

The partners of this coalition are managers, workers, shareholders, customers, suppliers, bankers etc. Each group has its own set of goals. For example, the managers want higher salaries, workers want higher wages, shareholders want higher dividend etc. There is a conflict of goals among the different partners of this coalition. The different groups bargain continuously to achieve their goals.

**Part B Ans 3**

**Reasons Behind Principal-Agent Problems**

The main reasons for the principal-agent problem are conflicts of interests between two parties and the asymmetric information between them (agents tend to possess more information than principals). The principal-agent problem generally results in [agency costs](https://corporatefinanceinstitute.com/resources/knowledge/finance/agency-costs/) that the principal should bear. Because agents can act in their interests at the principals’ expense, the principal-agent problem is an example of a moral hazard. The principal-agent problem was conceptualized in 1976 by American economists [Michael Jensen and William Meckling](https://papers.ssrn.com/abstract%3D94043).

The principal-agent problem has applications in political science and economics. The problem is especially significant in the understanding of [corporate governance](https://corporatefinanceinstitute.com/resources/knowledge/other/what-is-shareholder-primacy/)

**Solutions to Principal-Agent Problems**

Solutions to the principal-agent problem aim to align the interest of both parties. There are two main areas of improvement to address the problem:

 #1. Contract design

The main purpose of contract design is the creation of a contract framework between the principal and the agent to address issues of information asymmetry, stimulate the agent’s incentives to act in the interests of the principal, and determine monitoring procedures.

#2. Performance evaluation and compensation

The agent’s compensation is the primary method of aligning the interests of both parties. In order to address the principal-agent problem, the compensation must be linked to the performance of the agent.

The performance of the agent is measured by subjective evaluation because it is a more flexible and balanced assessment of complex jobs. The most common methods of agents’ compensation include [stock options](https://corporatefinanceinstitute.com/resources/knowledge/finance/stock-option/), profit-sharing, and deferred compensation. Nevertheless, these types of compensations alone are not the panacea for the principal-agent problem.

**Q2 Part B**

The CML is a line that is used to show the rates of return, which depends on risk-free rates of return and levels of risk for a specific portfolio. SML, which is also called a Characteristic Line, is a graphical representation of the market’s risk and return at a given time. One of the differences between CML and SML, is how the risk factors are measured. While standard deviation is the measure of risk for CML, Beta coefficient determines the risk factors of the SML.
The CML measures the risk through standard deviation, or through a total risk factor. On the other hand, the SML measures the risk through beta, which helps to find the security’s risk contribution for the portfolio. While the Capital Market Line graphs define efficient portfolios, the Security Market Line graphs define both efficient and non-efficient portfolios.

While calculating the returns, the expected return of the portfolio for CML is shown along the Y- axis. On the contrary, for SML, the return of the securities is shown along the Y-axis. The standard deviation of the portfolio is shown along the X-axis for CML, whereas, the Beta of security is shown along the X-axis for SML.

Where the market portfolio and risk free assets are determined by the CML, all security factors are determined by the SML. Unlike the Capital Market Line, the Security Market Line shows the expected returns of individual assets. The CML determines the risk or return for efficient portfolios, and the SML demonstrates the risk or return for individual stocks.

1. The CML is a line that is used to show the rates of return, which depends on risk-free rates of return and levels of risk for a specific portfolio. SML, which is also called a Characteristic Line, is a graphical representation of the market’s risk and return at a given time.

2. While standard deviation is the measure of risk in CML, Beta coefficient determines the risk factors of the SML.

3. While the Capital Market Line graphs define efficient portfolios, the Security Market Line graphs define both efficient and non-efficient portfolios.

4. The Capital Market Line is considered to be superior when measuring the risk factors.

5. Where the market portfolio and risk free assets are determined by the CML, all security factors are determined by the SML.