THEORIES OF ENTREPRENEUR

AGENCY THEORY

Agency theory was developed in the 1980s by economomist Michael C. Jensen at the Harvard Business School for the purposes of explaining and predicting the behaviors of investors and managers. Agency theory distinguishes between principals and agents, the former being parties that delegate responsibility for some set of actions to the latter. For instance, entrepreneurs and managers are often the agents of investors, who delegate the responsibility over a business organization.

The theory's underlying assumption is

that both parties are self-interested and that the interests of principals and agents diverge or are in conflict. Therefore, agents may make decisions on behalf of principals that are not in the principals’ interests, which is called an agency problem. Agents typically have better information than principals because they are in charge of day to day decisions and are usually closer to the organization than principals, who are typically investors somewhat removed from the business. Adverse selection is the problem of selecting agents that are ill-suited,
whereas moral hazard is the problem of selecting agents that misappropriate resources. Misappropriation comes in

many forms, including free riding, shirking, and the excessive consumption of perks. Agency theorists propose outcome-bases incentives as solutions to align the interests of agents with those of principals.

INFORMATION ASYMMENTRY

Information asymmetry **refers to a conditions whereby two parties in a market or organizational relationship have access to different information about the exchange. It can be seen as an alternative to the classical assumption of "perfect information" in economics. Information asymmetries have been acknowledged by regulators who have made laws forbidding insider trading.**

Insiders have special access to the real financial picture of a company and have **an unfair advantage when buying and selling company stock. Information asymmetry is also a potential source of problems in entrepreneurship. For example, an entrepreneur knows much more about the real potential of their ventures because they have inside access to knowledge about their customers and the issues with production. The investors, on the other hand, have less information about the true probabilities, so usually demands a higher return or interest rate to compensate them.** Even within the startup founding team, more

technical founders may have better information about the potential of an innovation but may not disclose it if it would undermine the motivations of sales and business oriented founders.

PECKING ORDER THEORY

The pecking order theory was developed by in the 1980’s by finance scholars seeking to understand the financing preferences of firms. Pecking order theory also relates to entrepreneurs’ preferences about financing choices. Financing options include using one’s own personal funds, reinvesting profits back into the business, selling equity to outside investors, and bank debt or loans.At the core of the theory are between the entrepreneur or the start-up’s executive team, and the prospective sources of funds for the business—that is, the financiers. Entrepreneurs and other insiders have better

information about the business' operations and potential than do prospective financiers because the former deal with stakeholders and problems on a day to day basis. Financiers usually have to rely on second hand information provided by the leadership team of the startup and the financial statements they provide. While corporate officers have a fiduciary duty toward shareholders, that is, they are legally required to be truthful, there is still plenty of room for understatement, overstatement, and obfuscation make up for their informational disadvantages, financiers typically demand higher interest rates or more favourable

terms to protect themselves against what they do not know, As a result, entrepreneurs tend to prefer to fund their ventures using their own funds and profits of the business rather than submitting to the costly demands of outside investors and lenders. New equity investors will typically demand a higher rate of return on their investment than the founding investors, thus entrepreneurs will typically prefer loans. Entrepreneurs also prefer short-term loans to long-term loans, as these will typically have lower interest rates.

BOOT STRAPPING

Bootstrapping describes a situation in which an entrepreneur start a company with little capital, relying on money other than outside investments. It is the utilization of limited resources to grow or start a business. It entails finding ways to efficiently utilize limited resources to lessen the impact of not having access to formal external resources. Often, small business owners are unable to obtain financing from formal sources, such as bank financing. Small business owners are forced to utilize the resources that they have to finance their business. Bootstrapping is referred to as an informal or creative source of financing a business.

There are two basic methods of bootstrapping that are interrelated:

- Efficiently utilizing the resources you have
- Acquiring new resources

They are interrelated because each method helps to achieve the other method. Efficiently utilizing resources may assist in acquiring new resources, and the reverse is true.