Expense Preference

The Two Problems

• Expense Preference
• Agency Problems

Expense Preference

• This is the microeconomics of control:
  How do you assure that the expenses an employee incurs are beneficial?

An Example

Cost of Heating the Office $X
Increase in Productivity $Y
The Dollar Equivalent of Utility the Heat Gives Me $Z

• Because KSU heats my office, they can pay me $Z less in salary.

An Example

• Most people would agree that
  $Y + SZ > SX
An Example

<table>
<thead>
<tr>
<th>Cost of Heating the Office</th>
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</tr>
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</tr>
</tbody>
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• Some people work outdoors without heat; for them
  \[ SY + SZ < SX \]

The CEO

• The Dry Cleaning Chain is profitable – very profitable.
• You decide to retire to Florida and live the good life. But you are stuck with the problem of hiring a CEO for your company.

The CEO

• Hire your son or daughter. They will inherit the business eventually, and so if they cheat anyone they are cheating themselves
  • The problems
    – May not be good or interested
    – Multiple children

Hiring the CEO

• You don’t go this way. You hire someone to manage the firm. Immediately they
  – Buy a company jet
  – Joins the country club at corporate expense
• How do you tell if $Y + SZ > SX$?

Hiring the CEO

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• How do you tell if $Y + SZ > SX$?
• On top of that, how do you know their financial reports are accurate?
Hiring the CEO

- You don’t go this way. You hire someone to manage the firm. Immediately they:
  - Buy a company jet
  - Joins the country club at corporate expense

Suggestions

- Make the interests of senior management identical with that of shareholders. Pay with stock options.
  - How do you know their financial reports are accurate?

Bring in Dull, Dull and Overpriced, CPA

Suggestions

- Make the interests of senior management identical with that of shareholders. Pay with stock options.
  - If the firm is run by the owner
    \[ X - Y < Z \]
  - If partially owned by the manager
    \[ \alpha(X - Y) < Z \]

Illustration

- Corporate Jet costs $100 (X = 100)
- Improved Productivity = $50 (Y = 50)
- Improved Utility = $40 (Z = 40)

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**Illustration**

- Corporate Jet costs $100 (X = 100)
- Improved Productivity = $50 (Y = 50)
- Improved Utility = $40 (Z = 40)
- $100 > $50 + $40
- $40 > 0
- Profits are down by $50 ($5)

**Two Rules**

- No one gets to approve their Expense Account.
- But what about the CEO?
  - No corporate comptroller will refuse to pay a CEO’s expense statement.

**Monitoring the CEO**

- No corporate comptroller will refuse to pay a CEO’s expense statement.
- A modest suggestion:
  - Require the board to review the CEO’s expense account annually before awarding a discretionary bonus
  - If the CEO has overspent by $50,000, just reduce the bonus by $50,000

Obviously not perfect: are you going to cut your golf buddy’s bonus?

**End**

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