

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

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

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- Most people would agree that

$$\$Y + \$Z > \$X$$

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- Some people work outdoors without heat; for them

$$\$Y + \$Z < \$X$$

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

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- 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 $\$Y + \$Z > \$X$?

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- 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 car
 - Joins the firm and increases expenses
- How do you know their financial reports are accurate?

Bring in Dull, Dull and Overpriced, CPA

Suggestions

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Is $\$X - \$Y < \$Z$?

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- Make the interests of senior management identical with that of shareholders. Pay with stock options.
 - If the firm is run by the owner
 - If partially owned by the manager

Is $\$X - \$Y < \$Z$?

Is $\alpha(\$X - \$Y) < \$Z$?

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**
- 10% ownership
- **\$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

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- A modest suggestion:

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 - 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

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 - 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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