

Leban corporation has accepted an offer to produce a special order of RIASY. The net profit to Leban will depend on the difficulty level of the production process. Leban has estimated that the difficulty level might be as in table 1

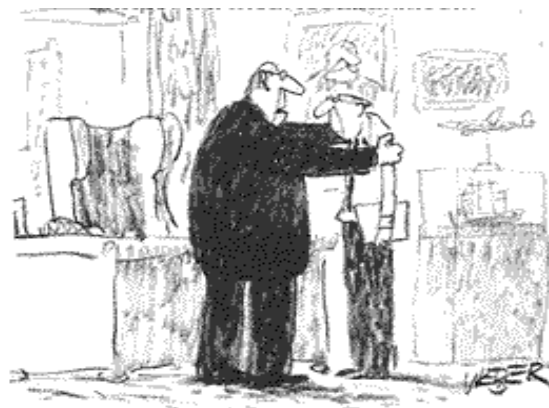
Galoot, a manager at Leban whose current pay is \$40,000 announces that he can take certain actions during the design and ahead of the production run that can affect the profits to Leban if the difficulty level turns out to be Medium. If the difficulty level turns out to be Medium and if Galoot had taken the necessary actions then there will be a profit of \$5,000 instead of a loss of \$1,000. Nobody knows or will know the actual difficulty level ever. If the difficulty level is low or extreme then Galoot's efforts will make no difference; i.e. if the difficulty level is low the profit is guaranteed to be \$5,000 and if the difficulty level is extreme then the loss of \$1,000 can not be avoided even by Galoot.

Galoot says that he will take the necessary actions for an additional pay of \$2,400 and Leban thinks that this amount is fair compensation. One way to think of this amount is that Galoot thinks that the additional effort costs him \$2,400 in dollar terms. That is if Galoot does not take the Riasy job, the leisure value of the time released is worth \$2,400 or that Galoot can use the time to earn \$2,400 elsewhere. But once he accepts the Riasy job, the opportunity cost of working hard for Leban is \$800. Leban evaluates risky payoffs in a risk neutral manner.

Questions

- 1 Suppose Leban can observe whether Galoot is taking the necessary actions. Should Leban hire Galoot?
- 2 Suppose Leban cannot observe whether Galoot is taking the necessary actions or whether he is consuming leisure or whether he is earning money elsewhere in the time that he is supposed to be working on the Riasy project. Assume that Galoot is also risk neutral. Should Leban hire Galoot?

If a constant salary is given to Galoot then he will not take the necessary actions. Set up an incentive contract for Galoot where his salary depends on the profit level of the Riasy project. There are two things to take care of. His expected salary should at least be equal \$2,400 from the Riasy project if he takes the necessary actions and he should be motivated to take the necessary actions instead of not taking them.



"It's up to you now, Miller. The only thing that can save us is an accounting breakthrough."

Table 1

Low	with probability of 0.25 in which case the profit will be	5,000
Medium	with probability of 0.50 in which case the loss will be	1,000
Extreme	with probability of 0.25 in which case the loss will be	1,000