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Operational Decisions, Capital Structure, and Managerial Compensation: A News Vendor Perspective

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Abstract

While firm growth critically depends on financing ability and access to external capital, the operations management and engineering economics literature seldom considers the effects of financial constraints on the firms' operational decisions. Another critical assumption in traditional operations models is that corporate managers always act in the firm owners' best interests. Managers are, however, agents of the owners of the company, whose interests are often not aligned with those of equity holders or debt holders; hence, managers may make major decisions that are suboptimal from the firm owners' point of view. This article builds on a news vendor model to make optimal production decisions in the presence of financial constraints and managerial incentives. We explore the relationship between operating conditions and financial leverage and observe that financial leverage can increase as margins reach either low or high extremes. We also provide some empirical support for this observation. We further extend our model to consider the effects of agency costs on the firm's production decision and debt choice by including performance-based bonuses in the manager's compensation. Our analyses show how managerial incentives may drive a manager to deviate from firm-optimal decisions and that low-margin producers face significant risk from this agency cost while high-margin producers face relatively low risk in using such compensation.

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