

ESCI - UPF

BUSINESS ORGANIZATION

Main Concepts

Academic Year 2012-13

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Topic 3. Markets, Organizations and Knowledge - Summary

1. There are many different ways of organizing economic activities. **Economists focus on Pareto efficiency in evaluating the effectiveness of alternative economic systems.** An allocation is Pareto-efficient if there is no alternative that keeps all individuals at least as well off but makes at least one person better off.
2. An important feature of a market economy is the use of private property rights. A property right is a legally enforced right to select the uses of an economic good. A property right is private when it is assigned to a specific person. Private property rights are alienable in that they can be transferred (sold or gifted) to other individuals.
3. In free markets, property rights frequently are exchanged. Trade occurs because it is mutually advantageous. **Trading produces value that makes individuals better off.** Gains from trade also motivate the movement of resources to more productive users. Total output increases when individuals specialize in production activities for which they have a comparative advantage (lower opportunity costs).
4. **Prices coordinate the individual actions in a market economy.** The market is in equilibrium when the quantity supplied of a product equals the quantity demanded. In equilibrium, there are no shortages or surpluses and inventories are stable at their desired levels.
5. Consumer surplus and producer surplus are measures of the gains from trade to consumers and producers from participating in a market. Government-imposed price caps or floors result in market imbalances and lost surplus (in an otherwise well-functioning market).
6. Externalities exist when the actions of one party affect the consumption or production possibilities of another party outside an exchange relationship. Externalities can cause markets to fail to produce an efficient resource allocation. The Coase Theorem indicates that the ultimate resource allocation will be efficient, **as long as contracting costs are sufficiently low and property rights are clearly assigned, well enforced,** and readily exchangeable.
7. General knowledge is inexpensive to transfer, whereas specific knowledge is expensive to transfer. Central planning often fails because important specific knowledge is not incorporated in the planning process. Within market systems, economic decisions are decentralized to individuals with the relevant specific knowledge. **Prices convey general knowledge that coordinates the decisions of individuals.** Private property rights provide important incentives to individuals to act productively, since they bear the wealth effects of their decisions.
8. In principle, all economic activity could be conducted through market transactions. However, even in market economies, much economic activity occurs within firms, where administrative decisions rather than market prices are used to allocate resources. **Firms exist because of the contracting costs of using markets.** However, organizing transactions within firms also involves costs. Individuals have incentives to organize transactions in the most efficient manner to increase the gains from trade. **Economic activities tend to be organized within firms when the cost is lower than that of using markets, and vice versa.**

Topic 4. Markets, Organizations and Knowledge - Summary

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Topic 5. Incentive Conflicts and Contracts - Summary

1. Treating a firm as if it were an individual decision maker who maximizes profits is a useful abstraction in some contexts. But to analyze organizational issues within the firm requires a richer definition. A particularly useful definition for our purposes is that the **firm is a focal point for a set of contracts**.
2. There are likely to be **incentive conflicts** among the parties that contract with the firm. Examples include owner-manager, buyer-supplier, and free-rider conflicts. Contracts (explicit and implicit) specify a firm's organizational architecture (its decision right, performance evaluation, and reward systems). **Contracts are unlikely to resolve incentive problems completely** because they are costly to negotiate, administer, and enforce. Asymmetric information causes particularly important problems.
3. **An agency relationship** consists of an agreement under which one party, the principal, engages another party, the agent, to perform some service on behalf of the principal. Many agency relationships exist within firms. Agents do not act in the best interests of principals automatically-there are incentive problems.
4. Asymmetric information usually implies that incentive problems cannot be resolved costlessly by contracts. The principal usually can limit the divergence of interests by structuring the contract to establish **appropriate incentives** for the agent and by incurring monitoring costs aimed at limiting dysfunctional activities by the agent. **Generally, it does not pay to resolve incentive conflicts completely**. Total agency costs are the sum of the out-of-pocket costs (monitoring and bonding costs) and the opportunity cost of the residual loss.
5. Precontractual informational asymmetries can cause breakdowns in bargaining and **adverse selection**. Adverse selection refers to the tendency of individuals, with private information, to make offers that are detrimental to the trading partner. Costs of adverse selection reduce the gains from trade and **can cause market failures**. Precontractual information problems can be mitigated by information collection, clever contract design, and mechanisms such as warranties.
6. Many of the contracts within firms are **implicit contracts** rather than formal legal documents. Implicit contracts are difficult to enforce in a court of law and depend largely on the private incentives of individuals for enforcement. **Reputational concerns** can provide incentives to honor implicit contracts.

Topic 6. Economics of Strategy - Summary

1. Strategy refers to the general policies that managers employ to generate value. Rather than focus on operational detail, a firm's **strategy addresses broad, long-term** issues.
2. The ultimate objective of strategic decision making is to realize **sustained profits**. To achieve this objective, managers must devise **ways to create and capture value**. There are at least **four general ways** that managers can increase value:
 - i. They can take actions to lower production costs or producer transaction costs.
 - ii. Managers can implement policies to reduce consumer transaction costs.
 - iii. They can adopt strategies to increase demand (increase perceived quality, lower the price of complements, or increase the price of substitutes).
 - iv. They can devise new products or services.
3. **Sometimes more value is created by cooperating** with firms than by competing against them.
4. Successful firms find ways to convert ideas and knowledge in their employees' into formulas and recipes for creating value. Firms face an unlimited set of opportunities to create better formulas, recipes, and methods for making improved products at lower cost. **New opportunities** are likely to emerge as technology continues to evolve.
5. Creating value is a necessary first step in making profits. **It is also necessary to capture value**. A firm may have reduced its transaction/production costs or increased its consumer demand, but if other firms copy these changes quickly and enter the market, the competition will eliminate the profits. The potential for firms to capture value increases with **market power**. The existence of effective entry barriers is required for market power. At least four other factors are important: the degree of rivalry within the industry, threat of substitutes, buyer power, and supplier power.
6. Both human as well as physical assets vary in productivity. If an asset allows the firm to make a profit because of its superior productivity, other firms will compete for this resource and bid up its price. Thus, in a well-functioning market, **gains from superior productivity go to the responsible asset**.
7. Because of the interdependencies among employees and assets, the value of the inputs *as a team* sometimes can be greater than the sum of their values if each were employed at their next best uses across other firms. Thus, **it is possible that the overall firm will be more valuable than the sum of its parts**. We characterize such a firm as having team production capabilities.
8. The business environment is constantly evolving with new technological developments, changes in consumer tastes, new business concepts, new firms, and so on. Given this, **it is unlikely that any competitive advantage will last forever**.
9. Some firms concentrate on a single major business but **many large firms engage in multiple businesses**: They are at least partially diversified. Economies of scope provide the primary reason why diversification might enhance value. Although diversification has potential benefits, **it also has potential costs**. As firms grow, they often become bureaucratic and more costly to manage. If diversification occurs through the merger of two firms (as often is the case) it also can be quite expensive to develop common personnel, communication, information, and operating systems.
10. Some managers **diversify to reduce earnings volatility**. This **often is a poor reason** to diversify because shareholders can diversify on their own account simply by owning the shares of multiple companies. Related diversification occurs when the businesses use related technologies or serve common markets. The net benefits are likely to be greater in related rather than in unrelated diversification.

11. Developing and implementing strategies that increase a firm's value require an **understanding of both the internal *resources* and *capabilities*** of the firm and the external business environment. A firm's resources and capabilities include its physical, human, and organizational capital. Most resources and capabilities are finite -choices have to be made. To make optimal choices, managers must consider the firm's resources and capabilities jointly, as well as threats and opportunities within the external business environment.
12. Strategy consultants often suggest that all firms can develop strategies that deliver systematic economic profits even if they do not begin with unique resources or team capabilities. Basic economics suggest that this claim is false.

Topic 7. Vertical and Outsourcing - Summary

1. When a firm participates in more than one successive stage of the production or distribution of a product or service, it is said to be **vertically integrated**.
2. An organization that begins to produce its own inputs is engaging in **backward or upstream integration**, whereas an organization that begins to market its own goods or to conduct additional finishing work is engaging in **forward or downstream integration**.
3. The term **outsourcing** frequently is used to describe a movement away from vertical integration-moving an activity outside the firm that formerly was done within the firm. The term outsourcing also is used to describe an ongoing arrangement. It is useful to think of the outsourcing decision as a choice along a continuum of possibilities, ranging from spot market transactions to vertical integration.
4. Well-functioning markets provide powerful incentives for efficient production and low prices; thus, firms acquire many goods and services through market transactions. Economists have identified at least three primary reasons why a firm might want to engage in **nonmarket procurement**: contracting costs, market power, and taxes/regulation.
5. Four factors can make the contracting costs of nonmarket procurement lower than the costs of market exchange: firm-specific assets; cost of measuring quality; externalities and coordination problems.
6. Firm-specific assets are assets that are substantially more valuable in their current use than in their next best alternative use. Investment in firm-specific assets can cause enormous. Once the investment in firm-specific assets is made, there is a sunk cost. This incentive subjects the supplier to a potential **hold-up problem**.
7. Due to contracting costs, **most contracts are incomplete**: Many contingencies are unspecified and subject to future negotiation. The prospect of future negotiations can motivate suboptimal investment in both capital and effort.
8. The owner has the right to determine the residual use of an asset. The choice between vertical integration and long-term contracts depends, at least in part, on which ownership structure creates more productive investment decisions.
9. A primary prediction of the economics literature is that **as an asset becomes more firm-specific, the firm is more likely to choose vertical integration** over long-term contracting. The analysis suggests that firms will enter long-term contracts when the desired investment is relatively firm-specific and where the environment is relatively stable and predictable.
10. Independent distributors can have incentives to **free-ride** on a brand name. One method to reduce this problem is vertical integration. Another method is to use contracts with specific provisions that control free-rider problems. Two types of contract terms that specifically address this concern are advertising provisions and exclusive territories.
11. At least four factors have contributed to the **recent trend in outsourcing**: increased worldwide competition, the development of less firm-specific production technologies, improvements in information and communication technologies, and excess capacity from a worldwide recession.
12. The recent trend, however, is not from vertical integration to spot market transactions. It is a movement from both end of the spectrum toward an **intermediate solution** of some form of long-term contracting.

Topic 8. Organizational Architecture and the Level of Empowerment - Summary

1. Organizational architecture includes **three important components** of organizational design that are major determinants of the success or failure of firms:
 - The assignment of decision rights
 - The methods of rewarding individuals
 - The systems to evaluate the performance of both individuals and teams
2. The **fundamental problem** facing firms involves trying to ensure that decision makers have the relevant information to make good decisions and that these decision makers have appropriate incentives to use their information productively.
3. Within firms, there is no automatic system for either assigning decision rights to individuals with information or motivating individuals to use information to promote the firm's objectives. **Organizational architecture has to be created.**
4. The **appropriate architecture depends on the environment** facing the firm. In some firms, senior management will have most of the relevant information for decision making, and relatively centralized decision making is more likely to be adopted. In firms where lower-level employees have the relevant information, decision rights are more likely to be decentralized. In this case, reward and performance-evaluation systems must be developed to control incentive problems and to promote better decision making.
5. Market conditions, technology, and government regulations interact to determine the firm's appropriate strategy and architecture. **The strategy and architecture**, in turn, are major determinants of the firm's value.
6. **Corporate culture** usually is meant to encompass the ways work and authority are organized and the ways people are rewarded and controlled, as well as organizational features such as customs, taboos, company slogans, heroes, and social rituals.
7. In **centralized decision systems**, most major decisions are made by individuals at the top of the organization. In decentralized systems, many decisions are made by lower-level employees. **Decentralized decision making** has both benefits and costs. Potential benefits include training/motivation for lower-level managers. Potential costs include contracting and coordination costs and less effective use of central information.
8. The **optimal** degree of decentralization depends on the incremental **benefits and costs**, which vary across firms and over time. There has been a recent trend toward greater decentralization, motivated in part by increased global competition and changes in technology.
9. Sometimes, firms assign decision rights to **teams of employees** rather than to specific individuals. Firms assign decision rights to teams for at least three basic purposes: i. managing activities, ii. recommending actions, and iii. making products.
10. The use of team decision making sometimes can increase productivity; but this is not always the case. **Team decision making is most likely to be productive when** the relevant information is dispersed and the costs of collective decision making and controlling free-rider problems are low.
11. When individuals do not bear the major wealth effects of their decisions, it generally is important to **separate decision management from decision control.**

Topic 9. Incentive Compensation and Performance Evaluation - Summary

1. Incentive problems exist because of **conflicts of interest** between employers and employees: most of the costs of exerting effort are borne by employees, whereas most of the gains go to their employers.
2. These problems are easily resolved **when actions are costlessly observable**. Firms can identify the most efficient actions by employees and pay employees only if these actions are taken. However, in most situations employee actions are not observable and firms motivate employees through incentive compensation.
3. Sometimes, there is a **simple way** to resolve this incentive problem even when the actions of employees are unobservable. The solution is to sell each employee the rights to his or her total output.
4. From a **risk-sharing standpoint**, it is better to pay employees more through fixed salaries and to let the risk of random income flows be borne more by the shareholders. Yet fixed salaries provide limited incentives for employees to exert effort: Therefore, there is a trade-off between optimal risk sharing and optimal incentives.
5. **Economic analysis of incentive compensation** relies on the basic principal-agent model and provides a number of useful insights for designing better compensation plans. The model suggests that firms should pay more performance-based pay when
 - a. the sensitivity of the value of output to additional effort by the employee is higher
 - b. the employee is less risk-averse
 - c. the level of risk that is beyond the employee's control is lower
 - d. the employee response to increased incentives in terms of exerting additional effort is more pronounced, and
 - e. employee output is more easily measured.
6. According to the **informativeness principle**, it is useful to include all indicators that provide additional information about employee effort into the compensation contract provided that these indicators are available at low cost. Including these indicators in the contract reduces the randomness of payouts and thus the costs of inefficient risk bearing.
7. **Individual Performance**. Performance evaluation is conducted for both individuals within the firm and subunits of the firm. The simple principal-agent model suggests that part of the employee' compensation should be based on performance (output). But basing pay on output requires that output is observable at low cost and is difficult to manipulate by the firm or the employee.
8. To set the **optimum compensation package**, management must know the employee's marginal productivity of effort. One way managers estimate these marginal productivities is to use time and motion studies or data on past performance. If past performance is used, dysfunctional incentives due to the ratchet effect can result; employees will limit output if they anticipate that the next period's target benchmark will be raised.
9. The informativeness principle suggests that when several employees are performing similar tasks, their combined output provides information about common random shocks affecting all their outputs. Thus, the employee's compensation should be adjusted relative to peers. This is called **relative performance evaluation**.
10. In some cases, the measurement costs or the costs from employees' dysfunctional attempts to maximize explicit performance measures become so great that alternative measures of performance are sought. **Subjective performance** evaluations are periodic reviews by supervisors. Subjective performance measures also involve costs. It becomes

easier for a manager or the firm to renege on the promise to reward good performance because it is harder to define "good." There is more latitude to exercise favoritism and introduce bias in subjective measures. Finally, subjective systems often generate greater influence costs as employees try to lobby for better ratings.

11. **Divisional Performance.** Decision rights are allocated to cost, expense, revenue, investment, and profit centers. These centers often are evaluated and rewarded based on accounting-based performance measures.
12. **Cost centers** are delegated decision rights over how to produce the output, but not over price or quantity. Cost centers are evaluated on either minimizing total cost for a fixed output, or maximizing output for a fixed total cost.
13. **Expense centers** such as the human resources department are like cost centers except that their output is not easily quantifiable. This difficulty in quantifying output means users often are not charged for the expense center's output; hence the demand for expense center services tends to grow faster than the firm's output.
14. **Revenue centers** are also similar to cost centers, with the difference that they are responsible for marketing the products. They have decision rights over how to sell or distribute the product, but not over the price-quantity decision. Revenue centers are evaluated on maximizing revenue for a given price or quantity and a fixed budget for operating expenses.
15. **Profit centers** have all the decision rights of cost centers plus product mix and pricing decisions. They do not have decision rights over the level of investment in their profit center. Profit centers are evaluated based on total profits.
16. **Investment centers** are like profit centers except that they also have decision right over the amount of capital invested in their division.
17. Large companies, particularly those operating across multiple lines of business, typically are organized into **multiple business units or divisions**. Such an organizational architecture is intended to provide senior managers with information about the profitability or efficiency of different businesses and to provide accountability and incentives for the operating managers charged with running those businesses.
18. Nonetheless, when there are significant interdependencies among different business units, often involving internal transfers, motivating individual profit centers to maximize their own profits generally will not maximize profits for the firm as a whole. Individual units focusing on their own profits often will ignore how their actions affect the sales and costs of other units. One valuable role of a **transfer-pricing** method, then, is to lead managers to allocate resources internally in ways that take account of such interdependencies among divisions. But transfer pricing is a quite complicated undertaking.

Topic 10. Ethics and Organizational architecture - Summary

1. Business ethics is the study of those behaviors that businesspeople should or should not follow. Assuming that people are motivated by self-interest, how are they expected to behave under alternative organizational architectures? **Ethics is primarily normative:** It is about how people should behave.
2. Managers often endorse the ethical philosophy by Adam Smith: through private ownership of property, self-interest, and competition, a society's resources are put to the best use and produce the highest quantity and quality of goods and services at the lowest prices. However, moral philosophers and all religions have debated ethics since ancient times and yet **we still do not have a universally accepted code of ethics.**
3. The **corporate social responsibility (CSR)** movement has focused less on raising corporate ethical standards than on transferring shareholders' wealth to other parties such as customers, employees, local communities, charities, or cultural institutions. Although other corporate stakeholders are important, if the corporation is to survive, it must maximize its value to its owners—a goal that in turn promotes efficient use of scarce resources.
4. There is no doubt that at least once during your career you will be faced with a key decision that some will label a major **ethical dilemma**: You may be called on to resolve a sexual harassment case, an environmental issue, or a product recall dispute. The same basic framework of earlier topics can provide guidance for understanding issues involving ethics.
5. There are a number of important managerial implications:
 - i. Behaviors that others classify as unethical impose real costs on the firm by lowering the firm's **brand-name capital**, especially when they are reported in the media. These costs from reduced reputation include forgone sales or higher costs because parties outside the firm are less willing to contract with the firm.
 - ii. Ethics has many **different meanings**, ranging from making firms socially responsible (transferring wealth from the firm to other parties) to trying to make employees less self-interested. Another use of ethics means informing employees that certain behaviors impose large reputational costs on the firm, and hence the firm will impose sanctions on employees found engaging in such actions.
 - iii. Mechanisms arise to constrain unethical behavior. Like contracting costs, **costs of unethical behavior** create incentives to minimize these costs. For example, extra care should be exerted when structuring deals with firms in financial distress.
 - iv. Ethics programs occasionally are used to try to alter people's preferences. Senior managers concerned about the ethical conduct of their employees would do better to spend less time searching for "an honest man." Rather, they should **pay more attention to the incentives** created by the firm's organizational architecture.
 - v. **Codes of conduct**, rather than trying to change employees' preferences, can communicate to employees those value-reducing actions that will not be tolerated and would lead to sanctions imposed on the employee, in addition to those value-increasing actions that are encouraged and would be rewarded.

Topic 11. Corporate Governance - Summary

1. Corporations have the **legal standing of an individual** (distinct from its shareholders) and can enter into contracts and participate in lawsuits. Shareholders have limited liability (only their initial capital contribution is subject to risk).
2. Some corporations are **closely-held** while others are **publicly-traded**. Publicly traded companies are often listed on organized stock exchange .
3. **Corporate governance** is the popular term that is used to describe organizational architecture at the top of a corporation. Alternative governance systems are often evaluated based on three key objectives that relate to value creation and survival of corporations:
 - i. the motivation of value-maximizing decisions
 - ii. the protection of asset from unauthorized acquisition use, or disposition;
 - iii. the production of proper financial statements that meet the legal requirements.
4. **Raising capital** from diversified investors is particularly important for large firms, and is the primary reason why most large firms are organized as publicly traded corporations. Public corporations also benefit from not having to restrict the supply of top managers to people who are rich enough to buy large firms.
5. **Separation of decision control and decision management is critical** when, as in the case of publicly traded companies, decision makers do not bear the full wealth effect of their actions.
6. **Top-level authority** in corporation is divided among shareholders, the board of directors, and top management. Other groups that can have roles in the decision-making process include the bondholders, preferred stock stockholders, lenders, independent auditors, and stock/credit analysts. While **shareholders** are traditionally viewed as the ultimate owners of the corporation and while the **board of directors** has primary legal authority for managing the firm, the typical board delegates much of this authority to professional managers. The board's primary function is top-level decision control-general oversight of the corporation and ratification of important decisions.
7. **Board composition vary** significantly across firms and through time; there is no one design that is optimal for all firms. Debate exists over whether the typical board is "captured by managers." Prominent examples exist where boards have fired powerful chairmen/CEOs. The chief executive officer (CEO) is the top executive officer of the corporation. The CEO does not have the relevant knowledge or time to make all (or even most) of the decisions within a large and complex organization. Many decisions are delegated to
8. **German and Japanese governance** systems are not directed at maximizing shareholder wealth. Rather their traditional focus has been on a broader set of stakeholders including employees, banks, affiliated companies, the broader community, and shareholders.
9. There is hard debate on how to improve corporate governance continues in the aftermath of the recent **corporate scandals**.

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