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B.LAB HANDOUTS

ORGANIZATION THEORY

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This handout is written by students with no intention of replacing university materials.

It is a useful tool for studying the subject, but does not guarantee preparation as exhaustive and complete as the material recommended by the University.

Organization theory

I. Preface

Three key features of organizational architecture: assignment of decision-making authority, reward system and performance evaluation system. This is called organizational architecture

II. Introduction

Benchmarking means looking at those companies that are doing something best and learning how they do it in order to emulate them. Happens formally and informally. For example, the adoption of independent boards.
Example scenario: For example, if the cover article in the next Fortune reports an innovative inventory control system at Toyota, managers across the country—indeed, around the globe—will read it and ask, Would that work in my company, too? Undoubtedly, the managers with the strongest interest in trying it will be those within firms currently suffering inventory problems.10 Some will achieve success, but others may experience disastrous results caused by unintended though largely predictable organizational "side effects"
Under economic Darwinism, the surviving architectures are relatively better than competition, not the absolute best.

Basic assumptions: People act in their own self-interest, and individuals do not all share the same information

III. Economists' view of behavior

Profitability analysis is the practice of treating customers differently based on how profitable they are to the business. Example: banks have 5 tiers of customers.
Gaming the system example: Food companies play on serving size
The slope of the indifference curve at any point is the willingness to substitute.

Other models different from the economic one: Only-money matters model of motivation, happy is productive model (happy employees are more productive than unhappy employees, little evidence for it), good citizen model (employees have a strong personal desire to do a good job, managers must thus communicate goals, help employees achieve them and provide feedback) and the product-of-the environment model.

Indifference curves with a good and a bad are upwards sloping (assuming bad on the x-axis)
The slope of an indifference curve at any point is -MUx/Muy.

According to Fisher separation theorem, do not consider the time preferences of stakeholders and simply focus on increasing NPV as the financing decision does not affect NPV (in perfect markets)

IV. Exchange and markets

Any economic entity faces three main issues: what to produce, how and how to allocate it
Coase theorem: Externalities can be regulated through the free market (Fable of bees), as long as contracting costs are sufficiently low and property rights are properly assigned, well enforced and readily exchangeable.

The more specific the knowledge, the more expensive it is to transfer it. The three other criteria that determine the cost are the characteristics of the ender and receiver, the technology available for communication and the nature of the knowledge itself (Idiosyncratic knowledge of particular circumstances, scientific knowledge and assembled knowledge are examples of highly specific knowledge). Important to remember the value of knowledge is often time-sensitive

According to Friedrich Hayek, market economies are more apt than centrally planned economies to incorporate relevant specific knowledge in economic decision-making.

Assets are specific when they are worth more in their current use than in alternative uses.

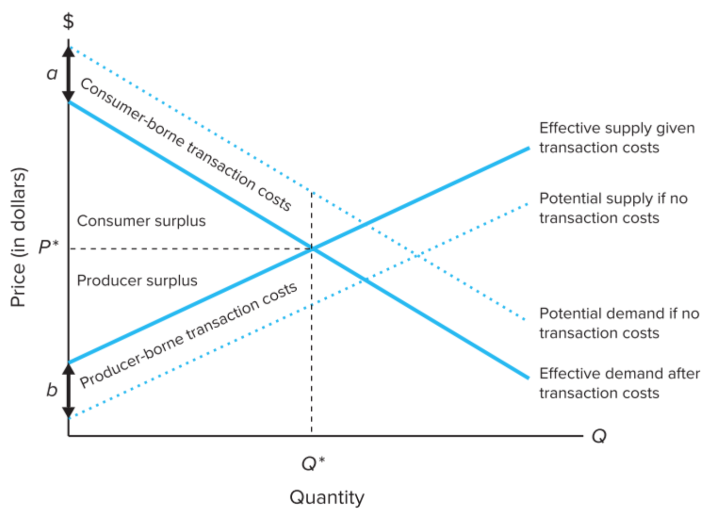
Self-evidently, firms are used when they are cheaper than using markets.

Constant growth model PV: P=D1/(k-g)

V. Economics of Strategy: Creating and Capturing Value

Strategy refers to the general policies that managers adopt to generate profits. This includes the choice of industry, products offered… The goal is to obtain sustained profits, by creating and capturing value<

Consumer transaction costs include such things as the costs of searching for the product, learning product characteristics and quality, negotiating terms of sale with a supplier, and enforcing agreements.



Potential steps top increase value include:

- Lowering costs of production or producer/consumer transaction costs
- Increase demand through non-cost related measures
- Create new products

Three main kinds of resources in a firm: tangible assets, intangible assets and human resources<
(hardware, software and wetware). Software differs from hardware as it is not a scarce resource.

In competitive markets, firms face horizontal demand curves and are price takers, whereas with market power they choose quantity/price combinations

To determine the level of competition, look at number of competitors (positively associated with competitivity) and the presence of a large, dominant firm (negatively associated). In general, excess capacity, high fixed costs, lack of product differentiation, and slow growth all increase the degree of rivalry within the industry. Competition tends to take a differentiated asset to its highest valued use, but at a price that reflects its second-highest valued use. A company can have a higher value than the sum of its parts if it has team production capabilities.

A firm's architecture consists of its assignment of decision rights and its systems for evaluating and rewarding performance. Hard to copy another firm's architecture as multiple systems need to be changed. To be an inframarginal firm (making profit in a competitive market), there are two conditions: Rivals cannot imitate the inframarginal firm and assemble teams of assets that produce the product at the same low cost—at least in the near term and the full value of the firm's superior productivity cannot be captured by selling its assets to other firms— unless they are sold together. Related diversification occurs when the businesses serve common markets or use related technologies. A firm's architecture also can influence its strategy—it is an important part of the firm's internal resources.

VI. Incentive Conflicts and contracts

The firm is a focal point for a set of contracts. Firms often use internal pricing systems to allocate resources. There are 5 sources of conflict between managers and shareholders.

- Effort Conflict: Additional effort from managers
- Perquisite taking: In the interest of owners to pay sufficient salaries, but not too much
- Differential risk exposure: Managers typically have higher levels of capital and personal wealth invested in the firm
- Differential horizon: Managers' claims on the corporation are typically limited by their tenure within, whereas owners care a lot about future cash flows
- Overinvestment: Managers prefer to empire build than divest

The dollar equivalent of the loss in gains from trade that results from this divergence of interests within the agency relationship is known as the residual loss, which, when summed with out-of-pocket cost (bonding and monitoring).

VII. Organizational architecture

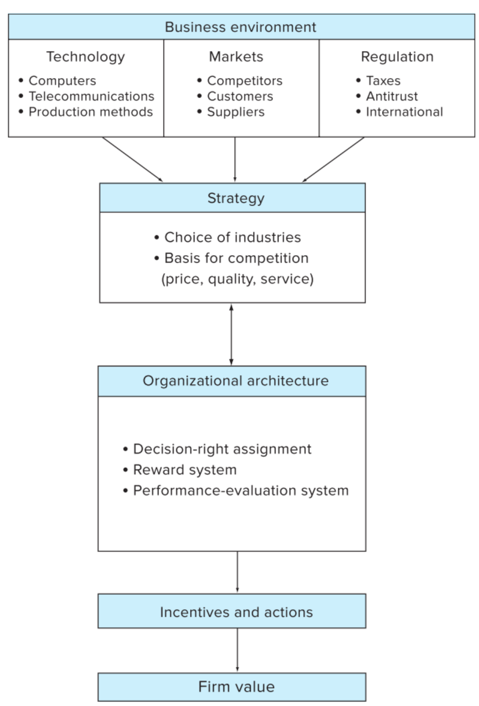
Although transfer prices are used to allocate selected resources in some firms, most resources are allocated by administrative decisions<

For decision-making, the CEO has three options: make most major decisions despite lacking information (less important to develop a detailed control system but suboptimal decisions more likely), obtain the relevant info (costly and time-consuming) or decentralize decision rights to individuals with better information (increased incentive problems, coordination becomes more challenging. The optimal strategy depends on the business environment. In smaller firms operating within relatively stable industries—senior managers are likely to have most of the relevant information for decision making, whereas for example in large firms experiencing rapid change, senior managers will often not be in the best position to make a broad array of decisions.

Structural differences are not random, and very in a systematic way with certain characteristics of firms.
In most cases, firms are unable to survive a “big-bang” disrupter (for example, Google maps for GPS navigation tool producers). Strategy also can be influenced by organizational architecture. A company might decide to enter a new market in part because its decision and control systems are especially well-suited for this new undertaking.
Two or more organizational policies are said to be complements when doing more of one increases the returns from doing more of the others.
Corporate culture usually encompasses the ways work and authority are organized; the ways people are rewarded and controlled; as well as organizational features such as customs, taboos, company slogans, heroes, and social rituals.

Figure 11.1 The Determinants of Strategy, Organizational Architecture, and Firm Value

Market conditions, technology, and government regulation are important determinants of strategy, which in turn helps determine organizational architecture. Two-way arrows are drawn to show important feedback effects. Both strategy and architecture affect the incentives and actions of employees within the firm and thus help determine the firm's value.



VIII. Decision rights: The level of empowerment

Benefits of decentralization include effective use of local knowledge, conservation of management time and motivation and experience for local managers. However, it raises incentive problems, coordination issues, less effective use of central information and lower economies of scale<

Net benefits of decentralization will be highest in rapidly evolving environments and are likely to increase as the firms enter new markets.

Team decision making is more likely to be productive in environments where the relevant specific knowledge for the decision is dispersed among individuals and where the costs of collective decision making and controlling free-rider problems are lower.

Dividing the decision-making process into four steps:

1. Initiation: Generation of proposals for resource utilization and structuring of contracts.
2. Ratification: Choice of the decision to be implemented
3. Implementation: Execution of ratified decisions
4. Monitoring: Measurement of the performance of decision makers and implementation of rewards

Decision management: The initiation and implementation of decisions.
Decision control: The ratification and monitoring of decisions.

IX. Decision Rights: Bundling Tasks into Jobs and Subunits

In broad task assignment, employees perform different functions whereas they perform only one in specialized task assignment. Specialized task assignment enables the exploitation of comparative advantages and has lower training expenses, but forgoes complementarity across tasks, requires coordination across tasks, risks employees overfocusing on their task rather than the overall process and leads to reduced flexibility.
With broad task assignments, the firm is concerned not only with how hard employees work, but also with how they allocate effort among the tasks.
Tasks that have similar degrees of measurability of whether the task was performed should be assigned to the same agent.

Grouping jobs by function is called the unitary form, whereas the multidivisional form is split based on product or geographic area. The former promotes effective coordination within the functional area, helps promote functional expertise and there is a well-defined progression path for employees. However, it does mean that senior managers have to spend time coordinating, more coordination issues are likely to arise and employees might focus too much on their function and lose sight of the overall goal.

In M forms, decision rights are assigned to individuals lower in the organization. To avoid conflict between different units, it can be smart to create groups that involve multiple units, and tie part of compensation to group performance.

Functional grouping works best in small firms with homogeneous products and markets. They are also more efficient in environments with more stable technology. With divisions organized around products or geography, different divisions can experiment with different architectures. Matrix organizations are those who use overlapping subunit structures, with individuals reporting to both a functional and a product manager. Very used in industries characterized by a sequence of new products or projects. Often difficult to implement due to intersecting lines of authority.
Network organizations are divided into work groups based on function, geography, or some other dimension, without formal lines of authority. This is for example the case of Japanese *keiretsu*, affiliations of quasi-independent firms.

X. Attracting and Retaining Qualified Employees

We assume the labor market to be competitive, market wages are costlessly observable, individuals are identical in training and skills, jobs are identical, no long-term contracts and all compensation is monetary. General human capital consists of training and education that are valued equivalently by a broad array of different firms, whereas specific human capital is more valuable to the current employer. The gains from the first go the employee, whereas the second go to the firms.
The extra wage to attract an individual to a less desirable job is called a compensating wage differential.

Efficiency wages are wages with a premium to motivate employees, who would not be able to get access to such a wage if they were fired.
Fringe benefits are compensation paid either in-kind or in a deferred manner

XI. Incentive compensation

Performance-based pay takes a variety of forms, including cash bonuses, commissions, piece rates, stock/option plans, performance-based pay raises, and promotions.
There is a tradeoff between efficient risk-sharing and contracts incentivizing behavior from employees

Factors That Favor High Incentive Pay

1. The value of output is sensitive to the employee's effort.
2. The employee is not very risk-averse.
3. The level of risk, that is, beyond the employee's control is low.
4. The employee's response to increased incentives is high (the employee exerts substantially more effort).
5. The employee's output can be measured at low cost.

Informativeness principle: In designing compensation contracts, theory suggests that it is productive to include all performance indicators that provide additional information about the employee's effort (assuming the measures are available at low cost). Measuring the employee's effort with more precision reduces the costs of inefficient risk bearing and leads to a more efficient effort choice.

Pros of group incentive plans over individual:

- Easier and cheaper to measure
- Encourages cooperation and teamwork
- Motivates employees to monitor each other
- Normally structured to retain valued workers and must be forfeited if the employee quits

Deferred compensation which is forfeited in case employees leave is particularly effective when stock price and opportunity costs are correlated.

XII. Individual Performance Evaluation

Employee performance helps the employee identify potential improvements and provides incentives. The ratchet effect refers to basing next year's standard of performance on this year's actual performance. Increasing the employee's incentive compensation should be accompanied by increasing the precision with which effort is measured. Whether or not a particular proxy variable is good for purposes of performance evaluation depends on whether the employee's actions have similar effects on both the proxy variable and the underlying output variable.

There are two widely used subjective performance-appraisal systems: standard-rating-scale systems and goal-based systems.

Standard rating scales requires the evaluator to rank the employee on a number of different performance factors on a scale, whereas in a goal-based system each employee is given a set of goals for the year, and the supervisor then evaluates to what extent each goal has been reached. Problems of bias are likely to be lower if the supervisor is held accountable for the future performance of individuals who are promoted based on the supervisor's recommendation.

XIII. Divisional Performance Evaluation

Briggs & Stratton changed the way performance was evaluated when it adopted Economic Value Added (EVA) in 1990. EVA is the after-tax operating profit of the division minus the total annual opportunity cost of the capital invested in the division.

Performance evaluation of business units exchanging goods or services requires establishing an internal transfer price for these exchanges.

Units can generally be categorized in five different types: Cost centers, expense centers, revenue centers, profit centers, and investment centers.

Cost centers have the decision rights to produce x amount of output, and is rewarded for achieving it efficiently. Must measure quantity +quality of output. In general, minimizing average unit cost is not the same as maximizing value.

Expense centres are given fixed budget and asked to maximize service/output, except output is not easily measurable. Expense center managers frequently derive additional benefits from managing larger staffs

(empire building). Potential benchmarks include comparing it to equivalents in similar firms, placing it under the control of the largest user (risks other users won't use it as much)
Revenue centers: Compensating a manager for selling a set of products. Important to fix either price or quantity.
Profit centers are composed of several cost, and possibly expense and revenue, centres. They get a fixed capital budget and have decision rights over product mix, pricing and quantity. Usually measured by comparing actual and budgeted profit for the division. Hard to determine which share of overhead profits and pricing of goods and services between two units.
Investment centres are similar, but have additional decision rights over capex and are evaluated based on ROI.
Residual income measures business-unit performance by subtracting the opportunity cost of capital employed from the profits of the business unit. (equivalent to EVA)
EVA = Adjusted accounting earnings − (Weighted average cost of capital × Total capital)
he optimal transfer price for a product or service is its opportunity cost—it is the value forgone by not using the product transferred in its next best alternative use.
Methods to approximate opportunity cost: market price, marginal production cost, full cost, and negotiated pricing.
Decision-making process can be divided into decision management (initiation and implementation) and decision control (ratification and monitoring)

Unit Type	Performance Measures	Decision Rights	Typically Used When
Cost center	Minimize total cost for a fixed output Maximize output for a fixed budget Minimize average cost	Input mix (labor, material, supplies)	Central manager can measure output, knows the cost functions, and can set the optimal quantity and appropriate rewards. Central manager can observe the quality of the cost center's output. Cost center manager has knowledge of the optimal input mix.
Expense center	Minimize total cost for a fixed level of services Maximize service for a fixed budget	Input mix (labor, material, supplies)	Output is difficult to observe and measure.
Revenue center	Maximize revenues for a given price (or quantity) and operating budget	Input mix (labor, material, supplies)	Central manager has the knowledge to select the optimal product mix. Central manager has the knowledge to select the correct price or quantity. Revenue center managers have knowledge of the demand curves of the customers in their sales districts.
Profit center	Actual profits Actual profits compared to budgeted profits	Input mix Product mix Selling prices (or output quantities)	Profit center manager has the knowledge to select the correct price/quantity. Profit center manager has the knowledge to select the optimal product mix.
Investment center	Return on investment Residual income EVA	Input mix Product mix Selling prices (or output quantities) Capital invested in center	Investment center manager has the knowledge to select the correct price/ quantity. Investment center manager has the knowledge to select the optimal product mix. Investment center manager has knowledge about investment opportunities.

XIV. Corporate Governance

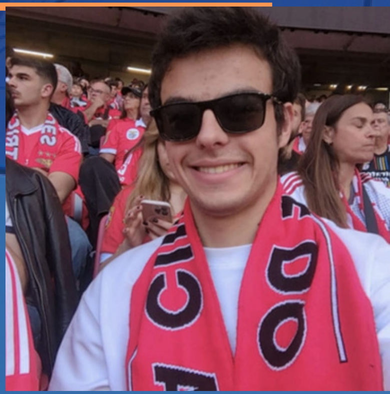
Sarbanes-Oxley Act of 2002: Most important corporate disclosure and governance legislation since the 1930s.
Restricts corporate interaction with public accounting firm, CEO and CFO must certify financial statements
Other relevant piece of law: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
Corporate governance is the popular term for describing the organizational architecture at the top of the firm
Governance systems have three key objectives: Maximizing value, protecting assets from unauthorized acquisition, use or disposition and the production of financial statements
Board members generally avoid legal liability even for disastrous business outcomes if they take reasonable care to make business decisions that they believe are in the best interests of the corporation. The audit committee has top-level responsibility for monitoring the firm's financial reporting, ethics, and control systems.

According to the managerial power theory, (1) the typical corporate board is captured by managers; (2) some firms have better governance and less managerial capture than others; (3) managers want high pay that is guaranteed (not performance-based); (4) “public outrage” places constraints on the excessive pay that can be taken by the managers; and (5) competition in product, labor, and takeover markets helps to limit executive pay and promote optimal contracts but does not work perfectly.

SOX:

- Establishes the Public Companies Accounting Oversight Board to oversee public accountants’ audits of publicly traded corporations.
- Touches on many of the issues that arose during the business scandals, including internal monitoring, public auditing, activities of external monitors, executive loans, and disclosure
- Prevents personal loans to executives
- Section 404: annual reports on internal controls over financial statements

FOR DOUBTS OR SUGGESTIONS ON THE HANDOUTS



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