

CHAPTER 1

INTRODUCTION

CHAPTER SUMMARY

This chapter introduces the book. It begins with the poor management of Volkswagen that started in 2011. This example illustrates how a company's organizational design is affected by bad management which ultimately affects the company's financial targets. It points to three critical elements of organizational design, which we refer to as *organizational architecture*. These elements include the assignment of decision rights, the reward system, and performance evaluation system. The chapter discusses the basic ideas behind economic analysis and how this framework can be used by managers to make better organizational, production, and pricing decisions. The chapter introduces the important concept of economic Darwinism.

CHAPTER OUTLINE

MANAGERIAL ECONOMICS AND ORGANIZATIONAL ARCHITECTURE

Organizational Architecture

Academic Applications—R&D and Executive Turnover

Economic Analysis

Managerial Applications—Creative Responses to a Poorly Designed Incentive System

ECONOMIC DARWINISM

Survival of the Fittest

Economic Darwinism and Benchmarking

Managerial Applications—Economic Darwinism: The Growth in Lead Directors

PURPOSE OF THE BOOK

Our Approach to Organizations

Analyzing Managerial Decisions—Société Générale

LEARNING OBJECTIVES

1. Define organizational architecture and discuss how economics can be used to help managers solve organizational problems and structure more effective organizational architectures.
2. Define economic Darwinism and discuss its implications related to the benchmarking of business practices.

TEACHING THE CHAPTER

Chapter 1 is an important chapter since it introduces the perspective that is used throughout the rest of the text. There are several *Managerial Applications* that can be used to generate class discussion. The examples from this chapter can also be referred to as these concepts are reintroduced later in the text.

There are two *Self-Evaluation Problems* and three *Review Questions* at the end of the chapter that can be used for class discussion to determine whether students understand the fundamental concepts of the chapter before discussing the *Analyzing Managerial Decisions* scenario presented at the end of the chapter.

The *Analyzing Managerial Decisions* scenario presented in the chapter, “*Société Générale*”, is a comprehensive scenario that asks students to evaluate the organizational architecture of the firm and the role its architecture played in allowing the events to transpire. (See the Solutions Manual for the answers to the *Analyzing Managerial Decisions* problems).

REVIEW QUESTIONS

1–1— What are the three aspects of *organizational architecture*?

The assignment of decision rights, the reward system, and the performance-evaluation system.

1–2— In the process of benchmarking, a colleague of yours notes that Lincoln Electric, a producer of electric arc welders, has much higher productivity than does your company. Unlike your firm, Lincoln has an extensive piece-rate compensation system; much of its employees’ total compensation is simply the number of units produced times the piece rate for that type unit. Your colleague recommends that your company adopt a piece-rate compensation system to boost productivity. What do you advise?

Piece rates are one part of Lincoln Electric’s organizational architecture. Piece rates work well for them because they fit well with Lincoln’s particular economic environment, business strategy, and other elements of the organizational architecture. It might be inappropriate to use Lincoln Electric as a benchmark if the firm is in a different environment or has a different business strategy. (Lincoln Electric will be discussed in more detail in Chapter 16.)

- 1–3— In the life insurance industry, we see two major ownership structures—common stock insurers and mutual insurers. In a common stock company, the owners—its stockholders—are a separate group from its customers—the policyholders. In a mutual, the policyholders are also the owners of the company. It has been argued that mutual insurance companies are dinosaurs—they are large, slow, bureaucratic, and inefficient. How would you respond to such an argument?

The initial reaction to this argument should be skepticism. Mutual insurance companies have existed for a long time in a competitive environment and thus are likely to have been an efficient form of organization in the past (economic Darwinism). It is possible that the environment has changed in a manner to make this form of organization undesirable. However, before this argument is accepted, it is important to identify these changes and to analyze carefully why mutual insurance companies are unlikely to survive in the changed environment.