



# Overview

---

---

## The Economics of Organizations

1. Finish up the problems from last class
2. Key assumptions and important concepts underlying the analysis of how managers can better motivate and control behavior.
3. Measuring and Evaluating Performance
4. Allocating Decision rights
5. Integration
6. Summary



# Emrich Processing

---

See the exercise “Emrich Processing”: Problem 2-11  
in Zimmerman, Jerold L. *Accounting for Decision Making and  
Control (4<sup>th</sup> Edition)*. McGraw-Hill/Irwin, 2002, pp 75-6.



## Problem – Corporate Jet Co.

---

---

A firm with three divisions has two facilities, one in Chicago, one in Orlando.

Everyday some of the executives in the Chicago office fly to the Orlando office, and others return. The Company is considering buying their own jet.

What are the factors the firm must consider in their decision to purchase the jet?



# Agency Costs

---

Most economic models assume people attempt to maximize their well being (known as utility).

Agency Problem: Agents will undertake actions to maximize their utility regardless of whether their actions maximize profits.

Moral Hazard - Insurance

Adverse Selection - Hiring/fuse

Short Horizon - project selection

Free rider - Group Projects



# Napster

---

---

File Sharing community to allow a group of individuals to share files through the internet.

The current innovation in this technology is known as Gnutella.

It is a form of peer-to-peer technology.

How can peer-to-peer technology be designed to reduce their agency problems?



## Free Riders

---

---

How do firms reduce the costs associated with free riders?

In a multidivisional firm, there are often “public goods” provided by the main headquarters to all of the divisions. How does the firm discourage free riders and the over use of the common good?

- Copy centers
- Building space
- Human resources
- Parking spaces
- Capital



## University Physician (Prob 4-6)

---

---

**See the exercise “University Physician”: Problem 4-6  
in Zimmerman, Jerold L. *Accounting for Decision Making and  
Control (4<sup>th</sup> Edition)*. McGraw-Hill/Irwin, 2002, pp 182.**



## Private Country Clubs (P4-16)

---

---

See the exercise “Private Country Clubs”: Problem 4-17 in  
Zimmerman, Jerold L. *Accounting for Decision Making and  
Control (4<sup>th</sup> Edition)*. McGraw-Hill/Irwin, 2002, pp 185-6.





## The Equitable

---

---

Mutual Insurance Company until 1993. Was a member of the Fortune 100.

Ownership of the company is maintained by the policyholders.

This means no single person owns a significant interest in the firm (no traded equity either)

What are some of the problems that are likely to arise from the mutual form of organizational structure?



# Agency Costs

---

---

What are the factors that limit the agency costs a firm will incur?

1. The principle's ability to monitor and thereby control the agent

Monitor until:

Marginal Costs > Marginal Benefits

How can the firm's internal accounting system be used to monitor the agent?



## Agency Costs

---

Consider Michael Eisner's 1996 employment contract with Disney:

1. 10 year contract
2. Base salary of \$750,000
3. Bonus based on Disney meeting targeted EPS.
4. Stock Options on 8 million shares of stock extending a period of 15 years.



# Agency Costs

---

---

Other Factors that limit the Agency costs of the firm:

- The market for corporate control.
- The competitiveness of the labor market.
- External Competition.



# Decision Rights

---

For a team to produce more efficiently than each of the individuals, decision rights must be allocated among the members of the team.

When the owner allocates decision rights, she must consider the following:

1. Shirking
- 2 Influence Costs
3. Separation of decision making and decision control.



## Decision Rights and Accounting Systems

---

How is accounting information important in the allocation of decision rights?

The principle should implement controls within the accounting system to reduce the costs associated with allocating decision rights. For example:

- Requiring competitive bids on purchases over a certain dollar amounts.
- Requiring approval of purchases over certain dollar amounts.
- Measuring firm performance that is reflective of managerial effort.



## Priceline.com

---

---

What is priceline.com?

Why doesn't Delta replicate priceline.com on their own ?

Why did priceline.com work for airplane tickets and not for supermarkets or gas sales?



# Value Added Retailing

---

---

AT&T is in the business of providing phone service.

One division provides phone lines for internet retailers or providers.

These companies typically need reliable connections to the WEB and costly equipment to provide these services.

AT&T has three divisions that jointly handle these transactions:

- Sales department for telephone lines
- Installation unit
- Billing department for both groups

What are some of the problems with this organizational design?





## Markets vs. Firms

---

---

When do transactions get conducted inside the firm vs. in a competitive market?

For a firm to survive, it must be less costly to internally produce the good than going to an external market.

Consider the following 2 examples:

Priceline.com

Value added retailing



# The Role of Accounting in Organizational Architecture

---

---

Accounting systems role within the firm.

1. Performance Measurement
2. Performance Evaluation
3. Allocation of Decision Rights



## Summary

---

---

1. Refresher on organizational problems within the firm
2. Managerial accounting plays an important role in reducing agency costs.
  - Motivate employees
  - Control their behavior