CHAPTER 11

ORGANIZATIONAL ARCHITECTURE

CHAPTER SUMMARY

This chapter introduces the concept of organizational architecture. It begins by discussing the dual economic problems of:

- linking decision rights with knowledge, and
- motivating agents to make productive decisions based on their information.

Markets solve this problem through a system of alienable private property rights. Within firms, the problem has to be addressed by management through the design of the organizational architecture. The three components of organizational architecture (decision-right assignment, performance-evaluation system, and reward system) are like three legs of a stool. They are complements and must be considered together. They also complement the less formal aspects of a firm’s “corporate culture.” If the management does not adopt a productive architecture the firm will suffer. Architecture is an important managerial tool that can be used at all levels in the organization.

CHAPTER OUTLINE

THE FUNDAMENTAL PROBLEM
- Architecture of Markets
  - Academic Application—Spontaneous Creation of Markets: Evidence from Prisoner-of-War Camps
- Architecture within Firms
  - Decision Rights Controls
  - Managerial Application—Organizational Architecture at Century 21
  - Tradeoffs

ARCHITECTURAL DETERMINANTS
- Managerial Application—Technology Changing the Energy Industry
- Managerial Application—New Technology Provides Better Controls
- Changing Architecture
  - Managerial Application—Changing Organizational Architecture at JCPenney
  - Managerial Application—Changing Organizational Architecture Requires Careful Analysis
  - Historical Application—Changing Organizations Too Frequently: Not a New Phenomenon
One of the key points in this chapter is that the three legs of the “organizational architecture” stool must be balanced. This chapter builds on the foundation presented in chapter 10, which highlighted the way decisions are made by firms and why it is important that the actors within the firm have interests that are aligned with the interests of the firm. This chapter is different in that the focus is now on explaining the factors that affect whether the three legs are balanced for a particular firm, which are highlighted in figure 11.1. This figure should provide the foundation that students need to analyze cases and students should be encouraged to refer to this table when answering the questions in the chapter. If students struggle with using figure 11.1 on their own, they can refer to the Managerial Implications section of this chapter for a set of questions that will aid them in their analysis. This chapter has numerous applications that can be used to illustrate the key points. This chapter focuses on concepts and not quantitative analysis so students should be able to offer good discussion about these topics without much lecture. This chapter serves as an introduction to these concepts which are covered more fully in the next six chapters.
Chapter 11 - Organizational Architecture

There are two *Analyzing Managerial Decisions* scenarios in this chapter. The first, “Tipping in Restaurants”, asks students to consider why waiters’ compensation is heavily dependent on tips. Students are also asked to consider why restaurants require a certain percentage tip for large parties. Students should consider the material from the previous chapter in formulating their answers. The second, “Eastman Kodak”, is more comprehensive in scope. Students should focus on explaining whether the three legs of the stool were balanced, since this is the approach introduced in the chapter.

The textbook authors recommend an additional case, *Nordstrom: Dissension in the Ranks? (A)* (Harvard Business School Case #9-191-002), and have provided the following detailed description of how this case can be used in class.

At the time of the case Nordstrom has experienced a long history of success. Its strategy and architecture appear to have worked well. In 1989, however, the company was engaged in a dispute with a labor union and several related lawsuits over its performance evaluation and reward systems. The relevant question is: Should Nordstrom make changes in its architecture? Figure 11.1 can be used to organize the discussion. A careful analysis suggests that, while Nordstrom had been successful, their system motivated violations of the Fair Labor Standards Act (the architecture did not fit the regulation box in Figure 11.1). These violations were exposing the firm to millions of dollars of potential liability that the labor union had private incentives to pursue (the union would like to stop Nordstrom from placing competitive pressures on other firms in the industry to mimic their commission oriented-system). Nordstrom should do something to address the issue. Yet, they must be careful not to make such radical changes as to destroy what made them great.

This case can be updated by talking about what has subsequently happened to Nordstrom. The employees in Washington ultimately voted to withdraw from the union — suggesting that most employees were not unhappy with the system. Nordstrom did make some minor changes in its system to help assure compliance with the law. However, the basic system remained intact. During 1999, Nordstrom had relatively bad stock price performance. They appeared to have lost their image as a trend-setter. Since 2000, however, Nordstrom has on average roughly tracked the S&P 500 (through April 2003). Starting in 2000 the company made some substantial changes in their management and organizational architecture. For example, Nordstrom’s centralized decisions on overall purchasing, advertising, etc. However, they have maintained local execution and selection. These developments are well summarized in “Fashion Victim,” *Barron’s* (April 3, 2000, pp. 20-22). This discussion can be tied back to Chapter 8 and the difficulty of maintaining an advantage in a competitive marketplace. (See the Solutions Manual for the answers to these problems).
REVIEW QUESTIONS

11–1. Describe the three aspects of organizational architecture?

First is the assignment of decision rights; this assignment indicates who has authority to make particular decisions within the organization. Second is the performance-evaluation system; this system specifies the criteria that will be used to judge the performance of agents within the organization (for example, employees). Third is the reward system; this system specifies how compensation (and other rewards and punishments) will be distributed among agents within the firm.

11–2. What is a major difference between the architectures of markets and firms?

The architecture in markets is created spontaneously with little conscious thought or human direction. Through market transactions, property rights are reassigned so that decision making and specific knowledge are linked. Private property rights provide strong incentives for productive actions — they create powerful performance-evaluation and reward systems. Within firms, the architecture is created by management.

11–3. How might the softer elements of corporate culture help increase productivity in an organization? Give some examples of how managers might foster these elements to implement desired change in an organization.

Softer elements in a firm’s corporate culture include such things as slogans, role models, corporate stories, and social gatherings. These features can be important in communicating the objectives of the firm to employees and other stakeholders. They can also serve to convey to employees the architecture of the firm (what decision rights employees have, what will receive positive evaluations, and rewards). Also, these features can be used to enhance employee expectations that other employees will behave in particular ways. As we show in the appendix to chapter 9, sometimes these expectations are important in fostering cooperation among employees. It is easy to give examples of how managers might use the softer elements to meet these objectives. For example, consider the case of Mary Kay Cosmetics, highlighted in a box in Chapter 11.
11–4. Prominent management consultants sometimes argue that decision making in teams is usually more productive than decision making by individuals (important synergies arise when teams operate that are absent when individuals work by themselves). These consultants suggest that most companies have long failed to make proper use of teams. Their advice is that most firms should increase their use of teams significantly. Critique this advice.

Managers should be skeptical of this type of advice. If firms have not used teams and continued to survive over a long time period, this suggests that the use of teams is not always productive. The principle of economic Darwinism suggests that competition long ago would have driven firms to use more teams if teams were always more productive. After all, teams are not a new idea. It is possible that the environment has changed in ways that make the use of teams more valuable for certain firms. However, this does not mean that all firms should use teams (it depends on the environment in which they operate). In the next chapter, we discuss the economics of teams in more detail.

11–5. Assume that some firms within the same industry are observed to be multidivisional whereas others are functionally organized. Assume further that all firms are about the same size and have existed for a long period of time in their current organizational structures. Is this observation inconsistent with the “survival of the fittest” concept discussed in class? Explain.

No. Firms in the same industry can vary on dimensions other than size. For example, one firm might produce many products and optimally organize as a multi-divisional firm, while another firm might concentrate on fewer products and organize as functionally.

11–6. Evaluate the following argument:

“Management fads make no sense. One day its TQM. The next it is empowerment or business-process reengineering. There is no economic justification for these fads. Management are just like sheep following each other to the slaughter.”
One can argue that this statement is not true. Changes in the business environment (technology, markets, and regulation) can promote a common demand for organizational changes among firms in a given environment. Consulting firms (and others) have incentives to provide help in making these changes and also to label them in a proprietary manner (e.g., EVA). The new products disappear as environments continue to change, as their usefulness wears out, as new products develop, etc. The pattern can produce what appears to be management fads. However, these “fads” can ultimately help to increase value if they are implemented correctly by the correct set of firms.

11–7. Some of the electric generating plants of the Tennessee Valley Authority are powered by coal. Coal is purchased by a separate procurement division and is transferred to the plants for use. Plant managers often complain that the coal is below grade and causes problems with plant maintenance and efficiency. What do you think is causing this problem? What changes would you make to help correct this problem?

There is likely to be a problem with organizational architecture. The procurement people are likely to be incented to purchase coal at a low price. This motivates them to be less concerned about quality. Possible solutions involve changing the incentive system of the procurement division to focus more on quality. Alternatively, TVA might reassign decision rights to purchase coal to plant managers. (This might lose certain economies of scale in purchasing.) In either case, they must also worry about the other two legs of the stool. For example, if the procurement people are evaluated on quality, someone must be assigned the decision right to monitor this quality. Alternatively, if decision rights are changed (for example by moving the responsibility to purchase coal), it is likely that incentives will need to be changed as well.