

# 1 Foundations of Business Decisions

## WEEK 1: Introduction to Business Decision Making, Stakeholders and Corporate Responsibility Stakeholders to Business Decision Making

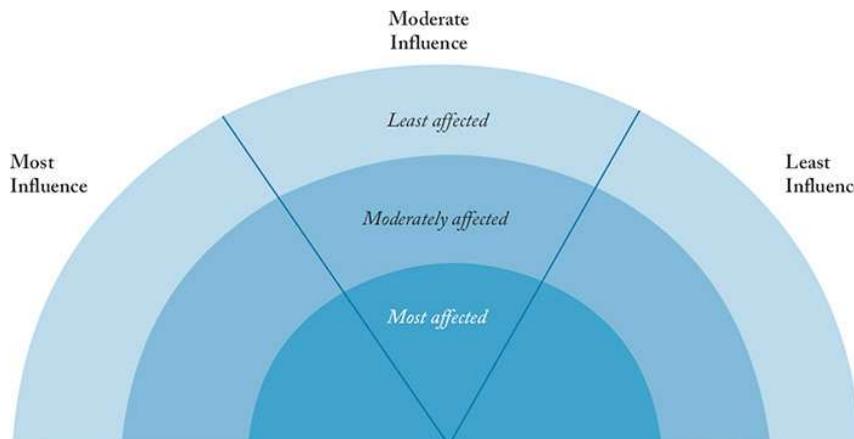
**Stakeholders** are a network of interrelated groups of people who can affect, or are affected by the business’s decisions. Examples include shareholders, employees, customers or governments. Within stakeholder groups, people may have very different interests or motivations in the organisation. Eg. a founder might want long-term prosperity of the business whereas a day trader might want short-term growth of share prices despite both being shareholders.

One way to categorise stakeholders is based on proximity to the core activities of the business:



SHAREHOLDER CENTRIC	STAKEHOLDER CENTRIC
<p>According to a <b>shareholder centric view</b> (Friedman), the company’s only responsibility is to its shareholders so maximising the shareholder value is an overarching objective of a company. Hence, managers only work on behalf of the shareholders.</p>	<p>According to a <b>stakeholder centric view</b> (Freeman), the purpose of business is to create and sustain value by working with its stakeholders, by considering not only the shareholder’s interest but also the stakeholder’s (this view generally broadly associated with corporate social responsibility). Hence, managers must consider the rights and interests of various simultaneous stakeholder groups.</p>

**Stakeholder rainbow** is a way to group stakeholders on their influence and how affected they are by actions/events in the organisation.



## Normative and Instrumental Factors

The **normative approach** to decision-making focuses on doing what is ethically right based on widely accepted standards and principles such as human rights, justice and fairness. A purely normative approach however may lead to ignoring practical constraints and neglecting the needs of the business.

The **instrumental approach** centres on the effectiveness of decisions in achieving specific business objectives such as financial performance, competitive advantage and regulatory compliance. However, a purely instrumental approach may neglect ethical principles that are valued by key stakeholders.

In real-world business scenarios, normative and instrumental approaches are generally blended to ensure decision making is both morally sound and effective towards the growth of the organisation.

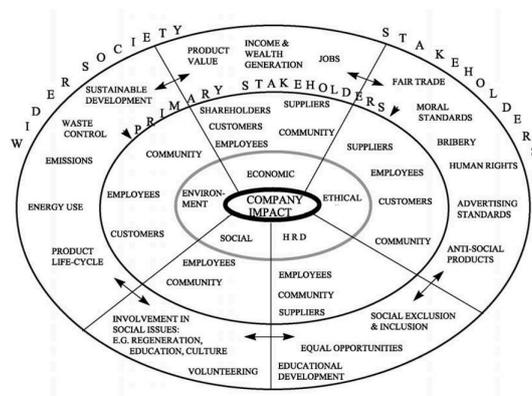
## Role of Corporate Responsibility in Decision Making

**Corporate Responsibility (CR)** reflects a company's commitment to operating as responsibly and sustainably. CR goes beyond profit maximisation and legal compliance, focusing on creating positive impacts on society, the environment and stakeholders beyond shareholders.

According to **Carroll's (1979) four indicators of corporate social performance**, it can be measured according to economic, legal, ethical and philanthropic efforts.



The premise of CR comes from the **“ripple effect”**, stating that managerial decisions will have “ripples” or small impacts across social, political, economic and ecological spheres. This is especially apparent with corporations becoming more influential (69 of the top 100 economic entities are companies).



Investors have started to look at **ESG (Environmental Social Governance)** performance of companies and the concept of legitimacy and social licence. Additionally, consumers want to spend money on products/services with their belief in and engage with companies which follow ethical practices that meet their own beliefs. Hence, CR has had increasing importance recently.

Corporate responsibility has many benefits:

- Rising consumer expectations of ethical standards, etc. (CR fulfils this)
- Employee engagement (greater satisfaction, commitment and reduced employee turnover.
- Reduced costs (less legal costs or boycotts)
- Greater social capital and scope for cross-sector partnerships (alliances with suppliers, NGOs and governments)

When making decisions from a CR perspective, one must consider if there are conflicts between stakeholder groups, and consider, 'who benefits and who is harmed by a decision'.

## **Economic Principles for Business Decision Making**

**Economics** is a social science that studies situations of unlimited wants and limited means. Economics offers a way of thinking and a set of tools for understanding individual decisions and how they interact in markets, organisations and society. The main tools of economics include:

- **Models** (often mathematical) that highlight essential features of reality relevant to the question at hand.
- **Empirical tools** that use statistical and experimental methods to estimate causal relationships using societal data, and laboratory/field experiments.

Two significant economic principles in decision making is:

- **Cost-benefit principle:** you should evaluate the full set of costs and benefits of any choice, and only pursue those whose benefits are as large or more than their costs. The difference between benefits and cost of a decision is known as **economic surplus**. When using the cost-benefit principle, only the top 2 mutually exclusive options are considered.
- **Opportunity costs (economic cost):** The missed benefit, and hence cost incurred by an individual, investor, or business when choosing one alternative over another (including the cost of the action taken). **Sunk costs** are costs that have been incurred and cannot be reversed (ignored when making rational decisions)

## **Legal Considerations and Implications of Decision Making**

The **law** is a set of norms (standards) of conduct in a society representing the collective political and philosophical viewpoints among all members of society.

Four legal concepts that impact business decision making include:

- **Control:** The law as a regulatory tool to not only prescribe what people cannot do, but informs people of what they can do and what they must do. Understanding how the law controls business activity is important for determining the amount of agency the manager has in deciding what they can and must do. Control can also stimulate business activity as it places business on the same "playing field", reducing the burden of competition.
- **Liability:** the state of bearing the consequences of one's actions if at fault. This concept extends primarily into torts law, company law, and consumer law. Liability is important for predicting outcomes and understanding the options that managers have when making decisions.
- **Ownership:** Ownership of property, including intangible property such as intellectual property, or shares in a corporation, provides legal protection to the owners over the property. Understanding ownership is important as the level of agency and number of options that managers have when making business decisions can change depending on level of ownership. Ownership can provide extra legal rights and responsibilities.
- **Agreement:** A mutual understanding between two parties. This is often in the form of a contract, a legally enforceable agreement. Understanding agreement is important for understanding types of options businesses may have when working with other stakeholders.

## WEEK 2: Decision Making in Markets

A **model** is a simplified representation of reality which helps us understand and communicate things. **Economic models** omit most of the details and complexities of reality This helps predict how people may act given a set of constraints or preferences. As a decision maker, it is important to understand the uses and pitfalls of a certain model.

### Comparative Advantage and Specialisation

**Comparative advantage** is making something at a lower opportunity cost of production (opportunity cost principle). This differs from **absolute advantage** when someone can produce something with fewer resources (cost-benefit principle).

Markets exist (trading and buying etc.) due to **specialisation** (ie. specialising in one thing then trading for others.). Specialisation increases the productivity of labour.

### Consumer Demand

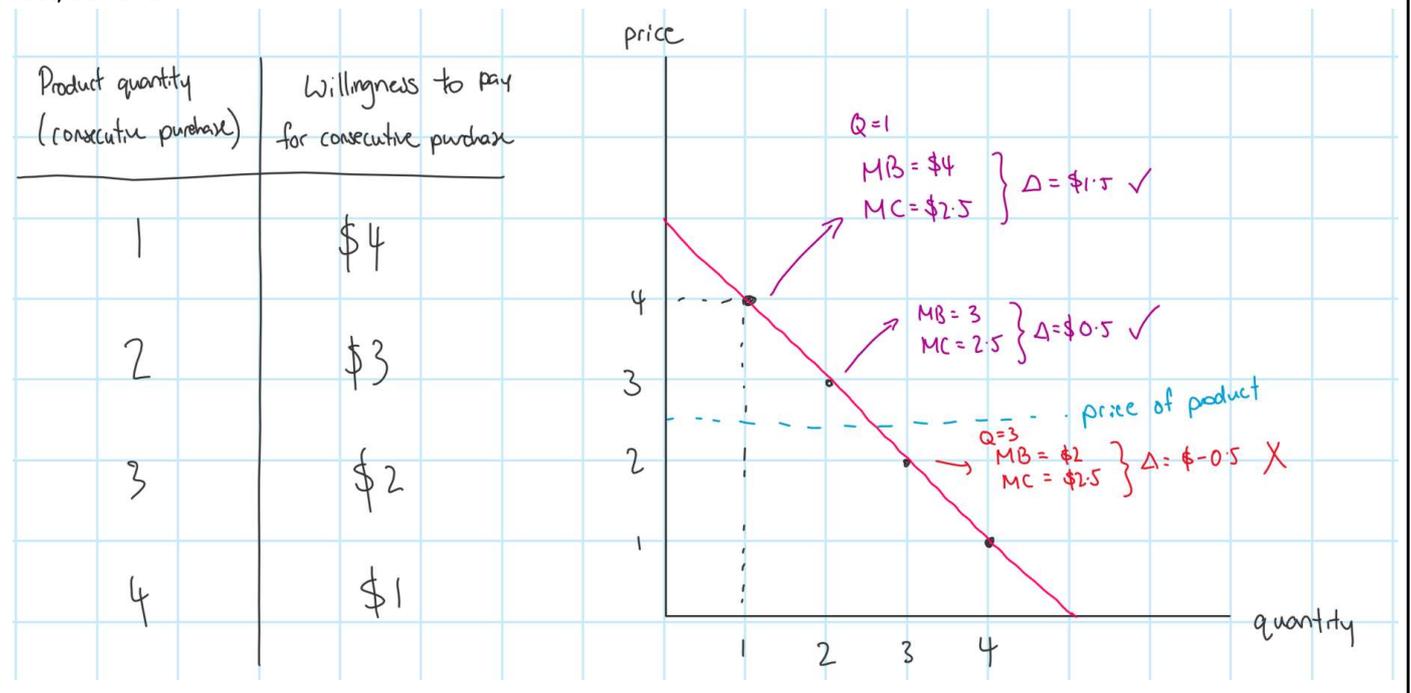
**Consumer demand** ( $q_d$ ) refers to the quantity of goods or services that a customer is willing or able to pay for. These can be influenced by a variety of factors such as price, quality or availability of product.

The **marginal principle** says that decisions about how many of something can be broken down into smaller, more marginal decisions. By following the marginal principle, we should do something if the extra benefit (**marginal benefit**) exceeds the extra cost (**marginal cost**) of something.

When considering consumer demand, we assume it to be a **perfectly competitive** market:

1. Everyone is a **price taker**, meaning they cannot influence the price in the market, and take the price as given.
2. The consumer applies the marginal principle, cost-benefit principle, and the opportunity cost principle.

Example: notice how the graph is done in progressive steps (marginal principle), rather than calculating total cost/benefits.



## Firm Supply

**Firm supply ( $q_s$ )** refers to how much of its goods and services it will sell and at what price. When considering firm supply, we consider it to be a **perfectly competitive** market:

1. Firms sell homogeneous (identical) goods.
2. Firms are **price takers**.

Being a **price taker** as a firm means that you have no reason to charge less than other firms, but charging more than other firms would result in a loss of customers. Hence, you have no **market power**, which is the power to raise your price without losing your sales to competing businesses. The **reservation price** is the minimum price that the seller is willing to sell their product for (also their marginal cost). Therefore, price is equal to marginal cost.

## Competitive Markets

**Market demand ( $Q_d$ )** is the total sum of individual consumer demand. The **Law of Demand** states that the quantity purchased is inversely proportional to its price. Factors that can influence the market demand curve include:

Factor	Explanation
Income	$\uparrow$ Income $\Rightarrow$ $\uparrow$ Spending money $\Rightarrow$ $\uparrow$ Willingness to spend $\Rightarrow$ $\uparrow$ Demand $\downarrow$ Income $\Rightarrow$ $\downarrow$ Money available $\Rightarrow$ $\downarrow$ Willingness to spend $\Rightarrow$ $\downarrow$ Demand
Prices of Related Goods	$\uparrow$ Price of related goods $\Rightarrow$ $\downarrow$ Opportunity cost of buying good $\Rightarrow$ $\uparrow$ Demand $\downarrow$ Price of related goods $\Rightarrow$ $\uparrow$ Opportunity cost of buying good $\Rightarrow$ $\downarrow$ Demand
Expectations (Perception) or Preferences	Generally: $\left\{ \begin{array}{l} \downarrow \text{Perception} \Rightarrow \text{Inferior good} \Rightarrow \uparrow \text{Buyers in market} \Rightarrow \uparrow \text{Demand} \\ \uparrow \text{Perception} \Rightarrow \text{Superior good} \Rightarrow \downarrow \text{Buyers in market} \Rightarrow \downarrow \text{Demand} \end{array} \right.$
Type and Number of Buyers	$\uparrow$ # of Buyers in market $\Rightarrow$ $\uparrow$ Demand $\downarrow$ # of Buyers in market $\Rightarrow$ $\downarrow$ Demand

**Price elasticity of demand** measures how responsive the quantity demanded changes in response to a change in price of a good or service. The price elasticity of demand can be generally larger when:

Factor	Explanation
More competition for the same products	$\uparrow$ Competition $\Rightarrow$ Price increase $\Rightarrow$ Customers find alternatives $\Rightarrow$ $\downarrow$ Demand for specific product $\Rightarrow$ $\therefore$ $\uparrow$ Elasticity
Non-Essentials (Superior Goods)	Superior good $\Rightarrow$ Price increase $\Rightarrow$ Customers choose inferior goods $\Rightarrow$ $\downarrow$ Demand $\Rightarrow$ $\therefore$ $\uparrow$ Elasticity
Easier for consumers to find alternative prices	Alternative prices $\Rightarrow$ Price increase $\Rightarrow$ Customers find alternatives $\Rightarrow$ $\downarrow$ Demand for specific product $\Rightarrow$ $\therefore$ $\uparrow$ Elasticity
More time to adjust	$\uparrow$ Time to adjust $\Rightarrow$ Price increase $\Rightarrow$ In long term, demand will adjust (even if inelastic in short term), $\therefore$ $\uparrow$ Elasticity