BACHELOR OF SCIENCE IN
BUSINESS ADMINISTRATION
& ECONOMICS

PROF. EMILIANO DI CARLO

Teaching notes of

Fundamentals
of Business Administration

Towards the primary interest
of the organizations and the common good

Learnings from ***Covid-19***

DRAFT VERSION
Use only for the course of *Fundamentals of Business Administration*
Please, **do not distribute**

Index-Summary

CHAPTER TWO

PRIMARY INTEREST OF THE *AZIENDA* (BUSINESS AND NON-BUSINESS ENTITIES)

CHAPTER THREE

CONFLICTS WITH THE PRIMARY INTEREST OF THE ECONOMIC ENTITY

CHAPTER FOUR

THE ACTIVITY OF BUSINESS ENTITIES THROUGH CIRCUITS

CHAPTER FIVE

LEGAL FORMS OF BUSINESS ENTITIES

CHAPTER SIX

FUNCTIONS AND ORGANIZATIONAL STRUCTURE

CHAPTER SEVEN

STRATEGIES

SPECIAL CONTENT

CRIMINAL ORGANIZATIONS

Introduction to the course

Hi everyone, I am Emiliano Di Carlo. Welcome to the course of Fundamentals of Business Administration (FoBA) at "Tor Vergata" University for the Bachelor in Business Administration.

These teaching notes are a part of the learning materials for attending and non-attending students. Their content is a miscellaneous of: 1) extracts of my works such as notes, published and unpublished articles and books; 2) extracts of article of other authors; 3) extracts of project work discussed in the previous years by students of FoBA.

Thus, the teaching notes ***must be used only as a text for this course of FoBA***. So please, **do not distribute**.

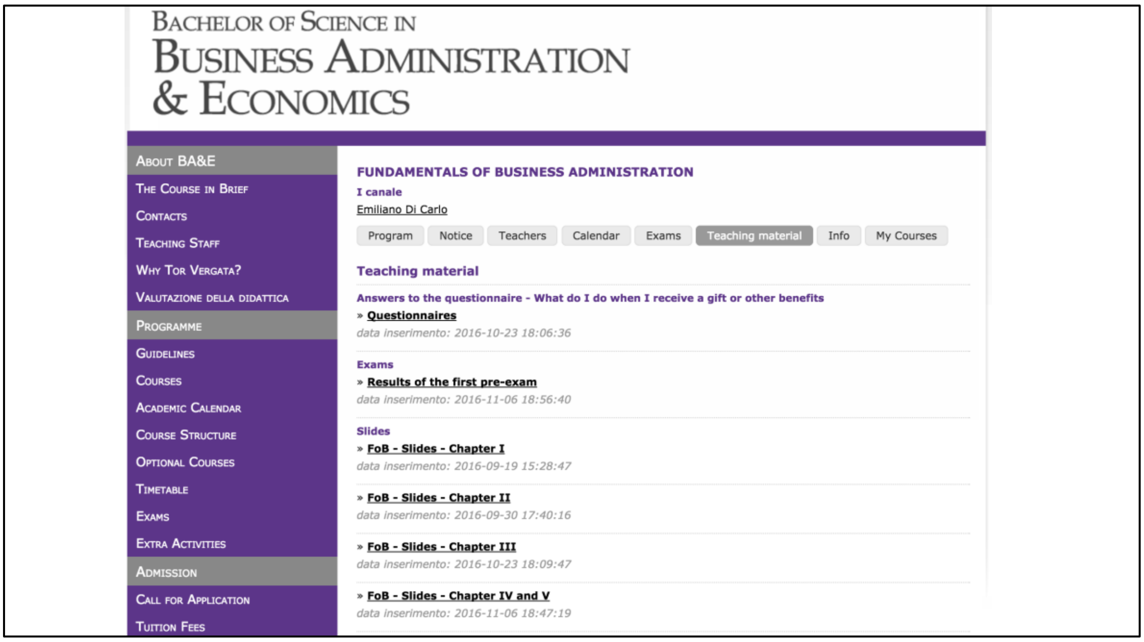
In addition to this course materials, you have also access to the **course website (from the professors' personal website)**, which will provide more learning content (Table 1).

Table 1 – *Fundamentals of Business: Professor's website*

Source: https://sites.google.com/site/dicarloe/corsi-universitari/fundamentals-of-business

The **multimedia content** of this course is updated from time to time and is available in the section Teaching material (Table 2, **from the official website**), where you can also find also the slides projected during the lessons. For downloading the teaching materials, the subscription to the course is needed.

Table 2 –



Source:

Before presenting this course let me briefly introduce myself. I am **Full Professor at the University of Rome "Tor Vergata"**, where I teach six courses: "Corporate Governance" (in English); "Fundamentals of Business" (in English), "Economics of business groups" (in Italian), "Finance and Governance of Business Groups" (in Italian), Economia Aziendale (in Italian) and "Governance and Ethics". All the information on my research and teaching activities is available on my website [1].

I was student at "Tor Vergata" University and I discussed my thesis in 1998. The aim of the thesis was to understand the financial strategies of one of the biggest Italian company, ENI, and more precisely the financial strategies of the ENI group, for the period 1992-1996. The topic of the thesis was extremely interesting because I had the opportunity to study a complex multinational group, composed by hundreds of companies controlled by a single company at the top of the group structure (Eni Spa, the holding company of the group).

I started my **doctorate in Banking and Finance (PhD)** in 2000 and I got the doctorate degree in 2003. During my PhD period I had the opportunity to deepen the management of business groups, in particular the transactions among the affiliated-group companies. The interest was focused mainly on the conflict of interest that arise from those transactions, since affiliated companies are often directed and coordinated by the controlling company at the top of the group. Thus, for intragroup transactions the holding company could be at the

[1] https://sites.google.com/site/dicarloe/

same time customer and supplier, financier and financed, raising various forms of conflict of interest situations.

Later, I expanded the topic of **conflict of interest** to many other contexts (e.g. public sector, corporate governance). One section of my web site is entirely dedicated to the conflict of interest phenomenon [2] that is also one of the most important topics for what concern the governance of the organizations. I am the Director of the **Master in Anticorruption** at the University of "Tor Vergata", where I am also responsible for the module on conflict of interest as antecedent of corruption.

During the PhD period I had the extraordinary opportunity to be the teaching assistant for the courses of *Economia Aziendal*e [3] held by the Professor Enrico Cavalieri. In Italy, the course of "*Economia Aziendale*" is one of the starting courses for students of economics. Many parts of this course come from the insights gained during the teaching of my *Maestro* Prof. Cavalieri as well as from the thought of many other scholars of the Italian doctrine *Economia Aziendale* (e.g. Gino Zappa – the founder of the doctrine –, and some of his pupils: Aldo Amaduzzi, Carlo Masini, Pietro Onida).

I am a **trainer at Luiss Business School** for the following topics: corporate governance, business ethics, conflict of interest, ethical dilemmas, financial reporting, accounting, economics and strategies of business groups, consolidated financial statements [4].

As trainer I have explored the dynamics of different types of organizations, e.g. public and private, banks, insurance companies, small and big firms, listed companies. This training activity, started around 2005, has increased the interest in the '**objective of the organizations**' that is one of the most important aspect of their governance as well as a central issue of this course.

The opportunity to be trainer for public and private organizations has allowed me to propose **common principles of governance and management**.

Moreover, the training activity for managers, in particular the executive coaching, has been fundamental in order to understand **how the theory is important when it is put into practice**. Often managers, especially top managers, look for theoretical models that can increase the effectiveness of their decision-making process. Indeed, a top manager with years and years of experience normally does not need to know the practice, but a theoretical framework that allows them to understand the complexity of his/her organization.

Students do not have the practice and they normally believe that theory is not important. This is exactly what I thought when I was student. After years of experience, I strongly believe that students of economics should find the **right balance between theory and practice**. That is why in all my courses I ask students to put theory into practice, doing a Project Work. Also for the final written exam for this course several questions that ask you to put the theory into practice will be asked [5]. Theory is important to give a framework, the principles to solve problems, especially in complex organizations.

The **main objective of this course (the WHY) is to introduce students into the field of business giving them an *easy and complete framework* on the life condition and**

---

[2] https://sites.google.com/site/dicarloe/conflitto-di-interessi

[3] Arguments that support the choice not to translate the term "*Economia Aziendale*" (EA) can be found in works by several Italian authors (Zan 1994; Dagnino and Quattrone 2006).

[4] https://sites.google.com/site/dicarloe/formazione

[5] Moreover, at the end of some Chapters there are some examples of those questions (e.g. see the Review Questions of Chapter IV).

the existence manifestations of all types of economic entities (both profit and non-for-profit), even if the main focus will be on the so called for-profit economic entities (i.e. business entities). Moreover, this course wants to *put theory into practice* and *stimulate the cooperation* among students and also among students and professor. At the end of this course, thanks to an integrated thinking, students should be able to establish a successful business contributing to the common good of the society.

In particular, the main **sub-objectives** are as follows:

– Familiarize with the language of business;
– Know and understand the concepts of the administration of a business, the characteristics of management processes (strategy and planning, organizational structure, human resource management, decision making, monitoring and reporting, etc.) and management functions (Marketing, Operations, Human Resource function, Finance and Accounting Function);
– Understand the organizations' existence, what is their role in society, what are their responsibilities, how and for whom they create value;
– Know the differences between a small business (e.g. a small family firm) and a big business conducted by multinational corporations all around the world (e.g. Apple, Coca Cola, Facebook, Google);
– Be able to apply knowledge and to draw original conclusions (critical thinking), by using management tools and techniques and by making judgments about the cost-effectiveness of management;
– Improve their communication skills, using an appropriate language during the presentation of management issues;
– Enhance their learning ability as well as time management capacity, with the analysis of real situations and case studies;
– Give a complete framework for the other courses on business (e.g. management and organization; business strategies; financial accounting; business law; marketing).

In order to reach these objectives, the teaching notes are articulated into the following seven chapters:

– Chapter I. *Economic problem, organizations and* aziende;
– Chapter II. *Value creation in business and non-business entities*;
– Chapter III. *Conflicts with the primary interest of the economic entity*;
– Chapter IV. The *activity of business entities through circuits*;
– Chapter V. *Legal forms of business entities*;
– Chapter VI. *Organizational structure*;
– Chapter VII. *Strategies*.
– Special content. *Criminal organizations*

Each chapter starts with a list of the objectives to achieve as well as of the assignment to complete.

In these notes you will find tables and figures that are discussed during the lessons. Moreover, you will find:

– YouTube videos;
– Assignment;
– Project work.

YouTube contains millions of videos on everything. Many videos treat economics and finance topics. The selected YouTube videos allow students to put theory into practice, giving an in-depth of the arguments treated in the Chapters through some examples that are useful for the learning (for an example, see YouTube 12, p. 54). Moreover at least one question of the written exam will be on the content of the YouTube videos to study [6].

In the following link you can find the play list of some lessons of the academic year (2020/2021):
https://youtube.com/playlist?list=PLORcO4LteyqY4zkhZxTCcO5Tr2xJ3Xdec

The **written exam is worth 60% of the final mark.**

The **Project Work** wants to give, to attending and non-attending students, practical application of the contents of the lectures and texts. Moreover, doing the PW is an effective way to be prepared for the final exam. Normally, who does a good PW achieves good results in the written exam. The **Project Work is worth 30% of the final mark.** For the structure of the project work, see the next section.

The **Assignments** allow students to discuss and exercise the topic treated during the lessons or read in these notes and in the other suggested texts, interacting among them. The **Assignment is worth 10% of the final mark**.

Following some anonymous answers given by the students (A.A. 2014-15) to the question: "Few words to describe the Fundamentals of Business course" [7]:

- *Great course which put yourself into the business world with a modern and pleasant approach;*
- *I think that Fundamentals of Business course is engaging, innovative, important for all of us;*
- *A course that has been carried on with passion, useful to learn the basis of business;*
- *Very interesting. It gives you a quick but effective framework of the business world;*
- *The course can let me to know what is the business and to have interest on it. Also I think this course can be useful in our lifetime.*

Hoping that this fourth (draft) version of the teaching notes will be useful and sufficiently clear for your learning, I wish you the best and I look forward to receive your suggestions (and report of error and typos [8]) to improve both this text and **OUR course**.

Thank you in advance!

Emiliano Di Carlo

[6] For every YouTube video it will be indicated if it is to study or just watch. The YouTube videos to watch are recommended but not mandatory for the written exam.

[7] The anonymous questionnaire was submitted after the end of the course and before the exam.

[8] **These teaching notes were not proofread**.

PROJECT WORK TO PUT THEORY INTO PRACTICE

This is the main point of the course. The theory is useful if you are able to put it into practice. Use the theory you will learn in these teaching notes and during the class to complete the Project Work (max 30 pages). The **Project Work is worth 30% of the final mark. The evaluation of the PW will take into consideration:**

1) The (online) class (or YouTube video) presentation (30%);

2) The word file that you should complete and send to the professor by email before the exam (not the pre-exam) (70%). In the same email send also the slides you discussed in the class (or using a YouTube video). PLEASE name the word file and the PPT with the name of your Project Work, and use this name also in the subject of the email. The day of the exam (or the day of the registration if you passed the pre-exam) you have to give to the professor a printed copy of the word file.

Insert the following information, in the front page of the word file:

FUNDAMENTALS OF BUSINESS ADMINISTRATIONS

PROF. EMILIANO DI CARLO

ACADEMIC YEAR 2022-2023

NAME OF THE PROJECT WORK (E.G. THE CATALOG)

Study group:

1. **Mario Rossi (matriculation number; email) (% of participation to the case study – from 0 to 100%; % of participation to the overall quality of the case study – from 0 to 100%)**
2. …
3. …
4. …

Contents

Part I (Chapters I, II and III) – 10 points

1) Describe in detail the needs you will satisfy with your business (i.e. your BUSINESS IDEA). It is very appreciated a link to the new needs that come from the Covid crisis (e.g. https://www.youtube.com/watch?v=DfTg4lN4XEw; https://www.youtube.com/watch?v=TVU4jEeZUvY);

2) Indicate if today in the market there are companies able to satisfy those needs and why you think you will succeed with your business (your competitive advantage);

3) Describe at least 3 situations of conflict of interest and corruption that may happen in your organization;

4) Describe the mission of your business distinguishing the WHY, WHAT and HOW, as well as FOR WHOM, HOW and IN WHAT TIME you want to create value. Underline the elements that belong to the primary interest;

a) Describe the HOW to produce using the IIRC framework, and the way you intend to use the so-called digital transformation for your business.

5) Write a short code of ethics for your business, with a special focus on:

a) the relations with stakeholders

b) the conflict-of-interest statement, specifying: the three different types of CoI and the meaning of the three elements included into the definition; how do you intend mitigate the risk of opportunistic behavior;

c) how do you intend manage the gift giving and receiving.

6) Describe your sustainable strategies using one or more of the 17 ONU sustainable development goals;

7) Describe the extrinsic, intrinsic and transcendent goods you provide in your organization and the common goods you want to generate.

Part II (Chapters IV and V) – 10 points

1) Choose the legal form for your business idea (sole proprietorship or partnership), specifying the reasons of your choice;

2) As in the Bio fruit experience, calculate the amount of the assets that you need and how you want to finance them. Necessarily you have to use both equity and loans;

3) Calculate the total income (with the three methods) for the entire life time of the firm (the hypothesis is that the period t0-tz is equal to 5 years), and the capital structure in t0 and tz. You should also represent the changes' analysis during this period;

4) Indicate the non-financial indicators that you want to achieve during this period (eg. training on business ethics for your employees, energy consumption);

5) Calculate the income statement of the first two years, and the Capital structure at the end of the first and the second year.

Part III (Chapters VI and VII) – 10 points

1) Design the organizational structure for your business;
2) Do the SWAT analysis of your business;
3) Describe the market forces of your business using the Porter framework;

Dear students, this year is a great year! We start the course with some weaknesses but also with great opportunities that comes from the difficult last years due to Covid crisis. We are here to learn from this period and to be active actors in the post-Covid era. We want to be creators of common good for the actual and future generations!

The fight against Covid-19 (or coronavirus), which began in China in November 2019 and then spread, at the beginning of 2020, with different intensity and times in European countries and in the rest of the world, undoubtedly represented the greatest global challenge and challenging in recent decades. The pandemic has had enormous health, economic and social consequences for the lives of individuals and organizations.

The struggle to safeguard the common good of public health was waged against an invisible (sometimes asymptomatic), sneaky and aggressive enemy, of which very little was known (e.g. the transmission, virulence), therefore difficult to deal with, and with often insufficient and inadequate resources. In conditions of extreme uncertainty, the most difficult choice was undoubtedly how to allocate the very scarce available resources (Emanuel et al., 2020). There have been many ethical dilemmas and inevitable errors, the latter also deriving from a generalized lack of preparation on how to deal with the fight against viruses and, more generally, how to govern and manage organizations in a situation of profound economic crisis.

Italy was the first European country to be seriously affected, with a high number of infections and deaths, also due, at least in the initial phase, to a large gap between the behaviors that should have been held and those that instead, they were kept.

To contain the spread of Covid, governments around the world have put in place a series of tools (e.g. recommendations, prohibitions, messages disseminated on traditional media and social media) and human resources (among others, health workers and police forces), which have produced important changes in the lives of people and organizations.

We have gone from simple recommendations (eg wash well your hands, distance people by about one and a half meters, wear a mask) and partial bans, ie valid only in some areas of the country (eg “absolute prohibition in Lombardy on mobility for persons subjected to quarantine”), to bans applied throughout the national territory (eg “ban for all to leave the house”). Within a few hours of the introduction of the ban on leaving the home, cities like Milan, Rome and Naples have seen almost all citizens collaborate.

The effects on economic and financial balances have been devastating for some companies (eg restaurants, hotels, entertainment) and extraordinarily positive for others (eg e-commerce, home delivery).

It follows that the fight against the pandemic can represent an example of extraordinary importance and effectiveness in relation to the struggle that is waged in organizations to achieve any type of purpose and objective, such as the struggle for competition, for organizational change, for compliance with legal and ethical rules, to counteract deviant phenomena and, more generally, for the survival and development of the company, especially in times of crisis. The company is an “institution destined to persist” (Zappa, 1957, p. 37-38) which lives and operates in a dynamic environment characterized by threats and unexpected opportunities that affect its conditions of survival and quantitative and qualitative development.

Many argue that “it will no longer be the same” because we will experience a “new normal” (Bhusal, 2020; Bianco, 2020). On closer inspection, in various areas it is highly desirable that it is no longer the same, that we do not go back. In particular, we refer to the fact that we can no longer afford to neglect the effectiveness and efficiency of companies and the need to direct them, as well as people and the community, towards the common good. The enormous debt that several countries, including Italy, have contracted to deal with this emergency and revive the economy, and which will be paid mainly by future generations, requires responsible behavior on the part of everyone.

The pandemic has highlighted some truths, positive for the business economy, denied in the past, first and foremost that of the increase in productivity and social advantages (e.g. less pollution, better balance between life and work) which, especially in some areas, smart working is able to produce. As noted by De Masi (2020), "smart working has saved the economy, because millions of people have continued to work. He saved his health and also his school".

Moreover, many have changed their ideas and priorities. Returning to pre-Covid normalcy means ignoring these new needs, leading someone to argue that it was better when it was worse.

To ensure that it is no longer the same and to maintain and not forget the good things this period has produced, it is necessary, however, to understand in depth what happened, to draw the appropriate lessons from it and to spread them (also to future generations). For years a different world has been imagined oriented towards the common good, now we can and must change to achieve this goal, with the strong awareness that "it can be done!". Many saw the pandemic not only as a profound crisis, but also an extraordinary opportunity for change.

YouTube 1 – *Covid and business*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Which businesses are benefitting from COVID-19 pandemic?	00:04:41	Study

* You can click on the title, having a direct access to the video

This course intends to focus on how organizations (including the State) have struggled, both internally and externally, to survive and / or seize development opportunities in a situation of extreme crisis in which compliance with the very strict rules aimed at containing the contagion, it had to find compatibility with the need to recover company balances. However, it will also be inevitable to look at the struggle carried out by individuals and the community, given the very close relationships with the struggle of corporate systems.

The answer to the research question allows us to draw useful lessons from what happened, providing contributions to theory, practice and regulation. This will also allow us to answer a series of questions, among which the following are recalled: why, despite the efforts made, have some results been achieved and others not? What were the mistakes made not to be repeated? Whose moral responsibility is there for the damage and positive effects of the behaviors? What were the elements that were taken into consideration in addressing the numerous ethical dilemmas (eg health vs economy, whose life to save)? In a moment of crisis, does man become more selfish or altruistic? What are the psychological factors that have led people to behave opportunistic, even to go against their own interest? Towards which new normal should people and companies be oriented?

The approach followed, placing man, the temptations and pressures to which he is subject and his vulnerability at the center, can only be multidisciplinary. In particular, disciplines are involved such as: business economics, political economy, law, psychology, sociology, behavioral economics and philosophy. The pandemic has been defined by many as the greatest social, psychological and philosophical experiment of all time. It is therefore an unmissable opportunity to understand how these aspects interact with each other and, above all, how they affect the conditions of survival and development of business systems.

The new scenario is undoubtedly leading to a review of the paradigms already questioned with the scandals and financial distress of the early 2000s (among others, Enron, Worldcom, Parmalat) and with the global economic crisis of 2008, resulting from the mortgage crisis. At that time, the enemy was identified in the logic of maximizing profit, which also allowed the accreditation of other theories that also look at social aspects, such as the well-known theory of creating value for stakeholders (i.e. clients, employees, suppliers, financiers, community). The financial difficulties that, on the other hand, characterized the period of the pandemic resulted from the impossibility of making a profit, due to a regulation aimed at stemming the spread of the contagion, which produced a zeroing of demand, in the phase of the lockdown, and a reduced demand in post-lockdown. It can also be said that compared to previous crises, this is a crisis "decided" by the regulator (Croce, 2020).

On closer inspection, however, the anti Covid legislation does not seem to have been the only enemy of business continuity. Several activities collapsed because of the the inability of entrepreneurs and managers to overcome the crisis, reinventing themselves to respond to the new needs of customers / users and employees, to the new values of society. In other words, the crisis has amplified the pre-crisis weaknesses. This inability may be derived, among other things, from the fact of not having had a reference compass to manage the complexity that derives from moments of extreme crisis such as those experienced during the pandemic.

With reference to business entities, for years the ability of entrepreneurs and managers to combine profit with social objectives has been questioned. However, few have considered the risk that managers might not be able to pursue profit in times of severe crisis. The period of Covid, on the other hand, marked a watershed between capable and far-sighted leaders and mediocre managers, and more generally between people responsible for the good of the company and irresponsible people. The former has managed not only to reinvent themselves but also to respect the stringent anti-contagion regulations, balancing the vital economic aspect with the social one linked to health.

The companies that in the past managed to survive, also due to favorable market conditions (e.g. markets that are not very competitive or protected), despite strong waste and the extraction of private benefits, are undoubtedly the ones that have the most suffered the crisis, also due to the lack of habit to tend towards the company economy and / or the presence of particular interests that hindered it.

The course intends, among other things, to explore the effects of Covid-19 on business systems, in particular on the organizations' attributes (systemic vision, decision-making autonomy and economy) and on their conditions of equilibrium. This objective is pursued by reading what happened through the teachings of the Italian doctrine of Economia Aziendale, which appear extraordinarily interesting since it provides a valid alternative to the paradigms proposed by theory and practice, that is to the well-known shareholder or stakeholders' approaches. Through this analysis we try to verify whether responding to a crisis, with the teachings of this discipline, can favor the simultaneous pursuit of economic and social objectives, and the orientation of all types of companies towards common good.

Today there are several suggestions to lead companies to create those skills in which they should have invested before the pandemic (e.g. be more digital, have more agile organizational structures), but no one seems to have put at the center a central aspect: developing the skills to govern and manage for the good of the company. This means questioning the logic according to which government and management must serve the interests of shareholders or stakeholders, as in these two approaches the company is a legal fiction, a tool aimed at creating value, respectively, for the shareholders and stakeholders. Both of these approaches, as we will have the opportunity to examine, do not seem adequate to face a crisis with the characteristics found in the one generated by Covid.

The Italian Economia Aziendale, "a science that studies the conditions of existence and the manifestations of life (of the company)" (Zappa, 1927, p. 30), has always integrated economic and social objectives, considering companies as distinct institutions with respect to its stakeholders, with their own interest in surviving and developing, in favor of their stakeholders and the economic and social growth of the community in which they live and operate. Economics and sociability to be achieved simultaneously without making one prevail over the other.

Covid has made this function very clear and it is an unmissable moment to draw the appropriate lessons from it by answering a series of questions, such as: what is the company? What is its purpose, that is, why does it exist? What are the attributes of corporatism? What are the balances to be respected in order to survive and develop, especially in times of severe crisis?

As noted by Paine and Srinivasan [2019], the debate on what the nature of the company is and its finalism may seem purely theoretical and more academic, but its practical implications are far-reaching. With reference to the pandemic, in a time of severe crisis and in the absence of conceptual maps, the company's finalism becomes the compass to counter the forces that hinder it and welcome those that, instead, favor it. Moreover, not all the concepts of company and finalism allow developing the skills that are increasingly required today, such as that of putting people at the center. On the website of the consulting firm Accenture we read: "Today this crisis is showing us how greater empathy at work can make a difference. If they want to create productive, inclusive and rewarding work environments in the long term, companies must go beyond the transactional aspect and truly understand their employees" (www.accenture.com). However, having a concept of a company as a tool for shareholders, or stakeholders, hardly leads to developing this competence. Considering the company as a community of people oriented towards the common good, typical of the approach of the Italian Economia Aziendale doctrine and of some well-known entrepreneurs, first of all Adriano Olivetti (Improda, 2020), leads to consider man as a being bearer of material, spiritual, moral and social needs, and therefore to tend towards its flowering.

The moment is also not to be missed because talking today about the teachings of Economia Aziendale can be much more effective than in the past, as they can be connected to concrete cases that everyone, directly or indirectly, has experienced, becoming clearer and more understandable. In other words, Economia Aziendale can be explained by retracing the current crisis period.

CHAPTER ONE

ECONOMIC PROBLEM ORGANIZATIONS AND *AZIENDE* (BUSINESS AND NON-BUSINESS ENTITIES)

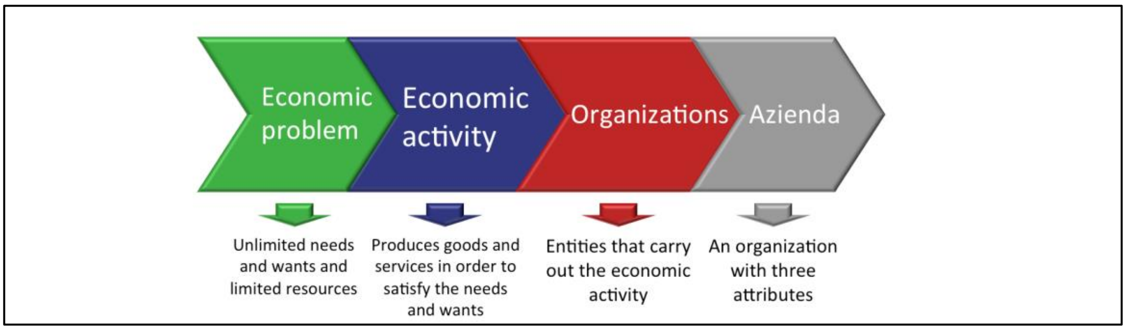
1. *Objectives and Assignments of this chapter*

After reading this chapter, you will be able to:

- Discuss why organizations exist;
- Describe the importance of the Italian doctrine of "*Economia Aziendale*" and of the "*azienda*" (the Italian term to indicate business and non-business entities with certain attributes) for the studies on organizations;
- Discuss what are the differences between business entities and non-business entities;
- Describe who the stakeholders are, what their interests are and why they are important for the survival and growth of the organization.

In particular it will be followed the path described in Table 3.

Table 3 – *Economic problem, economic activity and organizations*



Source: Our elaboration

Following the Assignments of this chapter:
Assignment 1 – Objective of the organizations (before the beginning of the course)
Assignment 2 – Maslow's hierarchy of needs
Assignment 3 – The tangible and intangible products
Assignment 4 – Factors of production
Assignment 5 – The needs satisfied and to be satisfied
Assignment 6 – Increase the productivity of capital and labor
Assignment 7 – The attribute of Economicità (effectiveness and efficiency)

The contents of this chapter allow you to do the following part of the Project Work:

Project Work – *Part I* – *Present your business idea*

Before starting with the following paragraph, complete the Assignment 1 – Objective of the organizations.

2. *What is the economic problem?*

The **economic problem** asserts that there is scarcity, or that the **finite resources available are insufficient to satisfy all human wants and needs** [1]. The problem then becomes how to determine what is to be produced and how the resources (such as capital and labor) are to be allocated. **Economics revolves around methods and possibilities of solving the economic problem**. Ideally, the resources are allocated to their highest valued uses.

The economic problem is most simply explained by the question "***how do we satisfy unlimited wants with limited resources?***". In the Covid economy this is a central question!

Samuelson's three questions [2]

America's first Nobel Prize winner for economics, the late Paul Samuelson, is often credited with providing the first clear and simple explanation of the economic problem - namely, that in order to solve the problem of scarcity all societies, no matter how big or small, developed or not, must endeavor to answer three basic questions.

What to produce?

Societies have to decide the best combination of goods and services to meet their needs. For example, how many resources should be allocated to consumer goods, and many resources to capital goods, or how many resources should go to schools, and how many to defense, and so on.

How to produce?

Societies also have to decide the best combination of factors to create the desired output of goods and services. For example, precisely how much land, labor, and capital should be used produce consumer goods such as computers and motor cars.

For whom to produce?

Finally, all societies need to decide who will get the output from the country's economic activity, and how much they will get. For example, who will get the computers and cars that have been produced? This is often called the problem of distribution.

In **capitalist countries** individuals have the **freedom of choice**, since they have the opportunity to decide "what", "how", "where" and "for whom" to produce on the basis of market demand. For this important function of satisfying human needs the State gives to the capitalist (the entrepreneur) the possibility (the freedom) of doing business and **obtain a profit** for him/herself. Private property and free market are the conditions of the capitalist model, or market economic system.

This model is in contrast to that of the **planned economies** in which all decisions are formed and implemented by a public body such as a government agency. The aim of the

---

[1] As pointed out by Amaduzzi: «*Il problema si presenta quotidianamente in termini quantitativi e qualitativi sempre nuovi, perché, innanzi tutto, i bisogni che l'uomo prova e desidera soddisfare sono dipendenti da fattori insiti nella sua vita vegetativa e spirituale, ovviamente sempre mutevoli. L'uomo invero anela per sua natura ad un continuo miglioramento del suo relativo benessere materiale e spirituale, in ciò è sollecitato anche, oltre che dalla sua singolare sensibilità, dal progresso che intorno a lui lo stesso istinto degli altri, della collettività, produce […] Comunque, l'illimitatezza dei bisogni, se può anche trovare eccezionalmente smentita presso singoli individui, vale certamente per la collettività degli individui*»; Amaduzzi (1978, p. 1).

[2] Source: http://www.economicsonline.co.uk/Competitive_markets/The_economic__problem.html.

planned economies is of ensuring **greater social equality and to avoid market failures**. The social equality is considered as the most important factor in ensuring people's well-being.

On the other hand, the choice of the model of capitalism depends on the fact that the **State**, in some contexts, **may meet the needs inefficiently (i.e. destroying value) or even may produce useless products** (i.e. products that nobody needs and wants).

YouTube 2 – *What is the economic problem?* *

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Economic problem	00:04:03	Study
Documentary	Economic problem (2)	00:03:26	Study
Documentary	Scarcity of resources	00:04:32	Study
Documentary	Covid-19: how bad will it be for the economy? | The Economist	00:06:32	Study

* You can click on the title, having a direct access to the video

The presence of non-profit (e.g. Greenpeace, WWF) and public organizations is justified, first of all, with the fact that not all needs to satisfy allow the capitalist to make a profit, then some individuals, not motivated by profit but by altruism, meet these needs, which otherwise would not be satisfied.

In addition, the State may decide to retain the control of some sectors (e.g. education, health care, public transport) to avoid that the logic based only on profit may be against the principle of equality and do not guarantee all the appropriate level of goods and services (Hart et al., 1996; Shleifer, 1998).

Thus, the resolution of the economic problem can follow different paths. On closer inspection the State, regardless of the chosen relationship between democracy and market, protects the profit and, more generally, freedom of private enterprise, only if they are not contrary to the collective well-being, resulting in the so-called market failures. If this happens the regulator intervenes, for example, through a normative antitrust or pollution.

2.1. *Needs and wants and the Maslow's hierarchy of needs*

In their life, individuals constantly manifest needs or desires of various kinds, to meet which they are active in the search for goods and services.

Usually there is a distinction between needs and wants.

Needs are material items people need for *survival*, such as food, clothing, housing. Until the Industrial Revolution, the vast majority of the world's population struggled for access to basic human needs. This is what still happens in the underdeveloped economies.

Wants are effective *desires* for a particular product, or for something that can only be obtained by working for it. While the fundamental needs of survival are key in the function of the economy, *wants are the driving force that stimulates demand for goods and services*. Wants are not necessary for survival but that add comfort and pleasure to individuals' lives (I desire a Ferrari but I do not need it). Examples of wants are: beer; TV; computer; book.

Hereinafter, we do not make difference between wants and needs, in the sense that **we use the term need also as synonymous of want**, i.e. we include within the needs not just the fundamental needs but also the non-fundamentals ones.

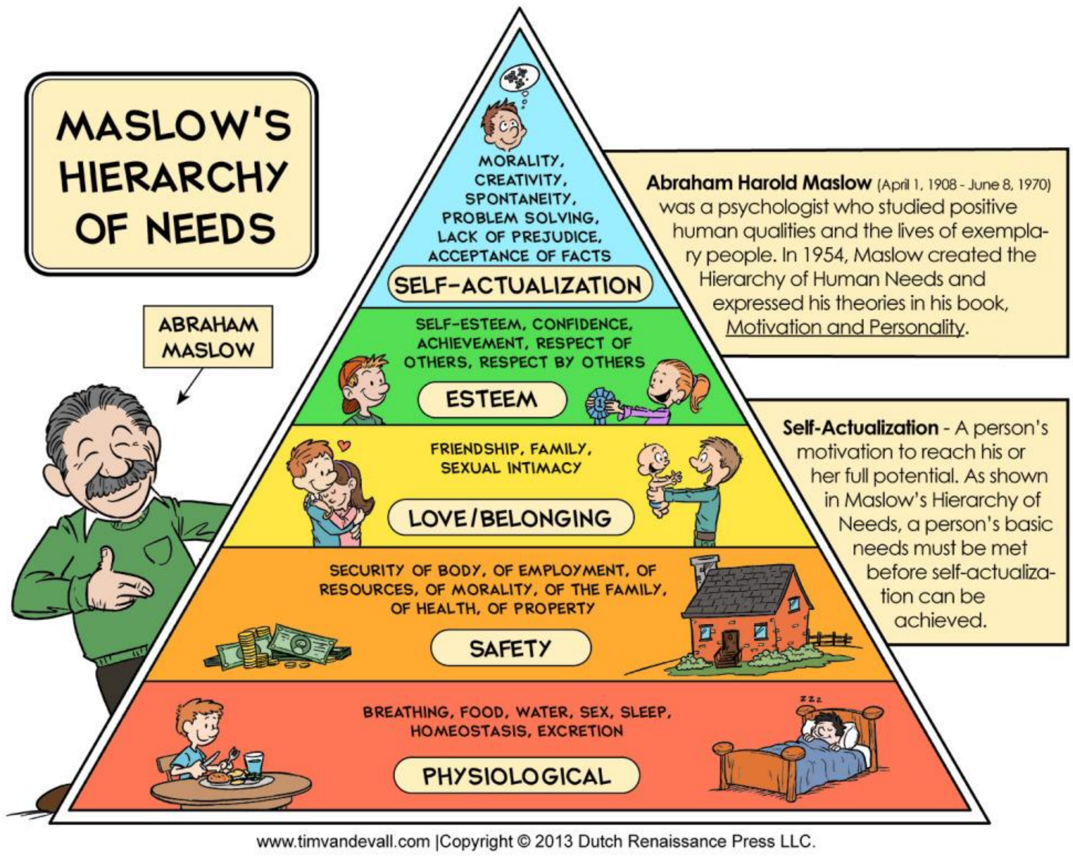
Each of us is motivated by needs. Our most basic needs are inborn, having evolved over tens of thousands of years. **Abraham Maslow's hierarchy of needs** helps to explain how these needs motivate us all (Table 4).

Maslow's hierarchy of needs states that we must satisfy each need in turn, starting with the first, which deals with the most obvious needs for survival itself.

Only when the lower order needs of physical and emotional well-being are satisfied are we concerned with the higher order needs of influence and personal development.

Conversely, if the things that satisfy our lower order needs are swept away, we are no longer concerned about the maintenance of our higher order needs.

Table 4 – *Maslow's hierarchy of needs*



Source: www.timvandevall.com

The five levels of Maslow's Hierarchy of Needs [3] are:

– *Physiological needs*: These are the basic needs of an individual, and include air, water, food, clothing, and shelter. All the basic needs that an individual need to live and breathe is categorized under physiological needs;

[3] http://communicatesmart.blogspot.it/2012/03/limitations-of-maslows-hierarchy-of.html

– *Safety needs*: The most common safety needs are physical and emotional protection. Health benefits are counted as physical protection and counselling services fall under emotional protection. The needs are necessary for an individual to feel secure and comfortable within any given environment;

– *Social needs*: The individual's need for love, care belongingness and acceptance. Once a healthy individual feel secure in any given work place, they must try to be part of the workplace culture and earn their acceptance;

– *Esteem needs*: Can be broken down into two types; namely internal esteem needs (self-respect, increase in self-confidence, learning of new skills, autonomy) and external esteem needs (recognition, attention, and admiration of their peers). Internal Esteem Needs are more towards the need for intrinsic rewards, while external Esteem needs is gaining acknowledgement from their peers that they are now officially a part of the workplace society;

– *Self-actualization needs*: The peak of the hierarchy chart can never be fully satisfied, and this becomes the ultimate motivator for each and every individual to try to strive for self-improvement. An individual will continue to experience growth in the area to achieve self-contentment. The hunger for more knowledge, creativity, and self-expressions are few of the goals that an individual may want to achieve.

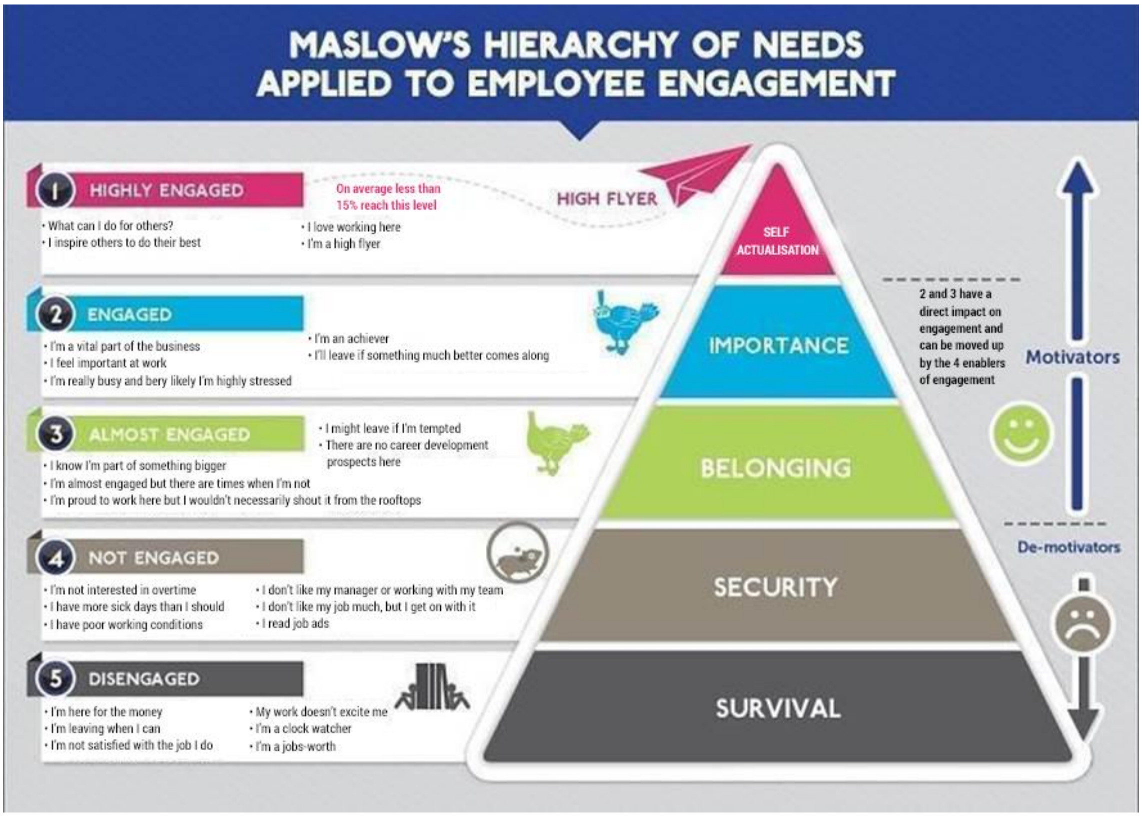
YouTube 3 – *Wants, needs and their classification*

Type	Title	Length (hh:mm:ss)	Study/Watch
Lesson	Wants and their classification	00:08:28	Study
Lesson	Scarcity, choice, opportunity cost	00:02:58	Study
Lesson	An introduction to Maslow's hierarchy of needs	00:09:51	Study

Assignment 2 – Maslow's hierarchy of needs

Following the Maslow's hierarchy of needs applied to employee.

Table 5 – *Maslow's hierarchy of needs applied to employee*



Source: internet

3. *What is the economic activity?*

Economic activity is a dimension of human activity and it is conducted for the satisfaction of human needs through the production of economic goods. Economic goods satisfy human needs.

The concept of economic activity comes from the mentioned economic problem, i.e. the contrast between the limitlessness of the needs and the scarcity of resources used to satisfy them.

If the goods to satisfy the needs were unlimited (e.g., such as air, sunlight) there would be no economic problem [4], and consequently no economic activity.

---

[4] According to Cassandro: «*Per soddisfare gli svariati bisogni di cui è portatore sin dalla nascita, l'uomo si serve di cose utili che vengono denominate beni. Taluni beni esistono in natura in quantità illimitata e sono liberamente conseguibili, come l'aria e la luce solare; altri, e sono la maggior parte, esistono in quantità limitata, di fronte al volume dei bisogni umani, crescenti con l'aumento della popolazione e con il progresso della civiltà; e richiedono uno sforzo (lavoro) per essere conseguiti e adattati al soddisfacimento dei bisogni. Questi beni limitati si dicono beni economici e l'attività rivolta al loro conseguimento e al loro impiego si dice attività economica*»; Cassandro (1988, p. 9).

The economic activity involves the production, distribution and consumption of **goods and services**.

Goods and services are the products of the economic activity. Goods are tangible products, while services are intangible.

Table 6 shows the main differences between goods and services looking to their attributes.

Table 6 – *Goods vs Services*

Attributes of goods (*Tangible product*)	**Attributes of services (*Intangible product*)**
Can be resold	Reselling unusual
Can be inventoried	Difficult to inventory
Some aspects of quality measurable	Quality difficult to measure
Selling is distinct from production	Selling is part of service
Product is transportable	Provider, not product, is often transportable
Site of facility important for cost	Site of facility important for customer contact
Often easy to automate	Often difficult to automate
Revenue generated primarily from tangible product	Revenue generated primarily from intangible service

Assignment 3 – The tangible and intangible products

3.1. *Resources: Land, labor, capital and entrepreneur*

Resources are those used (transformed) to produce output (products) and are: land, labor, capital and entrepreneur. Collectively, resources are called **factors of production**, or input of production.

Land

Land is a resource or input that is a "gift of nature". It exists independently of human activities. Soil, a forest, a deposit of oil, coal, rain, a river, and climate are a few examples of land. In economics the payment for land is often called **rent**. There are many categories of land.

Some resources, like solar or wind, are referred to as "flow resources." If the resource is used for one purpose, there is no significant impact on the availability of the resource for other uses.

Other land resources are called "**renewable**." A forest, fishery, herd of buffalo, whales, water quality and the like are renewable resources. Trees may be harvested from a forest at a maximum rate equal to the growth rate of new trees. This is called the maximum sustainable yield. Fish, whales and buffalo (and other wildlife) can be harvested and if a large enough population is left it will "renew" or replenish.

As pointed out by Farneti: «*L'attività economica implica l'utilizzo di beni economici, disponibili in quantità limitata, nella finalità di massimizzare l'utilità che da essi se ne ricava, in applicazione del principio del minimo mezzo. I beni infatti sono utilizzati per soddisfare i propri bisogni (attraverso i consumi), o per ottenere altri beni/servizi (soddisfacendo i bisogni dei produttori) o risparmiati in vista di un loro impiego futuro*»; Farneti (2007, p. 7).

Other resources are called **exhaustible resources**. There is a finite amount available and once used it is gone, it cannot be replaced. Coal and oil are examples of these resources. In practice, society does not know about all deposits of those resources. As one deposit of coal is mined out, new deposits may be discovered.

Labor

Labor is any human effort to produce goods and services. The payment for Labor is usually called **wages** (payments might be commissions, salary, bonus or whatever). Labor can be physical or mental. A person digging a ditch, managing a firm, or performing accounting functions is providing Labor.

"Human capital is the stock of competencies, knowledge, habits, social and personality attributes, including creativity, cognitive abilities, embodied in the ability to perform Labor so as to produce economic value. It is an aggregate economic view of the human being acting within economies, which is an attempt to capture the social, biological, cultural and psychological complexity as they interact in explicit and/or economic transactions" (Wikipedia).

Capital

The term capital means investment in goods that are used to produce other goods in the future. Capital goods are resources used to produce the final product.

Examples include machinery, plant and equipment, new technology, factories and buildings. Capital is a part of the so-called *assets* of the firm. An asset is an economic resource. Anything tangible or intangible that is capable of being owned or controlled to produce value and that is held to have positive economic value is considered an asset.

Entrepreneur

The term 'Entrepreneur' has been derived from a French word '*Entreprendre*' meaning to undertake certain activities. Thus, the entrepreneur uses land, capital and activities to produce certain output.

Following several definitions of entrepreneur:

– **Dan Sullivan** of Strategic Coach: "An entrepreneur is someone who does not expect compensation until he has created value for someone else."

– **Jean-Baptist Say**, French Economist: "Entrepreneur is someone who takes resources from a lower level of productivity and raise them to a higher level."

– **Peter Drucker**, Renowned Management Guru: "An entrepreneur searches for change, responds to it, and exploits it as an opportunity. Innovation is the specific tool of entrepreneurs, the means by which they exploit change as an opportunity for a different business or a different service."

– **Victor Kiam**, Former owner of New England Patriots: "Entrepreneurs are risk takers, willing to roll the dice with their money or reputation on the line in support of an idea or enterprise. They willingly assume responsibility for the success or failure of a venture and are answerable for all its facets."

– **Joseph Schumpeter**, Austrian Scientist: "An entrepreneur is the ultimate innovator and earns his profits, however temporary, from successful innovations."

– **Robert Callington**: "An entrepreneur is someone, who practices business judgment in the face of uncertainty of the future."

– **Nolan Bushnell**, founder of Chuck-E-Cheese and Atari: "The critical ingredient is getting off your butt and doing something. It's as simple as that. A lot of people have ideas, but there are few who decide to do something about them now. Not tomorrow. Not next week. But today. The true entrepreneur is a doer… not a dreamer."

None of the above definitions state that the entrepreneur is necessarily the owner of the organization. However, one of the most important decisions of the controlling owner who does not want to manage the firm (e.g. because he/she does not have expertise to do that) is the selection of the firm's managers. Just in small and medium organizations normally owner and entrepreneur are the same person.

The entrepreneur should be a leader, in the sense specified in the YouTube video.

YouTube 4 – *The leader*

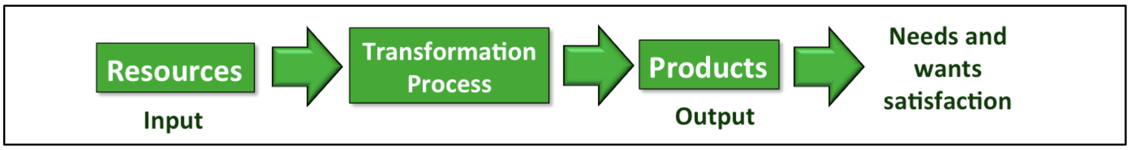
Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Are You a Leader Motivating	00:02:45	Watch

3.2. *The input-transformation-output process*

Through the **production process** (or transformation process) the inputs are transformed into output, goods or services.

The output can be purchased by the final consumer and/or by other organizations (e.g. Fiat sells its cars to consumers and to other companies that use those cars as factors of production for their activity). In the latter case the output represents the input of those companies.

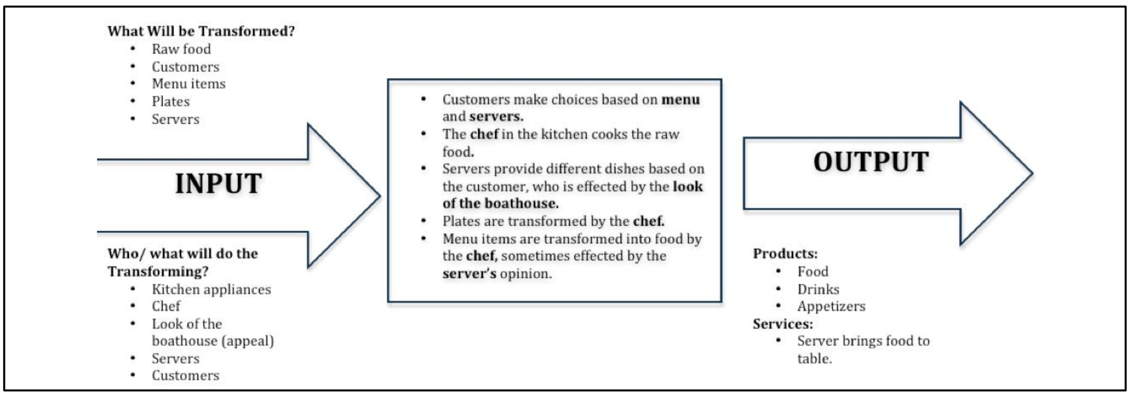
Table 7 – *Input-transformation-output and needs and wants satisfaction*



Source: Our elaboration

Table 8 shows the input-transformation-output process of the restaurant.

Table 8 – *The input-transformation-output process in a restaurant*



Source: Internet

3.3. *From linear to circular economy*

"A circular economy is an alternative to a traditional linear economy (make, use, dispose) in which we keep resources in use for as long as possible, extract the maximum value from them whilst in use, then recover and regenerate products and materials at the end of each service life.

Table 9 – *The circular economy*

Source: Internet

As well as creating new opportunities for growth, a more circular economy will:
– reduce waste
– drive greater resource productivity
– deliver a more competitive country economy.
– position the country to better address emerging resource security/scarcity issues in the future.
– help reduce the environmental impacts of our production and consumption in both the country and abroad" [5].

The case of Gispen

[5] http://www.wrap.org.uk/about-us/about/wrap-and-circular-economy

The production process

Steel is a good material for recycling. Recycling requires 70% less energy than new production using raw steel. Even better is to not let the steel fully melt, but to use it in its original form; the form of the intermediate product. An intermediate product is part of a product – the steel tubes from which we craft table legs, for instance.

By including intermediate products in the production of new pieces of furniture, waste production is reduced and less energy is needed to renew the products. Efficient and responsible. Options for a modular structure of intermediate products are already considered in the early stages of the design.

Craftsmanship

The focus in society is shifting from 'materials' to 'labour'. Well-organised logistics, handling and craftsmanship is becoming increasingly important in production. The result: more local employment opportunities.

Reusability increased in our production process

All the products that are delivered by Gispen must feel brand-new, whether they are made out of reused materials or not. In other words, **reuse does not lead to a loss of quality, but only to wasting fewer materials and energy**. It goes without saying that we attach great importance to the quality of our products. The part of our production process that utilises reused products is stepped up while new production is cut back.

For 10 examples of circular economy solutions, click the following link: https://stateofgreen.com/en/partners/state-of-green/news/10-examples-of-circular-economy-solutions/

YouTube 5 – *The circular economy*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Re-thinking Progress: The Circular Economy	00:03:48	Study

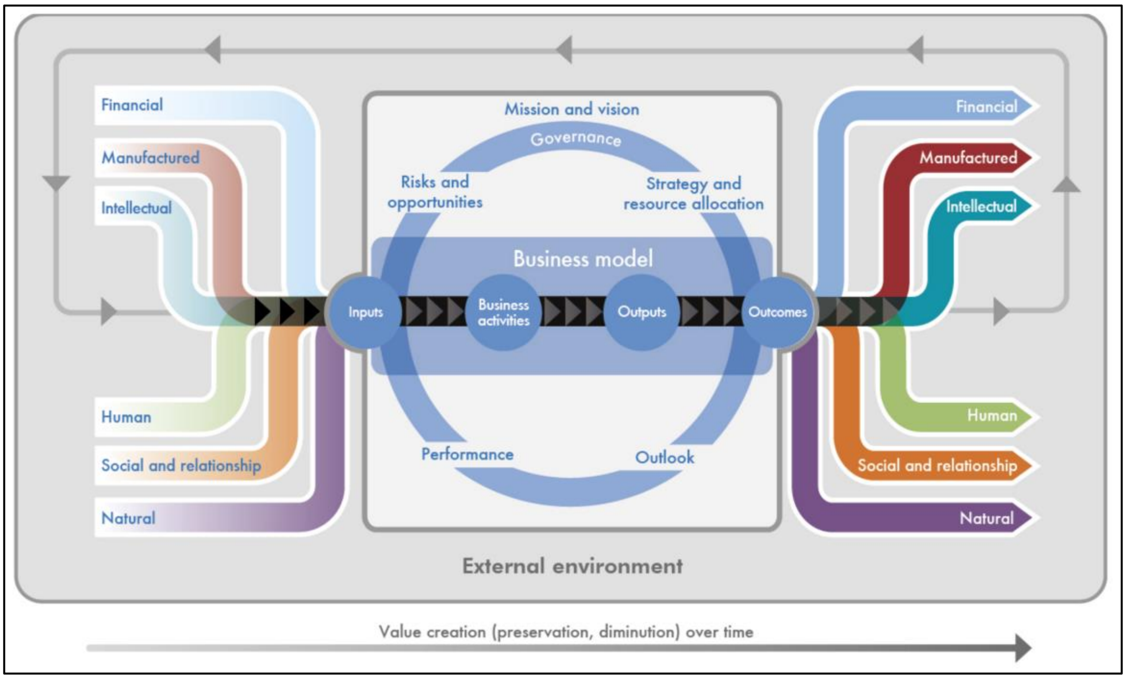
3.4. *The business model according to the framework of the International Integrated Reporting Council*

Table 10 contains the representation of the business model given by the framework of the International Integrated Reporting Council (IIRC).

"**An organization's business model is its system of transforming inputs, through its business activities, into outputs and outcomes that aims to fulfill the organization's strategic purposes and create value over the short, medium and long term**" (IIRC, 2013, p. 25).

The full document of IIRC is downloadable here.

Table 10 – *The value creation process*



Source: IIRC (2013)

The capitals (i.e. the input) are categorized and described as follows:

- ***Financial capital*** – The pool of funds that is:
  - available to an organization for use in the production of goods or the provision of services;
  - obtained through financing, such as debt, equity or grants, or generated through operations or investments;
- ***Manufactured capital*** – Manufactured physical objects (as distinct from natural physical objects) that are available to an organization for use in the production of goods or the provision of services, including:
  - buildings
  - equipment
  - infrastructure (such as roads, ports, bridges, and waste and water treatment plants)

Manufactured capital is often created by other organizations, but includes assets manufactured by the reporting organization for sale or when they are retained for its own use.

- ***Intellectual capital*** – Organizational, knowledge-based intangibles, including:
  - intellectual property, such as patents, copyrights, software, rights and licenses
  - "organizational capital" such as tacit knowledge, systems, procedures and protocols
- ***Human capital*** – People's competencies, capabilities and experience, and their motivations to innovate, including their:
  - alignment with and support for an organization's governance framework,

  - risk management approach, and ethical values
  - ability to understand, develop and implement an organization's strategy
  - loyalties and motivations for improving processes, goods and services, including their ability to lead, manage and collaborate
- ***Social and relationship capital*** – The institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective well-being. Social and relationship capital includes:
  - shared norms, and common values and behaviours
  - key stakeholder relationships, and the trust and willingness to engage that an organization has developed and strives to build and protect with external stakeholders
  - intangibles associated with the brand and reputation that an organization has developed
  - an organization's social licence to operate
- ***Natural capital*** – All renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current or future prosperity of an organization. It includes:
  - air, water, land, minerals and forests
  - biodiversity and eco-system health.

The value creation process is depicted in Table 10.

The **external environment**, including economic conditions, technological change, societal issues and environmental challenges, sets the context within which the organization operates. The **mission and vision** encompass the whole organization, identifying its purpose and intention in clear, concise terms.

Those charged with **governance** are responsible for creating an appropriate oversight structure to support the ability of the organization to create value.

At the core of the organization is its **business model**, which draws on various capitals as inputs and, through its business activities, converts them to outputs (products, services, by-products and waste). The organization's activities and its outputs lead to outcomes in terms of effects on the capitals. The capacity of the business model to adapt to changes (e.g., in the availability, quality and affordability of inputs) can affect the organization's longer term viability.

Business activities include the planning, design and manufacture of products or the deployment of specialized skills and knowledge in the provision of services. Encouraging a culture of innovation is often a key business activity in terms of generating new products and services that anticipate customer demand, introducing efficiencies and better use of technology, substituting inputs to minimize adverse social or environmental effects, and finding alternative uses for outputs.

Outcomes are the internal and external consequences (positive and negative) for the capitals as a result of an organization's business activities and outputs.

Continuous monitoring and analysis of the external environment in the context of the organization's mission and vision identifies **risks and opportunities** relevant to the organization, its strategy and its business model.

The **organization's strategy** identifies how it intends to mitigate or manage risks and maximize opportunities. It sets out strategic objectives and strategies to achieve them, which are implemented through resource allocation plans.

The organization needs information about its **performance**, which involves setting up measurement and monitoring systems to provide information for decision-making.

The value creation process is not static; regular review of each component and its interactions with other components, and a focus on the organization's **outlook**, lead to revision and refinement to improve all the components.

The transformation process should not be viewed only in the physical-chemical sense (e.g. the automotive companies that assembly components purchased by other companies in order to produce cars, see Fiat, Peugeot); it may consist, in fact, also in the **value creation through the transfer of goods and services in time and space** (e.g. commercial companies, see, Euronics, Ipercoop, Carrefour, Mediaworld, Walmart [6]).

YouTube 6 – *Production processes*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	How is made hot-dogs	00:05:03	Watch
Documentary	How is made Lego	00:05:04	Watch

Assignment 4 – Factors of production

The output of the production process should meet human needs. In other terms the production should be based on a **successful business idea**.

YouTube 7 – *An example of a successful business idea*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	The seabag	00:02:13	Study

Assignment 5 – The needs satisfied and to be satisfied

[6] "Walmart helps people around the world save money and live better -- anytime and anywhere -- in retail stores, online and through their mobile devices. Each week, more than 245 million customers and members visit our nearly 11,000 stores under 71 banners in 27 countries and e-commerce websites in 10 countries. With fiscal year 2014 sales of approximately $473 billion, Walmart employs 2.2 million associates worldwide". http://corporate.walmart.com/our-story/.

3.5. *Productivity*

Productivity is an overall measure of the **ability to produce a good or service** [7]. It is usually expressed as a **ratio of output to input**. It can be expressed as units of a product (e.g. cars) per worker-hour (total number of hours worked by all workers on that car). Given the cost of the worker-hour, productivity can also measure the efficiency of a company. These measures are quantitative and relatively easy to measure. However, other factors of productivity, such as creativity, innovation, teamwork, and even quality are qualitative and more difficult to measure.

"Productivity may also be defined as an index that measures output (goods and services) relative to the input (Labor, materials, energy, etc., used to produce the output). Hence, there are two major ways to increase productivity: increase the numerator (output) or decrease the denominator (input). Of course, a similar effect would be seen if both input and output increased, but output increased faster than input; or if input and output decreased, but input decreased faster than output. Organizations have many options for use of this formula, Labor productivity, machine productivity, capital productivity, energy productivity, and so on. A productivity ratio may be computed for a single operation, a department, a facility, an organization, or even an entire country" [8].

Assignment 6 – Increase the productivity of capital and

4. *What are the organizations?*

In today's economic system the economic activity is played by different entities: individuals, groups of persons, organized entities. These entities are named **organizations**.

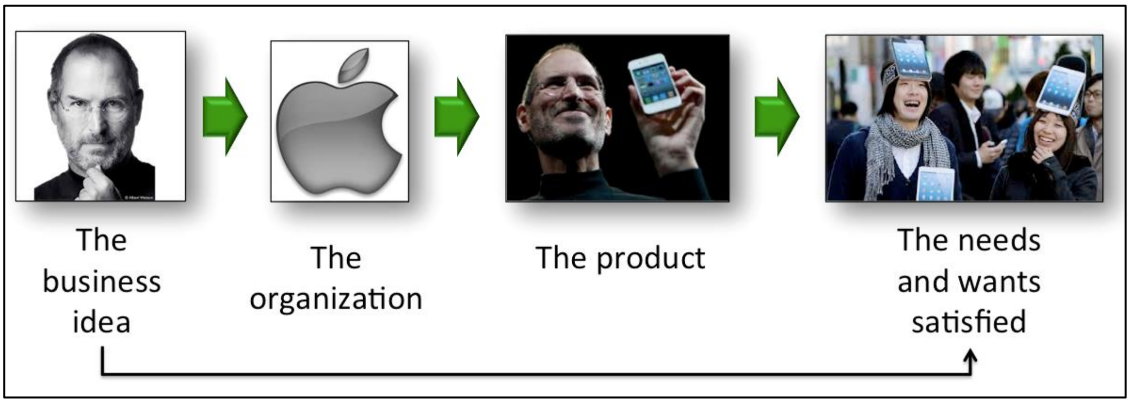
In Table 11 is represented how Apple Corporation (the organization) allows Steve Jobs to realize his business idea, the IPhone (as well as the other products, such as IPad, IPod, MacBook, etc.). The business idea starts from the needs to satisfy, then the organization allows Steve Jobs to realise his business idea.

Following a broad definition of the term organization: "*the term applies correctly to stable associations of persons engaged in concerted activities directed to the attainment of specific objectives*" (Bittner, 1965, p. 239). For instance, three persons decide to purchase coffee in Brazil and to sell it in Italy. Thus, they produce a service (a commercial service) to satisfy a specific need and make profit. They form an organization just to do these two transactions (buy and sell coffee).

[7] http://www.investinganswers.com/financial-dictionary/economics/productivity-643

[8] http://www.referenceforbusiness.com/management/Pr-Sa/Productivity-Concepts-and-Measures.html

Table 11 – *The business idea of Steve Jobs*



Source: Our elaboration

Organizations are usually distinct in profit (e.g. firm) and non-profit organizations (e.g. associations, foundations, public institutions, hospitals).

Following the definition used in this course:

The organization is an entity that in carrying out an economic activity produces useful goods and services that users need and want

Organizations create and satisfy human needs. All organizations have Labor and capital that are used to carry out the economic activity.

5. *The stakeholders of the organization. The particular interest of the stakeholders and the common good*

All organizations have stakeholders. A stakeholder is an individual who possesses (the "**holder**") a "**stake**", that is an **interest** in the organization.

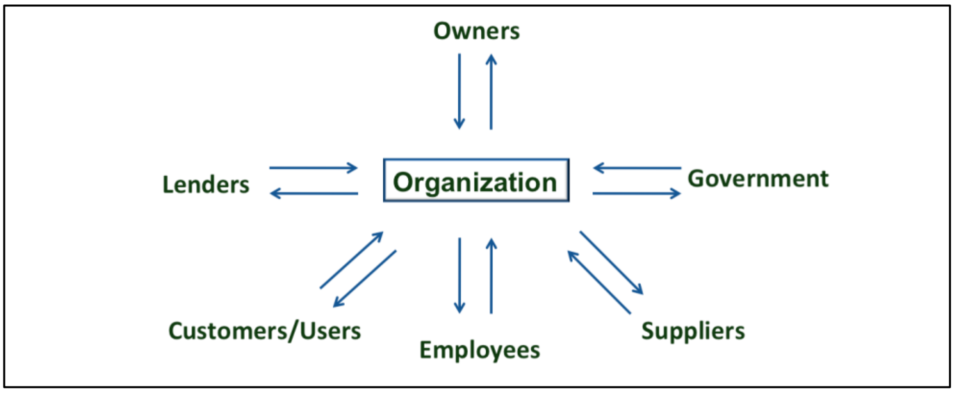
Following some definitions of the concept of stakeholders:

"Any group or individual that can affect, or is affected by, the performance of the organization" (Freeman, 1987).

"Individuals or groups who depend on the organization to fulfill their own goals and on whom, in turn, the organization depends" (Johnson & Scholes, 1999).

"The firm is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firms activities" (Clarkson, 1994).

Table 12 – *Stakeholders of the organization*



Source: Our elaboration

In Table 13 the primary stakeholder expectations (their particular interests) are presented.

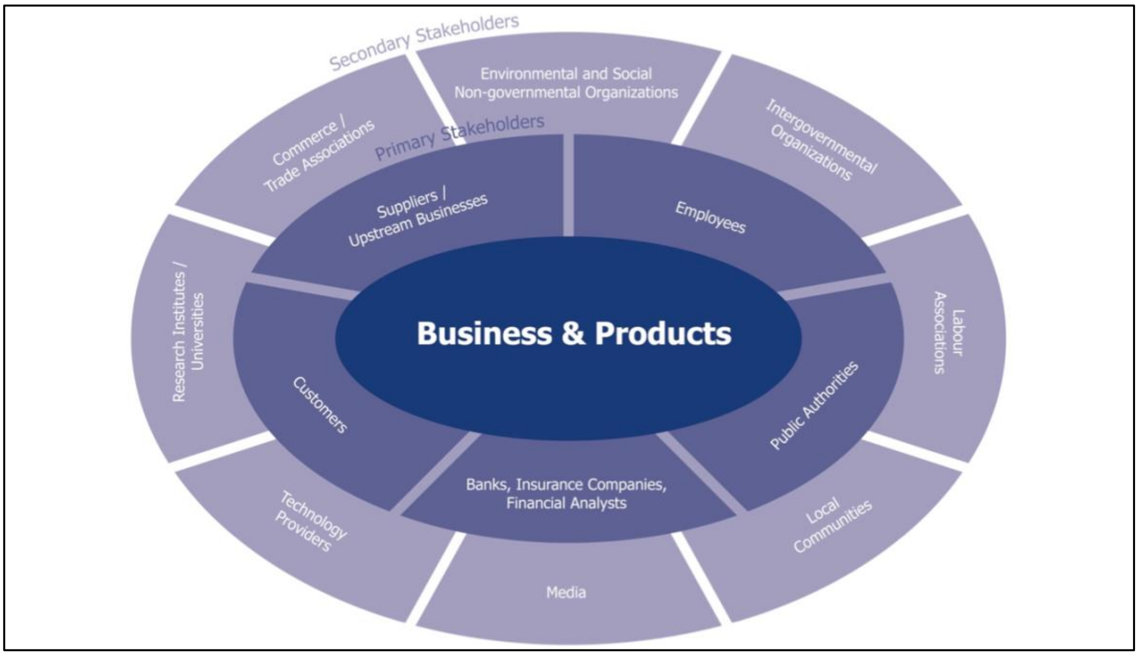
Table 13 – *Primary stakeholder expectations (particular interests of the stakeholders)*

Owners (Shareholders) • Growth in dividend payments • Growth in share price • Consistent dividend payments • Growth in net asset value	**Customers** • Price always competitive • Emphasis on quality • Return and Replacement policies • Warranty / guarantee provisions
Suppliers • Timely payment of debt by company • Adequate liquidity • Integrity and public standing of directors • Negotiating ability of the purchasing manager	**Employees** • Good compensation and benefits Job security • Sense of meaning or purpose in the job opportunities for personal development • Amount of interesting work
Government • Efficient user of energy and natural resources • Adhering to the country's laws • Paying taxes • Provision of employment	**Lenders** • Liquidity of the company • Character and standing of company management • Quality of assets available for security • Potential to repay interest and capital on due date

Primary stakeholders are those stakeholders that have a direct stake in the organization and its success. **Secondary stakeholders** are those that have a public or special interest stake in the organization.

Primary stakeholders have transactions (contracts) with the company, while secondary stakeholders do not.

Table 14 – *Primary and secondary stakeholders*



Source: Internet

"For instance, the **employees and investors** who depend on a company's financial well-being for their own are the **primary stakeholders**. Secondary stakeholders might include residents who live near a company and are thus affected if the company decides to pollute local waterways or local workforce boards that count on the business employing local workers.

Secondary stakeholders also are important because they often can be primary stakeholders, too. For instance, people who live in the vicinity of a company care about the company's effects on the local environment and economy. However, those same people may be employed by the company or own stock in it, so they have a direct financial interest in it. Conversely, they can impact the company financially by pulling out their investments in it" [9].

Stakeholder may be also classified in internal and external. The former operate within the firm (e.g. the owners, employee and board of directors). While the others are all external to the firm.

YouTube 8 – *The stakeholder of the business entities*

Type	Title	Length (hh:mm:ss)	Study/Watch
Lesson	Stakeholders	00:09:47	Study

[9] http://smallbusiness.chron.com/secondary-stakeholders-important-company-23877.html

Table 15 – *Internal and external stakeholders*

Source: Internet

"Finally, there is the set of groups and individuals that are **not stakeholders** at all. The focal organization has no moral obligation to these groups and individuals in addition to what is their due qua human (i.e., there is no stakeholder-based obligation) and the likelihood of their having an impact upon the organization or its other normative stakeholders is minimal. As such, managers may justifiably omit these groups and individuals from their stakeholder analysis" (Phillips, 2003, p. 34).

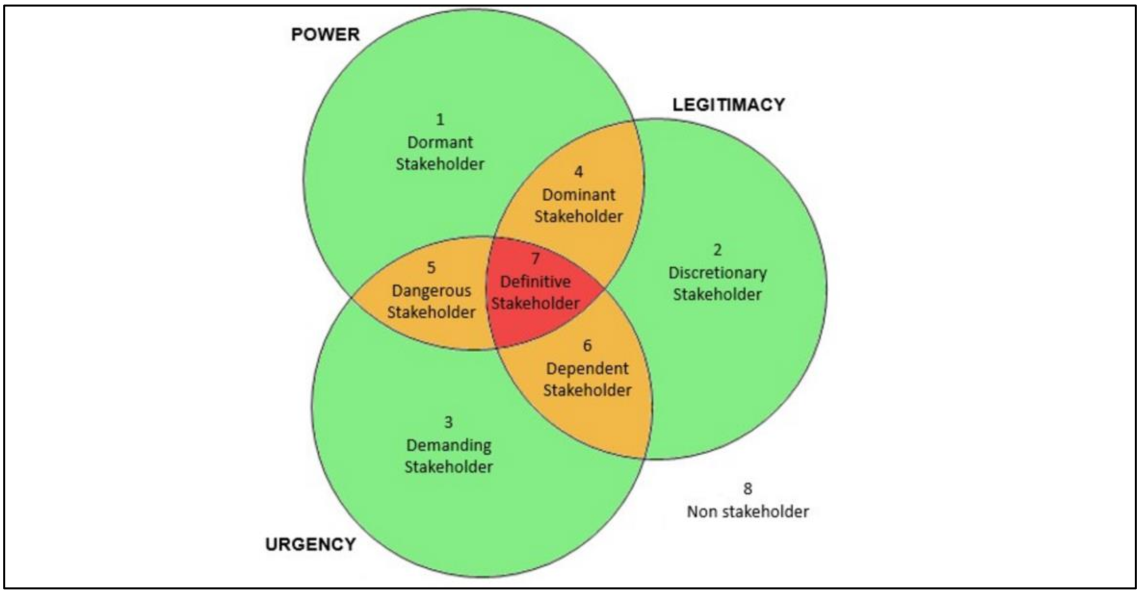
5.1. *Stakeholder management*

Stakeholder classification is important in order to give to manager the relationship them. For instance, Mitchell et al. (1997) proposed a normative theory of stakeholder identification based on three variables:

– **Power** to influence the firm;
– **Legitimacy** of the stakeholders' relationships with the firm;
– The **urgency** of the stakeholders claims on the firm.

"Mitchell et al. Draw on Etzioni (1964, p. 59) to define **power** as the extent to which a party has or can gain access to coercive (physical means), utilitarian (material means) or normative (prestige, esteem and social) means to impose their will.

Table 16 – *Stakeholders salience*



Source: http://www.stakeholdermap.com/stakeholder-analysis/stakeholder-salience.html

The definition of **legitimacy** is taken from Suchman (1995, p. 574) who defines legitimacy as 'a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions'.

Urgency is defined as 'the degree to which stakeholder claims call for immediate attention'. The 'degree' depends not just on time- sensitivity, but also on how 'critical' the relationship is with stakeholder or the importance of their claim (Mitchell et. al, 1997, p. 867). From this stakeholder typology the authors introduce managers' perceptions to develop a theory of stakeholder salience. They define 'salience' as 'the degree to which managers give priority to competing stakeholder claims'.

The more attributes – power, legitimacy, and urgency – stakeholder is perceived to have the higher their salience. In other words the greatest priority will be given to stakeholders who have power, legitimacy and urgency. Power and legitimacy are interrelated and the three variables can overlap. The combinations given seven different classes of stakeholders, which the authors illustrate using a Venn diagram" [10].

[10] Article source: http://www.stakeholdermap.com/stakeholder-analysis/stakeholder-salience.html

Table 17 – *Typology of stakeholders according to Mitchell*

The Mitchell typology of stakeholders			
Stakeholder category	Stakeholder salience	Attributes	Stakeholder subcategory
Latent stakeholders with only one of the three attributes	Low	legitimacy	Discretionary stakeholders
		power	Dormant stakeholders
		urgency	Demanding stakeholders
Expectant stakeholders with two of the three attributes	moderate	power and legitimacy	Dominant stakeholders
		legitimacy and urgency	Dependent stakeholders
		power and urgency	Dangerous stakeholders
Definitive stakeholders with all the three attributes	high	power, legitimacy and urgency	

Source: http://www.csrquest.net

5.2. *The interest of the organization as a common good of its stakeholders and community. From particular interest to common interest*

The interest of the organization is not only a sum of individual interests of stakeholders, being also a common good, or a common interest of all stakeholders and society. It happens when the organization satisfy human need, creating value for those who participate to the value creation process in a sustainable way. Thus, **the common interest is that the organization survives over time (a long period interest)**. This aspect is fundamental since **stakeholders should put the common interest beside their legitimate, but sometime temporary, particular interest**.

This *common good* is part of the company's goal, and it is not the sum of individual goals within it[11]. Furthermore, the needs of individuals will be satisfied by some peculiar goods (not necessarily produced by the company) that, although able to satisfy needs and desires motivating the individual and helping the common good, are not normally considered as such in economics. These reasons pushed Argandoña (2009) to distinguish the three following categories of goods:

– **extrinsic goods**. They are external to the individual and include both physical (i.e. remuneration) and intangible (i.e. being considered by superiors) assets. These goods are motivating and create an expectation of improvement on the subject.

– **intrinsic goods**. They are internal to the individual, despite resulting from its interaction with the outside world, and are part of what we commonly consider as personal growth[12].

– **transcendent goods**. They are generated by the individual for the sole purpose of being transmitted to other [13]. A person who manages to produce goods for other people, contribute to his own motivation receiving other goods in return.

[11] First, because these individual goals include many more things than the organization can provide and, secondly, because the company facilitates the achievement of personal goals indirectly, through the achievement of its own objectives (Argandoña, 1998).

[12] Consider, for example, the satisfaction deriving from a job well done, the acquisition of new knowledge, the development of skills or interaction with other people.

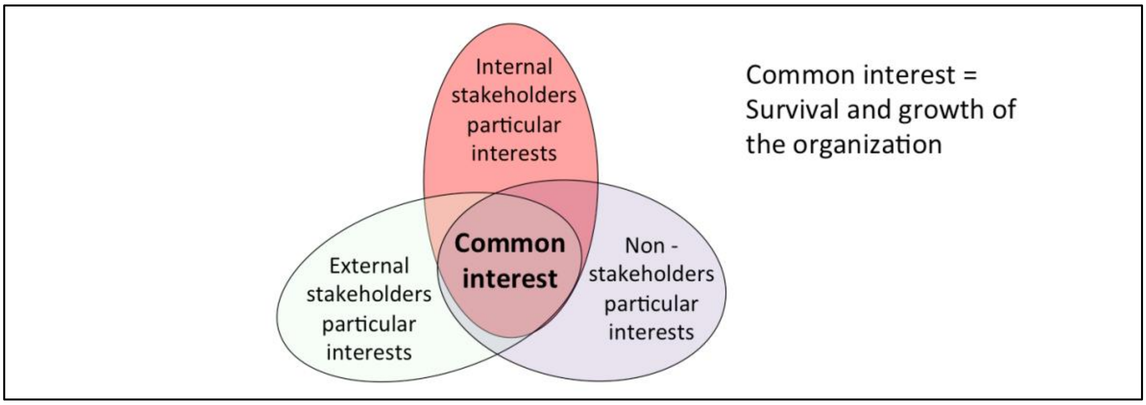
[13] Among the *transcendent goods* we can find the success in meeting customers needs, in contributing to the employees success, or in ensuring profit to shareholders or the survival and growth of the organization.

This classification of goods becomes crucial since it gives importance not only to extrinsic motivations but also to the internal ones (Osterloh and Frey 2004), and thus not only on the results but also on the actions performed to enable those results. According to Arjoon et al. 'Unethical practices occur when there is a disorder between internal and external goods (i.e., between means and ends). An exclusive focus on goods of efficiency can distort one's perception and judgment through blind spots and moral slippages, which make it difficult to recognize ethical issues and to determine what is the right thing to do' (2018, p. 150).

Moreover, the classification above becomes crucial in understanding the reasons that lead stakeholders to provide their effort to the activity. However, shareholders should not, even in their best interest, hinder these goods to be spread within the organization when those contribute to the achievement of sustainable profitability over time.

In general, when also the economic entity pursues the production of intrinsic and transcendent goods (and thus not only extrinsic ones), the organization has a responsible attitude towards its stakeholders. Consequently, the survival and growth of the organization is a common good (or common interest) for the internal and external stakeholders as well as for the whole community [14].

Table 18 – *The common interest*



Source: our elaboration

5.3. *The Common Good Theory. Contributions and limitations*

The common good is the set of a society's life conditions that promote the well-being and human progress of all citizens (Arjoon 2000; Martini 1993, p. 35), i.e. their cultural, moral and economic flourishing and growth. The concept of common good appears when the social human dimension is considered (Melé 2009, p. 235). While the instrumental stakeholder approach considers the man as a mere means to an economic end, the common good approach considers the man as an end in itself. It follows that his/her happiness and perfection (or flourishing) constitute the objective of the activity that he/she carries out.

[14] In this regard, Onida (1971) writes that «*the company's mortification or fall are bad for the whole society*» indirectly confirming the importance of the *azienda*. According to Alford and Naughton (2001) even though «*the company is not responsible for the common good, like all communities, it is responsible to the common good*». In addition, it must not prevent it and, as far as possible, it should contribute to it (Argandoña, 2009).

The result of the application of the concept of common good to business entities (Argandoña 1998; Melé 2002, 2009; Sison and Fontrodona 2011; 2012; 2013) is to consider individuals as members of the same corporate community, who support the recognition and promotion of a common interest, together with the pursuit of their particular interests.

Stakeholders must see in their contribution to the firm the possibility to better meet their needs, while the firm should be interested in meeting stakeholders' needs in order to improve its survival and growth. Argandoña observes that 'the common good has to do with the creation of these conditions that will allow for those involved in the business to achieve his personal objective. It can be said that there is no conflict between the common and the personal good (...) The common good is not the sum of the individual goals of members: first, because these individual targets include many more things than the company can offer; and secondly, because the company facilitates the achievement of personal goals indirectly, through the achievement of its objectives' (1998, p. 1097).

Individuals have needs (or wishes) that are satisfied with certain goods. For example, the remuneration that one receives for his/her job is a good that allows him/her to satisfy certain needs through the purchase of goods and services. The work, in turn, produces other goods for the individual, such as the possibility to perform an interesting job, to establish relationships with other people, to develop him/herself. Despite these goods (extrinsic, intrinsic and transcendent) being able to satisfy needs and desires, usually in the economy some of them are not considered as such, although they motivate the individual and contribute to the common good.

Contributions

a) Stakeholders are not seen as only self-interested "individuals" but as "persons" (Argandoña 1998, p. 1094) capable of cooperating with a spirit of service, altruism and reciprocity, thus they have intrinsic and transcendent motivations to develop, for the common good (hence for themselves), collaborative relationships. The observance of moral rules derives from intrinsic motivations rather than economic incentives, which may most foster opportunistic behaviours rather than mitigate them;

b) It offers 'the means for determining, in each specific case, the rights and duties of the participants, in accordance with the common good of the company, of the particular "society" it has with its stakeholders, and of society as a whole' (Argandoña, 1998, p. 1100).

c) Stakeholders have an interest in the common good company, so the firm itself should reciprocate by having an interest to meet their needs (Argandoña 1998, p. 1099);

d) It underlines not only the rights of the stakeholders, but also their duties to contribute to the continuity of the firm and consequently to the common good of society (Argandoña 1998, p. 1100). The rights and duties of individuals, in fact, are components of the common good. The company is therefore instrumental to stakeholders and vice versa;

e) The theory of the common good is linked to virtue ethics, as it requires acting for the good of the company, the stakeholders and the community (Arjoon 2000). According to Bright et al. 'virtuousness emphasizes actions that go beyond the "do no harm" assumption embedded in most ethical codes of conduct. Instead, it emphasizes the highest and best of the human condition' (2006, p. 249). Stimulating the virtuousness of the agents and stakeholders and highlighting the importance of intrinsic and transcendent goods, the common good theory has a positive effect on the value creation process of the firm and on the mitigation of opportunistic behaviour and unethical practices. Indeed, 'the common good provides direction for guiding behavior of all the various stakeholders and the context for understanding virtuousness, while it is through virtuousness that the common good is effectively realized. Virtuousness and the common good are therefore in effect two sides of the same coin.' (Arjoon et al. 2018, p. 143);

f) If a stakeholder is aware of the link between the common good and its own interest, this will encourage the reporting of acts against the firm (for instance whistleblowing in the case of corporate fraud).

Limitations

a) Common good theory focuses on the concept of satisfying human needs, without deepening the aspect of the equilibrium conditions to be achieved in order to allow the survival and growth of the firm;

b) If, on the one hand, the opportunistic behavior is mitigated by the orientation towards the common good and to the virtuousness, on the other hand the misinterpretation of the common good (the firm as good for everyone, a firm with duties and not rights) and excess of good (Kaptein 2017) may compromise the overall equilibrium of the firm, providing an excuse for managerial opportunism;

d) Although it is clear for the individuals that contributing to the common good also favours themselves, they may "free ride" because they do not intend to support the "costs" associated with this contribution (Olson 1965), at least until they notice the negative consequences on themselves of such opportunistic behaviour.

6. *The Italian doctrine "*Economia Aziendale*" and the "*azienda*" as a type of organization. The three attributes of the* "azienda"

Economia Aziendale (EA) is an Italian doctrine founded in 1927 by Gino Zappa (1927) who focuses on the '*azienda*' as a coherent unity (i.e. inseparability) of 'economic operations', which characterises institutions (i.e. for-profit organization, public administrations, and non-profit organizations).

Outside of Italy, together with Schmalenbach and Limperg, **Gino Zappa** has been acknowledged as **one of the 'accounting heroes'** of continental Europe during the first half of the last century (Guarini et al., 2013).

Zappa defines the *azienda* as an 'economic institution intended to last for an indefinite length of time and that, with the aim of meeting human needs, manages the production, procurement or consumption of resources in continuous coordination' (Zappa, 1956, p. 37, our translation), and the *EA* as a unitary science that studies the 'existence conditions and life manifestations of the *azienda*' (Zappa, 1927).

According to Amaduzzi, the objective of *EA* 'is to achieve the principles that are valid for every socio-economic regime, although they tend to change over time' (Amaduzzi, 1990, our translation).

Viganò and Mattessich point out that 'first of all, the *azienda* is regarded as an autonomous and holistic (*unitaria*) system, and *EA* is claimed to possess 'laws' of its own, independent of its subdisciplines or even of microeconomics. Second, *EA* is thought to be composed of three organic segments or sections. Thus, the *azienda* can be examined in terms of coordinated "subsystems" (Table 19) with such traditional segments as *organizzazione* (**organization**), *ragioneria* (**accounting**) and *gestione* (**management and operations**)' (2007, p. 25).

These doctrines may be identified as subsystems of the more vast 'business' system and may be divided into:

1. 'Gestione' [**Management and operations**]: the set of economic decisions and operations coordinated for the achievement of the corporate purpose;

2. 'Organizzazione' [**Organisation**]: the combination of personnel and equipment, broken down into structures and procedures for efficient corporate management;

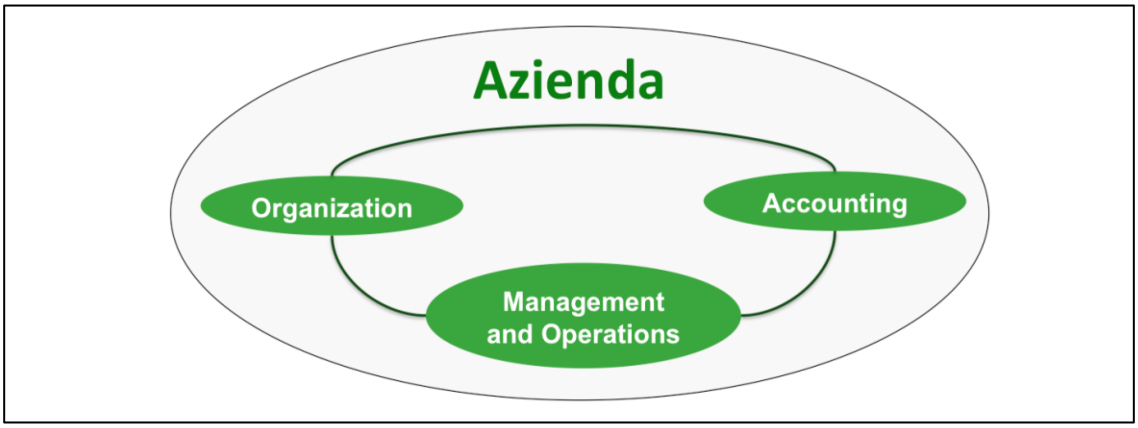
3. 'Ragioneria' [**Accounting**]: the set of instruments, operations and methods used for measurement, reporting and interpretation of corporate events (Zappa, 1956).

In this sense, management and organizations cannot be considered as separated from measurement (i.e. the accounting).

Zappa goes on to say: 'the accounting system should be based on knowledge about business phenomena: it is therefore necessary that its doctrine contain three complementary orders of investigation: a) the doctrine of accounting, even in its links with business statistics, b) the doctrine of management and c) the doctrine of the organization of business economics' (Zappa, 1927).

The subsystem organization will be treated in Chapter VI, while operations and management respectively in Chapter IV and VII.

Table 19 – *The sub-system of the* azienda



According to Cinquini and Marelli 'the main features can be summarised in two general points:

(a) **it covers all forms of economic organisation at all levels** – from the household, through business firms, public enterprises and town councils, right up to the state;

(b) **it aims at developing the general principles that govern the equilibrium of the 'azienda'** (used as a generic term, often translated as 'a concern') as a coherent unity' (2007, p. 2).

Since the science of '*Economia Aziendale*' is present only in Italy this term has not been translated into other languages. However, we can say that **'*Economia Aziendale*' is the economics of the organizations that possess certain attributes** [15]. Among the *aziendalisti*

---

[15] "The translation of the term 'economia aziendale' is a questionable issue. 'In a non-literal translation, it stands for something like the 'economics of economic units' or the 'science of economic administration' (. . .)' (Zan, 1994: p. 289). Others have translated 'economia aziendale' as 'concern economics': in fact 'A concern is an economic entity and the term covers all kinds of economic units such as business firms, government agencies, private households, etc. The term concern is used because it is general and applicable to the economic aspect of any social institute (typical institutes are a family, a firm or enterprise, a territorial public institute, a cultural institute and so on). The word firm (or enterprise or business) designates only the institute whose

(economists who study the *azienda*) the term *azienda* is used with different meanings. This problem is an old one and it is amplified when the term is used in other disciplines, e.g. law [16].

Thus, what are the boundaries of the *azienda*? Is a legal entity (e.g. a corporation, a partnership) [17] always an *azienda*?

In this book we adhere to the definition given by the Italian School of Accounting and *Economia Aziendale* (SIDREA [18]) proposes the following three attributes that allow distinguishing the *azienda* from the world of organizations (Sidrea, 2008):

– systemic coordination;
– decision-making autonomy;
– *economicità* [19].

All the *aziende* are productive organizations while there are some organizations that cannot be qualified as *aziende*, because they do not possess one or more of the three attributes listed above.

Thus, attributes of *aziendality* are not always present and do not emerge, therefore, as a predetermined condition following the mere establishment of a legal institution. Conversely, they are rather difficult to possess, but at the same time necessary for a long-term survival and sustainability of the *azienda*.

Examples of *aziende* are: public hospitals, public or private universities, companies, municipalities, foundations, associations and agencies.

Because of the international literature does not use the term "*azienda*", we decided to use the English terms "**economic entity**" and "**organization**" as a synonymous of *azienda*, although these terms are not perfectly overlapping.

Indeed, the concept of economic entity (or organization) does not ask for the presence of the three attributes listed above for the *azienda* definition, being based on the accounting concept of control for the consolidated financial statements of business groups. Thus, an *azienda* could contain more economic entities, could coincide with a single economic entity as well as an economic entity could contain more *aziende* (see Chapter V, § 8).

The need to demarcate the *azienda*'s boundaries stems from the fact that the principles, rules and tools developed by the disciplines *economico-aziendali* can only be applied to the *azienda*. It should be noted that the *Economia Aziendale* is fundamental also for those organizations that do not possess one or more of the three attributes (e.g. they do not operate with

---

economic aspect is the production concern' (Galassi, 2002: footnote 9). For immediacy 'business economics' has been chosen in the text" (Cinquini and Marelli, 2007, p. 8, note 1).

[16] The concept of azienda is also present in the art. 2555 of the Italian Civil Code: *L'azienda è il complesso dei beni organizzati dall'imprenditore per l'esercizio dell'impresa* ("the azienda is an aggregate of property organized by the entrepreneur for the conduct of the enterprise"). However this juridical concept has a total different meaning compared to that given by the *aziendalisti*, since, among other things, it is just referred to the concept of business entities (the for-profit organizations), i.e. the organizations that operate in the market (the Italian *imprese*), being excluded public administrations and non-for profit organizations. The *aziendalisti* include also the latter in the concept of *azienda*. In the common speaking the concept of *azienda* is used as synonymous of for-profit organization.

[17] For the concept of legal entity see Chapter V, § 2.

[18] Società Italiana dei Docenti di Ragioneria e di Economia Aziendale.

[19] Since there is not an equivalent in the international literature we decided to maintain the Italian term *economicità*.

economicità or they have not a systemic coordination) but they want to become *aziende*. This is the case of an inefficient public administration or private firm.

The search for these attributes becomes particularly important when the *azienda* is carried out by more than one legal entity under common control, i.e. in the case of the business groups (see Chapter V, § 8). Indeed, in a business group the governance of the legal entities (the so-called subsidiaries) could depend strongly from the governance of their holding company.

7. *Systemic coordination*

The *azienda* is a system in the sense that **its parts (e.g. assets such as machinery, equipment) and participants (e.g. Labor) are not separated; instead they are coordinated and integrated**, they are bounded together in order to achieve a specific objective, with its own interest. In the *azienda* the "system effect" must be reached, so that the whole is higher than the sum of the parts.

Thus, the *azienda* is a system with a specific objective, with its own finalism. The *azienda* "is not identified with the owners, the capital, the assets and the people taking part in it or with the contracts or the relationships among its components, but rather it is an autonomous and real entity composed of all these elements and the relationships among them. It is very important to point out the concept of system which is used by Zappa but not fully explored [...] In the *azienda*, the components will change, the elements will modify, but the whole will persist" (Zappa, 1950, p. 13). Onida emphasizes this concept, defining the *azienda* as a dynamic system in which the 'unity in the variety and permanence in mobility, comes true in a vital synthesis' (Onida, 1971, p. 4; 1954a, p. 12)" (Signori e Rusconi, 2010, p. 308).

Moreover, the *azienda* is not an organization with a short life-time, instead is an organization set to continue ('**institution intended to last for an indefinite length of time**') [20]. That is why often the term *azienda* is translated with the term **going concern**.

Amaduzzi (1936, p. 18) points out that the *azienda* is "a system with economic dynamics for the attainment of one given purpose". Such a system "can be understood and studied only as a coordination of forces which act and change without interruption".

The systemic vision basically involves the integration of all operations entered into in order to achieve the objectives of the organization. The systemic vision allows understanding the importance and the relativity of each behaviour and operation.

It could be the case of a business group where the affiliated companies (subsidiaries and holding) are so economically integrated (e.g. because they operate in the same sector participating to the same transformation process) that the group as a whole can be qualified as *azienda* (Chapter V, § 8). In such a case, certain affiliated companies in distress could be kept alive because they create value for other units of the group, i.e. they operate in function of the economy of the whole group (Onida, 1971).

The financial statements of a subsidiary, which operates as part of an integrated group, express the performance of a sub-system. Consequently, the analysis of that performance needs to take into account the link between that subsidiary and other parts of the group, i.e. other subsidiaries and/or the parent company.

---

[20] «*Un'azienda di successo deve quindi essere costantemente proiettata in avanti, in una prospettiva temporale praticamente senza confini*» (Bertini, 2013, p. 99).

Be a system is relatively simple when the *azienda* is small. For instance, in a sole proprietorship (see Chapter V, § 4) the sole proprietor is the only owner of the business, sometime he/she is the only employee and the level of money invested is low. The sole proprietor concentrates all the functions of the *azienda* (e.g. production, marketing, procurement, commercial), deciding everything.

The systemic coordination becomes much more complex in the large *azienda* (e.g. a big corporation, see Chapter V, § 6), for instance the one that operates in a multinational context (e.g. Coca Cola), with thousands of employees (e.g. Walmart), and with many different products (e.g. the Virgin company).

When the *azienda* has high dimension there is a risk that while some people operate for the interest of the *azienda* (e.g. the owners) others operate for their own interests, raising the so-called agency problem. That is why it is important to establish effective control systems in order to monitor the people behaviour, managing their eventual conflict of interest.

The system coordination is characterized by some adjectives: dynamic, long-lasting, complex, objective oriented, open and probabilistic.

7.1. *Dynamic*

This adjective immediately leads us to the concepts of *balance, economic problem* and *future* of an *azienda*. As Amaduzzi (1948) and Ferrero (1968) pointed out, an *azienda* features a permanent motion towards a balance which is not the rest or stagnation, but rather the mobility of the *azienda* in managing itself and to operate adjusting to the never ending changes in the necessary conditions to attain such *balance*, while always assuming a future-oriented perspective[21]. An orientation to the future (and to the cyclical flowing of time – past-present-future) implies that the *azienda* realizes that any current choice and action will bear consequences also in the long term and will therefore affect the balance conditions for the future

The equilibrium that the *azienda* should maintain is also defined as evolutionary equilibrium by the economist Amaduzzi; he used the term evolutionary because the *azienda* aims to a long-term orientation and it is necessary that despite the changes of the business over time, the *azienda* always maintains the equilibrium conditions.

7.2. *Long-lasting*

The *azienda* is defined also as long-lasting system. The occasional productive organization cannot be defined as an *azienda*. The durability allows the *azienda* to constantly satisfying recipients and stakeholders needs. Without durability, the system of the *azienda* cannot exist. This is a fundamental aspect for the reference income determination and for the ongoing capital.

A short-term orientation could put the business continuity at risk. For example, a common problematic issue is the transmission of the business to next generations: if the founder entrusts the management to incompetent heirs, surely current and familiar needs are satisfied,

---

[21] Under this viewpoint a company can be compared to a living being, which tends to regenerate itself endlessly, adapting to the outside conditions to survive. See on this: Amaduzzi (1978), pp. 78-81, and Bertini (1990), p. 29.

but the business continuity is at risk, because in the long-term even the familiar interests will be deteriorated.

Financial instabilities of big US companies like Worldcom and Enron, caused by short-term orientation together with the duty of managers to act towards shareholders (shareholder theory) give important indications on the issue. Sometimes, the short-term orientation was considered the real cause of the global economic crisis; therefore, the theory on the *azienda* could not forget to specify "in what time" create value, spreading a cultural model where the ideal time orientation is based on long-term and where the individual opportunism is seen as a threat.

Actually, according to Ferrero (1968) it is in the interest of the *azienda* istelf, seen as a «*durable source of present and future well-being*», to prevail over ephemeral and particular interests of the current *governance*.

The feature of being *durable* allows the organization to satisfy continuously the needs of those who are the final targets of its production or supply, as well as the needs of the other *stakeholders*.

7.3. *Complex*

The *azienda* is a complex system because of the high number of elements they feature, the factors they involve and the *interdependence* relations to which they are bound (Masini, 1986).

As said before, the system complexity increases as the dimension of the business gets bigger (Apple is much more complex than a small family business).

The system complexity requires subsystems differentiation; in this case the observation of the subsystems and their equilibriums it is necessary, considering at the same time the connection with the other subsystems and with the wide system they belong to.

The attempt to find a unique objective and to search for equilibrium among interest and objectives could represent the bearings leading management choices and solving trade-offs between objectives. The interest of the *azienda* should be, therefore, a "balanced synthesis" of all interests. Quoting Albert Einstein "Make thing as simple as possible, but not simpler" and this is what the Italian doctrine wants to do.

7.4. *Objective oriented*

Furthermore, the system of the *azienda* is objective oriented. It means that the system aims to achieve univocal objective. This objective should be shared, through the corporate hierarchy, and a good leadership makes all participants agree on the shared objective. Choosing the objective of the *azienda* is a crucial moment because on the basis of that, depend the aims to achieve, driven by the principle of "economicità". Economicità and objective of the *azienda* are strictly correlated as we will see.

Considering that the interest of individuals is not always aligned with the interest of the *azienda*, as emerged from the Anglo-American theories, the concept of primary interest of *azienda* will be proposed as broaden objective. The univocal and primary interest of all kinds of *azienda* consists of "satisfying human needs through the production of good and/or services". This univocal objective should consider the condition of survival and growth of the *azienda* as a system, which refers in few words to a sustainable value creation.

Another adjective belonging to the concept of azienda is to be an open system. The system of azienda is integrated in a high, order system: the environment system. The system of azienda works on the basis of the level of openness or closeness with the external environment.

7.5. *Open*

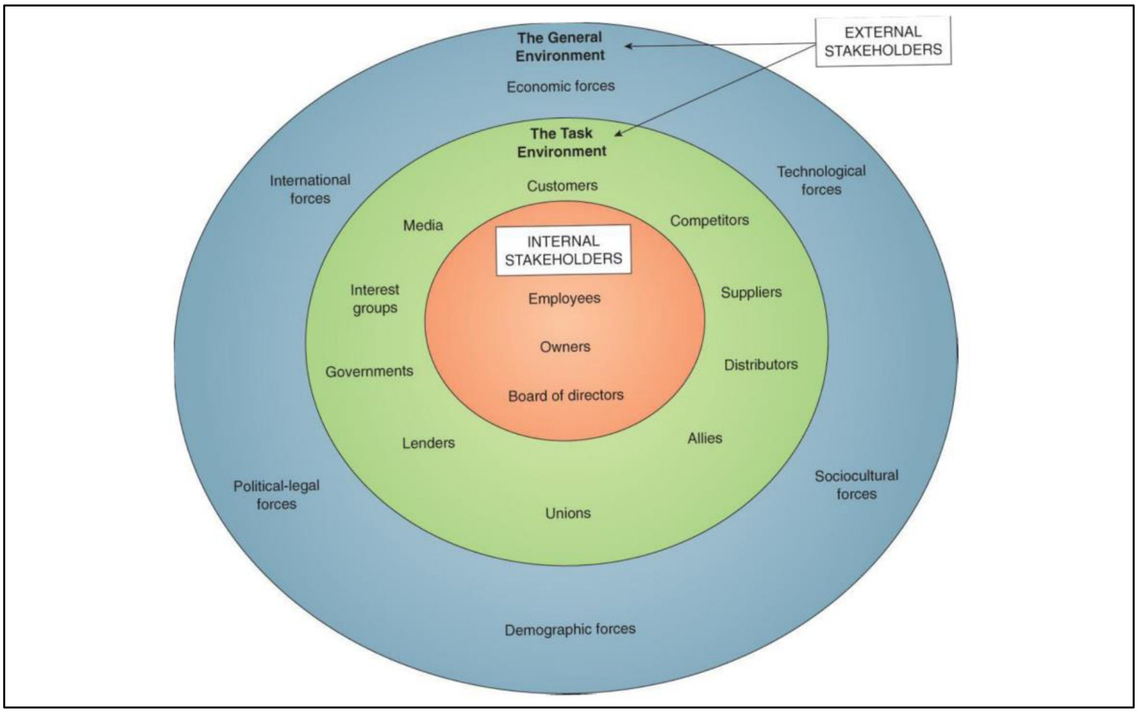
The *azienda* is an **open system** in the sense that it is inserted in an environment with which it interacts constantly.

The system of *azienda* is open because it is made of relations, exchanges with stakeholders. Precisely, the necessity to draw resources from the environmental broad system and the necessity to act in a sustainable way, leads the *azienda* to take into account various stakeholders' interests.

The interaction between internal (shareholders and employees) and external stakeholders (customers, suppliers, lenders and communities) and the azienda consists of a two-ways flow; that is because the azienda needs stakeholders like stakeholders need the azienda.

The external environment can be distinguished in task environment and general environment (Table 20).

Table 20 – *The environment of the firm*



Source: Internet

"The **general environment** is composed of the nonspecific elements of the organization's surroundings that might affect its activities. It consists of five dimensions: economic, technological, sociocultural, political-legal, and international. The effects of these dimensions on the organization are broad and gradual. The **task environment** consists of specific dimensions of the organization's surroundings that are very likely to influence the organization. It also consists of five elements: competitors, customers, suppliers, regulators, and strategic partners. Because these dimensions are associated with specific organizations in the environment, their effects are likely to be more direct and immediate.

The internal environment consists of the organization's owners, board of directors, employees, physical environment, and culture. Owners are those who have property rights claims on the organization. The board of directors, elected by stockholders, is responsible for overseeing a firm's top managers. Individual employees and the Labor unions they sometimes join are other important parts of the internal environment. The physical environment, yet another part of the internal environment, varies greatly across organizations.

Organizations and their environments affect each other in several ways" [22].

Indeed, in "system theory, an open system is a system which continuously interacts with its environment or surroundings. The interaction can take the form of information, energy, or material transfers into or out of the system boundary, depending on the discipline that defines the concept. An open system is contrasted with the concept of an isolated system, which exchanges neither energy, matter, nor information with its environment. Open system is also known as constant volume system and flow system" (Wikipedia).

The *azienda*, by its nature, sees its borders interweave with the macro-environmental system in several circumstances. It would not, albeit with some margin of choice, be able to close itself completely as it is the *openness* that allows the *azienda* to survive and function. Any type of firm needs to take from the environment *inputs* (whether they are machinery, natural resources or labor) to transform into a product or service which will be then returned to the external environment, thus reaching the final consumers in exchange for a compensation accorded by virtue of a proposed new value, which necessarily has to exceed the aggregate of productive factors used. Another interesting aspect that concerns the relationship between the *azienda* and its relative environment, is the fact that the entity is constantly exposed to influences from the outside. Vice versa, we can observe repeated attempts, during the *azienda* life cycle, to try affecting the overlying environment system through the cooptation of key resources for its survival[23]. The relationship between environment and *azienda* turns out to be rather complex, bi-univocal and not expressible as a simple adaptation of the entity to environmental changes (to which it remains, however, inevitably subjected).

This necessary relationship is beneficial for lawful economic activities and constitutes the reason why an *azienda* cannot ignore its *stakeholders* in their entirety, both internal and external to the organization. Indeed, there are many links of different nature that interleave stakeholders between them, as well as interleaving each one with the business entity itself and the environment. It is about bonds which underlie the enterprise, but that are able to condition it under several aspects, influencing the management itself to make a choice rather than another (enter or not into a business, for example).

7.6. *Probabilistic*

[22] http://college.cengage.com/business/griffin/management/7e/students/summaries/ch03.html

[23] The *azienda* seeks to influence the surrounding environment to limit its dependence on the acquisition of resources necessary to its survival (*Theory of the dependence of resources*, by Pfeffer and Salancik, 1978). In fact, the control and the obtainment of resources shapes the effectiveness of the entity that will need to constantly adapt itself to the environment by implementing strategies such as vertical integration or, for example, increasing the number of suppliers for most vital resources.

The *azienda* operates under uncertainty, because of its 'human' complexity (interconnections, internal and external relationships between agents characterized by bounded rationality, needs, impulses and judgments) that makes it unique and not deterministic. This necessarily implies that the *azienda* addresses its problems using a probabilistic approach (Amaduzzi, 1978), running the particular and general *risks* associated, which can be deadly. Among these risks, there is the *economic risk* (Cavalieri, 1995), which arises because the possibility to recover the capital invested in production factors is based on conjectures, and cannot be avoided (just reduced). Moreover, when you consider the physiological rigidity and resistance to changes of the existing organizational structures of the company in relation to the variety and variability of the environment in which it operates (Cavalieri, 1995), it becomes obvious how taking strategic decisions in probabilistically way may lead the *azienda* to bear multiple risks.

The adjective probabilistic is justified by the fact the economic decisions are taken in conditions of uncertainty. The unpredictability of internal and external conditions brings managers to face problems in a probabilistic way.

A very dynamic environment reduces the possibility to predict future events, especially if the organizational structures are rigid and with a certain resistance to change.

7.7. *The conditions to achieve in order to become a system. Differentiate, create an organizational structure, integrate*

After analyzing the representative adjectives of the concept of system, we will examine which are the conditions that allow an *azienda* to tend towards the attribute of system coordination. To become a system, the productive organization should follow these conditions: differentiation, structure and integration.

Differentiate

When the complexity of the system is very high, the first condition is to **differentiate it in a plurality of subsystems** (functions, departments etc.) (Chapter VI, § 4). Only in *aziende* of small dimensions could happen that the economic subject, the owner or the entrepreneur can manage all the activity functions (in that case he has only to integrate functions in the right way). Professor Cafferata stated that in the *azienda* the word should be differentiated in many parts, as much as it is necessary for the transformation of inputs in outputs. The differentiation is rational because it does not correspond to an exaggerate structure, but it represents instead a useful and accurate differentiation for achieving the specific objective.

Create an organizational structure

After differentiation, creating a structure is fundamental to understand what to do within the differentiated system. The most common organizational structures are the simple (Chapter VI, § 4.1), functional (Chapter VI, § 4.2), multidivisional (Chapter VI, § 4.3) and matrix (Chapter VI, § 4.4). It is important to choose the best structure and to adapt it to fit with the *azienda's* unique circumstances. The structure chosen will influence the *azienda's* strategy in the future (Chapter VII). Furthermore an organizational structure is defined as centralized when all decisions are taken by the top positions of the *azienda* (this is the example of the simple structure); when instead the top management only cares about corporate decisions and other important decisions are delegated to participants, the structure is decentralized (this is the example of multidivisional structure). A structure with a wide decentralization could appear lighter and ready to fit environmental changes, but a really good coordination is required.

Integrate

The third condition of being system, is the integration which consists of putting all sub-systems together and orienting them towards the univocal system objective.

While in some *aziende* the integration occurs spontaneously, in others it must be guided. The integration in decentralized structure for example, is obtained thanks to coordination and supervision activities.

8. *Decision-making autonomy*

In economics, the concept of "autonomy" can be referred to various aspects. When it is used as one of the three attributes of the *azienda* it refers to the **decision-making power**.

In particular, the *azienda* should have a decision-making autonomy in the sense that in reaching its objective it is not subjected to the direction of other organizations. In other words the *azienda* must be independent from external dominance.

For instance, if Entity A controls and manages Entity B [24] (i.e. Entity A and Entity B together form a business group, see Chapter V, § 8), thus entity B has not decision-making autonomy, being a sub-system of entity A (Di Carlo et. al, 2015).

More precisely **the *azienda* has a decision-making autonomy when it can autonomously achieve its objective**, i.e. what we will call the "WHY" of the *azienda* (*infra*, § 5). Thus **the WHY can be also assigned by other entities** (e.g. entity A assigns the WHY to Entity B)**, what is relevant is that the *azienda* is autonomous in achieving that objective and that its activity is not related to the activity of other entities** (e.g. entity A has a business related to that of entity B, since the former produces cars while the latter trucks).

Thus, if: 1) the Entity A controls Entity B without manage it; 2) its WHY is different from the Entity B's WHY and; 3) the activity of the Entity A is not related to the activity of the Entity B (e.g. because of Entity A produces cars, while Entity B produces Computers), thus Entity A and Entity B are two autonomous *aziende* even if they belong to the same group.

The decision-making autonomy is also important in terms of legal **responsibility**. Indeed, when an entity is directed by another entity the latter may be responsible for the activity of the former (see Chapter V, § 8.1).

The concept of decision-making autonomy is strongly connected to that of **economic independence**. Some economic entities have durability since they are strongly connected to other entities. It happens for instance when an entity has only one costumer or one supplier. In that case it can be said that the customer or supplier **economically dominates** the entity. Thus the dominated entity cannot be qualified as *azienda*, being a sub-system of the customers or suppliers entity.

[24] For example, the entity A controls entity B since it possess the 100% of its equity.

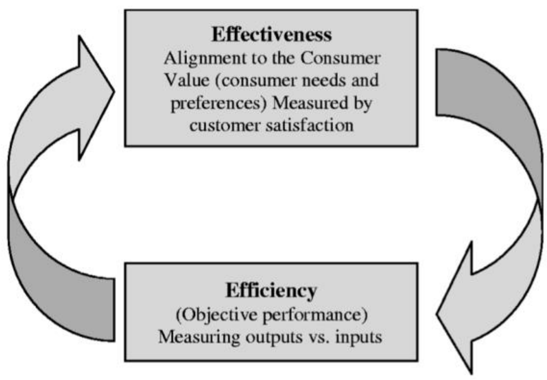
9. *Economicità (effectiveness and efficiency)*

The *economicità* is a **method of action**, a condition of existence and operation that implies that the entire activity of the *azienda* is permanently inspired by the logic of strategic effectiveness and operational efficiency.

The **strategic effectiveness** is the ability of the *azienda* to allocate the available resources to the achievement of winning goals, or, rather, to select useful products to meet and satisfy the overall expectations of the customers/users.

Operational efficiency is the *azienda*'s ability to achieve these productions, due to the levels of quality, reducing the use of available resources.

Table 21 – *Efficiency and effectiveness*



Source: Adapted from Evans and Simons (2000)

The goal can be considered successful when the *azienda* uses the acquired factors from the environment in which it is inserted to create products that meet the customers/users needs.

It follows that, for example, a car company operates with **effectiveness** when it is able to create a model of car (business object) that meets the customer need, allowing the company itself to achieve a **competitive advantage** in the market; the ability to operate effectively can be read through the trend of **revenues** [25]. In other words, ***revenues are the measure of the customers satisfaction***.

A local government (e.g. Municipality of Rome) is effective when it is able to produce services useful for its citizens/users, i.e. services that are both quantitatively and qualitatively satisfactory.

Unlike the firm, however, the ability of the local government to be effective can not be read through the revenues, because the service is transferred to those entitled (the citizens or users), for free or at unprofitable prices (e.g. public-school service, or other services where the so-called ticket is requested). In other words, the product made is not placed to the market, so the price, not being determined by the encounter between supply and demand, it is not representative of the value of the product.

It is necessary, moreover, that the production is carried out **efficiently**, i.e. minimizing, to the extent possible, the use of factors of production (increase the productivity). These

[25] The concepts of revenues and costs will be explained more ahead.

savings should not be achieved at any cost; the *azienda* must, however, be able to secure adequate levels of quality of its product, acceptable working conditions for its employees, as well as responsible behavior towards other stakeholders (e.g. environment and public administrations).

Going back to the previous example, if the car company fails to minimize the production costs it may be forced to sell its products under the production cost and, therefore, not to be able to remunerate the factors of production (e.g. Apple company sells the new IPhone 6 at € 900, having a cost of production equal to € 1.000). The market, in such cases, tends to exclude that organization (since the owners do not obtain profit from the business), if it cannot recover efficiency.

As for the local government, if the goods (or services) rendered, although appreciated by the citizens, have a high cost compared to the usefulness produced, the overall municipality does not create value, but destroys it. For example, if the local government builds a new road at a cost that is ten times higher than it should be if the local government were efficient, even though the need of the citizens has been satisfied (in the sense that the road is useful for the community), the total value of the output produced is far less than that of the input used.

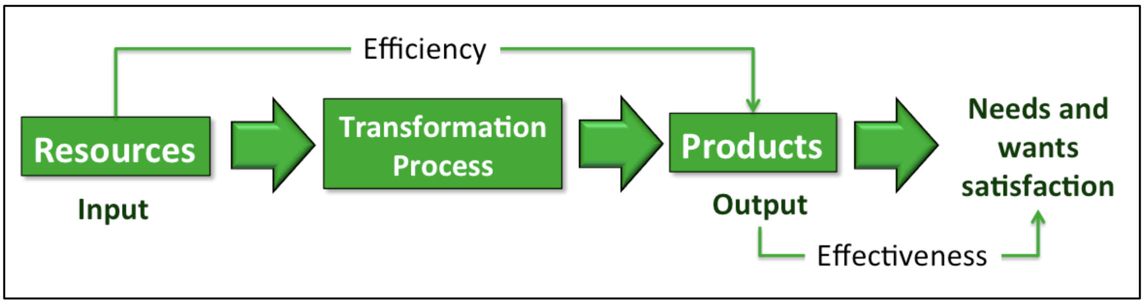
When the *azienda* operates with *economicità*, it sets the stage for its durability, even in the presence of changes in the way it operates. In other words, the tension to the *economicità* is a precondition for the *azienda* durability [26-27].

Summarizing, the *azienda* operates with *economicità* in the sense that the *azienda* should operates with:

– ***Effectiveness***: "Doing the right things", completing activities so that organizational objective (needs satisfaction) is achieved;

– ***Efficiency***: "Doing things right", getting the most output from the least amount of input.

Table 22 – *Input-transformation-output and needs satisfaction*



Source: Our elaboration

[26] «*L'azienda è un istituto economico che trova ragione di vita nella soddisfazione di bisogni umani, in quanto questa soddisfazione esiga consumo di beni economici e quindi anche produzione o acquisizione di questi beni. Nelle aziende si compongono, appunto, in sistema durevole, se pur vivamente dinamico, i processi di produzione o acquisizione e di consumo della ricchezza*»; Onida (1971, p. 39).

«*L'azienda è un fenomeno economico e come tale deve essere considerata. E l'azienda è soprattutto un fenomeno di durevole economicità*»; Giannessi (1960, Prefazione, p. XIV).

[27] «[…] *fondamento dell'azienda – scrive Bertini – è l'economicità, senza la quale vengono meno gli stessi presupposti della sua esistenza. Mediante l'economicità l'azienda è in grado di soddisfare non soltanto le proprie esigenze generali e particolari, ma anche qualsiasi altro tipo di esigenza: sociale, politica, umanitaria, assistenziale, sportiva, religiosa, familiare, sanitaria, culturale, individuale, etica, ecc.*»; Bertini (2006, p. 35).

Assignment 7 – The attribute of Economicità (effectiveness and efficiency)

In order to increase the effectiveness and efficiency, organizations are adopting the so called "digital transformation" of their business models. **«Digital transformation** is the integration of **digital** technology into all areas of a business, fundamentally changing how you operate and deliver value to customers. It's also a cultural change that requires organizations to continually challenge the status quo, experiment, and get comfortable with failure» [28].

YouTube 9 – *Digital transformation*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	What is Digital Transformation	00:04:42	Study

9.1. *The link between the* economicità *and the objective of the* azienda

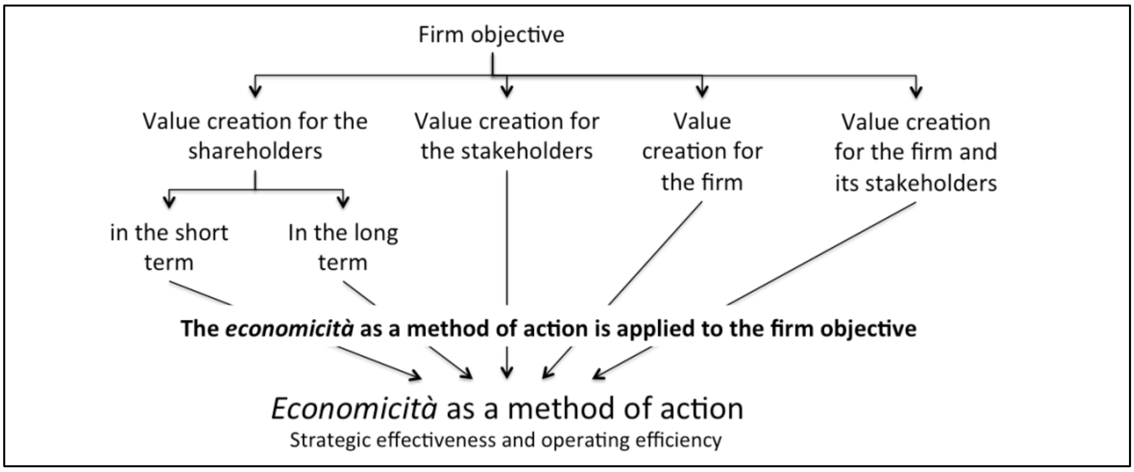
The identification of the purpose (or objective) of the *azienda* is a precondition of the *economicità*, in particular of the strategic effectiveness. Only after establishing the purpose, the *azienda* is able to elaborate a series of interim goals to be achieved.

Managers do not have the tools to set goals to be pursued when the purpose of the *azienda* is not clear, or when the company has more than one purpose.

As shown in Table 23, taking as a guideline the strategic effectiveness and operational efficiency (i.e. the *economicità*), the purpose of the firm allow the manager to decide what is right to do, even in case of inter-temporal choices, i.e. when the choices of today will affect the future, not always easily predictable (e.g. investments in research and development). Therefore, the result of the *economicità* is the achievement of the purpose of the *azienda*. While some *aziende* have only economic objectives (for example the creation of shareholder value in the short term), others look also for non-economic objectives (e.g. the creation of value for stakeholders).

[28] Source: https://enterprisersproject.com/what-is-digital-transformation

Table 23 – *Relationship between economicità and objective (or purpose) of the firm*



Source: Our elaboration

Corporate scandals involving major companies have been determined, in some cases, from the pursuit of wrong purposes (e.g. Lehman Brothers, Enron, Worldcom). In these cases, the tension toward the *economicità* led to inevitable disasters. It follows that the conduction of the firm with *economicità* does not guarantee its durability when it is applied to an inadequate objective (i.e. the maximization of profit at all costs).

Two managers, both acting with *economicità*, faced with the same problem can get to different choices because of the different purpose that characterizes their decision-making process. If a manager has the objective to maximize profits in the short term, while the other the survival and future growth of the firm, in having to decide whether to support the costs of research and development of a product to be launched in the following years, the first decides to abandon the investment unlike the second which will instead be interested in accepting it.

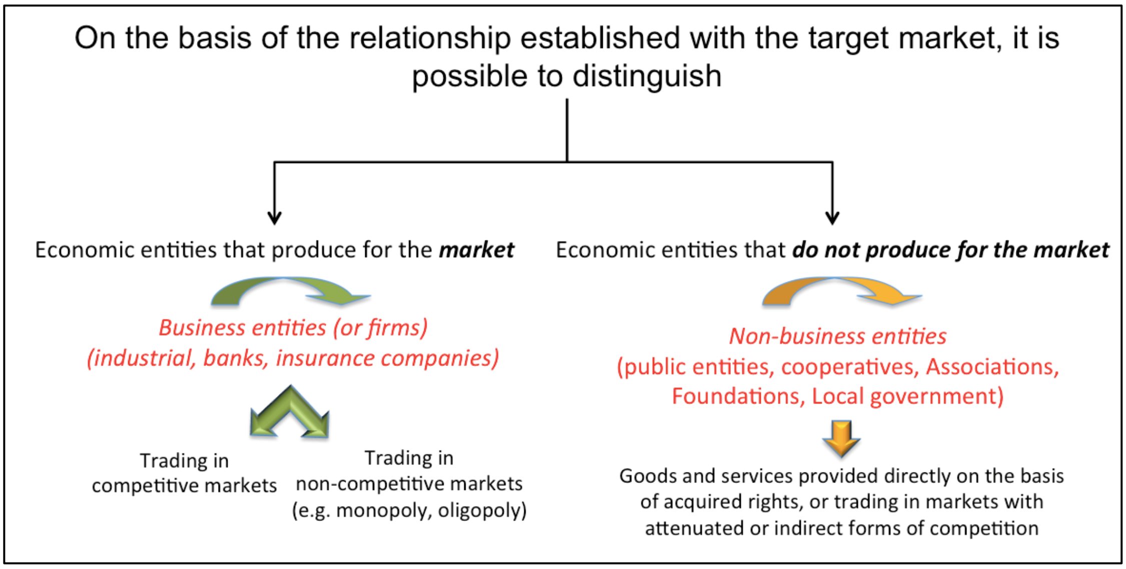
In the choice between fire or maintain ten employees, given the difficult economic situation of the company, the manager oriented to **maintain the workplace** may, with this choice, jeopardize the firm continuity and thus injure the interest of a wider range of employees.

If, instead, the goal is to ensure the **survival and growth of the company**, the lay off becomes the only possible option. Clearly it is impossible to make a decision when the manager is asked to simultaneously maximize two purposes, keep the workplace and at the same time ensure business continuity.

10. *The classification of the economic entities: business entities and non-business entities*

Italian scholars classify the *aziende* in different ways. Following Cavalieri (1999) here the *aziende* are distinguished in two categories (Table 24): the economic entities that produce for the market, i.e. the *business entities*, and the economic entities that do not produce for the market, i.e. the *non-business entities*. This classification is based on the *relationship established with the target market.*

Table 24 – *Classification of the aziende based on the relationship established with the target market*



Source: Our elaboration

While **business entities** (in Italian, *imprese*) operate in the market both when they purchase the factors of production (the input) and when they sell the products made (the output) (see also Chapter II, § 5), the **non-business entities** operate in situations in which the market is absent or limited in the acquisition of the input and/or in the placement of the output (see also Chapter II, § 7). In turn, non-business entities can be split in two categories: 1) public administrations (i.e. public entities, local government); 2) non-profit entities (associations and foundations).

Hereinafter, we use the terms "**firm**", "**enterprise**", "**corporation**" and "**company**" as a **synonymous of business entity**. Business entities may be partially or fully controlled by the State (e.g. in Italy, ACEA and Poste Italiane; Lenovo in China) or by private institutions or individuals (e.g. families controlled firms such as FCA controlled by Agnelli family and Porch controlled by Porch family).

Thus, the difference between business entities and non-business entities does not follow the classification, often used by scholars, which considers the former as entities that operate for-profit (for-profit organizations) and the latter for other purposes (non-for-profit organizations).

In our approach, **the profit is not the objective of the business entity but the condition to be met to ensure the continuity of the business**, as well as **the scope of the business entity founder** (or of the actual controlling party), the reason for which he/she strives to meet human needs.

However, business entities and non-business entities can be distinguished looking at their specific condition of survival and growth. The former must **create sustainable profit** while the latter **sustainable value in use**.

According to the classification proposed, all economic entities produce (in the economic sense) to satisfy human needs (Cavalieri, 1999, p. 118; Coda, 2006, p. 11; De Dominicis, 1958, p. 114; Farnsworth, 1999, p. 352; Sidrea, 2008). This approach is based on a broad concept of production that is separated from the fact that the production is fulfilled for the exchange on the market. Therefore, even economic entities that do not exchange on the market but give the goods and/or services to the users, sometimes for free, are considered as productive economic entities.

This approach allows, on the one hand, to interpret the economic activity of all the *aziende* as a phenomenon of production, while on the other hand, to overcome also the traditional distinction between **producing economic entities** (in Italian, *aziende di produzione*) and **consuming economic entities** (in Italian, *aziende di erogazione*), in relation to the prevalence of the activity performed. Moreover, seeing the production process also in the non-business entities allows considering the attribute the *economicità* also for them. Indeed, also the non-business entities must be managed with strategic effectiveness and operational efficiency.

This is the reason why, instead of distinguishing the **producing economic entities** from the **consuming economic entities**, we distinguish economic entities that produce for the market from those that do not produce for the market. In this regard, according to Coda "all *aziende* - whether business or government or non-profit companies - perform a function of production (goods or services) to the satisfaction of certain needs" (Sidrea, 2006, p. 11).

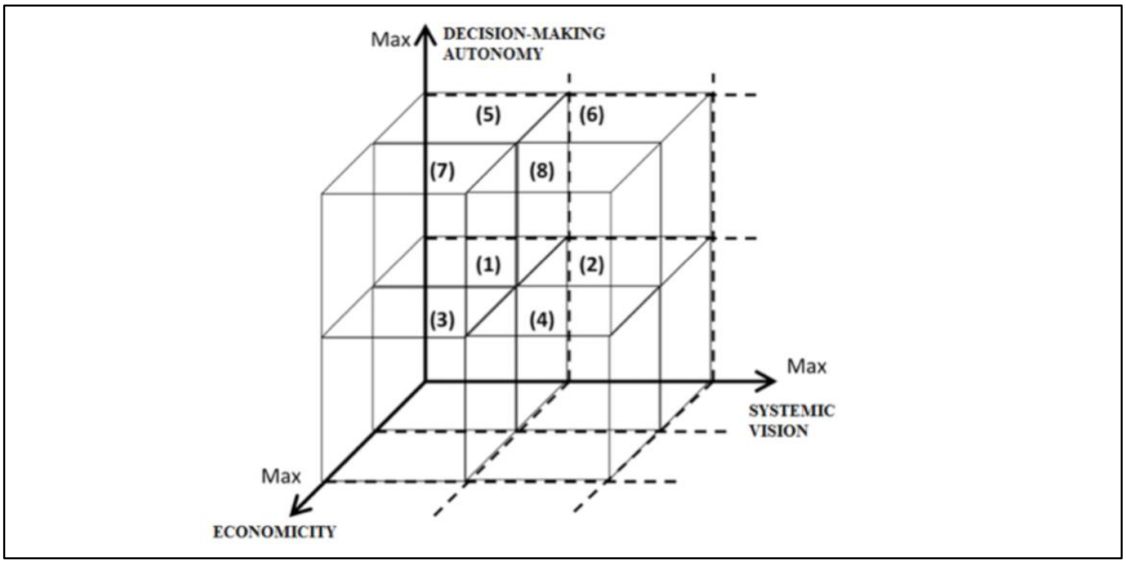
11. *The degree of aziendality*

Basing on the *aziendality* criteria description proposed in the previous paragraph, it is possible to say that these *criteria* may appear within an economic entity in different degrees. In particular, as we pointed out before, the *systemic view* and the *decision-making autonomy* criteria play a predominant role in the definition of the *azienda*'s boundaries while the *economicity,* however, remains a necessary condition for its existence in time.

In a hypotetic linear relationship between different criminal economic entities we put on one side firms that does not qualify as *systems*, operating in total absence of *economicity* and not being autonomous at all, while on the other side of the line we have the organizations who own *systemic view*, full *decision-making autonomy* and exercising their activity with *operating efficiency* and *strategic effectiveness*. In the middle there are all those economic entities, non-profit and for-profit, showing the three *aziendality* characters in different proportions and gradation.

With the afore mentioned principle in mind, it is possible to build the Table 25, where eight block are easily distinguishable. The closer to the axes origin the lower the degree of presence of the associated criterion is. We can place the perfect *aziendas* in the cube 8 while mere economic entities, with no aziendality at all, in the cube number 1.

Table 25 – *The degree of aziendality*



Except for these two extremes (1 and 8), we identify two other categories of entities:

Transitional entities (cubes 4, 6, 7): these entities present a satisfactory degree of two criteria out of three but, though they may differ a lot basing on the couple of criteria possessed, transitional entities are very close to the maximum aziendality degree, hence can be considered near to be aziende. The "transitional" adjective is in fact due to the likelihood that these firms are about to reach, with the necessary ownership's willpower, the status of azienda in the near future. Pursuing the missing criteria is, in these entities, sought after by top management in a professional and strategical way, since the efforts and achievement of all them cannot be a consequence of simple contingencies.

Incomplete entities (cubes 2, 3, 5): having just one criterion out of three sufficiently developed, these entities are far from being considered an azienda. Whatever criteria they present, its development may have originated by chance, luck or the nature of the business itself. Criterion development cannot be ascribable to any kind of business strategy. Incomplete entities are likely to be aware of their status and often unwilling to seek for aziendality to improve their position in the society. It is very unlikely for these activities to remain in the same business for a long time or create sustainable value for customers.

REVIEW QUESTIONS

Following, the review questions for this Chapter.

Open-ended questions

1) What is the difference between needs and wants?
2) Summarize the content of the YouTube video "Resources and their scarcity"
3) What is the general definition of organization?
4) What is the definition of *azienda*?
5) Why does the doctrine of *Economia Aziendale* is relevant for a course of Fundamentals of Business?
6) Why does the term *Economia Aziendale* has not been translated into English?

7) Describe the concept of Economicità using an example
8) Who are the stakeholders of the economic entity?
9) What are the employees' expectations?

Multiple choice

10) Public Authorities are:
    - Primary stakeholders
    - Secondary stakeholders
    - Both primary and secondary
    - Not stakeholders

CHAPTER TWO

PRIMARY INTEREST OF THE *AZIENDA* (BUSINESS AND NON-BUSINESS ENTITIES) [1]

1. *Objectives and Assignments of this chapter*

After reading this chapter, you will be able to:

- Elaborate the WHY, HOW and WHAT the *azienda* [2] produces;
- Describe FOR WHOM, HOW and IN WHAT TIME the *azienda* should create value;
- Elaborate the mission of any type of *azienda* using the primary interest framework;
- Conduct the activity of the *azienda* towards the common good of the society;
- Understand how to ensure the survival and growth of the business;
- Define the role of profit in society.

Following the Assignments of this chapter:

Assignment 8 – The useless entities

Assignment 9 – The British Petroleum case

Assignment 10 – The motivations under the Fundamentals of Business website

Assignment 11 – The Why, How and What

Assignment 12 – The objective of your private hospital

Assignment 13 – Unsustainable firms

Assignment 14 – The non-business entities

The contents of this chapter allow you to do the following Project Work:

Project Work – *Part II* – Design the mission statement of your business

---

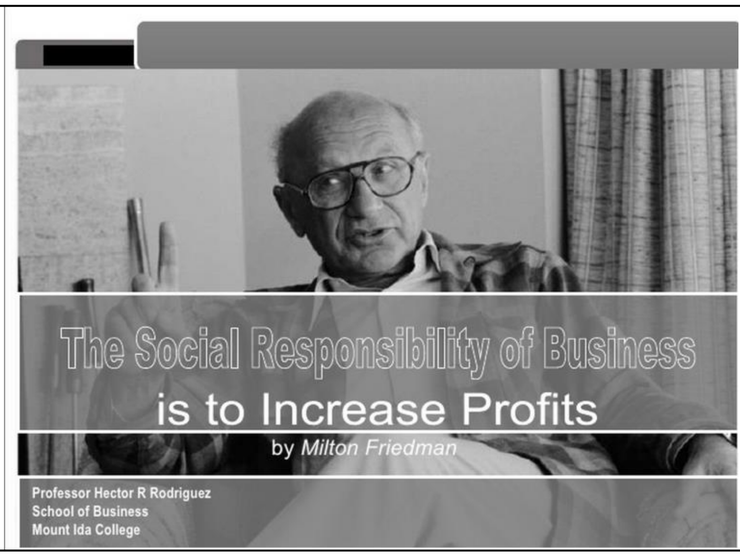
[1] This chapter is an adapted and short version of the unpublished article titled '*The primary interest of the* azienda *common good as a principle of good governance*', presented during the AIDEA congress on "Sviluppo, sostenibilità e competitività delle aziende: Il contributo degli economisti aziendali" (11th September 2015).

[2] The *azienda* is an organization (business or non-business entity) with three attributes (Chapter I, § 6): Systemic vision, Decision making autonomy; Economicità.

2. *Primary interest of the "*azienda*": satisfying human needs and create sustainable value*

After outlining, in the previous chapter, the three attributes that allow identifying the boundaries of the "*azienda*", the choice on what should be the *azienda*'s objective must be made considering what is the effect of its finalism on solving the economic problem and, therefore, on the effect on the development of the community well-being. For example, one of the most known debates on corporate objective is that between **shareholder theory** and **stakeholder theory**. For the former the firm should create value for the shareholder while for the latter this logic could be detrimental for the firm and the other stakeholders (remember that shareholders are stakeholder); thus, the firm should create value for all its stakeholders.

Table 26 – *Milton Friedman's idea*



Source: Internet

YouTube 10 – *Milton Friedman and the profit*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Milton Friedman on Self-Interest and the Profit Motive 1of2	00:05:25	Study

YouTube 11 – *Stakeholder theory*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	What is Stakeholder Theory? - R. Edward Freeman	00:02:58	Study

The supporters of the shareholder theory state that telling a manager to maximize the value of all the stakeholders will leave that manager with no "way to make a reasoned decision. In effect, it leaves the manager with no objective. The result will be confusion and a lack of purpose that will handicap the firm in its competition for survival" (Jensen, 2001).

In this regard, Keay pointed out: "all significant activity requires an objective, and the work of a company is no different. It has been said that a company is an entity whose 'defining characteristic is the attainment of a specific goal or purpose,' but the problem is that there is little agreement on what that goal or purpose should be" (2008). Moreover, "establishing the objective of the company is critical. First, it provides some guidance for directors in the carrying out of their functions. Secondly, it enables us to assess whether directors have done what they should have done. Thirdly, it helps us to formulate corporate governance mechanisms".

The importance of the *azienda*'s objective was also evident when it was defined the attribute of the systemic coordination (Chapter I, § 7), as it is said that *the "azienda" is a finalistic system*, in the sense that it is aimed at achieving a specific goal, or objective. Moreover, the *azienda* should have a decision-making autonomy in achieving its objective, and the objective is a precondition of the *economicità*, in particular of the strategic effectiveness (Chapter I, § 9.1). Indeed, the objective allows to elaborate a series of interim goals to be achieved.

The choice of a single objective for all *aziende*, that is valid regardless of the context and time, cultural and regulatory system in which the *aziende* operate, should be guided, *inter alia*, by the **effect that this objective has on the *azienda* continuity** and on the **resolution of the so-called economic problem** (Chapter I, § 2), i.e. the ability to meet - in a sustainable way, - unlimited needs in the presence of scarce resources. This aspect is particularly relevant considering the global financial crisis started in 2007, which saw its genesis in the lack of ethics in financial market as well as in the purpose of the corporations mainly focused on the profit maximization in the short-term (Kemper and Martin, 2010; Lazonick, 2011; Zamagni, 2009).

Moreover, whereas in the past it was common ground to say that the company was instrumental to satisfy the needs of capital and Labor (Masini, 1974), today the end of the company must take into account also other *stakeholders* (eg. customers, suppliers, community, environment) that contribute to the production process and/or that are affected by the economic activity of the *azienda*.

Using that approach the *azienda* can be seen not only as a **common good** of capital and Labor (Argandoña, 1998; Cassandro, 1978), but also as a cell, a common good, of the economic system that contributes to the human well-being. Indeed, there cannot be the growth of the national economy without the growth of the singular cells, the *aziende*, where national wealth is concretely created (Amaduzzi, 1978, p. 19; Cassandro, 1969).

Today it is evident that the sustainable growth of the economy derives from the "sustainable growth of the *aziende* that can promote, slowed down or prevent the economic growth" (Cavalieri, 2010, pp. 10-11). This approach broadens the range of responsibilities, in the sense that the irresponsible behaviour (or unsustainable) of the *azienda* is determined not only by those who govern and manage it, but also by the irresponsible behavior of the customers / users, funders, citizens, politicians and so on.

According to what was theorized by distinguished scholars of Italian *Economia Aziendale*, **the general purpose of all *aziende*** (i.e. for both business and non-business entities) **is to satisfy human needs, through the production of goods and services** (i.e. products) (Amaduzzi, 1978, p. 19; Ferrero, 1968, pp. 3-4; Onida, 1971, p. 3; Zappa, 1957, p. 37) [3].

---

[3] «*L'azienda è un istituto economico destinato a perdurare che, per il* soddisfacimento dei bisogni umani*, ordina e svolge in continua coordinazione la produzione, o il procacciamento e il consumo della ricchezza*»; Zappa (1957, p. 37).

«*l'azienda esplica una funzione strumentale rispetto alle finalità che dati soggetti – uomini e istituzioni – perseguono e che attengono al* soddisfacimento di tali bisogni»; Ferrero (1968, pp. 3-4).

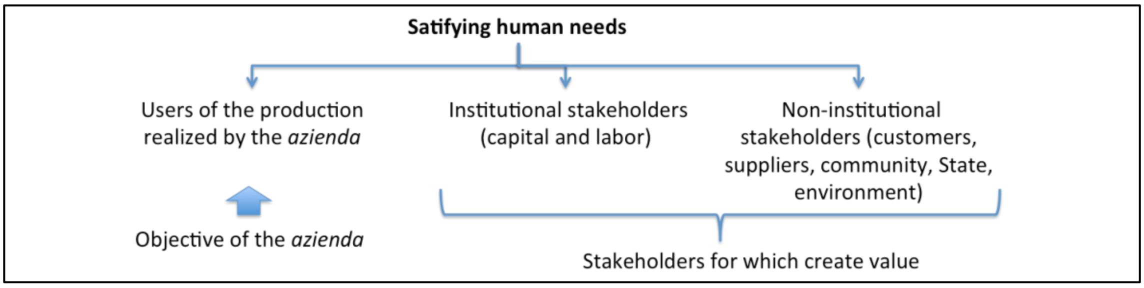
For instance, consider the need for health, satisfied by the pharmaceutical companies through the production of drugs and by other organizations (public and private) that provide health care services (e.g. a hospital); the need to move and travel, satisfied by organizations that produce vehicles or transportation services, the need to communicate, satisfied, among others, by Information and Communication Technology organizations.

The needs to be met can be divided into two categories (Table 27): those of the recipients (customers and users) of products produced by the economic activity and those of the individuals participating to this activity (i.e. stakeholders). The latter can be classified in **institutional stakeholders** (capital and Labor) and **non-institutional stakeholders** (eg. customers, suppliers, State).

The objective of the *azienda* is here referred only to costumers / users. In this case the product of the *azienda* is an input (i.e. a factor of production) for other *aziende*.

According to Cassandro, with regard to the business entities, "limiting the objective of the company to the profit maximization will diminish the fundamental economic and social functions of the company. The most important ones are to create new wealth for the community and distribute it among those who contribute to the production of that new wealth" (Cassandro, 1969).

Table 27 – *Classify the satisfaction of human needs*



Source: Our Elaboration

Some scholars, especially who see the business entity (i.e. the firm) as a common good, are aligned with this approach. For instance, Koslowski states "The necessary condition for the existence of the firm and the main purpose for which firms come into being is the production of products, not the production of profits or shareholder values" (2000, p. 38). Moreover Argadona (1998, p. 1097) points out that "When we make the distinction between shareholders, on the one hand, and employees and workers, on the other, we are suggesting that what each of these groups expects from the company may be something different. The shareholders may be looking for sustained profitability, limited risk, business opportunities, etc. The workers, managers and employees may be looking for decent remuneration, steady employment, career opportunities, recognition of their worth, a chance to improve their professional qualifications, cover against ill health or old age, and much more besides. Whatever their personal interests, they must all contribute to the company's goals, in other words, to

«*Le aziende sono ordinate a fini concernenti la* soddisfazione di bisogni umani»; Onida (1971, p. 3).

«*istituto economico unitario e duraturo, costituito da un complesso di persone e di beni economici e diretto al* soddisfacimento dei bisogni umani»; Amodeo (1964, p. 12).

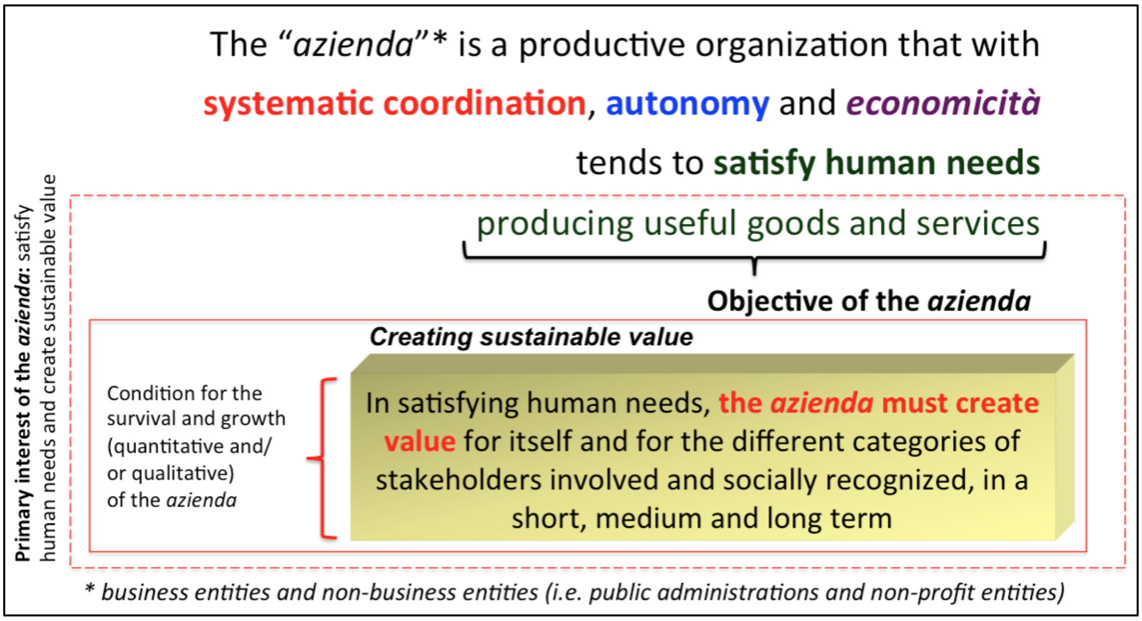
«*l'azienda costituisce un'organizzazione di beni (persone e cose materiali) che svolge una determinata attività umana, in vista di uno o più* bisogni da soddisfare»; De Dominicis (1966, p. 43).

its common good, which will consist in ***producing useful goods and services, and producing them efficiently (so as to create wealth) and sustainably, so as to guarantee the conditions in which each participant receives from the company what he or she can reasonably expect***".

For the *Economia Aziendale* the satisfaction of human needs is the objective of all *aziende* (business entities and non-business entities). In this regards Coda, a distinguished *economista d'azienda*, points out that "any productive institution - be it a business or non-profit organization or a local government - exists to deploy its mission, consisting in the production of goods or services intended to meet specific needs, in compliance with certain rules of the game. It follows that, if the production mission becomes blurred and there are less attention and dedication required for its full realization, it opens the way to **a crisis of lack of sense**" (2010, p. 25).

The definition of *azienda* proposed in Table 28 underlines four main elements: 1) the fact that the *azienda* is an organization that possess three specific attributes (Chapter I, § 6); 2) the production of goods and services (*what and how produce*) through the economic activity; 3) the needs to be satisfied (*the why produce*, i.e. the objective); 4) the condition for the survival and growth of the *azienda* (*infra*, § 3.1).

Table 28 – *Definition of* azienda and *its primary interest*

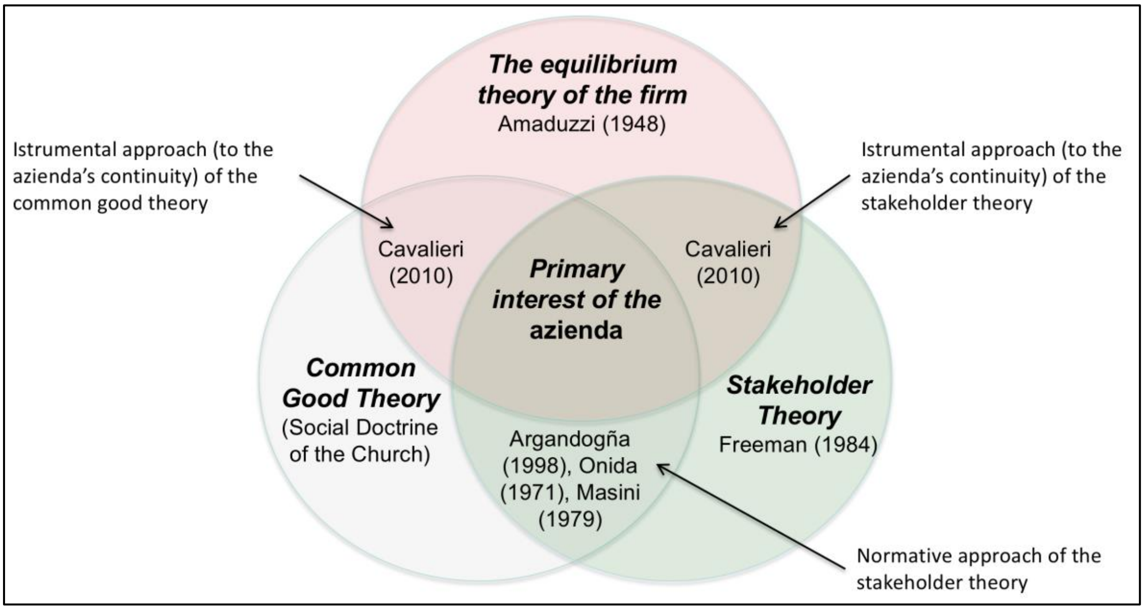


Source: Our elaboration

Our purpose derives from the intersection of three theories: the theory of equilibrium (from the Italian doctrine *Economia Aziendale*), stakeholder theory and common good theory (from the Social Doctrine of the Church).

The three theories, individually, present all the advantages and limitations regarding the conditions for the survival and growth of the *azienda*. However, the limitations of one or more theories are compensated by the advantages of the others. The intersection finds a simultaneous equilibrium among various dimensions of responsibilities of the azienda.

Table 29 – *Theoretical foundation of the primary interest of the firm*



Source: Our elaboration

As pointed out by distinguished scholars of *Economia Aziendale*, **the general objective of all *aziende* is to meet human needs through the production of goods and/or services** [4].

In this sense, the object – i.e. the type of economic activity – expresses "***what** the* azienda *makes*", what kind of goods and/or services it produces, while the *azienda*'s objective indicates "***why** it produces its products*", then what kind of needs are met.

It should be noted that as of now **the objective (the purpose) of the *azienda* wants to be distinguished from the scope of the individual or group of people that establish the *azienda*** (e.g. the entrepreneur, the owner, the founder of the *azienda*), as well as from the scope of all of the other stakeholders that participate in various ways to the economic activity (e.g. employees, lenders, suppliers). As stated before, the *azienda* cannot be identified with the owners, the capital, the assets, the people taking part in it or with the contracts or the relationships among its components, but rather it is an autonomous system and real entity composed of all these elements and the relationships among them (Chapter I, § 7).

The **purpose of those who decide to establish the *azienda*** becomes important to understand **why the *azienda* meets certain needs**: while in some cases it is the profit (special interest of the owner) to fuel the interest of such person, in other *aziende* is, for example, a philanthropic interest (e.g., in certain foundations or associations).

[4] «*L'azienda è un istituto economico destinato a perdurare che, per il* soddisfacimento dei bisogni umani*, ordina e svolge in continua coordinazione la produzione, o il procacciamento e il consumo della ricchezza*»; Zappa (1957, p. 37).

«*l'azienda esplica una funzione strumentale rispetto alle finalità che dati soggetti – uomini e istituzioni – perseguono e che attengono al* soddisfacimento di tali bisogni»; Ferrero (1968, pp. 3-4).

«*Le aziende sono ordinate a fini concernenti la* soddisfazione di bisogni umani»; Onida (1971, p. 3).

«*istituto economico unitario e duraturo, costituito da un complesso di persone e di beni economici e diretto al* soddisfacimento dei bisogni umani»; Amodeo (1964, p. 12).

«*l'azienda costituisce un'organizzazione di beni (persone e cose materiali) che svolge una determinata attività umana, in vista di uno o più* bisogni da soddisfare»; De Dominicis (1966, p. 43).

As stated by Koslowski (2000, p. 139) "If the purpose of the firm, the production of optimal products, can best be achieved by market efficiency and shareholder value maximization, they are the best means to achieve this goal. If it can be achieved by other means or be achieved by other means even better, these means must be chosen".

According to Adam Smith, with specific reference to the business entities, "**It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest**" (i.e. the interest to the profit)". Thus, the butcher, the brewer and the baker want to satisfy the needs of their clients because they can earn profit from those activities, and through this profit they can buy goods and services to satisfy their personal needs. In this sense, **the profit could be considered as the financial result of the needs satisfaction**. If business entities satisfy human needs in a productive and efficient way they will earn profit. Thus, for business entities the profit can be considered as control principle.

However, if the potential users of the products of the butcher, the brewer, or the baker, cannot afford economically those products, the only way to satisfy the needs of the former is to have non-for profit organizations.

In addition to "*what and why produce*", economic entities normally indicate in their mission statement "*how*" a certain goods and/or service is produced, i.e. what are the elements of their **business model** (e.g. Peugeot and Ferrari both produce cars but the needs they want satisfy is completely different, so the how they make cars is different) (see, Chapter I, § 3.4, Table 10).

Moreover, it is usually **the *why* to determine how a good and/or service should be made**.

Both the "*what*" and "*why*" can change over time, for example because of the customers/users needs change constantly. This inevitably leads to changes in "how" economic entities produce. For example, a company that operates in the luxury sector may decide to serve a greater number of customers by selling lower quality products at a cheaper price, changing its "why". This new orientation inevitably changes the how to produce.

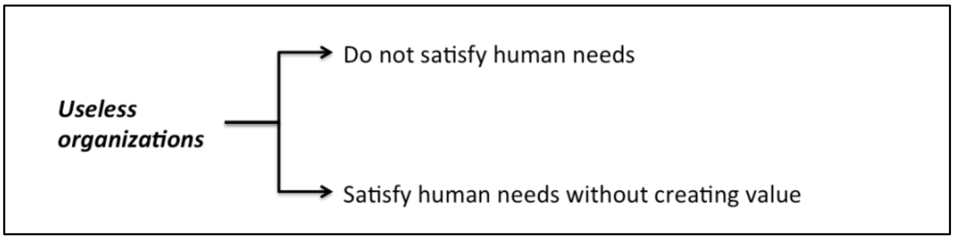
Why, what and how to produce constitute the most important aspect of **strategic effectiveness** with which the economic entity must conduct its economic activity. It should be noted that the strategic effectiveness, together with the operational efficiency, are the two elements that underpin the attribute of the *economicità* (Chapter I, § 9).

No *azienda* should be established if there are no needs to be met. Useless organizations make goods or services that nobody needs or wants.

This consideration is not trivial if we consider those useless entities sometimes established with the sole purpose of allowing certain individuals to extract private benefits. For the governance body of these entities, explaining the motivations, the interest for which a certain activity is performed is undoubtedly a way to regulate potential conflicts of interest.

It is also useless the organization that satisfies the needs of customers / users without operating with *economicità*. Operate without *economicità* means waste resources and thus do not resolve the economic problem, i.e. the organization satisfies human needs destroying value.

Table 30 – *Useless organizations*



Source: our elaboration

The durability of useless organizations is more common in public administration (they are only a cost for the community), since for organizations that operate in the market (i.e. the business entities) the impossibility to earn profit conduct these entities towards the end.

However, **the first problem of the governance body is to establish useful organization**.

Assignment 8 – The useless entities

3. *Value creation as a condition for the survival and growth (quantitative and/or qualitative) of the* azienda

In meeting human needs, the *azienda* must achieve a **condition of survival and growth** (quantitative and/or qualitative), summarized by the term "**value creation**" (Table 28). This is the condition (not the purpose of the *azienda*) under which the *azienda* should satisfy human needs. In other words, using the proposed approach **it is wrong to say that the purpose of the firm is to create value**.

The condition of survival and growth implies that "the value of the resources consumed to make and distribute the product is systematically lower than the value of production, to be placed on the market or to assign to the users" (Cavalieri, 2012, p. 12). Thus, the value creation is referred to the typical input-transformation-output process.

The condition of value creation that all *aziende* in satisfying human needs should meet can be summarized as indicated in Table 31 (Cavalieri and Ferraris Franceschi, 2008, p. 218).

Table 31 – *Condition of economic value creation applicable to any* azienda

$$\sum_{t=t_0}^{t_z} \mathrm{vp}^{\mathrm{t}} = v + \sum_{t=t_0}^{t_z} \mathrm{vf}^{\mathrm{t}}$$

where:

vp^t	= value of production (output) over time;
vf^t	= value of input (factors of production) consumed to enable the production (realized in the time frame of reference);
v	= new value created by the *azienda*'s activity;
t_0-t_z	= entire lifetime of the *azienda*, tending to infinity

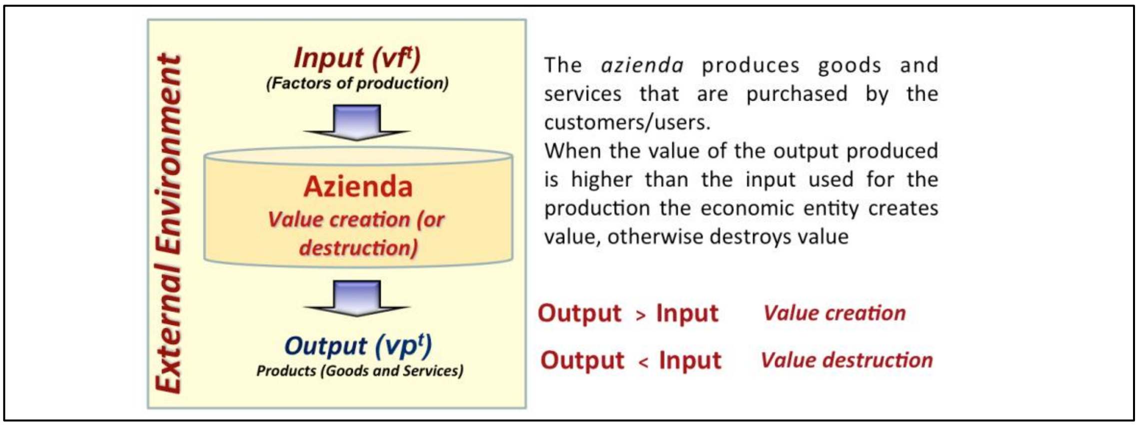
Source: Cavalieri and Ferraris Franceschi (2008, p. 218)

Therefore, in order to operate durably in the environment, the *azienda* must act with *economicità* (Chapter I, § 9), which requires that the utility generated (i.e. the economic value of the production to be sell on the market or assign to the users - vp^t) is systematically (in the short and long term) higher than utility consumed (i.e. the value of input that are consumed in the production process - vf^f); the difference is the value created by the economic activity (v).

The condition of economic value creation (or economic equilibrium) shown in Table 31 must be achieved by all *aziende*, in the sense that, for example, the value created (v) is given: in a business entity, from a satisfactory profit; in cooperatives, from the achievement of the mutual objectives; in a local government, from the fulfilment of the citizens expectations.

Thus, as shown in Table 32 the economic entity could satisfy human needs creating and destroying value. This happens for instance when the entity does not operate with efficiency.

Table 32 – *Satisfy human needs creating value and destroying value*



Source: Our elaboration

One of the main problems with the value creation condition is the measurement of that value, especially for non-business entities, because of the total or partial absence of the markets in the acquisitions of the factors of production or in the placement of the products.

Indeed, since business entities (Chapter I, § 10) operate on the market, the value of productive inputs (vf^f) is calculated multiplying the purchase price with the amount of inputs acquired (costs), while that of the output multiplying the price of sale with the amount of products sold (revenues) (vp^t). The difference between revenues and costs marks the height of income; positive if revenues exceed costs, conversely assumes a negative value.

It follows a central aspect that leads to distinguish the business entities from the non-business entities, i.e. the possibility to verify if the *azienda* is run with *economicità* using its financial results (for example, the operating profit, the revenue growth, return on investment). Moreover, for business entities meeting human needs is a necessary condition for the survival and growth, not being able to achieve their durability through the support of third economies. In other terms, the profit is not the objective of the business entity, which remains the satisfaction of human ne

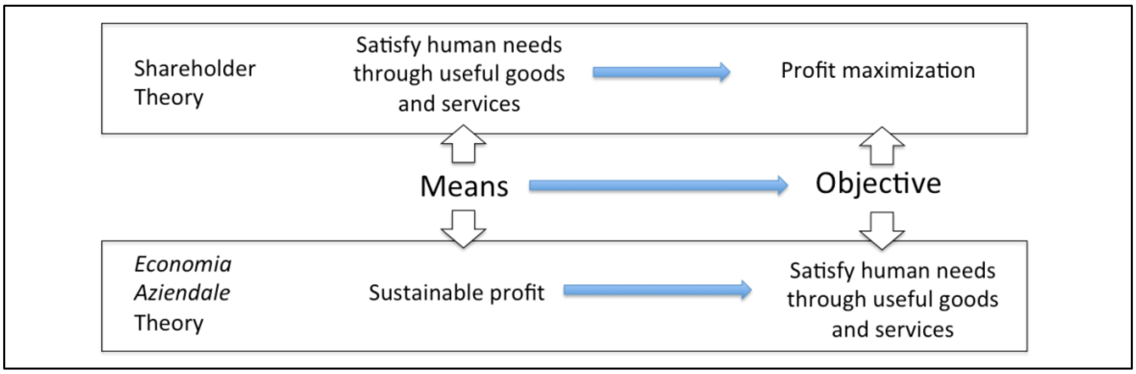
eds, but a condition that makes possible to satisfy those needs.

Therefore, profit and objective should not be confused, it would be like saying, because I need to work for living, the end of my life is to work. In this regard, it was noted that 'profits and purpose are two different ideas, and collapsing them is like concluding from the fact that I need red blood cells to live, that the purpose of my life is to make red blood cells'

(Agle et al., 2008, p. 166). 'The profit, even if it were, at best, the only stimulus for private initiative [...] could never constitute the end of the business entity' (Ferrero, 1968, pp. 30-31).

"Profits are like breathing. If you can't breathe, you can forget everything else that you're doing because you're not going to be around much longer" (Robert Mercer, Chairman and CEO of Goodyear Tyre and Rubber). "It's hard for me even to think about what we do that's purely for profit, because the concept at J&J is so out moded" (David Collins, former Vice Chairman of Johnson & Johnson). "Profits are one effective way to measure past performance, but they don't drive the enterprise. I think it's a great way to keep score, but I don't think it's the principal motivation" (Phillip Lippincott, Chairman and CEO of Scott Paper). "Profits are not the reason for the existence of a business. This is not to say that profits are unimportant or can be neglected" (John Bryan, Jr., Chairman and CEO of Sara Lee).

Table 33 – *Profits as a means or objective of the firm*



Source: Our elaboration

Moreover, in the case of the output is higher than the input it is necessary specifying what should be the satisfactory level of "v" (value created), and to whom this value is distributed. Sometime, who get the "v" may be not satisfied of the level of "v".

3.1. *The need to specify the value creation condition. The primary interest of the* azienda

As already observed, Cavalieri argues that "talk of creating value without any clarification is meaningless. We must, in fact, ask for whom, by what time references and how (and, that is, under what conditions) the company must create value" (2010, p. 25).

The answer to this question wants to be found in the proposal of Sidrea (*Società Italiana dei Docenti di Ragioneria ed Economia Aziendale*) that suggests that the *azienda* must create value for "***itself and for the different categories of stakeholders involved and socially recognized, in a long and short-term***" (Sidrea, 2008; Cavalieri 2012, p. 12).

However, differently from Sidrea, here the value creation condition is not considered as the objective of the *azienda*, but as the condition to be met to achieve its objective (i.e. the satisfaction of human needs) and to ensure the durability of the *azienda* that is sustainable, over time, economically, socially and environmentally.

Such choice (i.e. put the need satisfaction as the purpose of the *azienda* and the value creation as the condition, the means to achieve that purpose) is based, *inter alia*, by the following reasons:

a) **The concept of 'meeting needs' is more immediate and understandable from the practical point of view** than the value creation that has been variously interpreted in the literature (e.g. the value creation for the company, the shareholders, the stakeholders) and it requires, in order to be fully understood, the explanation, not always easy, of the 'for whom', 'how' and 'in what time' this value must be created;

b) The **fulfilment of needs is a preliminary condition for the value creation**. If an entity does not meet any need, it cannot create value for its stakeholders (e.g. the owners, employees, the community) as well as for itself;

c) Point the **focus on meeting the needs mitigates the risk that the entrepreneur faces on what he is able to do, and not on what is really useful**. As stated by Koslowski (2000, p. 142) for business entities "If shareholder value becomes the overall purpose of the firm, the managers have strong incentives to invest their attention and their time in finding ways and means to manipulate the price of shares in the stock market and in means that are not in the interest of those members of the firm that are not shareholders. The possible perverse incentives the shareholder value principle exerts on the management, if it is considered to be the only purpose of the firm, are considerable. They direct the resources of the management to unproductive instead of productive action. The second effect, the short-termism of an exaggerated attention to the short-term share price in the stock market, is also not in the long run interest of the firm if profitable long-run strategies are hindered by it". In a public administration do not focus on needs satisfaction leads to the risk of establish useless organizations that allow certain individuals (e.g. politicians and bureaucrats) to extract private benefits, damaging the community;

d) It **allows distinguishing the organizations that meet the needs in two categories: those that create and those that destroy value**.

As stated before, one of the most reliable management theories, the **shareholder theory**, puts the value creation for shareholders as the firm's objective. In particular, Milton Friedman's view is that in a **capitalist economy**, there is **one and only one responsibility** of business - **to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game**, which is to say, engages in open and free competition without deception or fraud.

This approach causes no little embarrassment for certain activities. In particular, we refer to: 1) pharmaceutical companies; 2) companies that perform control activities (e.g. auditing [5] firms and rating agencies [6]); 3) companies that operate in the so-called **controversial industries** (e.g. in the sectors of lotteries, in armaments, tobacco, alcohol).

A **pharmaceutical company** cannot put the profit as the objective of its economic activity. Profit is definitely an important component that allows that company to attract financial resources from investors and to do research for the discovery of new drugs, but the

[5] Auditing is defined as a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose.

[6] «Rating agencies, or credit rating agencies, evaluate the creditworthiness of organizations that issue debt in public markets. This includes the debts of corporations, non-profit organizations, and governments, as well as "securitised assets" – which are assets that are bundled together and sold as a security to investors. Rating agencies assign a letter grade to each bond, which represents an opinion as to the likelihood that the organization will be able to repay both the principal and interest as they become due. Ratings are made on a descending scale: AAA is the highest, then AA, A, BBB, BB, B, etc. A rating of BB or below is considered a "junk bond," because it is likely to default. Many factors go into the assignment of ratings, including the profitability of the organization and its total indebtedness. The three largest credit rating agencies are Moody's, Standard & Poor's, and Fitch Ratings»; Source: http://lexicon.ft.com/Term?term=rating-agencies.

objective of the enterprise must be the *improvement of people's health*. In the case of the physician, the primary interest should be the health of the patient, while his secondary interest would be to prescribe a drug not necessary for the patient just to reciprocate what has been received (e.g. a gift or any other benefit) from the pharmaceutical company.

YouTube 12 – *Pharmaceutical companies and profit*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Big Pharma	00:08:19	Study

An **audit firm** must have as its goal the production of the audit service to guarantee investors who want to put their money in the audited companies. Indeed, if the objective were the profit maximization this logic would easily enter into conflict with the need to operate in the market as an independent controller. The scandal involved the audit company Arthur Andersen in the Enron audit is nothing more than the result of almost a foregone conclusion generated by this finalism [7].

A public **hospital** and a private clinic cannot have different purposes, i.e. the former works for the health of the patient while the latter for the interest of the clinic's private owner (i.e. with the logic of profit). In fact, both entities should conduct their economic activity satisfying the same need: the health of the patients. Surely, these economic entities can be distinguished in terms of reasons that led the founder (citizens for the hospital and entrepreneur for the private clinic) to be interested in meeting the needs aforesaid (remember the butcher in the Adam Smith example), but this is precisely the interest of such person, not the interest of the *azienda*.

Thus, contrary to the shareholder theory (that is proposed only for business entities), in our approach, **the objective of the *azienda* (the needs satisfaction) and the condition of survival and growth (the creating sustainable value condition) give, together, what we call the *primary interest* [8] *of the* azienda. We consider that interest as a principle of good governance for any *azienda*. The primary interest of the *azienda* is the common good of the *azienda*.**

Since the aim of this course is also to propose an objective that is able to orient the *azienda* toward the common good of the community, by integrating business and ethics, we embrace the definition proposed by Melé (2009) who states that 'a corporate mission consistent with the principle of the common good becomes a practical way of introducing business ethics at the top of a company, and an effective implementation of such a mission a way of implementing business ethics' (p. 238). Moreover, 'the common good principle provides a compass for social life, including business. Business as a part of society should contribute to the common good through its specific mission. Within the business firm, all must contribute to the common good of the firm, which should be consistent with the common good of the society at large' (p. 238).

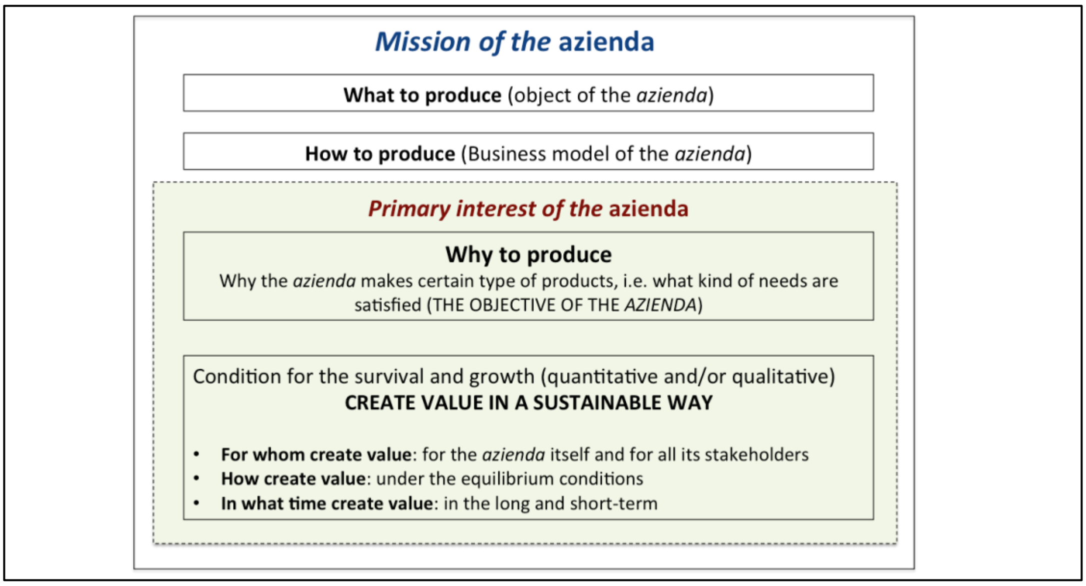
[7] For more information on the Arthur Andersen case: http://www.independent.co.uk/news/business/news/arthur-andersen-returns-12-years-after-enron-scandal-9707572.html

[8] The choice of the term "primary interest" is not random, but rather stems from the literature on conflict of interest that, with reference to economic entity agents (e.g. a physician of an hospital), distinguishes between the primary interest of the economic entity and the agents potential secondary (particular) interests.

The primary interest can be considered as the central part of the *azienda* mission, which should contain, in addition to this interest and in brief, the object, that is "what" the *azienda* produces, and 'how' it produces (i.e. its business model), as shown in Table 34.

The 'what' and 'how' produce were excluded from the primary interest because the *azienda* must be ready, in its interest as well as in the interest of its stakeholders, to react (i.e. change of their own 'what' and / or 'how to' produce) when its products or the how to produce are obsolete, i.e. they are no longer able to meet the needs of the client / user. Indeed, the *azienda* does not have to only produce goods and services but it has to produce ***useful*** goods and services. It is the outcome not the output that really count**.** Governance body and management who are concentrated on the WHY facilitate this behavior.

Table 34 – *Primary interest as a part of the* azienda *mission*



Source: Our elaboration

YouTube 13 – *Starting with the WHY* [9]

Type	Title	Length (hh:mm:ss)	Study/Watch
Presentation	How great leaders inspire action	00:17:57	Study

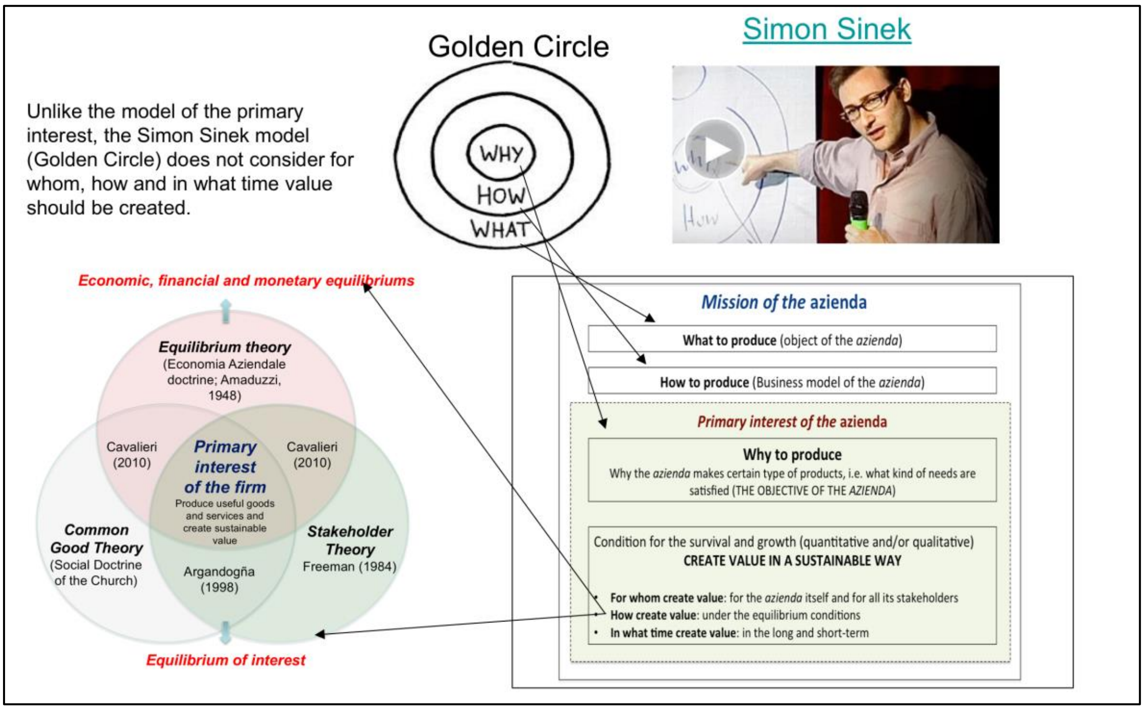
[9] This video is only referred to business entities and does not consider the value creation condition.

Table 35 – *Golden Circle*

An excessive focus on 'what' and 'how' produce is likely to orient to the short term, not to look at the real needs of the customers (or users), and thus making difficult to get out of period of economic crisis.

Unlike the model of primary interest, the Simon Sinek model does not consider for whom, how and in what time value should be created.

Table 36 – *Golden Circle and the primary interest of the firm*



This specification on the primary interest of the *azienda* is not trivial, because, for example, the agent (the manager) of an irresponsible company (oriented only to the shareholder wealth) who is oriented just to the short-term investment, would experience the conflict of interest only when he/she is the bearer of a secondary interest in contrast with the approach to profit maximization in the short term. In other words, a company that focuses solely on profit, and then only to a category of stakeholders, damaging other stakeholders (eg. the State, through the corruption of public officials, or the environment through pollution) has a limited primary interest, or rather an unsustainable private interest, like the one that can have an individual. Not a few were the financial disasters generated by this mental approach.

YouTube 14 – *The limits of the shareholder value creation*

Type	Title	Length (hh:mm:ss)	Study/Watch
Lecture	Who's Minding the Store? The Ethics of Corporate Governance	00:11:15	Watch

Assignment 9 – The British Petroleum case

Therefore, the choice to use the term "primary interest of the *azienda*" is also instrumental to the proposed definition of conflict of interest (Chapter III, § 2).

Moreover, studies on conflict of interest often include, in addition to the conflict that concerns natural persons (i.e. individuals), also the so-called **institutional conflict of interest** (Argandoña, 2004; Bradley, 1995; Hasselmo, 2002). In this sense, it is in conflict of interest, for example, the publishing company that is tempted to eliminate negative news about one of its sponsors.

Furthermore, it is increasing the necessity to confer an interest to the *azienda*, as if it were an individual, which also includes ethical, social and environmental responsibilities. For instance, on 2001, the Italian Government – in compliance with the principles set forth in EU legislation on the prevention of corporate crimes and the assessment of companies' liability – enacted the Legislative Decree no. 231/01 (the "Decree no. 231") that introduced for the first time into the Italian legal system the direct liability of companies and other legal entities for crimes committed by directors, executives, their subordinates and other subjects acting on behalf of the legal entity, when the unlawful conduct has been carried out ***in the interest of or to the benefit of the company concerned***.

3.2. *'For whom' create value*

Stakeholders to take care in the value creation process (Table 10) are widely intended here, including the *azienda* itself, its owners, employees, customers/clients, suppliers, lenders, the community, government authorities, and last but not least, the environment. These stakeholders contribute to the economic activity in the expectation of an adequate reward for their contribution. Then ***each stakeholder has a particular interest*** **that motivates his/her behaviour** (Chapter I, § 5).

With specific reference to the business entities, unlike the shareholder theory, here the agents are responsible not only to shareholders, but also of a plurality of stakeholders - including the environment - in respect of which the agents have economic, ethical, social and environmental responsibilities.

This approach would seem to be aligned with the stakeholder theory of the firm, however, the proposed framework also requires responsibility towards the survival and growth (qualitative and/or quantitative) of the *azienda*, seen as an economic institution (Zappa, 1957) separated from its stakeholders, as a common good for its stakeholder as well as for the society.

In particular, **the *azienda* is not here conceived as a juridical fiction**, as just a set of contracts with its stakeholders (Jensen and Meckling, 1976), instead it is viewed as an **institution that is distinct from its stakeholders**, with *its own interest to survive and growth, in order* *to satisfy human needs*. Following this approach, it can be also said, for example as regards to the business entities, that the shareholder interest to the profit maximization is particular and should be compatible with the interests (general) of the *azienda* and other stakeholders. In other words, when the profit is achieved in an irresponsible or fictitious way (e.g. firms that make profit through corruption, criminal firms), it becomes secondary if compared to the primary one that considers the firm as a common good of the community.

The proposed approach is also different from the one followed by those who ask to create value for the company (eg. *organic theory*), taken for granted that by doing so, they strive to create value for all stakeholders. However, the reality shows that this automatism does not always occur. For example, a company could improve its value destroying the environment, failing to ensure appropriate working conditions for its employees who have very limited possibility to find alternatives in other firms.

For this reason, in order to achieve its primary interest, the *azienda* has to maintain good relations with the *stakeholders*, while *stakeholders*, including the community, should understand the problems of the *azienda*. In other words, the proposed approach differs from the theory of value creation for the *azienda* as it offers practical solutions to reconcile the interests of the *azienda* with those of its stakeholders, finding a balance between the economic and social equilibriums.

3.3. *'How' create value*

This question is about the **modality through which creates value (i.e. to what conditions create value)**, aiming to explain not only what kind of value should be created for the various stakeholders, but also what is the right remuneration they should receive for their contribution.

In this regard, it is increasingly felt the need by economic entities to communicate the **code of conduct (or ethics) of their business**, in which are specified the responsibilities and obligations they have in relation to the various stakeholders [10] and the common good.

[10] In the following link, the code of ethics of Enel group: http://www.enel.com/en-GB/doc/governance/code_of_ethics/ENEL_CodiceEtico_CodeOfEthics.pdf

Table 37 – *The 17* Sustainable Development Goals

YouTube 15 – *The 17* Sustainable Development Goals

Type	Title	Length (hh:mm:ss)	Study/Watch
Interview	The global goals we've made progress on -- and the ones we haven't	00:14:11	Study

The 'how' create value is related to the sustainability of the condition of economic equilibrium expressed in Table 31. Two *aziende* that make the same product satisfying the same need can be distinguished by the different ways on how they produce (they may have a different business model) and consequently on how they create value.

Indeed, the value creation condition (Table 31) does not say anything about the **sustainability** with which the value is created. In other words, a car company in which the value of the output is higher than the value of the input may not be ethical, social and environmental responsible, as well as a public administration that meets the value creation condition may not behave in a sustainable way in respect to certain stakeholders (think of the structural delay in payments to suppliers).

This is why we added the term '**sustainable'** to the value creation condition expressed in Table 34.

Within the input-transformation-output process, the ethical, social and environmental responsibility can be considered in the phase of acquisition of factors of production (e.g. the use of renewable energy), in that of transformation of these factors in goods and services (e.g. reduction of polluting emissions, decent working conditions for employees) and in the placement phase (e.g. sale of products not harmful to health), that is in all the business model of the firm. Making a product that is not dangerous for the consumers' health does not indicate the responsibility that the *azienda* has had in the use of the input, or in the production process that allowed making the product.

Users of two different municipalities (Comune di Roma and Comune di Firenze) could see satisfied their needs to obtain a license in order to perform a certain activity (e.g. open a pub, drive a taxi), but in one City the license is obtained quickly and without unnecessary red tape, while in the other the waiting times are much longer due to organizational inefficiencies. It follows that the first citizen has satisfied his/her need exactly as the second one, however the value created in the first case is higher than in the second, since the quality of the service provided by the local government was higher. It can be also said that the granting of the license has satisfied a need while the quality of the service satisfied a desire.

A closer look, while for a firm achieving the quality of the service provided is often vital (i.e., what we have defined as "how to produce"), otherwise the risk of losing the client an do not survive, for a public administration this aspect could be underestimated because of lack of a market that may lead the user to choose a different administration, putting the ineffective administration at risk of continuity.

Assignment 10 – The motivations under the Fundamentals of Business website

Financial, monetary and interests' equilibriums

The conditions to achieve in order to create sustainable value, or sustainable economic equilibrium, are: financial, monetary and interests' equilibriums. The first three conditions (economic, financial and monetary equilibriums) derived from the theory of the business entity equilibrium proposed by Aldo Amaduzzi (1948), one of the Zappa's pupils. The theory of equilibrium, which initially covered only the business entities, was later revisited by Cavalieri (2010), an Amaduzzi's pupil, who expands the scope of the theory of equilibrium to all types of organizations, adding a fourth condition, the so-called overall strategic equilibrium intended as 'equilibrium position simultaneously against the different social partners and the markets' (Cavalieri, 2010, p. 28, our translation). However, in the primary interest model the overall strategic equilibrium was substitute with the equilibrium of interests. For non-business entities the concept of revenue is substitute by that of value of production over time, while the concept of cost by the value of factors consumed in the production process.

In particular, the sustainability over time of the economic value creation includes three conditions: 1) have a balanced capital structure (financial equilibrium) in order to guarantee the solidity of the azienda and overcome unfavourable economic periods that have a negative impact on the economic equilibrium, because of losses that decrease the level of the equity; 2) meet regularly its payments (monetary equilibrium); 3) be socially and environmentally sustainable (equilibrium of interests).

– *Financial equilibrium* is the necessity (of the azienda) to develop appropriate correlations (in quantitative and qualitative terms) between investments (assets) and financial sources (liability and equity), in order to maintain a systematic capability to satisfy its obligations timely and in a correct manner, without prejudice in the future.

– *Monetary equilibrium* is achieved when the company is able to meet at any time, the payment commitments, for example, with employees, suppliers, financiers. This equilibrium then binds to the concept of liquidity, through which measures the company's solvency in the short term.

– *Equilibrium of interests* is intended as a balancing of interests of stakeholders who participate in various ways to the value creation. This equilibrium is connected to the shared value creation and it is reached when the rewards (not only monetary) received by stakeholders are aligned to the contributions they provide to the azienda. The firm should be able to produce extrinsic, intrinsic and transcendent goods (Chapter I, § 5.3). In this way it can serve the common good of stakeholders and society.

Under the azienda's equilibrium model the stakeholder management does not see any contrast between normative and instrumental approach (Donaldson e Preston, 1995), due to the fact that the instrumental approach is not referred to the shareholder's interest, but rather to the company's interest. Indeed, managers have to deal with the stakeholders – in order to achieve the equilibrium of interest – in accordance to the company's interest and, by trying to find (according to internal and external contingencies) the right balance between a fair behaviour (regardless of the economic results) and a behaviour that has to be instrumental to the survival and growth of the company itself. However, going deeply in the investigation, the primary interest theory sees the instrumental approach as a way to exalt the fairness approach toward all other stakeholders. The need to preserve the business continuity has to be considered in fact the right behaviours even if a possible consequence could be the short-term sacrifice of some stakeholders' expectations.

The overall equilibrium

The *azienda* achieves the *overall equilibrium* when it cannot improve a single equilibrium (economic, financial, monetary and interests) without damaging, in the long term, its condition of survival and growth. It can be also stated, in the mathematical sense, that the overall balance is a system of four interrelated equilibriums that the solution of the system (survival and growth in the long term) should meet simultaneously. The equation is solved when it has chosen the best composition of the balance for the survival and/or growth of the *azienda*. The manager can evaluate the impact of his/her choices on the overall equilibrium. Improve that equilibrium is a fair behaviour towards all the stakeholders.

Thus, an increase of welfare of a single stakeholder is acceptable when it has a positive effect on the overall balance. Indeed, the unitary vision of the *azienda* suggests connecting the effect of the stakeholder management to the economic, financial and monetary equilibrium. If increasing the well-being of a stakeholder improves, in the long term, the overall equilibrium the *azienda* the manager should do that, also because increasing the possibility of the *azienda* to survive and growth is the right thing to do for all the actual and future stakeholders.

3.1. *'In what time' create value*

The last element of the value creation conditions relates to the period in which that value should be created. The condition for value creation must be respected in the short and long term. The Italian *economista d'azienda* Bertini argues that "when management issues are experienced in long-term perspective, all issues are relativized in the presence of dominant theme of firm continuity [...] It relativizes the profit that becomes a means to ensure greater stability to the firm [...] If, instead, a short term approach prevails, everything tends to be exasperated: look for a daily profit sacrifices future profit opportunities; conflicts of interest between the various protagonists are dominated by the need for immediate and selfish fulfilment of their expectations; and fatally, the equilibrium of the system is put into crisis" (2013, p. 99).

Cavalieri points out "the government of the simultaneous short and long term belongs to the tasks of a conscious management" (2010, p. 27).

The 'how' and 'for whom' create value assumes a significant weight in the choice between short and/or long-term orientation. Creating value in a sustainable way means having a better perception of how irresponsible behavior may affect the survival and / or the growth of the *azienda*. In other words, sustainability can bring out certain future costs and benefits associated with the current choices.

The temporal problem of the value creation becomes particularly relevant looking to the peculiar interests of the party (or parties) that have the power to control the *azienda*. Indeed, a dominant party (e.g. the one who owns more than 50% of the control rights) that is oriented to the short term will lead the company following this logic, jeopardizing business continuity, while long-term oriented dominant party might not realize the effects that poor management of the short term may have in the long term, hoping that in the long run the short imbalances can be reabsorbed. However, it cannot be underestimated the effect that the short-term management has on the long-term performance.

Like in football, if a team wants to win the championship it has to give importance not only to future matches, since also the matches of today are important. The short is so important as the long run, and cannot be underestimated.

Sometimes **the problem is not to think to the long term, but have adequate decision-making tools to link the effect of short choices with long-term consequences**.

In this regard, an important factor that may caused some corporate frauds - at least in the initial stage - was that related to the good profitability condition of the defrauded corporations (think of Parmalat, called after the default "the European Enron"), and the expectation for future growth (as in the Mariella Burani case) that they would have to absorb, in the long term, the costs of expropriation generated by the dominant party. In other words, the predators 'entrepreneurs' seem not to have perceived the risk that the destruction of the economic balance in the short-term could cause catastrophic consequences in the medium-long term. Moreover, manipulation of the financial statements gave to the market just the appearance of equilibrium conditions, not allowing the external observers, even to the authors of the expropriation, the severity of the situation and, therefore, to take action in order to avoid disaster.

Since the value creation is connected to the *azienda* and its stakeholders, the timing of value creation can be also referred to individual stakeholders. For example, in periods of economic downturn it is sometimes unthinkable that the *azienda* can meet the expectations, the particular interest of its employees to keep their jobs or the same salary conditions recognized in times of prosperity. The *azienda* may ask them to understand the difficult situation in order to overcome the crisis and come back into balance. If not, the particular interest of the employees may prevail over the primary interest of the *azienda*, coming sooner or later to affect negatively the interest of the *azienda* (since it cannot survive ensuring the same condition) and employees. During the same period, however, the *azienda* could be forced, for economic convenience, not to nick the satisfaction of the particular interests of customers and suppliers, since they are fundamental for the *azienda* survival.

Following a further example. A public administration in order to safeguard the employment and despite it does not meet the needs for which it was established, it continues to survive thanks to government grants (so thanks to the citizens). In this case, the interest in maintaining the employees overrides the logic of value creation. In the medium-long term such a situation is clearly unsustainable.

Concluding, the answers to the questions (for whom, how and in what time) on the value creation are not unique because they depend on (among other things) the type of *azienda*, the current economic environment the *azienda* is operating, the interest of the person (or group of people) who has the power to govern the *azienda*, and so on.

4. *The importance of the concept "primary interest of the* azienda*"*

The choice of the term '**primary interest**' in the proposed approach comes from at least the following reasons:

1) it is instrumental to the definition of conflict of interest, necessary to identify the phenomenon and mark the boundary between particular interests and secondary interests of the stakeholders;

2) the term 'primary' highlights the prevalence of such interest over the particular interests of the stakeholders, especially if these interests become secondary, scoring the strengthening of the logic of the *azienda* as 'institution act to persist', the systemic logic and the cooperation;

3) the lack or the loss of the primary interest should determine the end of the *azienda*, for failing to meet certain needs or for inability to create value;

4) with specific reference to business entities, moves the focus of the governance and management from of the profit in the short term to the condition of the overall equilibrium of the entity;

5) it is in line with the tendency of the law to attribute an interest to the *azienza*, like if it were an individual, and therefore juridical responsibilities when that interest is in conflict with that of the stakeholders, internal and external to the firm.

With regard to the first point, the conflict of interest **is the situation in which the secondary interest (financial or non-financial) of a person tends to interfere with the primary interest of the *azienda***, to which the first has specific duties and responsibilities (Di Carlo, 2011). This aspect differentiates our approach from the main corporate governance theories that see the so-called agency conflict between managers and shareholders, or between major shareholder and minority shareholder, that is in all situations where there is a separation between ownership and control. However, there are cases where even the only owner can have a secondary interest that is in contrast with the primary interest of the firm. In could be the case where the dominant owner hire in the firm his incompetent son or daughter, damaging the firm durability and thus all its stakeholders.

For what concern to the second point, the specification of the primary interest allows to **clearly identify the boundary between the particular interests of stakeholders** (e.g. the legitimate interest of the employee to the remuneration for his/her work contribution) **and their secondary interests** (the interest of the employee to receive more than his/her contribution). Thus the proposed approach allows to distinguish, and thus to easier measure, the mismatch between the interest of the stakeholders and that of the *azienda* to survive and growth.

Moreover, the proposed approach facilitates the orientation of the company towards the corporate social responsibility. Indeed, managing the company in the interest of the capital and Labor does not exclude the possibility that it may generate negative externalities suffered by other stakeholders (eg. the State with tax evasion; the community with pollution), putting at risk the durability of the *azienda* (eg. due to sanctions).

In the case of a shareholder his/her particular interest is the profit but that interest becomes secondary when it is in conflict with the survival and growth of the firm, such as when to maximize profit in the short term workers are humiliated, or when costs for research and development are reduced undermining the ability to innovate and be more competitive in the future.

With regard to the third point, any organization without a common and shared project by the various stakeholders (primarily, by capital and Labor), lacks of a clear and shared purpose. Any organization ceases or is destined to die of conflicts when there is not a common project that can bring individuals to cooperate and / or solve (even if not completely remove!) in a positive way the conflicts themselves. If, despite the lack of a shared primary interest the governance bodies are still interested in the organization survival, it is reasonable to believe that they want to extract private or personal benefits. **In the absence of a primary interest,**

the peculiar interests of the stakeholders become all legitimate and, not being secondary to any primary interest, they will try to dominate each other.

While for the *aziende* that operate in the market, ie business entities, the lack of the primary interest increases the risk of not having continuity, in non business entities, for example, the public administrations, the continuity is ensured by the citizens, which have to contribute to the survival of these organizations, even if they are destroying value for the citizens themself.

As for the fourth point having given the company its own primary interest to survive and growth enhances the concept of business as an institution. Underlining the primary interest enhances the theory of equilibrium of the *azienda* (Amaduzzi, 1948; Cavalieri, 2010), in the sense of considering jointly, the balance of the following conditions: economic, assets/liabilities, monetary and interest. Just the view of this dynamic system of balance leads to pay attention to the balance of short and long term.

The last point is probably one of the most important, since it refers to the **introduction of regulations that call for the responsibility of the firm for crimes perpetrated by its agents** (e.g. directors, managers) **in its interest or advantage**. For instance in Italy the Legislative Decree n. 231/2001, introduced in the legal system this complex norm that provides personal and direct assumption of responsibility of the whole legal entity (e.g. companies, recognized and not recognized associations, public entities). This responsibility derives from the perpetration of specific types of crimes by individuals - linked to the entity - who have acted in the ***azienda*'s interest or advantage**.

The Legislative Decree represents a significant revolution in the Italian legal system, compared to the traditional Roman principle of '*societas delinquere non potest*', under which no criminal responsibility may be borne by legal entities. The Legislative Decree stem from the Convention on the fight against corruption involving officials of the European Communities or officials of the Member States of the European Union, drawn by the Council on 26 May 1997, along with the OECD Convention of 17 November 1997 on Combating Bribery of Foreign Public Officials in International Business Transactions.

5. *The primary interest of the economic entities that produce for the market. The WHY of the business entities*

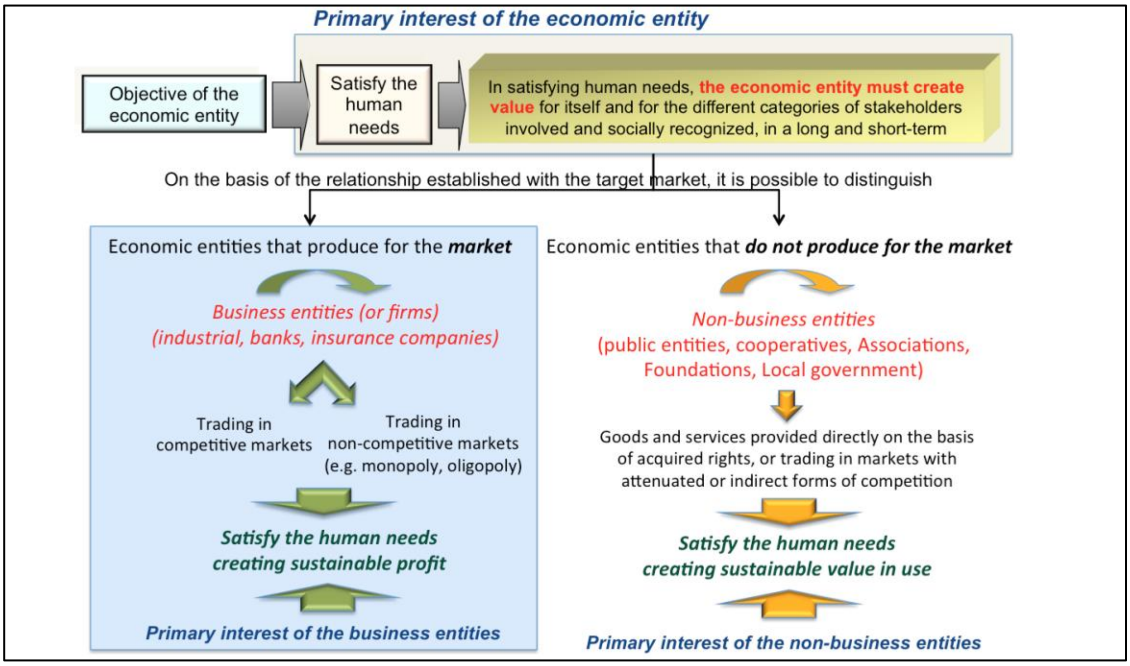
Business entities, as the entities that do not operate on the market (non-business entities), must meet the needs through the production of goods and services. The entrepreneurial function must constantly strive not only to meet current needs, but also to **create and satisfy new needs**, contributing to the progress and development of society and the well-being of people.

Moreover, business and non-business entities must satisfy a condition of survival and growth, i.e. they must "create a sustainable value". Satisfy human needs creating sustainable value represent the primary interest of the both economic entities.

However, the concept of "value creation" can be better specified for the two classes: business entities must create **sustainable profit**, while non-business entities must create **sustainable value in use** (*infra*, § 7).

This paragraph focuses on the business entities (left side of Table 38).

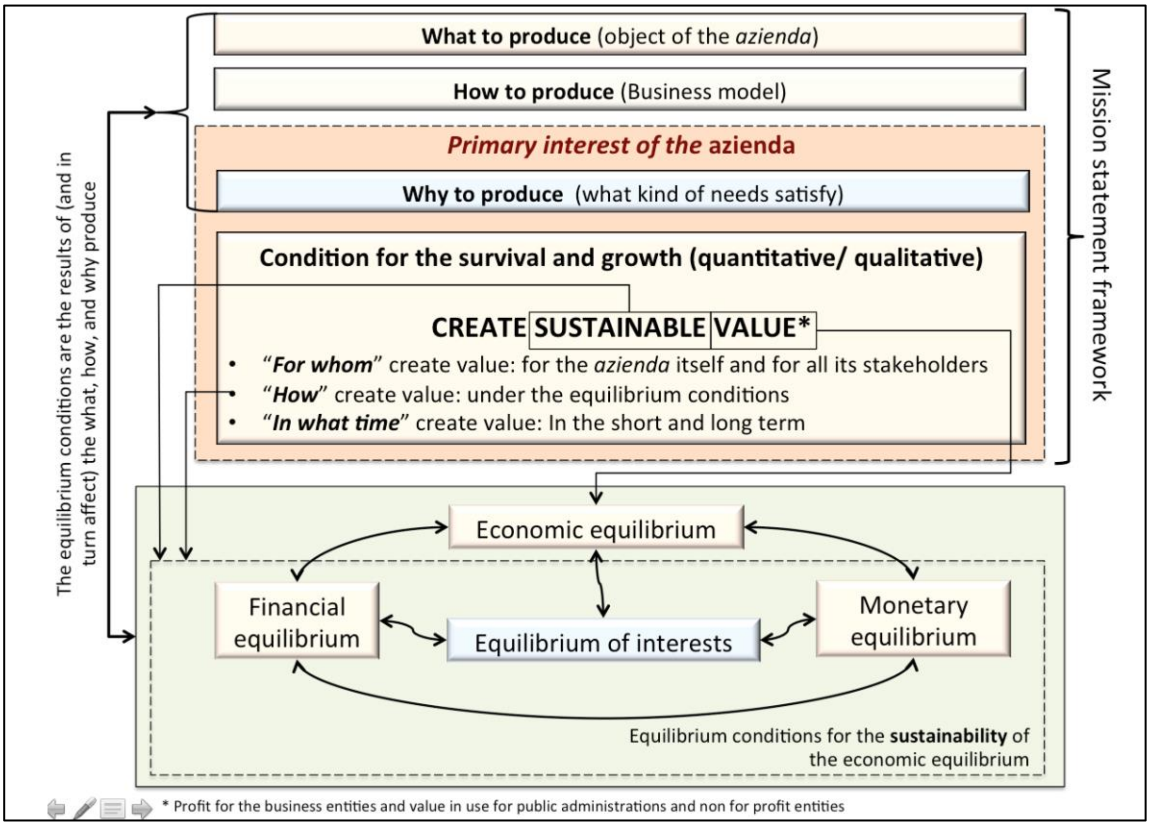
Table 38 – *The business entities*



Source: Our elaboration

Thus, the framework of the mission presented for all the *aziende* in Table 34 can be better specified for the business entities in Table 39.

Table 39 – *Primary interest as a part of the business entity mission*



Source: Our elaboration

The type of goods and/or services made is indicated in the object of the business entity, and it is often summarized in its mission/vision.

For example, the mission of Fiat states:

> «The Group designs, engineers, manufactures, distributes and sells vehicles for the mass market under the Fiat, Alfa Romeo, Lancia, Abarth and Fiat Professional brands and Chrysler brands such as Chrysler, Jeep, Dodge and Ram brand vehicles and vehicles with the SRT vehicle performance designation, as well as luxury cars under the Ferrari and Maserati brands.
>
> Fiat also operates in the components sector, through Magneti Marelli and Teksid, and in the production systems sector, through Comau and in after-sales services and products under the Mopar brand name. In addition, the Group provides retail and dealer finance, leasing and rental services in support of the car business through subsidiaries, joint ventures and commercial agreements with specialized financing services providers. Fiat is an international auto group engaged in industrial activities in the automotive sector through companies located in 40 countries and has commercial relationships with customers in approximately 150 countries»; www.fiatspa.com

This mission contains the object, but not the objective of Fiat company. Following the approach presented in Table 39 the objective should be related to the type of need satisfied. However, it can be argued that the company is shareholder oriented.

If in Fiat the objective were meeting the needs, the lack of a detailed specification would be understandable, considering that the objective accompanying the production of vehicles for the mass market (generalist brands) is undoubtedly different (albeit related) compared to that of luxury cars, or components or services funding. It is therefore reasonable to expect different objectives for the different businesses.

Indeed, with specific reference to the Ferrari mission, it is stated that:

> «The marque's story began in 1947 […] The company has travelled a long way since then, but its mission has remained unaltered: **to make unique sports cars that represent the finest in Italian design and craftsmanship, both on the track and on the road**. The very definition of excellence and sportiness, Ferrari needs no introduction. Its principal calling card is the numerous Formula One titles it has won: a total of 16 constructors' championships and 15 drivers' championships. And of course, there is the impressive line-up of legendary GT models. Cars that are unique for their design, technology and luxurious styling and that represent the best in Italian the world over»; www.fiatspa.com

Although better clarified, the company objective (i.e. the WHY of the company) is not well explained yet. However, the Ferrari mission indicate how the cars are made "to make unique sports cars that represent the finest in Italian design and craftsmanship".

The WHY is well explained in the Ikea mission:

> "The Ikea Concept is based on offering a wide range of well designed, functional home furnishing products at prices so low that as many people as possible will be able to afford them. Rather than selling expensive home furnishings that only a few can buy, the Ikea Concept makes it possible to serve the many by providing low-priced products that contribute to helping more people live a better life at home".

Thus, the what, how and why of the Ikea business are:

– The "**WHAT**" (produces): *home-furnishing products*;

– The "**HOW**" (produces): *a wide range of <u>well designed</u>, <u>functional</u> home furnishing products;*

– The "**WHY**" (produces): […] *prices so low that as many people as possible will be able to afford them. Rather than selling expensive home furnishings that only a few can buy, the Ikea Concept makes it possible to serve the many by providing low-priced products that contribute to helping more people live a better life at home.*

Many other companies produce furniture but the WHY (the needs Ikea satisfy) differentiates Ikea from all the other competitors. Question to the reader: do you have Ikea furniture at home? If yes, the why you bought that is probably the same of the Ikea's WHY.

As point out by Sinek in his book "Start with Why": "*A clear sense of WHY sets expectations. When we don't know an organization's WHY, we don't know what to expect, so we expect the minimum—price, quality, service, features—the commodity stuff. But when we do have a sense for the WHY, we expect more*" (Sinek, 2009, p. 162).

The Ikea WHY requires a competitive strategy based mainly on cost leadership. Moreover, from Ikea website, it is stated that the Ikea Concept *"guides the way IKEA products are designed, manufactured, transported, sold and assembled. All of these factors contribute to transforming the IKEA Concept into a reality".* It is evident the relevant support of the functional strategies to the competitive strategy of the company and, therefore, to the achievement of its mission. Some products, for example, are designed so to be transported in "flat packs", which allow saving space and money. To meet this need an Ikea designer was asked to design a chandelier that can be put in such containers.

Table 40 – *The Ikea "flat packs"*

1956

Designing furniture for flat packs and self-assembly
The decision for IKEA to design its own furniture stems, ironically from competitors pressure for suppliers to boycott IKEA. Exploration of flat packaging begins when one of the first IKEA co-workers removes the legs of the LÖVET table so that it will fit into a car and avoid damage during transit. After this discovery flat packs and self assembly become part of the concept. To read more, please visit Our business idea.

Source: www.ikea.com

The primary interest of the company, however, cannot be attributed only to the satisfaction of needs. In fact, this purpose must be accompanied by the *creation of a sustainable profit*. This aspect is an important component of the corporate mission (Table 39).

On closer inspection, the mission Ikea – while explaining the what, why and how to produce – it does not say anything about the value creation, i.e. for whom, how and in what time create value. Also the Fiat and Ferrari's missions do not indicate the value creation condition.

In this sense, the Terna mission mentioned below is undoubtedly the most complete, although the WHY of its service is not well specified:

> «Terna manages electricity transmission in Italy guaranteeing its safety, quality and affordability over time. It ensures equal access conditions to all grid users.
>
> Terna develops market activities and new business opportunities with the experience and technical skills gained in managing complex systems.
>
> Terna creates value for shareholders with a strong commitment to professional excellence and with a responsible approach towards the community, respecting the environment in which it operates», www.terna.it

As for Ikea mission, Terna mission can be analyse as following:

The "**WHAT**" (produces): *manages electricity transmission in Italy*;
The "**HOW**" (produces): *guaranteeing its safety, quality and affordability over time*;
The "**WHY**" (produces): *not present.*

In addition, the mission also contains "for whom" and "how to" create value, since it specifies that the value should be created for shareholders, having also a social, ethical and environment responsibility. It is not shown what is the temporal orientation of the value creation ("in what time"), i.e. short or long term.

It should be noted that the way in which Fiat and Ikea create value, although is not explicated in the mission, could be found indirectly in the sections of their web sites dedicated to the sustainability [11].

Among other things, we included the creating sustainable value in the mission (Table 39), and in particular in the concept of "primary interest", in order to better clarify the definition of conflict of interest that will be discussed extensively more ahead (Chapter III). This is extremely useful from the operational point of view. For example, looking at Fiat group, the Fiat code of conduct, in particular the section dedicated to the conflict of interest, it is stated

[11] For Fiat see: http://www.fiatspa.com/en-us/sustainability/2014/pages/default.aspx

that: "all decisions made on behalf of the Group must be made in the **best interest of the Fiat Group**." At no point in the code and in the website seems to be indicated what is that best interest. This is likely to cause confusion or uncertainty in the practical application of that rule.

In this regard, it is interesting to recall the cases where the corporate executives (the managers), convicted of bribery offenses, have declared to bribed in the interests of the company, even if the company had a code of ethics explicitly prohibiting conduct aimed at making profits in an irresponsible way.

Also the university students have their specific objective, i.e. their specific WHY. It can be said can say that they share the same WHAT since they attend the same courses (e.g. the students of the course of Fundamentals of Business), they probably have a different HOW because they attend the courses and they study in different way (e.g. some are non-attending students, some study just two hours a day some others seven), and they have a different WHY (e.g. some want to reach a maximum score, some others want just to pass the exam, some want to study hard because they hope to have more possibilities to get a very well remunerated job, some others want just to get a job!).

Table 41 – *The WHY of Emiliano Di Carlo website*

Source: https://sites.google.com/site/dicarloe/

Assignment 11 – The Why, How and What

5.1. *The profit as a condition for the survival and development of the business entity. The economic equilibrium*

Business entities must satisfy human needs, creating sustainable profit. This section is focused on the concept of profit, while in the next section on sustainability.

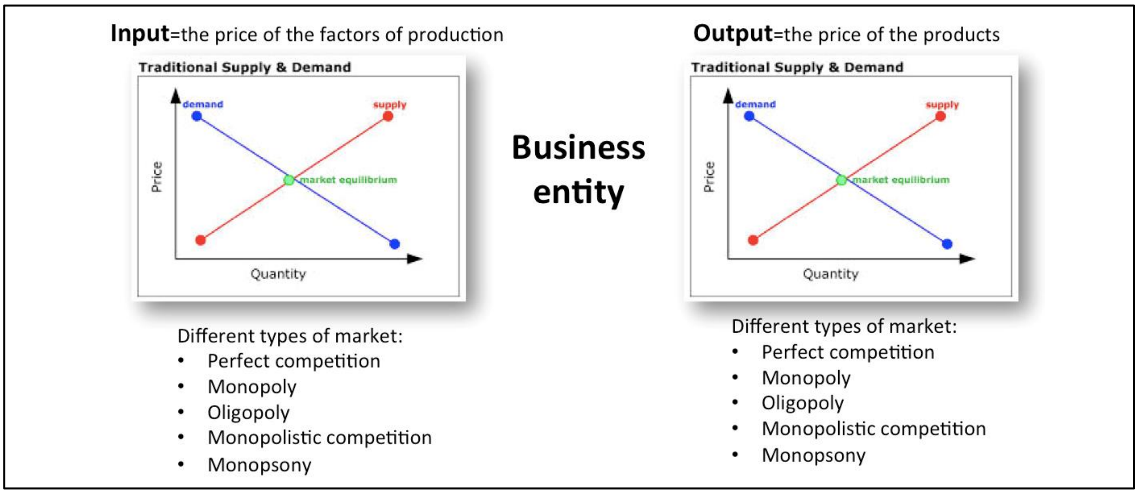
According to Carroll "Historically, business organizations were created as economic entities designed to provide goods and services to societal members. **The profit motive was established as the primary incentive for entrepreneurship**. Before it was anything else, the business organization was the basic economic unit in our society. As such, its principal role was to produce goods and services that consumers needed and wanted and to make an acceptable profit in the process. At some point the idea of the profit motive got transformed into a notion of maximum profits, and this has been an enduring value ever since. All other business responsibilities are predicated upon the economic responsibility of the firm, because without it the others become moot considerations" (1991, p. 40).

In other words, **the profit is the main incentive, the main extrinsic motivation** (for some there are also intrinsic motivations, e.g. success, fame…Why do billionaires still run their businesses? – see Mark Zucherberg with its creature Facebook), **of the entrepreneur to do business and satisfy needs**. Individuals are "**extrinsically motivated** if they are able to satisfy their needs indirectly, especially through monetary compensation" (Osterloh and Frey, 2000, p. 539). Money, then the profit, is a "goal which provides satisfaction independent of the actual activity itself" (Calder and Staw, 1975, p. 599). However the interest of the entrepreneur may as well be intrinsic. "**Motivation is intrinsic** if an activity is undertaken for one's immediate need satisfaction" (Osterloh and Frey, 2000, p. 539).

But what does actually mean to create monetary value, i.e. create profit?

The business entities (both private and controlled by the State), are those units that realize their productive function operating on the market (Chapter I, § 10), both when they acquire the factors of production and when they sell the products made (Table 42).

Table 42 – *Business entities and their market*



Source: Our elaboration

They survive if they are able to replenish their production processes, through the resources generated by the placement of products on the markets. On the basis of their activity, firms are distinguished in industrial, commercial, banking and insurance.

As is known, the market for a product is made up of the supply and demand for that product. These are the two forces that determine the price of the good or service exchanged. The situations in which this phenomenon occurs can be different, and each of them corresponds theoretically to a market configuration. Typical ones are perfect competition and the various forms of imperfect competition, namely the monopoly, monopsony, oligopoly and monopolistic competition.

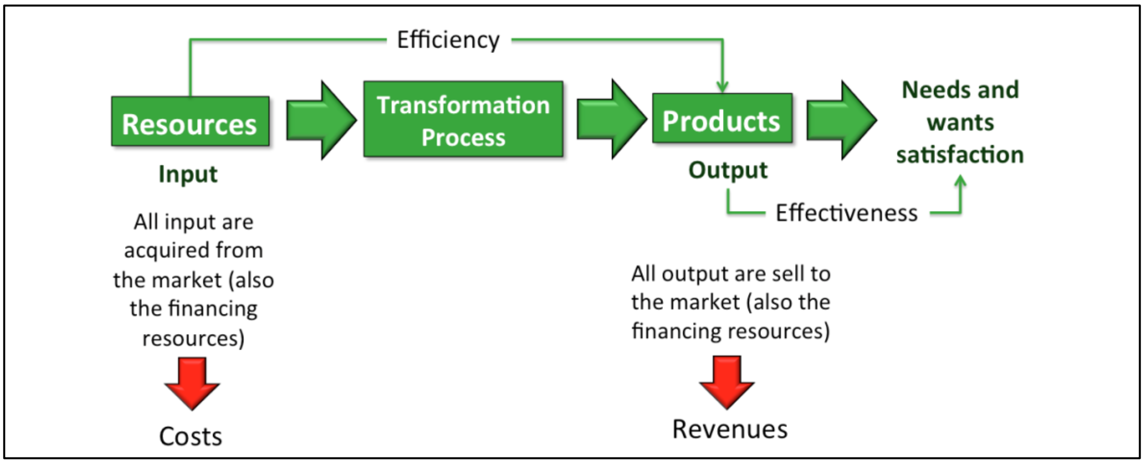
Table 43 – *Market typologies*

Perfect Competition Perfect competition is a market system characterized by many different buyers and sellers. In the classic theoretical definition of perfect competition, there are an infinite number of buyers and sellers. With so many market players, it is impossible for any one participant to alter the prevailing price in the market. If they attempt to do so, buyers and sellers have infinite alternatives to pursue. **Monopoly** A monopoly is the exact opposite form of market system as perfect competition. In a pure monopoly, there is only one producer of a particular good or service, and generally no reasonable substitute. In such a market system, the monopolist is able to charge whatever price they wish due to the absence of competition, but their overall revenue will be limited by the ability or willingness of customers to pay their price. **Oligopoly** An oligopoly is similar in many ways to a monopoly. The primary difference is that rather than having only one producer of a good or service, there are a handful of producers, or at least a handful of producers that make up a dominant majority of the production in the market system. While oligopolists do not have the same pricing power as monopolists, it is possible, without diligent government regulation, that oligopolists will collude with one another to set prices in the same way a monopolist would. **Monopolistic Competition** Monopolistic competition is a type of market system combining elements of a monopoly and perfect competition. Like a perfectly competitive market system, there are numerous competitors in the market. The difference is that each competitor is sufficiently differentiated from the others that some can charge greater prices than a perfectly competitive firm. An example of monopolistic competition is the market for music. While there are many artists, each artist is different and is not perfectly substitutable with another artist. **Monopsony** Market systems are not only differentiated according to the number of suppliers in the market. They may also be differentiated according to the number of buyers. Whereas a perfectly competitive market theoretically has an infinite number of buyers and sellers, a monopsony has only one buyer for a particular good or service, giving that buyer significant power in determining the price of the products produced.

The ability of the firm to reactivate its production processes is synthesized, at least in part, by the creation of **monetary value**, so called because it is formed through monetary exchanges in the markets. Indeed, in trade market, the money represents the value of the products exchanged. For instance, if I buy a pair of shoes that cost 100 euro because I think that it is the fair value. But if I think that the cost is too high, I do not buy the shoes and I go to another shop where the cost is lower.

The value of the input is given multiplying the quantity of factors of production purchased by the price for the single unit of factor of production, the so-called **costs**, while the value of the output is given multiplying the quantity of product sold by the price of the single product, the so called **revenues**. The difference between revenues and costs marks the level of the **income**, positive if revenues exceed costs, conversely assumes a negative value.

Table 44 – *The link between costs and efficiency and between revenues and effectiveness*



Source: Our elaboration

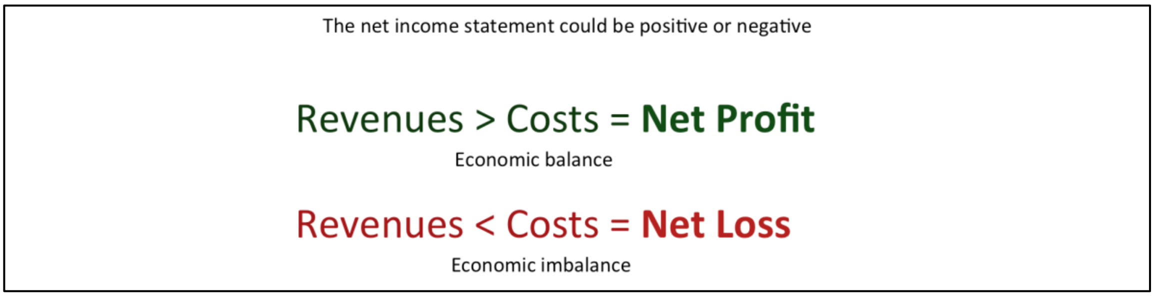
Summarizing:

Cost: the amount of money that is needed to pay for or buy something;

Revenue: the total amount of money received by the company for goods sold or services provided;

Net Income: the difference between a company's total revenues (money earned from sales or investments) and total costs (money paid to produce goods or services, plus salaries, rent, depreciation, etc.) for a given period of time.

Table 45 – *Net profit and net loss*



Source: Our elaboration

Thus, for business entities meeting human needs is necessary but not sufficient for their survival and growth. In fact, firms must also generate a positive margin between revenues and costs.

What should be the level of that margin? Is it sufficient to state that Fiat company creates value when the difference between revenues and costs is positive? And what if the margin is just one euro, with thousands of shareholders that ask for a good return on their investments?

In order to answer the question "what should be the level of income", it is appropriate that the value creation condition seen previously (Table 31) for all *aziende* finds the quantitative determination expressed in Table 46 (Amaduzzi, 1978, p. 192; Cavalieri and Ferraris Franceschi, 2008, p. 221).

Table 46 – *Condition of economic value creation applicable only to business entities*

$$\sum_{t=to}^{tz}\sum_{i=1}^{n} f_i p_i^t + \alpha = \sum_{t=to}^{tz}\sum_{k=1}^{m} Q_k P_k^t$$

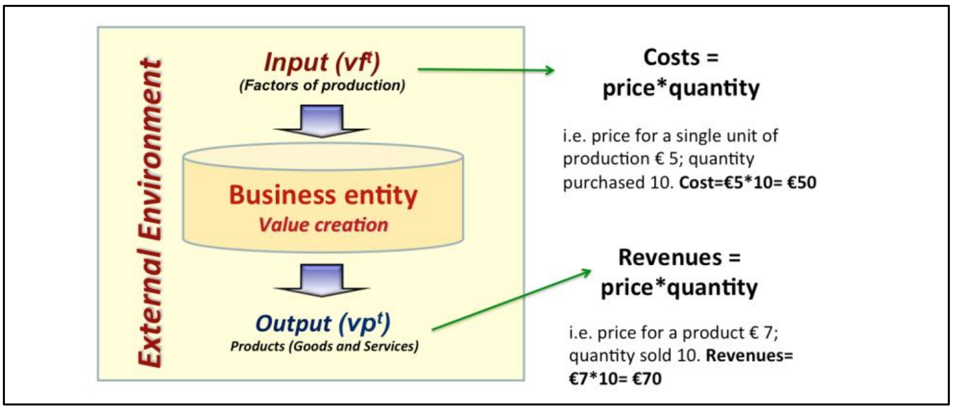
where:

f_i = quantity of factors of production;
p_i = purchase prices of factors of production;
$f_i p_i$ = costs of factors of production;
α = profit;
Q_k = quantity of products;
P_k = selling prices of the products;
$Q_k P_k$ = revenue from sale of products;
$\sum f_i p_i$ = summation of the cost of factors of production during the life of the business entity;
$\sum Q_k P_k$ = summation of the revenue from sale of products during the life of the business entity;
i = i-th factor of production;
k = k-th product;
t = period considered.

The above condition expresses the **economic equilibrium** with regard to business entities; this balance is formalized synthetically as positive difference, i.e. profit (α), between revenues and costs.

Then, in a **long-term perspective if the flow of revenues is greater than the flow of costs, the conditions of economic equilibrium is achieved**.

Table 47 – *Costs and revenues*



Source: Our elaboration

As a result, the firm is in economic equilibrium when is able to remunerate all the input used (Ferrero, 1968, p. 200; Onida, 1971, p. 18); this equilibrium is being achieved only if the entity operates with *economicità*. ***Business entities that operate with* economicità*, meet also the economic equilibrium condition***. In other terms they are self-sustainable (i.e. self-sufficient from an economic point of view), in the sense that their survival and their development should not be secured by other economies.

Thus, while the *economicità* can be understood as the set of rules that the company must follow in carrying out its action, the rules that are summarized in permanent tension on strategic effectiveness and operational efficiency, the economic equilibrium is the target to be achieved by the business entity action, i.e. the conditions to be met so that the business entity can survive and grow over time.

In business entities, the concept of economic equilibrium tends to overlap with the *economicità*. As already noted, the factor that discriminates the business entities from the other economic entities lies in the fact that the former must find their conditions of survival on the market, both in the demand side of factors of production, and in the supply side of products. It follows that if the firm operates with *economicità* it is also able to achieve the economic equilibrium condition over time. As we will see more ahead, for the economic entities that do not operate in the market the *economicità* does not necessarily imply the economic equilibrium.

The condition contained in Table 46 must be met in the **long-term**. This obviously does not mean that the **short-term** equilibrium is not important, but that imbalances in the short term do not affect the going concern assumption, when it derives from accidental factors that will be absorbed by an effective and efficient management [12].

Following this logic, the profit is not the objective of the firm (which is, in our view, the needs satisfaction), but a condition that makes it possible. Thus the profit, as expressed in Table 46, is what remains (also so-called economic residual) after the remuneration of the various factors of production (such as Labor, capital, and the State). In other words, the profit is what is left in the company, in the form of non-distributed income, and then used by the firms to finance its quantitative and/or qualitative growth [13].

At this point we can easily give the answer to the question "what would be the amount of the difference between revenues and costs to say that the firm is creating economic value?". The answer is: "To a level that would be remunerated suitably, in a perspective of short and long term, both the owners (through the distributed income) and the firm that, thanks to the undistributed income, will grow and develop quantitatively and qualitatively, benefitting all its stakeholders", as summarized in Table 48.

Table 48 – *The profit for the owners and the profit for the business entity and its stakeholders*

There is an economic value creation when: Net income (revenues-costs) is positive (net profit) and **=** a) Profit for the owners: **Distributed income** to the owners (dividends that satisfy the owner's interest) **+** b) Profit for the firm and all is stakeholders: **Undistributed income** (that remains in the business entity allowing its growing).

[12] In other terms, «*in una prospettiva di lungo periodo se il flusso dei ricavi riveniente dalla vendita sui mercati di collocamento di tutti i prodotti (beni e servizi) si delinea superiore al flusso dei costi di acquisto di tutti i fattori produttivi (comprendendo tra questi ultimi anche l'interesse sul capitale di proprietà e l'eventuale remunerazione al proprietario-lavoratore), si realizzano i presupposti dell'equilibrio economico, identificabile in un soddisfacente flusso atteso di maggior ricchezza (profitto)*» (Cavalieri e Ferraris Franceschi, 2008, pp. 221-222).

[13] As stated by Cassandro: «*il profitto, specie se si considera correttamente come l'eccedenza del reddito di esercizio dell'impresa (il cosiddetto utile netto, risultante da un conto profitti-perdite) rispetto all'interesse sul capitale di proprietà, calcolato a un tasso normale, rimane per la maggior parte se non addirittura per la totalità investito nell'impresa e quindi in sviluppo della sua economia e conseguentemente della economia della nazione. Non vi può essere, infatti, sviluppo della economia nazionale senza sviluppo delle singole cellule, le imprese, dove la ricchezza nazionale concretamente si produce. Il profitto allora può quasi considerarsi come il compenso oggettivo dell'organismo aziendale perché si conservi e progredisca*» (Cassandro, 1969).

Using the Cassandro's view the **pure profit** is just the component *b)*. We agree with him since when we ask to the firm to create profit we do not refer to just a positive net income, instead we want that the economic value creation condition is satisfied. It should be stated that the undistributed profit increase also the value of the owners share. Indeed, owners have a double remuneration: dividend and capital gain.

Table 49 – *The income statement*

	Income Statement: Quarter 1 2013	
	Revenue	
	Shirt Sales	$14,000
	Total Revenue	**14,000**
	Expenses	
	Costs of Shirts	6,500
	Cost of Ink, supplies	2,000
	Marketing (website, etc.)	1,200
	Wages	5,000
	Shipping	1,500
	Total Expenses	**16,200**
Bottom line	**Net Profit (Loss)**	**($2,200)**

Source: Our elaboration

Assignment 12 – The objective of your private hospital

5.2. *The role of profit in society. Is profit a dirty word?*

Following the role of profit in society:

"1. Investment in Research & Development. This leads to better technology and dynamic efficiency. This profit is particularly important for some industries such as oil exploration and car manufacture. Without this investment the economy will stagnate and lose international competitiveness, leading to job losses in some sectors.

2. Reward for Shareholders. Shareholders are given dividends. Higher profit leads to higher dividends and encourages people to buy shares. Shareholders are an important source of finance for firms. Profit is important to be able to remunerate shareholders.

3. High Profit should attract new firms into the industry. For example, the high price of oil and hence profits for oil companies should encourage firms to develop new oil fields. This assumes the market is contestable and new firms can actually enter.

4. Risk Bearing Economies. Profit can be saved and provide insurance for an unexpected downturn, such as recession or rapid appreciation in the exchange rate.

5. Tax Revenues. Governments charge corporation tax on company profits and this provides several billion pound of tax revenue per year. In UK the corporation tax rate is 20%

6. Acts as Incentive. Higher profit acts as an incentive for entrepreneurs to set up a business. Without the reward of profit, there would be less investment and less people willing to take risks. For example, it is argued higher corporation tax, which reduces a firms post tax income may deter inward investment.

Evaluation of importance of profit:

– Though profit plays an important role in an economy. It is worth bearing in mind;

– Pursuit of profit may damage environment;
– Higher profit can lead to greater inequality in society;
– Pursuit of short-term profit can encourage risk-taking and reckless behaviour. For example, commercial banks took more risks in the 1990s and early 2000s; this contributed to the credit crunch;
– Firms may pursue other objectives apart from profit-maximization. These objectives can include: growth maximization, cultural / social objectives / sales maximization, profit satisficing” [14].

YouTube 16 – *Is profit a dirty word?*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Profit is not a dirty word	00:03:29	Watch

5.3. *The social and environmental sustainability of the profit*

In the previous section it was said that the profit – as well as being the purpose of the entrepreneur/owner (and not the objective of the business entity) – is essential to the survival and development of the firm. However, in Table 38 it was added that **the profit must be sustainable**.

In this sense, we fully endorse Onida, who notes that even if the firm has an economic object “it does not mean that in practice the firm has only or prevalently economic purposes and that its life gives only economic problems. As a social institution the firm serves to elevate the human well-being, to promote the development of his personality and to make better achieve the purposes of associated human life that are essentially of ethical nature” (Onida, 1971, p. 44).

The **unsustainability of the profit – is not only ethically unacceptable – could be a way to take action that undermines the durability of the firm**. In other words, achieving just the profit maximization could still represent a necessary but not sufficient condition for the durability of the firm, when the profit itself is not accompanied by the other sustainability conditions. An unsustainable management can compromise the economic equilibrium of the firm in a long term.

The Italian scholar Onida believes that the more profitable politic for the firm is to **maximize simultaneously a number of elements**. Indeed, “the non-ephemeral prosperity of the firm, although (the firm) should operate in the market with *economicità*, requires not just the maximization of a single element, such as the profit, but rather the realization of **maximum simultaneous**, as regards wages, dividends, and self-financing, dynamically combined together, even in their relative changes, in order of their mutual reinforcement, while practicing - for products provided by the company - prices suitable to support and expand the demand” (Onida, 1971, p. 91) [15]. Moreover, Onida points out that “the firm that needs

[14] Source: http://www.economicshelp.org/blog/572/business/the-role-of-profit-in-an-economy/

[15] Following the quoted text not translated: «*la non effimera prosperità dell'impresa, pur tenuta a operare nel mercato secondo criteri di economicità aziendale, esige, non già la massimizzazione di un solo elemento, quale il profitto, ma la realizzazione di massimi simultanei, per quanto riguarda salari, dividendi e autofinanziamenti, dinamicamente insieme combinati, anche nelle loro variazioni relative, al fine del loro mutuo rafforzamento, pur praticando – per i prodotti forniti dall'impresa – prezzi idonei a sostenere e dilatare la domanda*» (Onida, 1971, p. 91).

masses of workers, masses of capital, masses of direct or indirect consumers, cannot permanently prosper as a system conceived just in function of the profit" (1971, p. 81) [16].

In line with Onida is also Ferrero, according to which the profit "has not only ethical and legal limitations, but also economic ones: and about one should bear in mind that the durability of the company is not anchored to any claim or attitude the same propensity to pursue profit or, like it is said, to maximize the profit in accordance with expectations given lucrative. The capitalist private initiative, even if it were solicited primarily by the stimulus of profit, should not give incompatible remuneration with the stabilized attitude of the firm to suitably remunerate all factors of production complementarily considered [...] It follows that *even if the profit represents, at least, the only incentive for the private initiative [...] it can never constitute the objective of the economic entities that produce for the market*" (1968, p. 30-31, emphasis added) [17].

We want to point out that what was stated by the Italian *economisti d'azienda* fifty years ago – so long before the scandals and the global economic crisis – it has been proposed recently by some distinguished USA scholars, as Porter in the article "*The big idea: creating shared value*" (Porter and Kramer, 2011) and Jensen (2010) with the theory of "*The enlightened shareholders value*".

YouTube 17 – *Creating shared value*

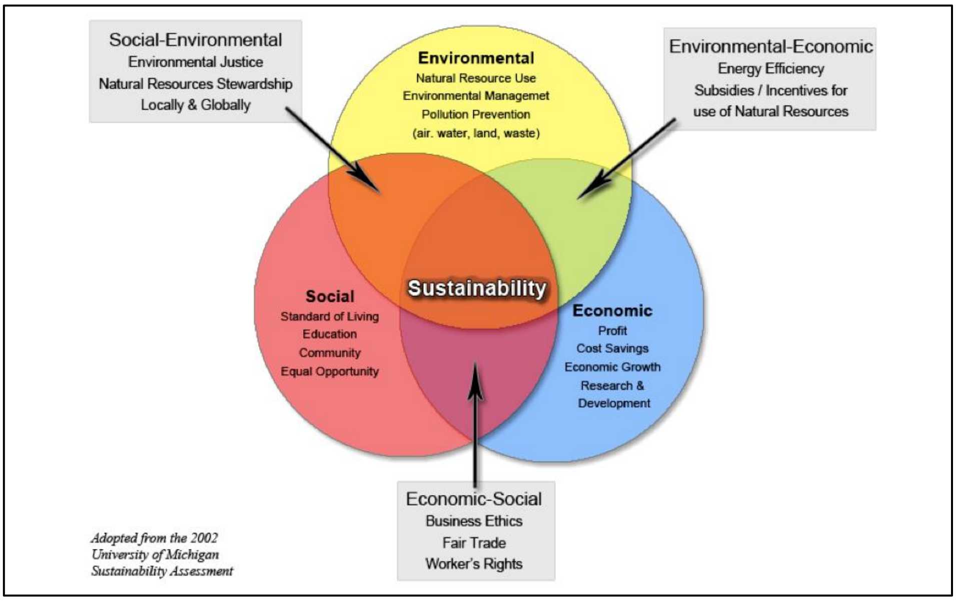
Type	Title	Length (hh:mm:ss)	Study/Watch
Interview	Rethinking Capitalism	00:16:40	Watch

The three "spheres of sustainability (Table 50) shows the economy and society nested within the environment. This illustrates that everything we do starts and ends with our natural environment. Everything we produce and consume takes from the natural world water, energy, plants or animals. Ultimately, all the goods, materials and by-products that we create are returned to the natural environment in our air, water and land. Sustainability is not just about recognizing the relationship between the three spheres of economy, society and the environment. It is also about taking a long-term view, knowing that today's decisions will influence tomorrow's choices. For this reason, we need to consider not only a decision's immediate impacts but also its potential longer-term consequences".

[16] Following the quoted text not translates: «*l'impresa che ha bisogno di masse di lavoratori, di masse di capitali, di masse di consumatori diretti o indiretti, non può durevolmente prosperare come sistema angustamente concepito in funzione soltanto del profitto*» (Onida, 1971, p. 81).

[17] Following the quoted text not translates: «*il lucro trova delle limitazioni non soltanto di ordine etico e giuridico, ma anche di natura economica: ed in merito giova tener presente che la durabilità dell'impresa non è ancorata ad alcuna pretesa attitudine o propensione della medesima a perseguire il lucro o, come anche si dice, a massimizzare il profitto conformemente a date attese lucrative. L'iniziativa privato capitalistica, quand'anche fosse sollecitata essenzialmente dallo stimolo del lucro, non dovrebbe attendere rimunerazioni incompatibili con la stabilizzata attitudine dell'impresa a rimunerare congruamente tutti i fattori produttivi complementarmente considerati* [...] *Ne deriva che il lucro, quand'anche costituisse, al limite, l'unico stimolo per l'iniziativa privata* [...] *non rappresenterebbe mai il fine dell'azienda di produzione per il mercato*» (Ferrero, 1968, pp. 30-31).

Table 50 – *The three spheres of sustainability*



Source: Internet

Table 51 shows the Novo Nordisk case. In a single document (the so-called integrated reporting) the pharmaceutical company discloses the financial and non-financial (social and environmental) performance.

Table 51 – *Financial and social performance in Novo Nordisk corporation*

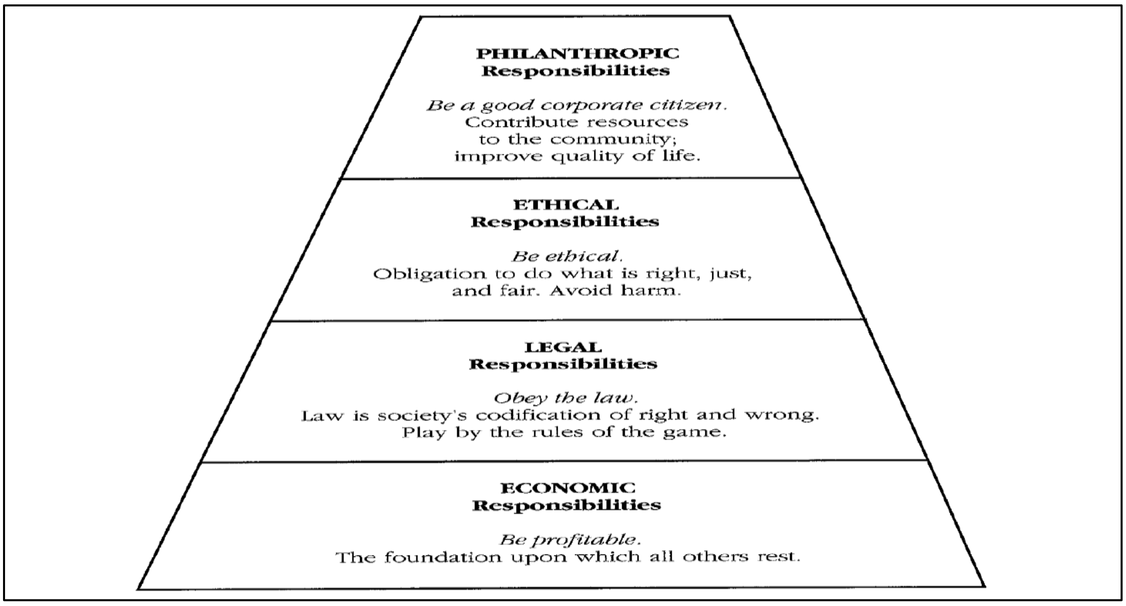
		2011
Financial performance		
Sales total	DKK million	66,346
Diabetes care	DKK million	50,425
– of which modern insulins	DKK million	28,765
– of which Victoza®	DKK million	5,991
Biopharmaceuticals	DKK million	15,921
Gross profit	DKK million	53,757
Gross margin	% of sales	81.0
Sales and distribution costs	% of sales	28.6
Research and development costs	% of sales	14.5
Administrative expenses	% of sales	4.9
Operating profit	DKK million	22,374
Net profit	DKK million	17,097
Effective tax rate	%	22.0
Capital expenditure, net	DKK million	3,003
Free cash flow	DKK million	18,112
Long-term financial targets		
Operating profit margin	%	33.7
Growth in operating profit	%	18.4
Operating profit after tax to net operating assets[1]	%	77.9
Cash to earnings (three-year average)	%	112.8
Social performance		
Healthcare professionals trained or educated in diabetes	1,000	835
Donations	DKK million	81
Employees (total)	Number	32,632
Average of full-time employees	Number	31,499
Employee turnover	%	9.8
Relevant employees trained in business ethics	%	99
Long-term social targets		
Least developed countries where Novo Nordisk sells insulin according to the differential pricing policy	%	75
Engaging culture	Scale 1–5	4.3
Diverse senior management teams	%	62
Environmental performance		
Energy consumption	1,000 GJ	2,187
Water consumption	1,000 m^3	2,136
CO_2 emissions from energy consumption	1,000 tons	93

Source: Novo Nordisk Annual report 2011

However, the well-known three spheres of sustainability, even if important since they clarify the content of the sustainability of the business, do not resolve the trade-off between the three conditions. In other words, they do not give answers to the questions: to what extent a company may be social and environmental responsible? How integrate the business with the ethics, i.e. with the environmental and social responsibilities?

The Carroll's pyramid of corporate social responsibility (Table 52) try to give an answer to those questions, proposing a scale of firm's responsibilities.

Table 52 – *The Pyramid of Corporate Social Responsibility*



Source: Carroll (1991, p. 42)

"In his 1991 article *The Pyramid of Corporate Social Responsibility* Carroll, a business management author and professor, identifies four areas that make up a corporate social responsibility pyramid: legal, economic, ethical and philanthropic. This pyramid has become widely used and is meant to explain the main areas that a business's duties to its stakeholders fall under.

Economic and Legal

According to the 2011 book "Business Ethics," a company's **economic responsibilities** include being profitable in order to provide a return on investment to owners and shareholders, to create jobs in their communities and to contribute useful products and services to society. Part of being economically responsible means streamlining processes to find the most efficient ways to run your business and innovating your product offerings and marketing to increase revenue.

Corporations must ensure that their business practices are **legal**. Obeying regulations helps protect consumers, who rely on a business to be truthful about the products it sells, and investors, who stand to lose profits if a company is penalized or shut down because of illegal practices.

Table 53 – *Economic and Legal Components of Corporate Social Responsibility*

Economic Components (Responsibilities)	Legal Components (Responsibilities)
1. It is important to perform in a manner consistent with maximizing earnings per share.	1. It is important to perform in a manner consistent with expectations of government and law.
2. It is important to be committed to being as profitable as possible.	2. It is important to comply with various federal, state, and local regulations.
3. It is important to maintain a strong competitive position.	3. It is important to be a law-abiding corporate citizen.
4. It is important to maintain a high level of operating efficiency.	4 It is important that a successful firm be defined as one that fulfills its legal obligations.
5 It is important that a successful firm be defined as one that is consistently profitable.	5. It is important to provide goods and services that at least meet minimal legal requirements.

Source: Carroll (1991, p. 40)

Ethical and Philanthropic

Beyond abiding by the letter of the law, an organization's ethical responsibilities include managing waste, recycling and consumption. These areas are sometimes regulated by city, state or federal governments, but often a company can go further than what the law requests and institute policies that help sustain the environment for future generations. Other ethical responsibilities come in the form of advertising, as in not stretching the truth to a customer just to get them to make a purchase, and treatment of employees. A company can provide more than minimum wage and minimum safety precautions for employees; it can provide excellent benefits, insurance and invest resources in building a clean and safe workplace where employees will be happy to come each day.

The authors of the 2011 "Business Ethics" also suggest that part of the philanthropic responsibility corporations face is to promote the welfare of humans and to spread goodwill. An example of this is The Xerox Foundation's "Xerox Employee Matching Gifts Program" in which Xerox matches its employees' contributions to higher education institutions up to $1,000. Similarly, the PepsiCo Foundation has committed over $2 million to World Food Program USA, which helps fight hunger in "vulnerable communities around the globe". [18]

[18] Source: http://smallbusiness.chron.com/corporate-social-responsibility-11605.html

Table 54 – *Ethical and Philanthropic Components of Corporate Social Responsibility*

Ethical Components (Responsibilities)	Philanthropic Components (Responsibilities)
1. It is important to perform in a manner consistent with expectations of societal mores and ethical norms.	1. It is important to perform in a manner consistent with the philanthropic and charitable expectations of society.
2. It is important to recognize and respect new or evolving ethical/moral norms adopted by society.	2. It is important to assist the fine and performing arts.
3. It is important to prevent ethical norms from being compromised in order to achieve corporate goals.	3. It is important that managers and employees participate in voluntary and charitable activities within their local communities.
4. It is important that good corporate citizenship be defined as doing what is expected morally or ethically.	4. It is important to provide assistance to private and public educational institutions.
5. It is important to recognize that corporate integrity and ethical behavior go beyond mere compliance with laws and regulations.	5. It is important to assist voluntarily those projects that enhance a community's "quality of life."

Source: Carroll (1991, p. 42)

The relevant aspect of that pyramids is that it puts the economic responsibility at the first level. Indeed, the profit is a vital condition for the firm. However, also in this case is not clarified how the management should behave in case of trade-off between the three dimensions. Moreover, sometime the firms, in order to maintain their economic equilibrium, are ethically responsible with some stakeholders, even if they do not obey the law. For instance, a firm is responsible with all its stakeholders, except with the State, since it evades taxes.

The *framework* of the primary interest of the firm, proposed before, seems to give the best answer on how integrate the business with the ethics, in particular thanks to the model of the overall equilibrium that allow the firm to survive and growth. Indeed, the social and environmental equilibrium are included in the equilibrium of interests, that is just one of the four equilibriums to achieve in order to favorite the durability of the firm. Moreover, we added the financial and monetary equilibrium that are considered as conditions of sustainability of the profit in the long term, regardless the social and environmental responsibility. The other relevant aspect is that the profit is not see just as the remuneration of the shareholders being also the remuneration of the firm, for the amount of the retained earnings.

Assignment 13 – Unsustainable firms

6. *The firm as a real entity and a community of persons: leadership for the common good* [19]

Firms, differently from individual (physical person), would not be able to express its needs and wants, being committed to do what their governance bodies (i.e. board of directors) decide. Each decision could have two interpretations: one according to which a decision is the result of the combination of individual actions, the other one in which it is the firm itself

[19] The following sections are an extract of the PHD thesis of Cristina Quaranta (from 6 to 6.6).

to decide (see Bainbridge, 2002). Indeed, having the impossibility to express needs (interests) does not means to do not have needs. Different reasons are leading to a comparison between the firm as a real entity and the individual, with its interests and responsibilities, rights and duties. Business ethics literature for example makes a distinction between corporate ethics, that express values and principles by its side (i.e. thought the code of ethics and the code of conducts or thought the corporate culture) and the ethics of the actors operating in business (Argandoña 2012a; Arthur 1987; Treviño et al. 1998). The firm in fact can express its personality that, in turn, affects how stakeholders interact with. As individuals, also the firm has its own image and reputation and an interest in do not jeopardize it (Barnett et al. 2006). Individuals can identify themselves in other people as well as in institutions (Social identity theory, Stryker and Burke 2000). Studies on conflict of interests refer to both conflicts concerning physical corporate actors as well as the so-called *Institutional conflict of interest* (Argandoña 2004). Legislation seems to be oriented to provide the firm as a real institute a responsibility for violations perpetrated from its internal actors (managers, directors, etc.) if they have acted in the (illicit) interest of the firm (e.g. the Italian Legislative Decree 231/2001). Therefore, even firms can have particular interests competing with the interests of some stakeholders and the community as well. In this regard, the *common good theory* has as starting point the consideration of the firm as a community of persons, a real entity having as objective the production of useful goods and services efficiently and sustainably, creating conditions for each participant to receive back what it is reasonably expected (Argandoña, 1998, p.1097). The common good would constitute a common interest for all stakeholders. Indeed, the risk in following only the personal interest of each business participant would imply the possibility to jeopardize even the satisfaction of the latter. Make of the interest of the firm a common good means to align the individual particular interests with the own interest of the corporation. Table 55 shows some of the definitions of common good provided by Argandoña (1998, p.1097) and adapt them to the organizational context to understand why and how the interest to serve the common good favorites the survival and growth of the firm, considered as a system of parts and participants, and the community well-being.

Table 55 – *The common good and the interest of the firm*

Common good (Argandoña 1998)	Interest of the firm as a common good
"The common good is the good for society as well as the good of its members, since they are part of the community. The interest of the community is not independent from the objective of its participants"	"The common good is the good for the firm as well as the good of its stakeholders, since they are part of the organization. The interest of the firm is not independent from the objective of its stakeholders"
"The common good is not a partial good; it belongs equally to all individuals (as part of the community) […]"	"The interest of the firm is not a partial interest; it belongs equally to all stakeholders and the community […]"
"The common good could even be seen as the set of means (helps) that society provides to its members to allow them reach their objectives"	"The interest of the firm could even be seen as the set of means (helps) that firm provides to its stakeholders to allow them reach their objectives"
"The common good is the good of the social system, realized in its members"	"The interest of the firm is the good of the social system, realized in its members"

Thus, the view of the firm as a set of contracts is a hypothesis just for economic purpose, useful to develop theories to understand and predict events. However, this view lacks in considering individuals beyond their instrumental and material relations. In today's thinking organizations cannot be successful for very long time unless change is first built on the predominance of human resources; people and process will always be more important than tasks and structure in achieving goals and increase productivity; highly motivated and well-trained employees provide the effectiveness in accomplishing goals (Page and Wong 2000). Leadership has the role to invest in followers since it starts from within (Bender 1997). However, there exist two macro dimensions of leadership, one that is concerned with the social-emotional and moral aspects of leadership; it involves having a heart for others and an interest in developing humans' inner potential (Page and Wong 2000). While the other one is concerned on how a leader implements his/her work in leading followers, and includes the typical abilities associated with management and leadership such as decision-making, visioning and implementing. The leader oriented to the primary interest of the firm is a mix between a leadership oriented to serve people with a focus on them more than on the organization objectives (literature has suggested different leadership style focused on this objective such as the servant leadership, ethical leadership, empowering leadership, benevolent leadership, responsible leadership, etc.), a leadership oriented to the organization objectives trough the understanding of followers' needs (transformational leadership, self-sacrificing leadership, level 5 leadership, etc.) and leadership focused only on results (transactional leadership). The leadership style suggested in the present chapter is in charge to balance uncertainty, the interests of individuals, the firm and the community thanks to its ability to assess the problem complexity.

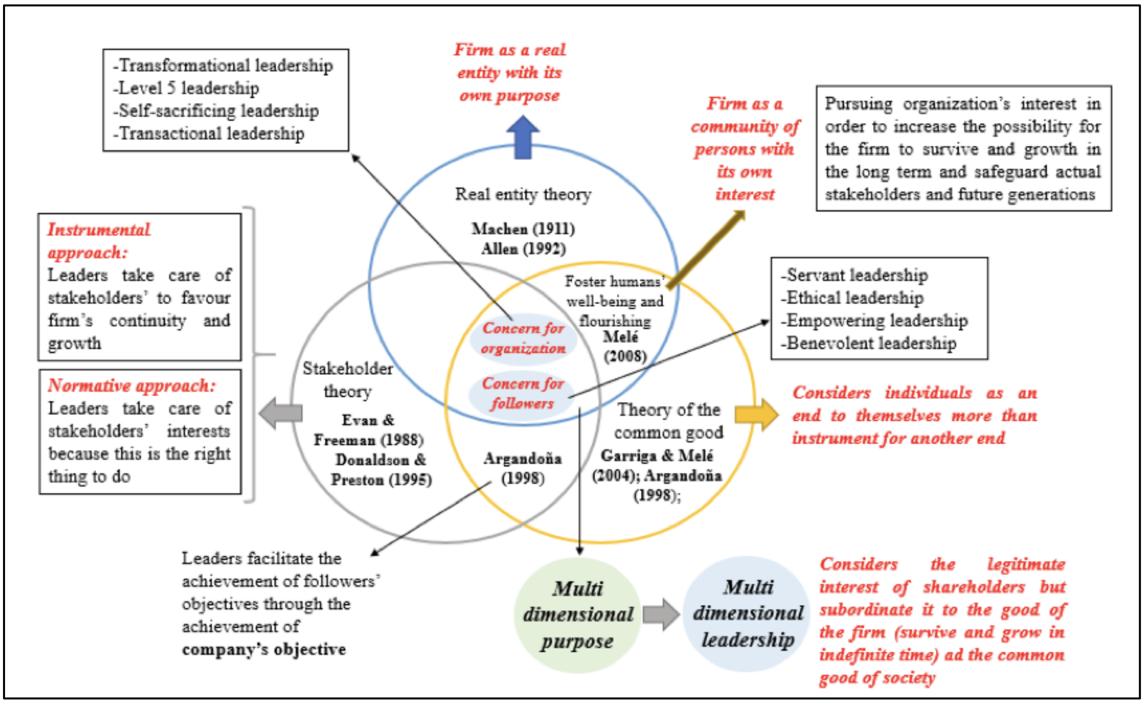
6.1. *The importance of leadership in pursuing the primary interest of the firm*

The ambitious purpose of the firm proposed that integrate different spheres of business and ethics needs an appropriate leadership style to be pursued. Indeed, for managers, especially young ones, leaders are example of behaviors (Ba□d□ 2018). However, the actions of a leader could become more detrimental than positive for the followers since leadership occurs when people, leaders included, are motivated to do what is ethical and beneficial for the organization (Yukl 2010). Leadership is tied to the concept of purpose because literature tends to entwine it with notions of vision, mission and shared objectives (Bass 1990; Hunt and Conger 1999). A proper concept of the business-society relationship and corporate social responsibility has been analyzed focusing on the assessment of a plurality of dimensions (meeting objectives that produce long-term profits; responsibly using business power; integrating social needs and contributing to the good of society by doing what is ethically correct) and the integration among them (Garriga and Melé 2004). The primary interest of the firm is a multi-dimensional objective that asks for a multi-dimensional leadership style in charge to balance the interests of individuals, the firm and the community thanks to its ability to assess the problem complexity and consider more than one variable simultaneously before making decisions. The role of a leader oriented to the primary interest of the firm is that to pursue the good for people internal and external to the organization always keeping in mind the limits within which business continuity is ensured as well as people's internal and external growth, as a good *family man* does.

6.2. *Theoretical foundation of multi-ends leadership (MEL). Real entity theory, Stakeholder theory, and theory of the common good*

The theoretical foundation of MEL comes from the intersection of three theories: the real entity theory, the common good theory, and the stakeholder theory. In the model of leadership proposed leaders have to support stakeholder private interests serving of the primary interest of the firm (common good) as a compass for decisions. On the one hand, this will make stakeholders feel like part of a community (Melé 2008) and on the other, business and ethics become part of the multi-ends purpose of leaders and the organizations.

Table 56 – *Multi-ends leadership. Intersections between the real entity theory, the stakeholder theory and the theory of the common good*



6.3. *The contribution of the real entity theory*

Reducing the firm to a fictitious person existing only in contemplation of law presents problems (Melé 2008); people carry out activities in cooperation and results cannot be attributed to anyone in particular, but to the organization as a whole. Firms have culture and history, and an accumulative learning, which remains when individuals, who can join and leave the firm, have gone. These arguments let considering the firm as something more than the sum of the parts who compose it. However, consider the firm as a real entity does not eliminate individuals, on the contrary, it completely depends on them and their relationship. Together with the need to take care of stakeholders' interests, the leader and the whole community need to take care of the organization's interests as well. For example, an increase in the welfare of a single stakeholder (i.e. employees) is acceptable when it has a positive effect on the overall balance in the medium and long-term. Indeed, the unitary vision of the business dimensions suggests connecting the effect of the stakeholder management to the economic, social and environmental equilibrium. If increasing the well- being of a stakeholder improves in the long term the overall equilibrium, leader should do that, also because increasing the possibility of the business to survive and grow is the right thing to do for all the actual and future stakeholders and the overall community of persons. All that given, the real entity theory seems to do not specify which the interest of the firm as a real entity has to be and *which are the right conditions needed to ensure its survival and growth*. This is a relevant aspect given that the interest of the firm and the interests of stakeholders can be sometimes competing. For example, in facing the decision to distribute profit to shareholders or use it as saving capital for financing future investment, which the leader choice should be? Giving management too much discretion about business decisions could favor opportunistic behaviors. Thus, the real entity theory does not clarify how to solve the trade-off between the interest of the firm and the interests of stakeholders. Leader has to share message throughout the organization being aware that the interest of the firm could sometimes differ from the interests of the group of stakeholders he has to serve. He needs to know how to balance economic and social dimensions without obstructing others.

6.4. *The contribution of the stakeholder theory*

In the stakeholder theory corporation is considered as a center of coordination of stakeholders' interests (Evan and Freeman 1988) or as a system of primary stakeholders groups with different rights, objectives and expectations (Freeman 1995, pp. 196-107). The main contribution of stakeholder theory lies in the need to take care of stakeholders' interests not only because of fairness, as the normative stakeholders' approach suggests, but also because of economic reasons (Plender 1997). However, a leader oriented to the primary interest of the firm links together the view of the firm as a real entity and the stakeholder theory since the latter does not consider relations among stakeholders more than contractual ones. This theory like the real entity theory does not provide a shareable and common interest that leaders have to use a compass to manage business complexity.

6.5. *The contribution of the common good theory*

The common good provides the missing elements to the stakeholder theory and the real entity theory. It gives the former a superior objective serving as a compass in managing the trade-off between all stakeholder interest and to the latter the right conditions needed to ensure firm survival and quantitative and qualitative growth. The conception of the firm as a community of person (Melé 2008) according to the real entity theory, gives a more complete model of *men* considering them able to develop cooperation and human virtues within the organization. The common good theory gives an overall effect for the whole business community since individuals are not self-regarding but able to cooperate with a sense of service, altruism, and reciprocity having extrinsic, intrinsic and transcendent needs to satisfy. These attitudes of cooperation improve people's happiness and well-being (Lyubomirsky et al. 2005; Post 2005), thus, the common good orientation fosters human flourishing. Moreover, the common good theory is strictly connected to virtue ethics (Arjoon et al. 2018). The common good provides the right direction for actors' behaviors and the right conditions to understand virtues, while, it is through virtuousness that the common good is realized. A specific behavior is not considered as virtuous if it is instrumental to the pursuit of another objective that is not related to the common good. In the same way, link virtuousness to the good for the firm is not instrumental. The survival and growth of the firm is a common good and a virtuous behavior aimed to balance all other dimensions (economic, social, etc.) will serve the common good. Those behaviors, enabling to improve the overall dimensions of the business purpose, can be considered as virtuous since they are aimed to favor the good for the firm, for stakeholders and the community. Therefore, the virtuous behaviors of leader towards his followers have to be weighted with the effects they have on the overall equilibrium, especially when the orientation to the good for individuals would tend to worsen the company's long-term continuity.

6.6. *How to manage followers' orientation, leaders' reccomendations*

At this point of the work, it is important to understand which is the process leader has to follow in making a mission oriented to the primary interest of the firm concretely implementable. This is a relevant aspect since the mission of a company can be achieved both in a *reactive* (the need coming from external and internal contingencies to manage the firm with a MEL approach even if the initial purpose is different) or *proactive* way (the intentional spread of a business culture based on the concepts exposed). The chapter proposes a possible proactive process for the achievement of the primary interest. Leader needs to establish a reciprocal relationship with followers leading them to return and facilitate their service towards the firm mission. An employee intrinsically virtuous and oriented to the firm will likely tend naturally towards the well-being of the community as well as the firm long-term durability. However, there exist individuals that are oriented to the firm but incentivized to act for a short-term interest. What does it mean? That the firm orientation may depend on how the firm is considered. For example, being oriented to the firm but see it as a fictitious person would lead followers to be oriented towards a specific group of stakeholders (e.g. customers, employees) or the short-term interests of shareholders. To establish what is right and what is wrong usually it is useful to answer the question *for whom?* Since a leader oriented to the primary interest ask for creating value both for the firm and all other stakeholders, it is not possible to assess that it has a mere concern for the firm more than for followers or vice-versa. The proposed recommendations are in terms of behaviors that leaders oriented to the primary interest has to have. This because literature usually identifies leader's characteristics and attributes without going in-depth on the concrete messages he/she has to provide. This gap is probably due to the lack of linking leadership style with corporate finalism. The starting point for recommendations is that leader has to have clear what the primary interest of the firm is and the ways to promote it. He/she has to have the right understanding of the common good and the goods that compose it, to work for its generation and spread. 1) *Leader has to permeate the necessity to elaborate a clear mission* shared by all and oriented to the primary interest, contrasting the tendency to consider this instrument as useless. 2) As a good family man, *he/she has to be able to create a community and orient people to the interest of the latter* (so, to the mission). Moreover, he/she has to make clear that, differently from a family context, the firm is not only a community of persons but a system composed of goods (material and non-material) and persons and a series of relations among them. It is not enough to create the community since it needs to preserve it, thus, *leader has to clarify followers the concept that the firm has distinct interest from stakeholders;* shareholders are not the owners of the firm but the owners of the shares (Alchian and Demsetz 1972), as a consequence, the firm cannot be managed in their exclusive interest. This especially because the interests of shareholders and the interest of the firm are not always aligned (Di Carlo 2017). 3) *Leader has to make followers able to understand what does pursue the primary interest mean*. For example, facing an ethical dilemma (makes the interest of A prevailing on the interest of B), he has to underline how the primary interest of the firm is the only compass for decision. *4) Leader has to transmit to followers the courage to criticize his choices,* since leader too can make mistakes, for example, by don't understand deeply employees and other stakeholders' needs. The last statement implies a deep followers' knowledge of the interest of the firm and their interests in pursuing it. 5) *Followers have not to identify themselves in the figure on the leader but the firm*. This is order to create a business culture that can overpass the time of permanence of leader within the firm, safeguarding the firm in governance decisions (e.g. family succession). 6*) Leader has to be aware that cooperation can bring to the firm a new kind of knowledge, that differ from the sum of individual bits of knowledge*. This can help to face a situation of complexity that asks for integration among parts of the organizational system (Thompson and Perry 2006). Moreover, *7) in case of delegation of some activities to external parties, the leader must recall also for the latter the need to be aligned with the primary interest*. In this case, he has to consider the possible misalignment and take responsibility for it. In aligning followers towards the primary interest *8) leader has also the role to make clear the tangible and intangible costs deriving from followers mis-orientation*. This can allow avoiding opportunistic behaviors of those followers who realize that a short-term orientation would bring them higher personal benefits than costs. 9) *Leaders have to make followers understand their relevant role in pursuing corporate objectives and rewards them (with extrinsic and intrinsic goods) for their contribution*. He/she has to reward decisions that bring results aligned with the primary interest more than only positive results; for example, if he/she does not punish the betrayal behaviors of an employee towards customers (regardless of the increment of profit it has generated for the firm) the employee would never have the awareness that his actions will go against the interest of the firm. Important in this case is addressing to the code of ethics to underline possible deviances of conduct. All these recommendations aim to avoid that individuals pursue their self-interest jeopardizing the interest of the firm.

7. *The primary interest of non-business entities*

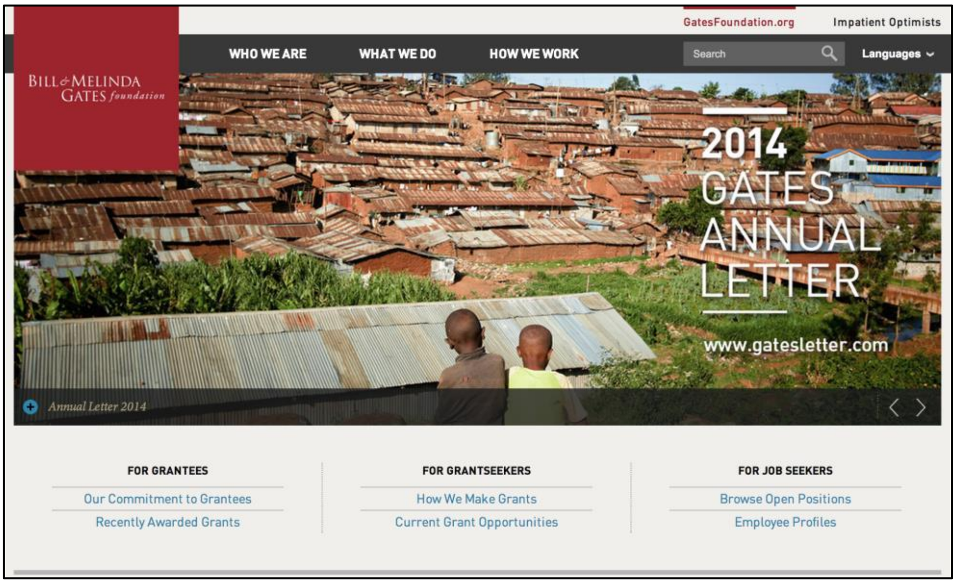
Business entities (i.e. economic entity that produce for the market) do not meet all human needs. Indeed, some economic activities are subtracted (in whole or in part) and in the interest of community, to the exclusive logic of the market and, therefore, of the profit. Consider, for example, the education, health, or some strategic areas in which, in some countries, the State decides what and how to produce.

The risk is that the exclusive logic of profit can satisfy the needs of customers/users in an inappropriate manner. For example, in the case of healthcare sector, services could be guaranteed only to those who have been able to afford an insurance policy to cover medical expenses, or companies may sell ineffective or dangerous drugs.

There are other economic activities that failing to provide an adequate level of profit, are not attractive for entrepreneurs. In this case the impossibility to make profit does not allow the economic entity to survive and develop, not only because there would be no investors interested in financing the economic activity, but also because such activity would not be able to remunerate the other stakeholders (e.g. employees).

In some cases there are reach entrepreneurs that use the profit they get from their business entities to finance philanthropic organizations. For instance, this is the case of the billionaire Bill Gates with *Bill & Melinda Gates Foundation* (Table 57).

Table 57 – *Bill & Melinda Gates Foundation*



Source: http://www.gatesfoundation.org/

For this reason, some people, with purposes other than profit, constitute the so-called non-business entities (e.g. Educational Institutions, Government, Museums, Hospital, Universities). We include in this category all the *aziende* that do not produce for the market (right side of Table 58).

Consider, for example, the foundations that are involved in the research of rare diseases present in underdeveloped countries, where the users of the drugs cannot afford proper care and where, therefore, an entrepreneur guided by the exclusive interest to the profit would not find profitable to invest in it.

YouTube 18 – *From profit to philanthropy*

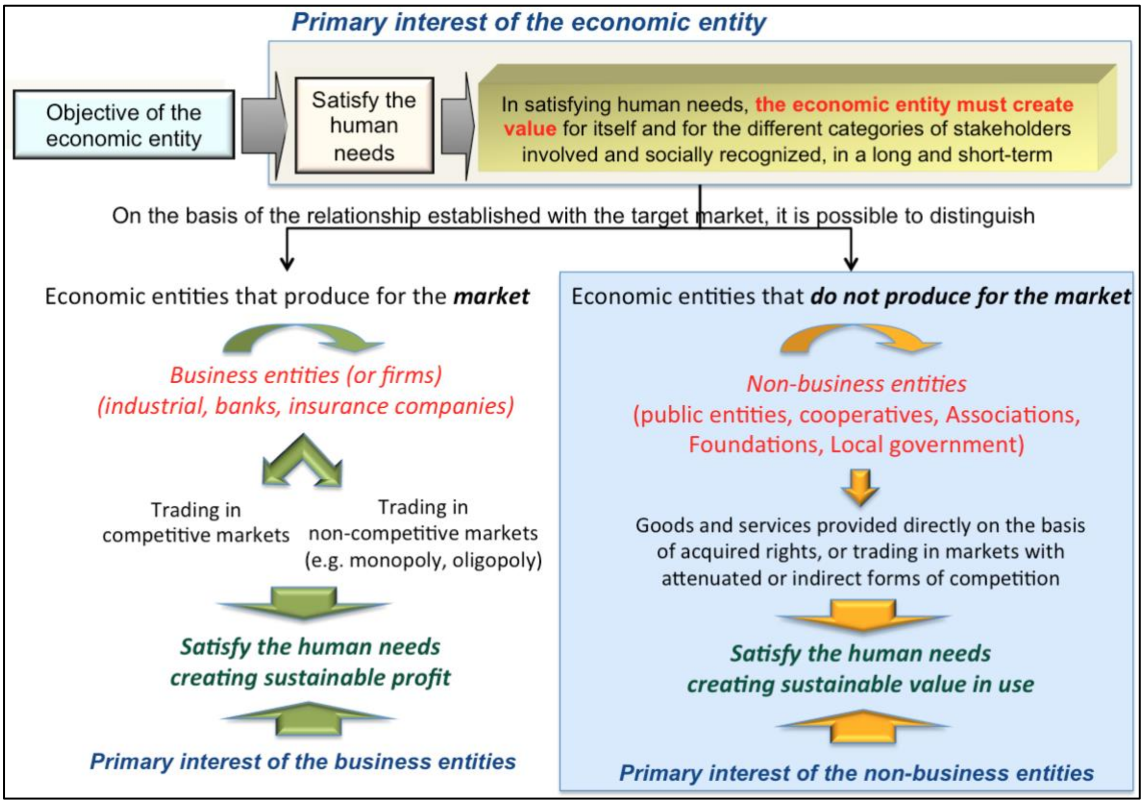
Type	Title	Length (hh:mm:ss)	Study/Watch
Interview	Bill Gates: Mosquitos, malaria and education	00:20:17	Watch
Interview	Peter Singer: The why and how of effective altruism	00:17:19	Watch

A non-business entity exists in order to provide goods and/or services to members for which it was established. Thus, the production is not destined to the market but to specific individuals or group of people. For instance, in the previous example the foundation is established in the interest of the cancer patients. Thus, the altruism is central in that economic entity. For some non-business entities the altruism is the base for the fundraising (e.g. associations and foundations).

The business entity "needs to generate sufficient income to cover expenditure incurred. Income earned in excess of expenditure is regarded as a surplus and not as a profit. Similarly, expenditure incurred in excess of income earned is described as a deficit and not as a loss".

Business and non-business entities "provide goods and services to the community and use scarce resources in the process; both obtain these resources from external sources and are accountable to the providers of the resources or their representatives; both control stocks of resources; both incur obligations; and both must be financially viable to meet their operating objectives".

Table 58 – *The economic entities that do not produce for the market*



Source: our elaboration

Like business entities, non-business entities have the character of durability when they meet the needs for which they were constituted and operate with *economicità*.

So, what is common with the business entities is the objective: both produce goods and/or services (object) to meet the needs and both must, in meeting those needs, create sustainable value.

Assignment 14 – The non-business entities

Therefore, **the main difference between business and non-business entities is on what motivates to meet human needs (profit in business entities, social motivations in non-business entities), as well as by the fact that only the business entities operate in the market both in the acquisition of factors of production and in the placement of products made**. This leads to further clarify the concept of "value": value in exchange for the business entities and value in use for non-business entities. That is why the interest of the former should be ***crate sustainable profit***, while for the latter ***create sustainable value in use***.

In the absence of markets, or in situations in which the forces of supply and demand are attenuated or indirect, the significance of the price, as a means of measuring the value of goods and services provided is reduced; thus, the value must be measured directly through the benefit perceived by the users of goods and services (the so-called value in use).

YouTube 19 – *The concept of value*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	[What's the difference between price and value?]	00:01:26	Study

That is why some public administrations uses the emoticons "Show your face" which entails the gathering of users satisfaction data on services received, with the aim of constantly improving the services provided for.

Table 59 – *The emoticons in public administration*

Source: Internet

In non-business entities, the *economicità* does not necessarily imply economic autonomy, i.e. the economic equilibrium. There may be cases in which the durability of the entity is supported by positive economic results, even in the presence of *economicità*; in these cases, the survival of the economic entity must be achieved through the support of third economies (e.g. government subsidies). It follows that manage the economic entity with *Economicità* also means finding a justification for economies that allow them to survive.

REVIEW QUESTIONS

Following, the review questions for this Chapter.

Open-ended questions

1) What is the difference between *economicità* and economic equilibrium?
2) Is it possible for an economic entity satisfy human needs destroying value? Why?
3) Who are the stakeholders of the economic entity?
4) What are the employees' expectations?
5) Is the conflict of interest a form of corruption?

Multiple choice

6) Public Authorities are:
   - Primary stakeholders
   - Secondary stakeholders
   - Both primary and secondary
   - Not stakeholders

7) The three spheres of sustainability are (only one is correct)
   - Economic, social, environmental
   - Economics, efficiency, effectiveness
   - Social, environmental, effectiveness
   - None of the previous answers is correct

8) Which of the following is a characteristic of non-business entities?
   - The objective is to create value in use
   - They do not operate for the market
   - They produce only services
   - None of the previous answers is correct

Put theory into practice

Following the mission of Coca Cola company. Identify, if present, the What, How and Why of that mission:

Coca Cola Mission

Our Roadmap starts with our mission, which is enduring. It declares our purpose as a company and serves as the standard against which we weigh our actions and decisions.

To refresh the world...

To inspire moments of optimism and happiness...

To create value and make a difference.

CHAPTER THREE

CONFLICTS WITH THE PRIMARY INTEREST OF THE ECONOMIC ENTITY

1. *Objectives and Assignments of this chapter*

After reading this chapter, you will be able to:

- Recognize, evaluate and manage the conflict of interest in the economic entities [1];
- Distinguish the conflict of interest from other forms of conflict;
- Distinguish the conflict of interest from the corruption.

Following the Assignments of this chapter:

Assignment 15 – Actual, potential and apparent conflict of interest

Assignment 16 – Corruption

Before starting with the following paragraph, complete the two anonymous questionnaires:
– What do I do when I receive a gift or another utility?
– What do you know about conflict of interests and corruption?

2. *Defining the actual conflict of interest*

In the previous chapter the term "**primary interest**" of the economic entity (i.e. satisfying human needs creating sustainable value) was used in order to distinguish that interest from the particular interests of its stakeholders (e.g., owners, employees, suppliers, customers) (Chapter I, § 5).

Now we focus the attention on the interest of the so-called agents, i.e. the individuals delegated to achieve the primary interest of the economic entity. In particular, we refer to the directors, managers and employees, politicians (e.g. in case of a public administration, or a business entity controlled by the State).

Are the agents (e.g. employees, managers) of the economic entity always oriented towards its primary interest? In some cases, the agents have private interests that could conflict with that of the economic entity in which they operate.

For instance, how would you answer the following question?

[1] In this chapter and in the following the term "economic entity" is used as sinonimous of *azienda*.

I am in charge of personnel of a private company and I have the responsibility to decide if hiring one of my close family members who, however, is not a competent person to play the requested role in my company. Should I hire him?

The actual conflict of interest (CoI) is here defined as

the situation where a secondary interest of the agent tends to interfere with a primary interest of the economic entity

The proposed definition allows the inclusion of all relevant situations of CoI within the organization. It is a general definition, but can be easily adapted to various situations of conflict that may characterize individuals and institutions in various fields.

The definition contains the following three key elements:

– Agency relationship and primary interest of the economic entity (in the previous example the agency relation exists since you are an employee of a private company, and the interest of the economic entity is to select a competent person);
– Presence of a secondary interest of the agent (the family link);
– The secondary interest of the agent tends to interfere with the primary interest of the economic entity (the family link tends to interfere with the primary interest of the economic entity).

2.1. *The primary interest of the* economic entity

The first element of the definition requires the presence of an agency relationship (i.e. a relationship between the agent and the economic entity). The agent must act in the interest of the principal (i.e. the economic entity): in the absence of such relationship CoI cannot exist. The primary interest of the agent is referred to the duty that he/she has in reaching the primary interest of the economic entity (Chapter II, § 2).

Sometimes the primary interests are stated as ends or goals (e.g., promoting the interest of the economic entity), as obligations (e.g., agents' obligation to promote the interest of the economic entity) or as rights (e.g., the economic entity right to have the agents promote their interest).

2.2. *The secondary interest of the agent*

Undoubtedly, among the elements of the CoI, the presence of the agent's secondary (private) interest is what causes more problems for what concern CoI recognition. The private interest is in human nature and it is almost surreal to think that an individual, even altruistic – it is therefore inclined to think the good of others – can give all their private interests.

Normally, the interests of individuals find their genesis in the needs that they aim to satisfy (Maslow, 1954). The interest is therefore a factor that motivates the behavior of the individual. The secondary interest is typically financial gain and could be seen as an extrinsic motivation. Individuals are "extrinsically motivated if they are able to satisfy their needs indirectly, especially through monetary compensation" (Osterloh and Frey, 2000, p. 539). Money is a "goal which provides satisfaction independent of the actual activity itself" (Calder and Staw 1975, p. 599).

But the secondary interest may as well be intrinsic. "Motivation is intrinsic if an activity is undertaken for one's immediate need satisfaction" (Osterloh and Frey, 2000, p. 539).

Financial conflicts may be the easiest to identify, but they may not be the most influential. The agent can also have no financial (personal) interests (Thompson, 1993 and 2009). Indeed, secondary interest may also include professional advancement, recognition for personal achievement, and favor to friends and family (Cohen, 2001; Foster 2003).

In this respect, Thompson (2009) clarifies that the majority of secondary interests are – within limits – entirely legitimate (and desirable) to some extent, but they become critical when they have a greater say in the decisions of the agent as compared with the primary interests.

2.3. *The tendency to interfere*

The third element of the definition of CoI requires that the secondary interest of the agent "tends to interfere" with the agent's duty to exercise his/her professional judgment in accordance with the interest of the economic entity.

Many of the decisions of individuals, involving other individuals, although influenced by competing interests, are not consider in the category of CoI, because of the absence of this third element. As Carson argue "It would be in my personal interest for my employer to pay me $1.000.000 a year, but it would not be in my employer's interest to pay me such a salary. This is a case in which the interests of an employee conflict with those of her employer, but it is not a CoI. Conflicts of interest involve a clash between the interests of an individual (or those of her friends and family, etc.) and the interests of some other party for whom she works".

Obviously, it is not unfair to a certain situation, the fact of getting a private interest, as, for example, when someone change jobs because of higher remuneration or when he/she helps a friend find a job. In fact, the problem arises when that interest becomes secondary to a primary interest that the individual has a duty to obey as a consequence of the position held and the liabilities assumed.

The term "tends to interfere" wants to emphasize that the interference of the secondary interest occurs with varying intensity depending on the agent secondary interest and importance assumed by that interest. As argued by Resnik (1998) "Tendencies admit of degrees: some things tend to have certain properties more than other things. Glass tends to break more easily than steel; Dobermans tend to be more aggressive than Beagles. When it comes to conflicts of interest, some situations tend to undermine our judgment or will more than others".

The agent decision-making is fair when he/she is not affected (even potentially) by secondary interests (Davis, 1993). The fair judgment of the agent could be considered as the ability to make sound decisions based on knowledge and skills that are obtained through education, training, and experience (Foster, 2003). The ability to judge, the professionalism of the agent is a prerequisite of his/her independent judgment. If the agent is incompetent, he/she does not receive any interference on the decision-making but just because the agent does not know what is his/her role and responsibility.

The *secondary interest may tend to interfere with 1) the proper exercise of judgment; 2) agent's ability to fulfill his/her fiduciary obligation.*

According to Resnik (1998), our definition emphasizes two components: the *impairment of the judgment* and the *corruption of the will.* In the first case the agent does not properly exercises his/her judgment, while in the second the agent does not have the ability to fulfill his/her fiduciary obligation. Both of these cases can have adverse impact on agents' objectivity and trustworthiness.

Judgment, according to Davis (1982), is a form of cognitive activity, such as decision-making, observation, or evaluation, that requires more than mechanical rule-following or common sense. Conflicts of interest tend to impair our judgment, and they can lead us to make unsound decisions, observations, and evaluations.

Conflict of interest can impair judgment in two ways (Davis, 1982; Resnik, 1998).

First, a CoI may *bias a judgment*. A director who is asked to assess a manager who is also his best friend is likely to make a biased assessment. *People who know this bias can compensate for it*. Using Resnik example, we can say that this situation is like when we have a thermometer consistently underestimates air temperature by two degrees centigrade, then we can correct this bias by adjusting in the temperature we record.

Second, a CoI may render a director's *judgment unreliable*. A director with biased judgment makes errors that are slanted or skewed in a particular way.

Move to *corruption of the will*, Resnik observes that "the will is that part of the person that transforms cognitive states into actions". Many situations of director's CoI involve corruption of the will instead of corruption of judgment. For example, we can say that all the situations where directors are called by the dominant shareholder to protect his/her interest, allowing him to extract of private benefits of control, and consequently damaging minorities, we are in the context of corruption of the will. This is because, differently from bias of the judgment, in corruption of the will director may know how to carry out his/her obligations to minorities, but fail to do so because he/she ignores these duties in order to satisfy his/her private interest.

3. *Apparent and potential conflict of interest*

Now, using Resnik's approach we adapt actual CoIs' definition, to define apparent and potential CoI.

> The *apparent (or perceived) conflict of interest* is the situation where an agent has a secondary interest that *appears to outside observer(s)* to interfere with the primary interest of the economic entity

Indeed, an apparent CoI exists when a reasonably well-informed outside observer(s) could have a reasonable apprehension that the secondary interest interferes with the primary interest. Outside observer may include for example colleagues, shareholders, the press, members of the public.

All CoI involve perceptions or appearances because they are specified from the perspective of people who do not have sufficient information for assessing the actual motives of a decision maker and the effects of those motives on the decisions themselves (Lo and Field, 2009).

Resnik (1998) argue that "in defining apparent conflicts of interest, we can also observe that different people may arrive at different judgments about whether particular situations tend to undermine a person's will or judgment. Although affected parties may agree that a situation is not a conflict of interest, outside observers may have different opinions. (…).

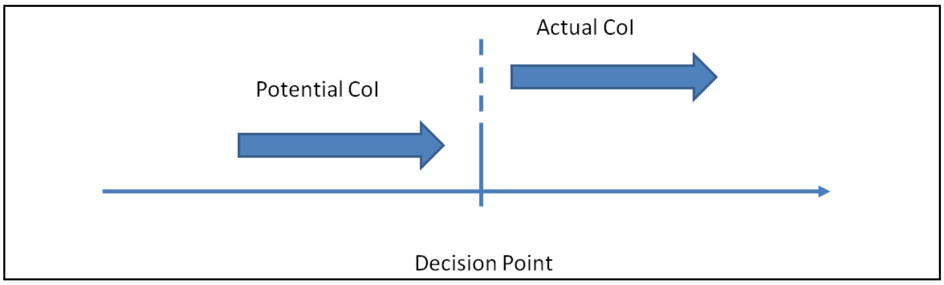
Outside observers and affected parties may arrive at different opinions due to differences in knowledge about the situation or differences in their assessments of its ethical aspects".

Then, in apparent conflict, the situation is likely to seriously damage the reputation of the agent and the organization in which he/she operates, even when the agent has no interference in his/her judgment (Winch 2003).

> The *potential conflict of interest* is the situation where an agent has a secondary interest that *could* interfere with the primary interest of the economic entity.

For example, all the agents who have family and/or professional relationships with the management or the main shareholder are in potential CoI, as well as agents who have financial interest in customers (i.e. director has a partial ownership in a company that buy goods from the firm) or supplier of the firm. These ties could bring an actual CoI in the future.

Table 60 – *Potential and actual Conflict of interests*

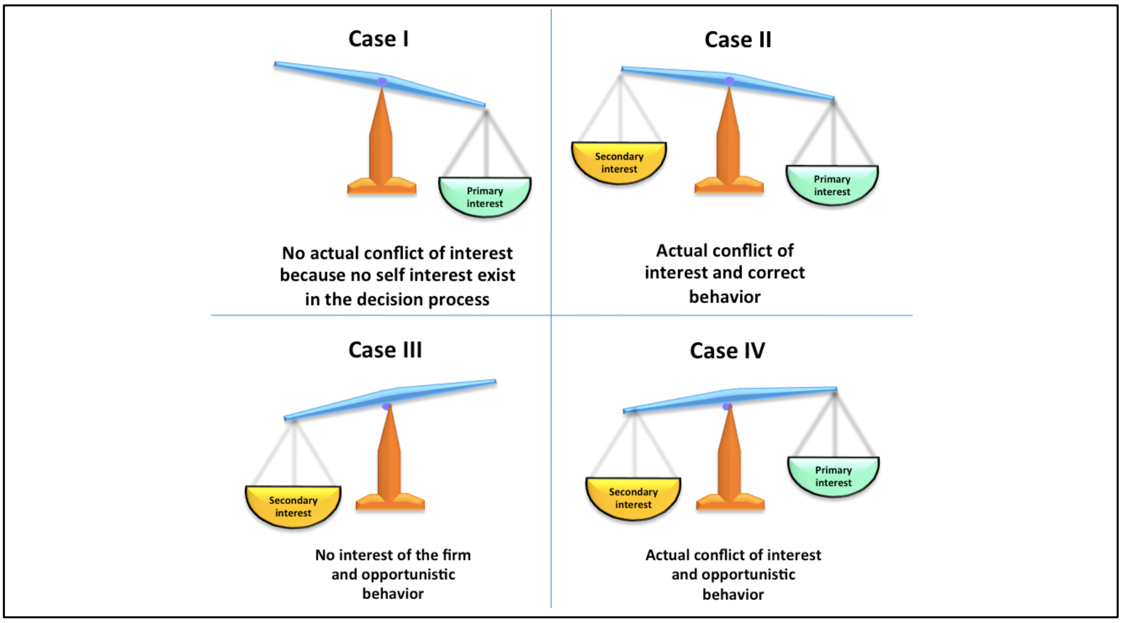


Source: Our elaboration

Assignment 15 – Actual, potential and apparent conflict of interest

We find useful to represent graphically the conflict of interest, in particular the actual one, with a weighing scale (Table 61). In the left arm we put (if exist) the private or personal interests of the agent whereas in the right arm the primary interest of the economic entity (creating value).

Table 61 – *Conflict of interest with and without opportunistic behaviour*



Source: Our elaboration

The use of the scale well depicts what happens into the agent's mind when during the decision-making process there is a situation of incompatibility between the agent's self-interest and the interest of the economic entity.

Indeed, in each decision process the agent could be in four different situations:

– The first is the situation without actual conflict of interest, because the agent's self-interest is not present;

– The second is the situation with actual conflict of interest but the interest of the firm prevails on the other interests as a result of a correct agent's behavior;

– The third is referred to an agent that has just self-interests. In the decision process he or she does not consider the interest of the firm and always behaves in an opportunistic way (i.e. fraudulent case);

– The fourth is the situation with actual conflict of interest, in which the agent feels both the self-interest and the interest of the economic entity, but the first prevails on the second.

Situations III and IV are cases of corruption because the secondary interest prevail on the primary one.

Recalling the previous situation:

I am in charge of personnel of a private company and I have the responsibility to decide if hiring one of my close family members who, however, is not a competent person to play the requested role in my company.

This is a decision in conflict of interest, indeed there is a secondary interest (familiar link), a primary interest (act in the best interest of the economic entity, hiring competent persons), and the interference of the secondary interest on the primary one. So if I do not hire my family member I am in case II, if I hire him I am in case III or IV. The difference among the two is that in case III I do not feel the primary interest of the firm, while in the second I feel it but I decided to have an opportunistic behaviour.

YouTube 20 – *Corruption*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Corruption police in Bali, Indonesia	00:04:49	Study

Assignment 16 – Corruption

4. *From conflict of interests to corruption*

For Transparency International (2009) 'corruption involves behaviour on the part of officials in the public sector, whether politicians or civil servants, in which they improperly and unlawfully enrich themselves, or those close to them, by the misuse of the public power entrusted to them'. Bardhan (1997, p. 1321) defines the corruption as the 'use of public office for private gains, where an official (the agent) entrusted with carrying out a task by the public (the principal) engages in some sort of malfeasance for private enrichment which is difficult to monitor for the principal'. Nye (1967, p. 416) argues that the corruption is the 'behaviour that deviates from the formal duties of a public role (elective or appointive) because of private regarding (personal, close family, private clique) wealth or status gains'.

From these definitions it is almost evident that the main difference between CoI and corruption lies in the fact that the first is a situation of risk while the second is an harmful behaviour (McMunigal, 1998).

To be in CoI, the duties of the public official should not necessarily be influenced by a secondary interest, and even if it happens it is not necessary that the influenced behaviour generates a damage to the public interest. Indeed, it is sufficient that there is a risk of interference, a temptation that could compromise the public official independence (Thompson, 2009).

The presence of a CoI for the agent is not synonymous with dishonesty or bias, but is only a potential interference in what he has said or written (Connolly, 1996).

Just the existence of private interests makes agent no longer free, no longer independent. Honesty and objectivity are virtues that go beyond the bonds of interest and may even be enhanced, where it is noted that a CoI did not affect the proceedings against the primary interest.

Carney (1998) points out that 'corruption is the final stage of conflict of interest. It may be said that all cases of corruption include conflict of interest, whereas the opposite does not always hold good'. Using the CoI definition of OECD we can say that in the corruption the secondary interest of the public agent prevails on the primary one (public interest). Andvig et al. (2001) identify six forms of corruption: bribery, embezzlement, fraud, extortion, favouritism, and nepotism.

Under the Italian Penal Code, the term corruption is a general term that describes the following crimes: corruption during an official act (Article 318 of the Italian Penal Code); corruption during an act contrary to official duties (Article 319 of Italian Penal Code); corruption of a person in charge of a public service (Article 320 of Italian Penal Code). Thus, the public official may carry out an official duty (for example: speed up a file of public concern), and an act against his/her duties (for example: the public official accepts money to secure the award of a tender).

In particular, pursuant to Article 318 a public official is corrupt when he/she receives, for oneself or a third party, cash, other benefits, or undue payment or accepts the promise of such remuneration in order to carry out an official measure. Article 319 states that the public official is corrupt when he/she receives, for oneself or for a third party, cash or other benefits, or accepts the promise thereof, as payment for omitting or delaying or for having omitted or delayed an official measure as well as for performing or having performed an act against official duties.

Hence, pursuant the Italian Penal Code, the boundaries of corruption are smaller than seen in the corruption definitions given by the literature. The former include the crime of bribery, while the latter any form of abuse of power, regardless of the presence of a corruptor.

The presence of a third party is not necessary even in the CoI situation, because an individual in CoI could have an opportunistic behaviour for his/her own exclusively interest, without favouring a third person. Moreover, corruption most often is a crime; CoI incorporates a wide circle of various types of behaviour, the majority of which are not classified as crime (Carney, 1998). There are many CoI situations that could impair the fiduciary duty of an agent, causing damage for someone, even if the law does not condemn that behaviour. In this case we could say that the behaviour coming from a CoI situation is morally wrong (Argandoña, 2004).

5. *Differences between conflict of interest, conflict of commitment and competing interest*

To be in a CoI situation the agent must have a secondary interest that could improperly influence his/her duties and responsibilities. However, in some cases, the primary interest is not adequately achieved because other interests distract the agent, as happens in the so-called conflict of commitment (Dickens and Cook, 2006; Steiner, 1996).

Conflicts of commitment (also called conflict of obligations) usually involve issues of time allocation. As argued by Winch (2003, p. 325) 'conflicts of obligation happen all the time in everyday life – being torn between career goals and family interests, for instance. It may be necessary to work six days a week to keep your job, but what is the effect on your relationship with your spouse and children?'

Then, in the conflict of commitments the two first elements of the CoI are present, i.e. the primary interest and the secondary one, while the third element differs due to the fact that the secondary interest takes time away from the agent so as to prevent him from adequately perform his duties.

Therefore, it is precisely the absence of the "the improper influence" to exclude the conflict of commitment from the CoI. For example, if a professor devotes little time for the exams because he has other things to do (busy professor!), it is possible that his judgment on the scores given to the students, hastily examined, may be affected positively or negatively, sometimes causing the same effects of a CoI (e.g. when the students are family members of the professor). Therefore, CoI and conflict of commitments stem from different assumptions although they may lead to similar results.

Another example is that of a manager of a car company, who accepts a position as a director in a company that produces canned food. This situation could create a conflict of commitment, subtracting time that the manager can dedicate to the first and/or the second task. The conflict of commitment, however, can be added to the CoI, for example when the car company diversifies its activities in the canning industry.

With regard to the conflict of commitment, the Italian Code for public employees states that 'Observing his/her work hours schedule, the employee shall devote the proper amount of time and energy to discharging his/her duties; he/she undertakes to carry these tasks out in the simplest and most efficient manner possible in the interests of the citizens and assumes the responsibility related to his/her duties' (Article 2).

Another important difference is that between CoI and competing interests (Foster, 2003; Jenik and Julius, 2009). Competing interests occur when the agent is placed opposite to different alternative solutions for achieving the primary interest. Jenik and Julius (2009, p. 16) give the following example: 'when two or more core governmental functions, whether social, health, educational or environmental, compete with each other, an inevitable conflict arises because a government is constitutionally obliged to pursue and further all competing objectives. The only solution is in making a political decision – the responsibility cannot be delegated to the private sector'.

Thus, in competing interests the private interest of the agent is absent.

6. *How much is really known about the meaning of the term conflict of interest by the Italian public official?*

In order to answer to our research questions, 'How much is really known about the meaning of the term conflict of interest?', and 'do individuals share the same CoI definition?', we use the results of an anonymous questionnaire administrated to 86 public sector employees. They belong to different public administrations (e.g. ministries, agencies, local governments) and geographical regions. The questionnaire was administrated before starting five lessons I taught on issues of conflict of interest and corruption, during April 2011 – January 2012.

The respondents are homogeneous in the sense they have to be comply with the code of conduct for the Italian public sector employees.

The questionnaire had three objectives, aiming to understand: 1) if the sample supposes to know what the CoI is and if it is able to describe the differences between CoI and corruption (Table 63 and Table 64); 2) the ability of the sample, faced with certain CoI situations, to recognize the CoI and its different typologies, as well as to distinguish that phenomenon from other types of conflict (i.e. conflict of commitment and competing interest) (Table 65 and Table 66); 3) if the sample is aware that it has to adhere to a code of conduct for Italian public sector employee (Table 67). The questions of Table 63, Table 65, Table 66 and Table 67 allow for a "Yes", "No" or "I do not know" answer, while that of Table 64 is an open-ended question.

Table 62 shows the characteristics of the sample, for each of the five lessons.

Table 62 – *Characteristics of the sample*

	Lesson 1	*Lesson 2*	*Lesson 3*	*Lesson 4*	*Lesson 5*	***Average***
Average age:	43.5%	46.7%	47.1%	49.0%	43.4%	***46.0%***
Gender:						
% Male	42.1%	42.9%	50.0%	29.4%	33.3%	***39.5%***
% Female	57.9%	57.1%	50.0%	70.6%	66.7%	***60.5%***
Education:						
% Degree	57.9%	89.5%	83.7%	72.8%	40.7%	***66.3%***
% Post Graduate Diploma	42.1%	10.5%	16.3%	27.2%	59.3%	***31.1%***

Our respondents have on average 46 years, the 60.5% are female, and they all have high education, since they have at least a degree or a post graduate degree.

6.1. *Results*

In Table 63 the answers to the question Q1 are very encouraging, since 91.9% of the sample claims to be able to define what CoI is. However, just 37.2% declares to know the difference between actual, apparent and potential CoI (Q2). Slightly higher is the percentage (43%) of those who have heard about the difference between these three types of CoI (Q3). These responses give rise to the question of what kind of CoI the respondents suppose to know.

Table 63 – *Conflict of interests and corruption*

Questions	Answers		
	Yes	**No**	**I do not know**
Q1. Are you able to define what conflict of interest is?	91.9%	1.1%	7.0%
Q2. Do you know the difference between actual, apparent or potential conflict of interest?	37.2%	45.3%	17.5%
Q3. Have you ever heard about the difference between the actual, apparent and potential conflict of interests?	43.0%	47.7%	9.3%
Q4. Are you able to recognize a conflict of interest when it occurs?	72.1%	2.3%	25.6%
Q5. Is there the offense of conflict of interest?	11.6%	74.4%	14.0%
Q6. Is it correct to say that the conflict of interest is a form of corruption?	36.0%	58.1%	5.9%
Q7. Are you able to describe the difference between conflict of interest and corruption?	83.7%	3.5%	12.8%

Q8. Which of the following answers best describes, in your opinion, the phenomenon of conflict of interest?	
A1. The conflict of interest is the situation in which a person has a private interest that tends to interfere with his/her duties and responsibilities, regardless of the actual conduct	*86.0%*
A2. The conflict of interest is the behaviour of the person who makes use of his/her private interest in order to obtain a personal advantage	*12.8%*
A3. The conflict of interests is simply an abuse of power	*1.2%*

The 72.1% answers that is able to recognize a situation of CoI when it occurs (Q4), while 25.6% says that it does not know. Thus, some who declare to be able to define the CoI (Q1), say that they are not able to recognise it.

Almost 74.4% of the sample indicates (Q5) that the CoI is a crime.

There is more uncertainty in the responses to the question Q6, since 58.1% says "Yes" CoI is a form of corruption, while 36% says "No" and 5.8% "I do not know".

The 83.7% declares to know the difference between CoI and corruption (Q7). To better understand what the public employees think is that difference, we asked to write it. The Table 64 contains six of the most significant answers (from A1 to A6).

Table 64 – *Differences between conflict of interest and corruption*

Open-ended responses given to the following question: '*Can you describe briefly what is, in your opinion, the difference between conflict of interest and corruption?*
A1. Corruption is when a person obtains an advantage for himself or for others using another person who misuse the power of his public office. Conflict of interest stems from a current or potential advantage that public employees may receive directly from the use of their powers of office.
A2. Corruption is an act contrary to the official duties, which takes place after receiving a bribe. The conflict of interest occurs whenever a person puts in place a policy, which should not be put in place.
A3. In the conflict of interests the person is the bearer of conflicting interests, but that does not necessarily lead to abusive behaviour. Corruption, however, constitutes a specific crime.
A4. The conflict of interest, as the expression says, is a situation of real conflict between the interests of a person and that of another, corruption is a crime expressly provided by the Criminal Code.
A5. The subjects involved in the corruption are three while in the conflict of interests are two.
A6. Corruption is a more tangible situation often accompanied by money payment, the conflict of interest is a less tangible and more difficult situation to ascertain.

Some respondents consider the CoI as a situation of risk, while the corruption as an opportunistic behaviour. However, the definition of corruption is very narrow, since the public employees seem only consider the case of bribery within that phenomenon, excluding all the other forms of corruption (e.g. nepotism, cronyism). Then, the corruption definition is very close to that provided by the Italian Penal Code, coinciding with the crime of bribery.

Moreover, some respondents argue that the CoI is characterised by the presence of two subjects (who is in conflict and the public administration), while three are in corruption (corrupt, briber and public administration).

Table 65 contains the second group of questions (from Q1 to Q8) which represents different situations: some of them are undoubtedly CoI situations, while others may fall, depending on the definition used in the case of actual, apparent or potential CoI.

Table 65 – *Concrete situations of conflict of interests*

	Answers			
Question: ***Which of the following are conflict of interest situations (even only apparent, or potential)?***	**Yes**	**No**	**I do not know**	***Adopting OECD definition***
Q1. I am in charge of personnel (but not the owner) of a private company and I decide to hire one of my close family member who, however, is the most competent person in the Labor market to play a certain role	67.4%	30.2%	2.4%	**n.a.**
Q1.1. In Q1, if I were also the owner of the company	27.9%	68.6%	3.5%	**n.a.**
Q1.2. In Q1, if I were in a public administration	90.7%	8.1%	1.2%	**Yes**
Q1.3. In Q1, if my family member were not a competent person	87.2%	11.6%	1.2%	**n.a.**
Q2. I am a university professor and during an exam I must assess a family member, but I am person with sound moral principles and not get influenced	84.9%	14.0%	1.1%	**Yes**
Q3. I am the purchasing manager of my administration, and now my wife (or husband) is hired by one of my suppliers	76.7%	19.8%	3.5%	**Yes**
Q4. I am the mayor of a municipality and I purchase services from an insurance company in which my son is employed	80.2%	14.0%	5.8%	**Yes**

Q5. I work in a public administration and I carry out parallel activities forcing me to fail to commitments with my administration	73.3%	20.9%	5.8%	**No**
Q6. I am a physician and I have to decide whether to give priority to the care of patient A or patient B	12.8%	81.4%	5.8%	**No**
Q7. I am a politician and I have to choose between building a road or a school	2.3%	87.2%	10.5%	**No**
Q8. I am a university professor and during an exam I feel the desire to benefit a student cheering for my football team	51.2%	43.0%	5.8%	**No**

The last column of Table 65 shows the correct answers adopting the OECD's definition. The definition is not applicable to the questions Q1, Q1.1 and Q1.3, because these are situations where the individual is not a public official. However, considering the definition given by scholars (e.g. Argandoña, 2004; Carson, 1994; Davis, 1982), we can certainly say that the correct answer to these questions is "Yes", so they are all CoI situations.

The aim of this second group of questions is to understand if public employees share the same definition of CoI.

Questions from Q1 to Q1.3 are connected together, as they refer to the same situation, i.e. to an individual that is in charge of personnel and he decides to hire a family member who is the most competent person in the Labor market to play a certain role. Interesting is the difference between the answers given to Q1 and those given to Q1.2: for some respondents the CoI is present only if the personnel officer operates within a public administration, while if he operates in a private company the CoI does not exist. Moreover, the answer to Q1.3 demonstrates that some individuals recognize the presence of CoI only in case of the family member is not a competent person, thus only in case of damage to the organization.

The question Q2 gives an example of apparent CoI, since even if the professor is not influenced during the examination, the external observer can think that his non-financial interest (the family tie with the student), 'could improperly influence' the performance of his duties. The 14% of our sample sees no conflict in this case.

The question Q3 is an example of potential (and apparent) CoI, given that the public official has a non-financial interest that could lead to an actual CoI in the future, in particular when the official will be involved in his responsibilities (i.e. when he/she has to choose the suppliers for the organization). The 19.8% of our respondents does not see any conflict in this case.

The question Q4 is different from the previous in that the mayor is not just in a situation of risk, since he has purchased insurance services from the company in which his son is employed. However, even if we do not know whether the mayor had an opportunistic behaviour (e.g. if the price charged is higher that the market price, allowing to his son to get a promotion) we can certainly affirm that the outsider observe could see a CoI in that transaction. Thus, we are in the apparent CoI hypothesis that could also generate an appearance of nepotism. The 14% sees no CoI.

The question Q5 contains a typical example of conflict of commitment, because it is the case where the individual has a parallel activity that force to fail his/her duties. However the 73.3% of the sample considers the conflict of commitment as if it were a CoI.

Questions Q6 and Q7 are example of competing interests, since the physician (Q6) and the politician (Q7) have different alternative solutions for achieving the primary interest: the healthcare of the patient for the former, the welfare of the citizens for the latter. Just a minority of the sample see the CoI even in these cases (12.8% for Q6 and 2.3% for Q7).

For the last question (Q8), 51.2% answers that the professor's desire to promote a student supporter of his football team, without having a personal tangible interest, constitutes a CoI.

This situation does not constitute CoI, because the desire cannot be regarded as a tangible interest.

Table 66 focalizes the attention on the questions Q2, Q3 and Q4, but just among 37.2% who answers "Yes" to the question Q2 of Table 63, i.e. 'do you know the difference between the actual, apparent or potential CoI?'. The aim is to understand if those who say to know the difference between these three types of CoI, when faced with certain situations of CoI (Table 3), are actually able to recognize these discrepancies.

Table 66 – *Differences between actual, apparent and potential conflict of interests*

Questions	Answers		
Which of the following are conflict of interest situations (even only apparent, or potential)?	Among the 37.2% who answers "Yes" to Q2 (see Table 63): "Do you know the difference between the actual, apparent or potential conflict of interest? "		
	Yes	**No**	**I do not know**
Q8. I am a university professor and during an exam I feel the desire to benefit a student cheering for my football team	87.5%	12.5%	0.0%
Q3. I am the purchasing manager of my administration, and now my wife (or husband) is hired by one of my suppliers	81.1%	18.9%	0.0%
Q4. I am the mayor of a municipality and I purchase services from an insurance company in which my son is employed	81.2%	18.8%	0.0%

Even in this case we do not find a clear orientation, since for some respondents there is not CoI.

Finally, 12.8% (Table 67) responds that its administration does not have a code of ethics (or conduct). Moreover, 46.5% says that the administration where it works does not provide ethics training for its employees, while the percentage of those who have attended ethics training is just 18.6%.

Table 67 – *Code of conduct and ethics training*

Questions	**Answers**		
	Yes	**No**	**I do not know**
Q1. Does my public administration adopt a code of ethics (or conduct)?	70.9%	12.8%	16.3%
Q2. Does my public administration provide ethics training for its employees?	37.2%	46.5%	16.3%
Q3. Did I attend ethics courses in my public administration?	18.6%	79.1%	2.3%

6.2. *Discussion and findings*

This study provides an insight into the ability of the Italian public sector employees to define and recognize the CoI phenomenon.

As shown in Table 63 (Q1), 91.9% of the sample is confident of being able to define the term CoI. This positive result is quite normal if we consider that the questionnaire was administered to civil servants, before starting a course on conflict of interests and corruption. In fact, we could expect that the sample responds saying the "right thing", since the phenomenon of CoI might be clear for public sector employees. Therefore, the answers may be affected by the so-called social desirability bias (King and Bruner, 2000; Middleton and Jones, 2000; Paulhus and Reid, 1991). This effect is the respondent wishes to provide the answer that is most "socially acceptable" rather than speak his/her true feelings. In other words, the respondent is actually responding with public opinion rather than his/her own personal views.

Positive feedback given to the first question may also arise from the illusion of the respondents of being able to define the CoI, thanks to their knowledge and skills. As shown in Table 62, all respondents have high education, since they have at least a degree or a post graduate degree. Scholars demonstrated that individuals perceive themselves as being better than others on a variety of desirable attributes, e.g. decision making, negotiating, rationality, driving skill, health, and intelligence (Babcock and Loewenstein, 1997; Kramer, 1994).

This positive illusion, however, is questioned by the sample itself when asked if it is able to recognize CoI situations when they occur (Table 63, Q4), since 25.6% answer "I do not know".

It is quite strange that among those who said to know how to define CoI there might be someone who claims not to recognize it or is unsure of being able to. We can reasonably assume that those who are able to define the phenomenon are also able to recognize CoI situations.

Particularly interesting are the answers to the question that asks the sample if it knows the difference between real, apparent and potential CoI (Table 63, Q2). The percentage of those who claim to know this difference is just 37.2%, despite the Italian Code requires public employees to avoid even the appearance of CoI, in order to protect the image of the public administration. The answers given to the questions in Table 64 demonstrate that the concept of CoI used to recognize the CoI situations is not unique as well as that, although the respondents do not know the difference, some of them are often inclined to consider as CoI situations those where the conflict occurs even just potentially or apparently. This result is only partly reassuring, considering that the jurisdictions and codes of conduct usually ask to regulate the three types of CoI in a different way (e.g. disclosure of the potential CoI, prohibition of the actual and apparent CoI), so it is important that public employees are able to make the distinction.

The answers given to the question Q6 (Table 63) reveal that 36% of the sample is led to consider the CoI as an abuse of power. This is also confirmed by the responses to the questions Q1.3 and Q8 (Table 63).

This way of seeing the CoI it is not just incorrect, but it could be a strong limit to the activation of the remedies for dealing with it: if a person believes that the CoI is an abuse of power, he/she hardly activates, for example, the remedy of disclosure. This could happen even when the individual in CoI intends to act in good faith.

One of the major problems with CoI is that there is still a widely held view that CoI is equal to corruption (McMunigal, 1998; Williams-Jones, 2011). But CoI is not a crime. As a result of this pejorative or negative connotation, the term CoI loses much of its utility, in practice, because of the risk of representing a barrier for activating the remedies to deal with it. With regard to the scientific research Connolly (1996, p. 1555) states: 'we are currently reviewing our policy on conflict of interest and will soon be suggesting some changes. We have learnt that authors often have conflicts of interest that they do not declare. One reason that authors don't declare conflicts may be the idea […] that there is something mendacious about a conflict of interest. This is not so. Conflicts of interest are common, and there is nothing wrong with having a conflict of interest. What is more of a problem is not to declare a conflict of interest'. With regard to the medical sector Schneider (2010, p. 600) points out that 'conflicts of interest will often be unavoidable, both in the academic sphere and in clinical practice. There is nothing automatically dishonourable about this and it does not in itself either detract from the value of the work being done or impugn the integrity of the people doing it. But the issue becomes critical when possible conflicts of interest are ignored. Inadequate awareness and transparency may cause substantial damage, both to the quality of research and clinical practice, and also to the reputations of individuals and of the medical profession and the scientific community as a whole'.

Corruption is widely seen as an abuse of power, including various form of opportunistic behaviour, e.g. bribery, nepotism, cronyism, embezzlement. However, from the analysis of the responses contained in Table 64, it is clear that the Italian public employees have a narrow view of the phenomenon of corruption, to encompass only the crime of bribery. This could have as consequence that the other phenomena of abuse of power might be considered less serious than bribery, or even normal, especially in environments with lower ethical culture.

In addition, from the answers (Table 64) emerges that no one mentions the possibility that the CoI could be even just apparent, since our respondents try to define the actual CoI, or the potential one. This could have an important implication from the practical point of view: despite the presence of a financial (or non-financial) interest a person might think of not having an interference in his/her decision-making. In other words, agents might think of not having potential or actual CoI.

Moreover, the bounded ethicality of the agents does not assure that they will be able to recognize the CoI. About it, Chug et al. (2005) argue that 'individuals view themselves as moral, competent, and deserving, and this view obstructs their ability to see and recognize conflicts of interest when they occur'.

However, the presence of a private interest generates the appearance of a CoI for the outside observers, affecting the credibility of the decision makers as well as the credibility of the institution in which they operate, even when they express their judgement or will with honesty and objectivity.

That is why often codes of conduct, as that for the Italian public employees, ask agents to ensure the integrity of their behaviour by taking steps to avoid conflict of interest, or even the appearance of conflict of interest.

In Table 65, there are several situations where the CoI is only apparent (Q1, Q2, Q3 and Q4), but some respondents do not consider them as CoI situations. Therefore, if these respondents had found themselves in those situations they would not deal with the CoI, as required by the Italian Code.

The 19.8% does not see the existence of CoI in the case where the purchasing manager's wife (or husband) is hired by one of the suppliers of the administration where the former works.

Often codes of conduct ask to communicate financial (and non-financial) interests that could potentially conflict with future duties and responsibilities of agents (Di Carlo and Testarmata, 2011). For a significant part of our respondents, if they had been in the situation of the purchasing manager, they would not adequately disclose the potential CoI, though the Italian Code asks to deal with this conflict.

Particularly interesting is the answer to the question Q8 (Table 65), given that 51.2% of the respondents sees the CoI when a university professor, during an exam, feels the desire to benefit a student cheering for his/her football team. However, in this case the absence of a tangible private interest leads to the exclusion from the scope of CoI. Consequently, none of the remedies provided to manage the CoI can be activated (e.g. disclosure of the desire, abstention from the exam). The desire to benefit the student should instead be self-controlled by the professor in respect of the principle of impartiality.

Almost half of the sample sees a CoI in this situation having a CoI definition too broad, with the risk that they consider a private interest in the same way as a desire. Considering that the desire to promote one's interest must be controlled through the principle of impartiality, the risk is that individuals use that principle to deal with CoI situations. In other words, CoI may be self-managed and remedies, like for example disclosure or abstention, are not activated.

6.3. *Conclusion and remarks*

Identifying CoI is not a simple task. CoI recognition is fundamental in order to activate the remedies to deal with it. Therefore, a clear definition is necessary to understand what is and is not a CoI, making the CoI more understandable.

Despite the multiplicity of studies on CoI, there is not an accepted definition of this phenomenon both in literature and practice. Code of conduct of Italian public employees does not provide a definition of CoI, but only some of the situations that could generate it. That approach is also common in code of conduct of private organizations and it can lead to the risk that employees applies their own definition for the CoI recognition.

The various remedies proposed by scholars and practitioners seem to assume that individuals have a very clear definition of CoI and are perfectly aware of what are the different ways in which the phenomenon occurs, and its potential for harm.

However, from the results of our analysis emerges that some public employees do not have that knowledge and, more worryingly, they believe they know how to define and recognize the phenomenon, but when faced with concrete situations of CoI, they appear uncertain or come to different considerations of what CoI is and is not.

The term CoI is frequently used in many different and often inconsistent ways, especially considering the difference between actual, potential and apparent CoI. This distinction is extremely important to deal with the CoI, because CoI remedies could be differentiated according to the three types of conflicts.

Despite the evident difference between CoI and corruption, there are some who believe that CoI is a form of corruption. But CoI is just a risk of harm while corruption is a behaviour that generates damage. Hence CoI cannot be seen as a crime. As a result of this pejorative or negative connotation, the term CoI loses much of its utility, in practice. Also for that reason there is a need to do a much better job of clarifying the concept.

These results have several implications for researchers, practitioners and regulators.

The definition of the various types of CoI (real, potential and apparent) and remedies for their management must find adequate space in the ethics programs, considering at least two steps.

The first step is to provide conduct rules in case of CoI situations. Certainly, no code or policy can contemplate every situation of CoI that may arise. Codes of ethics should not attempt to describe all possible CoIs, instead they should provide a clear CoI definition and the explanation of the differences between the harm and the risk of CoI as well as the differences between actual, potential and apparent CoI. These definitions could be considered as a general guideline to agents in order to allow them to recognize the various forms through which the conflict occurs and to respect the rules provided to deal with it.

The next step should be that of ethics training, through which it is appropriate to transfer, using numerous examples, the meaning of the concept of CoI, and especially the damage that the mismanaged CoI can generate on individuals and their organizations.

A relatively high proportion of our sample answer that the public administration does not have a code of conduct or that it does not know if a code exists. Moreover, just the 18.6% declare to have participated to ethics courses in its public administration. These results could partly explain the uncertainty about the difficulty they found in define and recognize the CoI.

Since the CoI recognition is not always easy, even if codes of ethics contain a clear definition of what actual, potential and apparent CoI are, organizations should also provide CoI training (e.g. lectures and videos), making examples to facilitate CoI identification (Handfield and Baumer, 2006; Stevens et al., 2005). In fact, a popular way to conduct CoI training is to cite examples (both hypothetical and real-world), so that they are better able to identify a CoI and remedy the situation before it comes to fruition. A code of ethics, even well-structured, is of little use if the principles and values contained therein are not transferred to the agents' behavior through training (Felo, 2001; Palmer and Zakhem, 2001; Valentine and Fleischman, 2004). In this regards, Valentine and Fleischman (2004) observe that ethics training 'should ideally teach individuals the ethical requirements of the organization, as well as how to recognize and react to common ethical problems experienced in the workplace'. Moreover, Palmer and Zakhem (2001) wrote: 'merely having standards is not enough, a company must make the standards understood, and ensure their proper dissemination within the organizational structure'.

In this context, it is particularly appropriate to emphasize that the CoI should not be confused with corruption. Consequently, the sanctions system might provide punishment for those who cannot handle the CoI (e.g. when CoI is not disclosed), regardless of any damage caused.

Undoubtedly the most important task of a CoI training is to make individuals aware of the risk in which they may find, questioning their natural illusion to consider themselves more moral, competent and worthy of others and therefore less vulnerable to the CoI situations. In fact, individuals seem to have a psychological barrier to the CoI recognition (Chugh et al., 2005), so as to make it invisible even to themselves.

CoIs that go unnoticed or are improperly managed threaten to impugn the reputation and integrity of the public employees involved and, potentially, the public administration as a whole. They undermine the public's confidence in the public sector employee and their ability to pursue the public interest, devoid of bias and personal interests. Without that public confidence, the effectiveness of the public administration is diminished.

REVIEW QUESTIONS

Following, the review questions for this Chapter.

Open-ended questions

1) Is the conflict of interest a form of corruption?
2) What are the three elements of the conflict of interest definition?
3) Make an example of just apparent conflict of interest

CHAPTER FOUR

THE ACTIVITY OF BUSINESS ENTITIES THROUGH CIRCUITS

1. *Objectives and Assignments of this chapter*

After reading this chapter, you will be able to:

- Represent graphically the activity of any type of business entity through the Aldo Amaduzzi circuits;
- Describe the relationship between the circuits of investments and circuits of financing;
- Describe the effect of the operations on the economic and financial values.

Following the Assignments of this chapter:

Assignment 17 – The phases of production and the outsourcing

Assignment 18 – Classifying the factors of production

Assignment 19 – The risk

Assignment 20 – The analysis of changes of values

This chapter, as well as the followings, is focused only on **business entities** [1] and the terms "business entity", "firm", "company" and "enterprise" will be used as synonymous.

2. *The Amaduzzi's circuits*

In Chapter II (§ 2) we discussed "**How**" the firm produces its goods and provides its services. The How is connected to the business model of the firm (Chapter I, § 3.4). "An organization's business model is its system of transforming inputs, through its business activities, into outputs and outcomes that aims to fulfil the organization's strategic purposes and create value over the short, medium and long term". (IIRC, 2013, p. 25)

The activity of any type of business entity (small and big firms; industrial, commercial, service, bank, insurance firms) can be represented graphically through the following three circuits (Table 68):

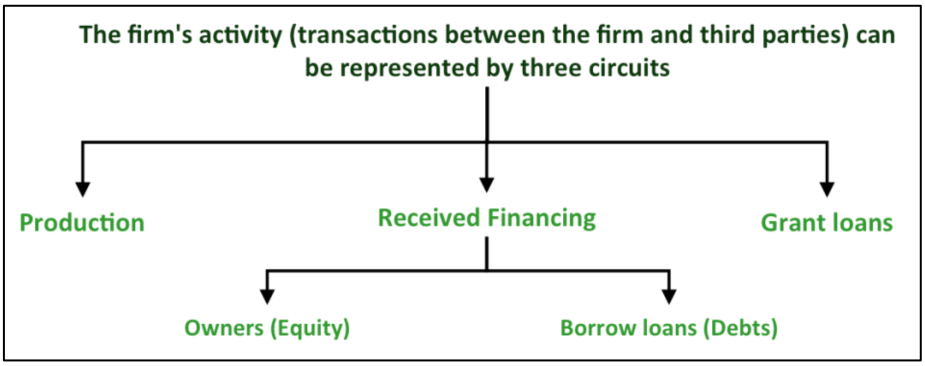
– The circuit of **production**;

[1] For the classification of the economic entities in business entities and non-business entities, see Chapter I, § 10.

– The circuit of **received financing**, which in turn can be split into two circuits: the received financing **from the owners** and the circuit **of borrow loans from financial creditors**;

– The circuit of **grant loans**.

Table 68 – *The circuits of business entities*

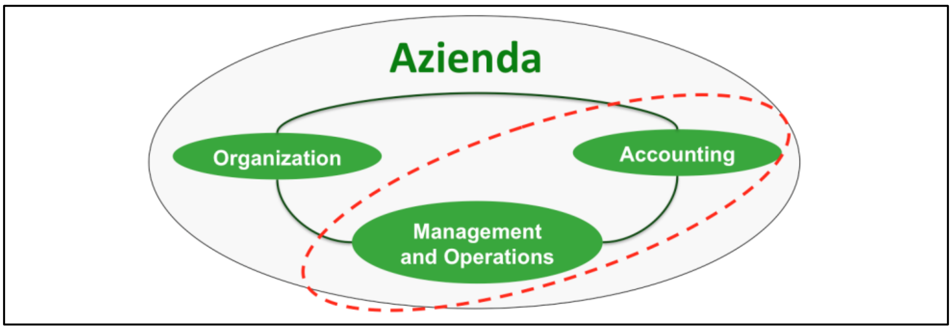


Source: Our elaboration

The circuits were suggested by Aldo Amaduzzi (1978), one of the most distinguished scholars of the Italian doctrine of *Economia Aziendale* (Chapter I, § 6) [2]. Since the business entity is a system (Chapter I, § 7), all the operations represented in those circuits should be oriented to achieve the goals fixed to achieve the primary interest of the firm, i.e. satisfy human needs creating sustainable profit.

The circuits are also useful because they allow **linking the operations, in particular acquisition of the input and selling of the output, to the economic values (revenues, cost and equity) and financial values (cash, trade receivables, trade payables)**. Thus, they investigate the link between accounting (i.e. performance) and operations.

Table 69 – *The three sub-systems of the* azienda *and the link between operations and accounting*



Source: Our elaboration

The following sections are dedicated to the description of the circuits listed above.

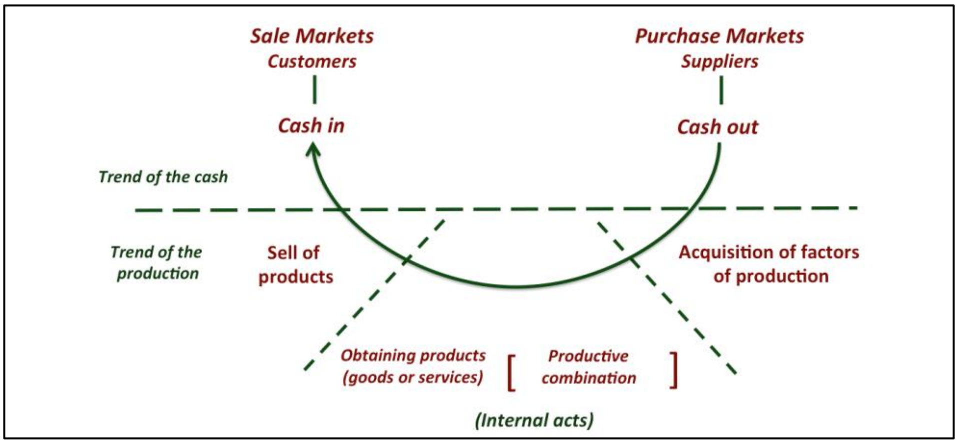
[2] These circuits are contained in many books of Economia Aziendale as that of my Maestro Prof. Enrico Cavalieri, one of the Aldo Amaduzzi's pupils. Amaduzzi was one of the Zappa's (the founder of the Economia aziendale) pupils.

3. *The circuit of production*

The circuit of production (Table 70) represents graphically the input-transformation-output process of the firm (Chapter I, § 3.2) separating the **transactions between the firm and the external parties** (i.e. with the markets of suppliers and customers) from the **internal acts** that transform the input acquired into the output to sell. In other terms that circuit shows how the firm creates the economic value.

The construction of that circuit starts from the broken line (that Amaduzzi called the "horizon line") that separates the trend of cash (above the horizon line) from the trend of the production (below the horizon line).

Table 70 – *The circuit of production*



Source: (Cavalieri, 2008)

Above the broken line there are transactions between the firm and the market of suppliers of factors of production (input) and between the firm and its customers (output). It is useful to remember that the main characteristic that differentiate business entities from non-business entities stems from the fact that only the former operates in the market both when they purchase the input and sell the output.

When the **firm purchases the factors of production** it pays suppliers, so a cash out is recorded [3]. Using the Amaduzzi metaphor the cash invested "sets over the horizon line". In that moment **the business risk arises** since the money (a generic factor of production) is transformed into specific factors of production (e.g. raw materials, machineries, labour).

The acquisitions of input put the firm in touch with the procurement markets, i.e. with all the points in space where there are potential suppliers who can offer these factors to the company. Some firms buy their input in different geographical areas. Prices and conditions vary over time.

The labor is a factor (an input) of production, however, in the labor market the *labor demand* is the firm's demand for labor and the *supply* is the worker's supply of labor. The supply and demand of labor in the market is influenced by changes in the bargaining power.

[3] Thus for now it is not considered the possibility to postpone the payment, having the so-called trade payables. That possibility is analysed more ahead in Table 73.

In the **labor market**, prices as well as general and special conditions of employment do not arise simply from the matching of supply and demand, but are the consequence of a complex regulation, place basically to **protect the dignity of work and human being**.

The monetary resources that are necessary to acquire the input can be found by using the different alternatives offered by the capital market (see, *infra*, § 4).

When the **firm sells products to the customers** (other firms or final customers) it receives an amount of cash for the products sold [4]. Using the Amaduzzi metaphor, the "cash rises from the horizon line". This proves that the firm is satisfying human needs achieving its objective. However, *we cannot say yet that the firm is creating value, because it depends on the level of the value of sales and costs* [5]. Moreover, **this circuit does not tell if the production is conducted in a sustainable on unsustainable way**. Even a criminal organization can have a circuit of production with positive results.

The sale of products obtained through the productive combination puts the company in contact with the sales markets, with all points of space, i.e. where there are potential buyers of goods and services that the firm offers. For example, some companies sell their products all around the world (e.g. Coca-Cola sells a global product). The prices and conditions are variable over time. In these markets the offer of producers is confronted with the demands of customers.

From the accounting point of view, **every transaction generates a double effect**: the ***monetary effect*** (cash in and cash out) and the ***wealth (or economic) effect*** (costs and revenues). In particular, when the firm acquires the input, cash out and costs are recorded, while cash in and revenues are recorded when the firm sells its products. The **costs** can be seen as a sacrifice of the owner's wealth (or sacrifice of money), while the **revenues** are a recovery of the owner's wealth (or recovery of money).

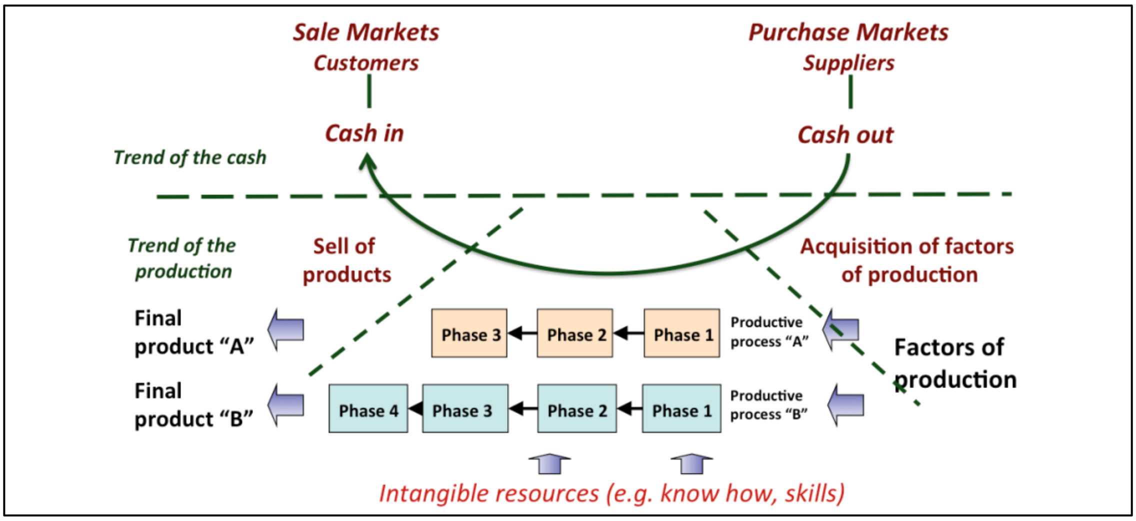
Below the broken line there are the internal acts that transform input into output, i.e. the transformation process. The transformation process is not only affected by the inputs that the firm buys in the market, but also by **intangible resources that are internally created by the firm**. We mainly refer to the input of the business model (Chapter I, § 3.4) such as human capital (e.g. know how) and social and relationship capital (e.g. key relationship stakeholders).

The entire **productive combination** could be defined as the nexus of **productive processes** that transform input into output (Table 71). Some firms have only one productive process since they make only one product; while some others are more diversified (e.g. Virgin group). The productive processes could be autonomous or related (e.g. in Apple the productive process of IPhone is related to those of IPad and IMac), since some phases are shared (i.e. some components of the IPhone and IPad are the same). It allows achieving different types of synergies (e.g. cost synergies) and the so-called system effect.

[4] Also in this case it is not considered the possibility to postpone the proceeding, recording the so-called trade receivable.

[5] The value creation condition for business entities is represented in Chapter II, § 5, Table 46.

Table 71 – *The circuit of production and the breakdown of the productive combination*



Source: Our elaboration

The final products could be sold to other organizations and/or to the final consumers. In the first case the products become factors of production of other firms. For instance, Brembo is an Italian company that makes automobile brakes for many car companies (i.e., Ferrari, Maserati).

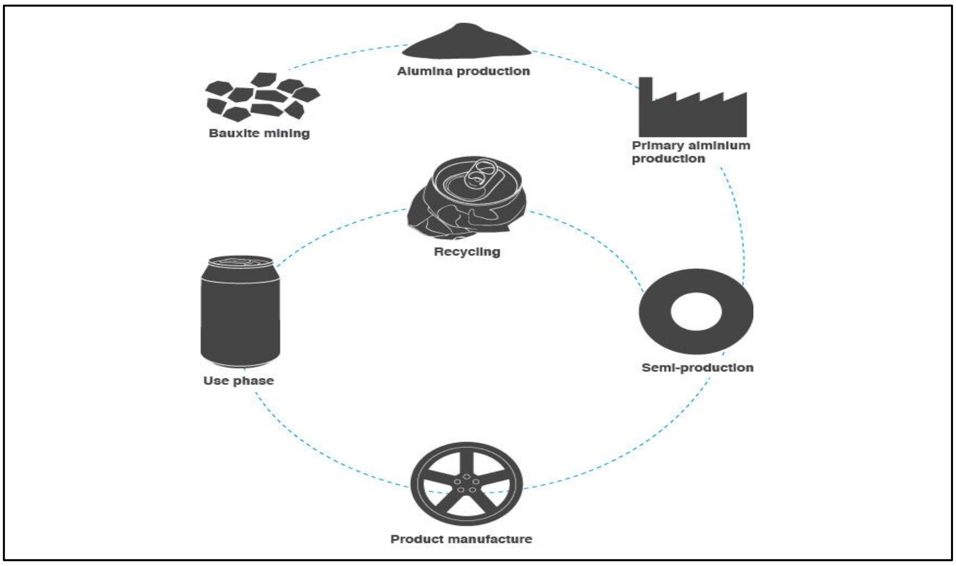
Each productive process could be divided into phases (or stages) of production.

For instance, the movie-making process consists of five phases: 1) Development; 2) Pre-production; 3) Production; 4) Post Production; 5) Distribution.

"Aluminium production is a time-consuming and energy-intensive process. But once the aluminium is made, it can be recycled over and over without losing its superb qualities.

The production process includes many phases. Here is an overall view on the various steps, showing aluminium production way from mine to recycling" (Table 72).

Table 72 – *Steps in aluminium production process*



Source: http://www.hydro.com/en/About-aluminium/Aluminium-life-cycle/Production-steps/

YouTube 21 – *Steps in aluminum production process*

Type	Title	Length (hh:mm:ss)	Study/Watch
Lesson	AK - Production Phases	00:05:37	Watch

Assignment 17 – The phases of production and the outsourcing

There are some companies that have all the phases of production while some others give in outsourcing some phases. The reasons why some companies externalize some phases of the productive process stems from the **logic make or buy**.

That logic is strongly connected to the character of *economicità* (Chapter I, § 9) and can be described as the act of choosing between manufacturing a product in-house or purchasing it from an external supplier. In a make-or-buy decision, the two most important factors to consider are **costs and availability of production capacity**. A firm may decide to purchase the product from the market rather than producing it, if it is cheaper to buy than make or if it does not have sufficient production capacity to produce it in-house. With the phenomenal surge in global outsourcing over the past decades, the make-or-buy decision is one that managers have to grapple with very frequently.

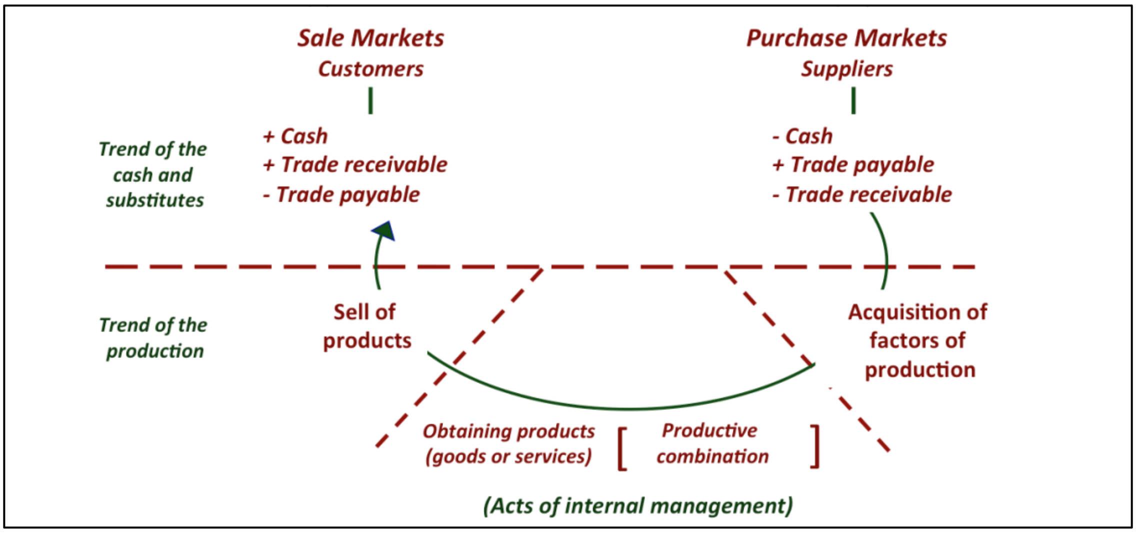
One of the sectors where the outsourcing is more frequently used is the automotive one. Indeed, car companies assemble the components of the car purchased from hundreds of different suppliers (e.g. Fiat).

The circuit of production is **virtuous** when the amount of cash in is higher than the cash out, i.e. when revenues are higher than costs; on the contrary the circuit is **vicious**. In other terms, in the first case the firm creates economic value, while in the second it destroys value. The virtuous circuit generate the so-called phenomenon of **self-financing**, in the sense that the firm can finance its investments without ask for money to the external financiers, i.e. owners and lenders.

3.1. *The circuit of production with trade payable and trade receivable*

So far, we have assumed that all exchanges with suppliers and customers were regulated through the movement of money (cash out and cash in). However, normally the **cash out can be temporarily substitute by commitments to pay** (trade payable), while the **cash in by rights to cash** (trade receivable).

Table 73 – *The circuit of production with trade receivable and trade payable*



Source: Our elaboration

Trade payables are amounts billed to the firm by its suppliers for goods delivered to or services consumed by the firm in the ordinary course of business. **Trade payables postpone the cash out**.

Trade receivables are amounts billed by the firm to its customers when it delivers goods or services to them in the ordinary course of business. **Trade receivables postpone the cash in**.

Thus, costs as well as revenues can be financially measured by cash and its substitutes (i.e. trade payable and trade receivable).

For example, if a firm buys raw materials that costs € 1.000, of which € 100 paid immediately, while € 900 after three months, in the moment of the acquisition a cost equal to € 1.000 is recorded (**negative economic change**), measured for € 100 by a cash out and for € 900 by a trade payable (**two negative financial changes**). When the firm sells its products obtaining revenues equal to € 2.000, of which € 600 cashed immediately, while € 1.400 after three months, in the selling moment a revenue equal to € 2.000 is recorded (**positive economic change**), measured for € 600 by cash and for € 1.400 by a trade receivable (**two positive financial changes**).

3.2. *Factors of production*

For what concern the factors used in the productive combination, they can be distinguished in several ways, depending on:

1) ***tangibility***: intangible factors (e.g. brand, services, Labor) and tangible factors (e.g. machinery, equipment);

2) ***mode of participation in the productive combination***: factors usable just once in a productive cycle (non-durable factors of production, e.g. raw materials, goods, labor) from those that can be used for more productive cycles (durable factors of production, or long-term assets, e.g. machinery, property equipment). In other terms the former exhaust their economic utility by participating in a single production cycle, while the latter by participating in several production cycles, while maintaining their technical specifications of inputs;

3) ***mode of recovery of cash invested in the factors***: the recovery is entrusted to the revenue from the sale of the single product obtained by the sole production cycle at which the factor participated (non-durable factors of production); the recovery is entrusted to the revenues from the sale of all products from all the production cycles to which the factors participated (durable factors of production);

4) ***acquisition mode***: factors acquired from third parties through acts of exchange (e.g. raw materials, equipment, patents, brands, services); intangible factors not purchased by third parties through acts of exchange (e.g. expertise, business skills, know-how, reputation). The intangible assets are classified in the business model framework (see, Chapter I, § 3.4), for instance, as human capital (e.g. loyalties and motivations for improving processes), social and relationship capital (e.g. key stakeholder relationship).

Assignment 18 – Classifying the factors of production

3.3. *Amortization of long-term assets* [6]

When a company acquires assets, those assets usually come at a cost. However, because most assets don't last forever, their cost needs to be proportionately expensed based on the time period during which they are used. Amortization and depreciation are methods of prorating the cost of business assets over the course of their useful life.

Amortization

Amortization is a method of spreading the cost of an intangible asset over a specific period of time, which is usually the course of its useful life. Intangible assets are non-physical assets that are nonetheless essential to a company, such as patents, trademarks, and copyrights. The goal in amortizing an asset is to match the expense of acquiring it with the revenue it generates.

Let's say a company spends €50,000 to obtain a license, and the license in question will expire in 10 years. Since the license is an intangible asset, it should be amortized for the 10-year period leading up to its expiration date. Using the straight-line method of amortization, which is a method for charging a cost to an expense at a consistent rate over time, the company's annual amortization expense for the license will be €5,000 (that's €50,000/10 years), meaning the asset will decline in value by €5,000 every year.

Depreciation

Like amortization, depreciation is a method of spreading the cost of an asset over a specified period of time, typically the asset's useful life. The purpose of depreciation is to match the expense of obtaining an asset to the income it helps a company earn. Depreciation is used for tangible assets, which are physical assets such as manufacturing equipment, business vehicles, and computers. Depreciation is a measure of how much of an asset's value has been used up at a given point in time.

Let's say a company purchases a new piece of equipment with an estimated useful life of 10 years for the price of €100,000. Using the straight-line method, the company's annual

[6] This pharagraph comes from the website: www.fool.com

depreciation expense for the equipment will be €10,000 (€100,000/10 years). This is important because depreciation expenses are recognized as deductions for tax purposes. It is also possible for a company to use an accelerated depreciation method, where the amount of depreciation it takes each year is higher during the earlier years of an asset's life.

Differences

The key difference between amortization and depreciation is that amortization is used for intangible assets, while depreciation is used for tangible assets. Another major difference is that amortization is almost always implemented using the straight-line method, whereas depreciation can be implemented using either the straight-line or accelerated method. Finally, because they are intangible, amortized assets do not have a salvage value, which is the estimated resale value of an asset at the end of its useful life. Depreciated assets, by contrast, often have a salvage value. An asset's salvage value must be subtracted from its cost to determine the amount in which it can be depreciated.

YouTube 22 – *Amortization and depreciation of of long-term assets*

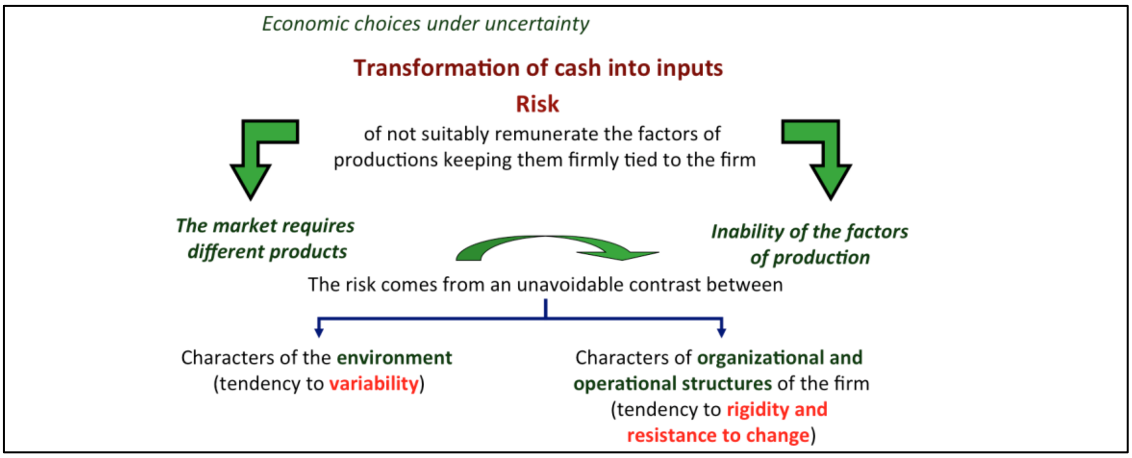
Type	Title	Length (hh:mm:ss)	Study/Watch
Lesson	Amortization and depreciation	00:03:47	Study
Lesson	What are "depreciation" and "amortization" all about?	00:08:05	Study

3.4. *The risk of the business entity*

As mentioned before, the risk of the firm starts when the money, considered as a generic factor of production, is transformed into specific factors of production (e.g. property, raw materials, equipment), i.e. when the cash invested "sets over the horizon line". The economic entity is a probabilistic system (Chapter I, § 7.6)

The risk is in that the circuit of production is vicious, since the firm is not able to remunerate the factors of production used (Table 74).

Table 74 – *The risk of the firm*



Source: Our elaboration

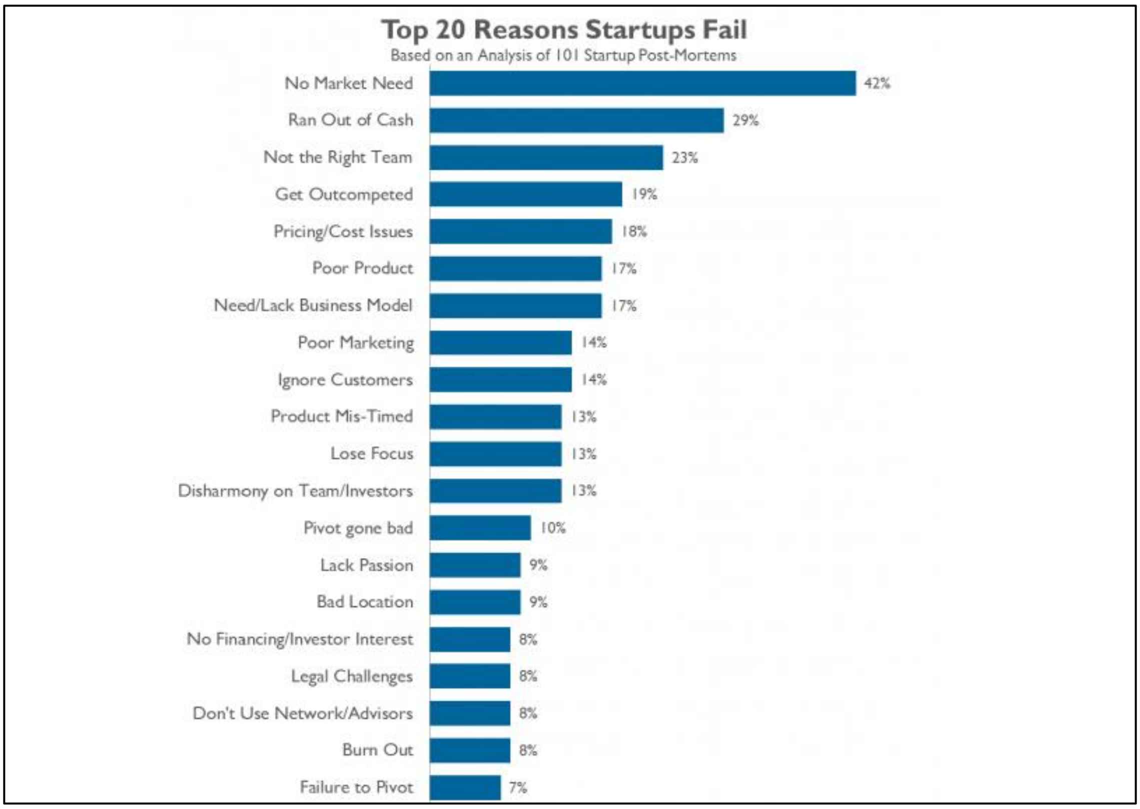
It could happen because:

– The market (i.e. customers) asks for different products (no markets needs);
– The factors of production are not adequate for the productive combination.

The first reason is linked to the fact that the firm does not satisfy human needs, thus customers choose the product of other firms. This reason is the first of the top 20 reasons of startups failure (Table 75).

The second reason is connected to the factors of production used in the productive combination. For example, some factors are not efficient, because they consume too much energy; the productivity of the Labor is low. In other words, that reason is connected to the so-called **obsolescence risk**, i.e. the "risk that a process, product or technology used or produced by a company for profit will become obsolete, and therefore no longer competitive in the marketplace. Obsolescence risk is most significant for technology-based companies or companies with products or services based on technological advantages" [7].

Table 75 – *The top 20 reasons startups fail*



Source: http://www.businessinsider.com/the-top-20-reasons-startups-fail-2011-5

In other terms, **for some factors the physical life is lower than the economic life**, i.e. even if they are in perfect working order, it is not economically convenient to use them in the productive combination (e.g. would you use a computer working perfectly made 20 years ago?).

[7] *Source*: http://www.investopedia.com/

The genesis of the risk is linked to the characteristic of the environment and firm. While the **environment changes** continuously (e.g. competitors create and satisfy customers needs better than us) the **firm is rigid and resistant to change**. However, the dynamism of the firm is fundamental for its survival (Chapter I, § 7.1). Some organizational structures are more flexible than others (Chapter VI, § 3), it means that they better react to the changes of the environment.

Assignment 19 – The risk

3.5. *The circuit of deferred revenues*

The circuit of production has usually a trend that starts from an outflow of cash for the acquisition of factors of production and ends with cash inflows for selling products.

This is the typical trend for the majority of the productive activities: the obtainment of products precedes the selling of the same, thus, revenues' earning.

However, there exist activities having the opposite trend: products are sold before being obtained and revenues are earned before all costs (or part of them) related to the productive combination are supported (e.g. I buy the ticket for the airplane on 18th December, but I will fly on 15th of January).

Deferred revenue is not yet revenue. It is an amount that was received by a company in advance of earning it. The amount unearned (and therefore deferred) as of the date of the financial statements should be reported as a liability. The title of the liability account might be unearned revenues or deferred revenues.

This is the case of the so called "deferred revenues", deferred from the supporting of the relative costs.

The firm that records deferred revenues is committed to accomplish its performances, thus carry out the productive process in order to obtain and deliver the yet sold outcome, in quantity and quality contractually defined.

The theory above could be related both the production of products as well as the delivering of services from firms.

For example, an insurance company that collects early its insurance premium (deferred revenues), assumes the obligation to eventually indemnify the insured from a car accident (according to the contract).

The Table 76 shows the trend of the circuit of production in case of deferred revenues.

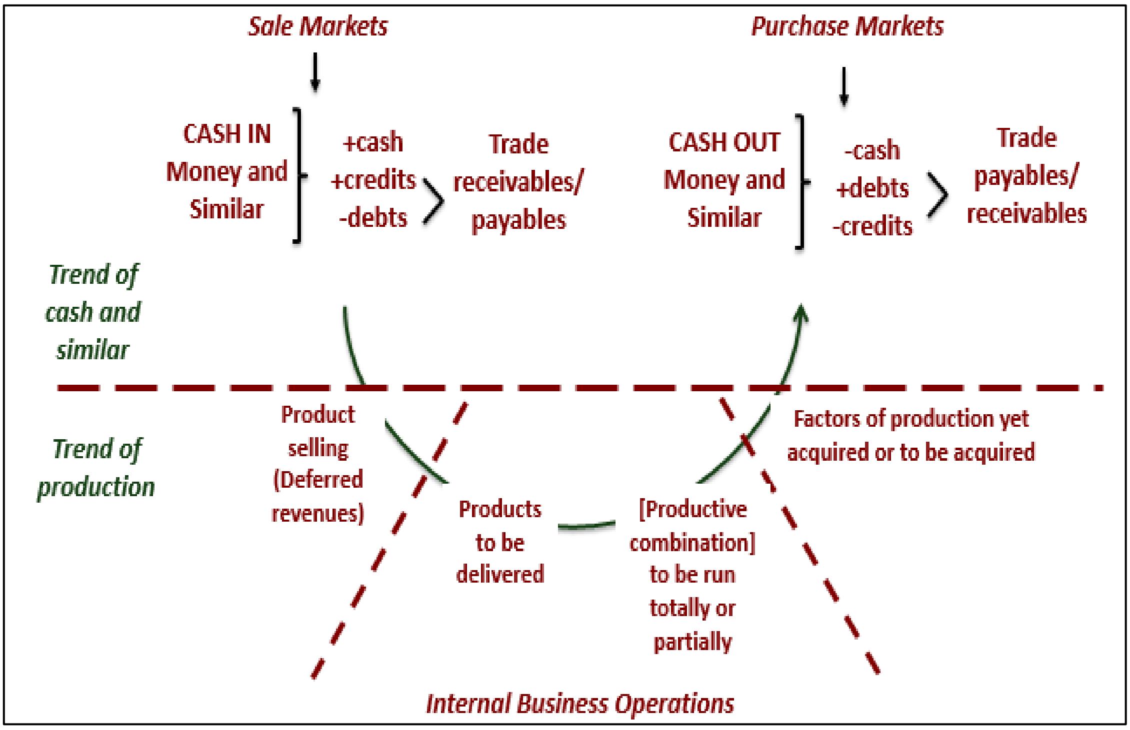
Deferred revenues, when collected in cash, represent external financial means which availability has been acquired by the firm, even if it has not yet delivered its performances.

Remember that the financial need is the amount of financial means useful to face the investments' plan, beyond financial means recovered from selling products (revenues flow). Thus, deferred revenues reduce the financial need of the firm, being part of the revenues flow.

In the hypothesis in which deferred revenues are measured from cash inflows, the firm's liquidity tends to increase and this requires an appropriate management.

While, in the case in which deferred revenues are measured by trade receivables, the financial need of the firm has no modification until their expiration.

Table 76 – *Circuit of production in case of deferred revenues*



Source: (Cavalieri, 2008)

4. *Circuit of received financing*

Before going to the procurement market to buy the factors of production, the firm needs to raise money to pay its suppliers. In the business model framework, the first capital considered as input is the financial one (Chapter I, § 3.4).

There are two ways to raise money (Table 77):

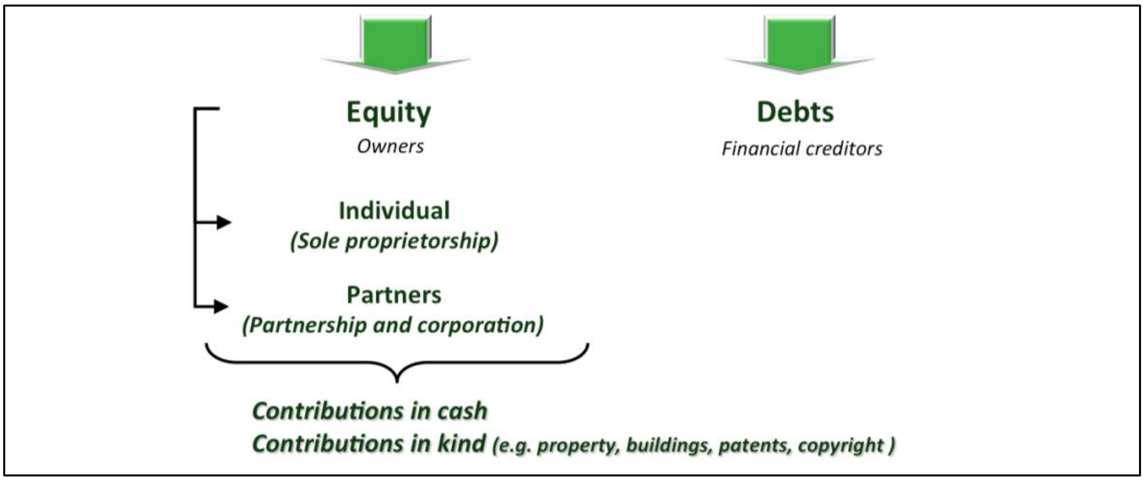
– ***Equity***: is the capital paid into or invested in the business by the owner/shareholders. It serves as a security for the creditors of a business since it cannot be withdrawn to the detriment of the creditors;

– ***Debt***: is an obligation owed by one party (the debtor) to a second party, the creditor referring to assets granted by the creditor to the debtor. A debt is created when a creditor (lender) agrees to lend a sum of assets to a debtor.

Those who finance the company with the equity are defined owner (or shareholders in case of a corporation), while who finance through debts are financial creditors.

The equity could be a contribution in cash as well as in kind. In the latter case, owners contribute to the equity conferring, for example, properties, plants, brands.

Table 77 – *Equity and debts*



Source: Our elaboration

Moreover, the equity can be given by just one person – e.g. in the case of a sole proprietorship – or by a group of people – e.g. in partnerships and corporations.

4.1. *The circuit of received financing from owners*

When the promoter or promoters intend to start-up a business, they are called to equip the newly-formed business entity of adequate monetary resources (starting capital).

The equity may also be increased at a later date, whenever there is the need for more monetary resources, in order to finance larger productive combinations and increase the volume of the business.

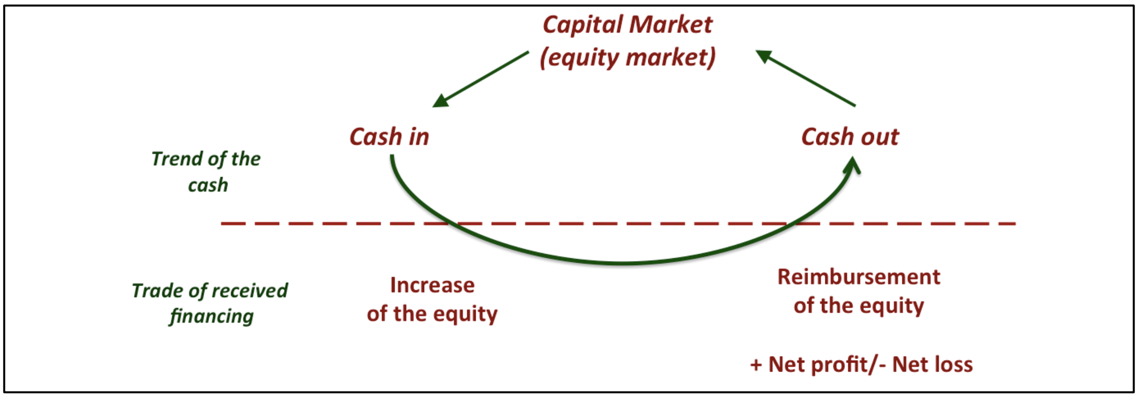
The equity does not have temporal obligations of restitution; usually it is bound permanently to the company, in the sense that, except for special cases, will not be returned to the owner until it becomes excessive or when the firm wants to stop the production, i.e. in case of liquidation of the business.

Therefore, the constraint of permanence is fundamental in relation to the type and character of the investments to be carried out, in the sense that the equity appear to be more suitable to be invested in assets that generate a constant financial need (e.g. property, plants and equipment).

The **remuneration of the equity is not contractually defined**, but it is decided - in turn - by the same owners in relation to the performance of the company (i.e. at the level of income generated by the business) and to the prospects of increasing the volume of investments. It is, therefore, **a variable remuneration**, which should not be paid in the event of negative income, when the productive activity, rather than creating new value, destroys part of the capital invested in it.

The construction of the **circuit of received financing from owners** starts from the broken line that separates the trend of cash (above the line) from the trend of received financing (below the line) (Table 78).

Table 78 – *The circuit of received financing from owners*

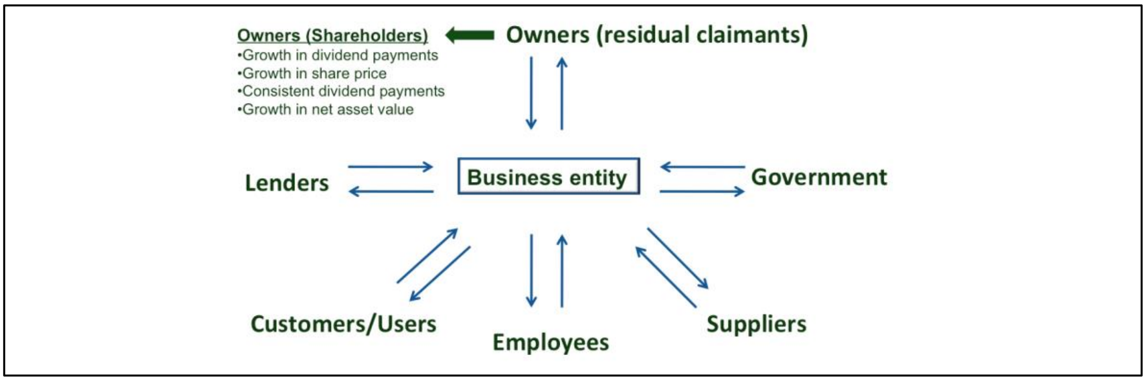


Source: (Cavalieri, 2008)

When the owner put the money in the business there is an increase of equity (**positive economic change**). As said before, the remuneration of the equity depends on the business performance, since it is remunerated only if the net income is positive, thus in case of net profit. However, sometimes it could happen that even in case of losses firms decide to distribute dividend using the profit retained (not distributed) in previous years.

The owners are residual claimants and are the first to bear losses, and therefore they have incentive to obtain maximum revenues with minimum costs (Table 79). All the other stakeholders are protected by contracts, in other terms they are remunerated regardless the financial performance of the firm (e.g. debt holders must be paid even in case of firm losses). Thus, they do not have the same incentive of the shareholders in conducting the business with *Economicità*. That is why the power to elect the board of director (the governance body of the company, see Chapter V, § 6.1) is normally in the hands of the shareholders.

Table 79 – *The owners are residual claimants*



Source: Our elaboration

"Cash flows from share ownership are purely residual claims. These claims are due only after all other committed corporate claims (e.g., payments to suppliers, wages and salaries to employees and management, and interest and principal payments to bondholders) have been met" (Sundaram and Inkpen, 2004, p. 353).

This is the reason why, for many scholars the maximization of the firm performance occurs when the control rights are assigned to the residual claimant (Alchian and Demsetz, 1972), i.e. the owners. This is in line with the so called “shareholder theory”. Thus, “shareholders are the main residual claimants of the firm’s income stream and have ultimate control over the corporation. The sole purpose of management is to maximize shareholders’ wealth, and it should only engage in activities that are financially beneficial to shareholders” [8].

4.2. *The circuit of borrow loans*

Normally companies finance investments not only with the equity but also with loans, i.e. with the money received from lenders (or financiers, e.g. banks).

The **loans are available for a specified period of time**, engaging in loan agreements that define conditions and operating procedures (technical forms) of the loan.

Therefore, the loan remains in the availability of the borrower for longer or shorter periods depending on the duration of the loan provided in the loan agreements. Also the remuneration is specified by the agreement. Thus, differently from the equity, the remuneration does not depend on the income of the firm.

The **interest rate that remunerates the financiers can be fixed or variable**.

The way the firm repays the loans is called **loans amortization**, i.e. a loan with scheduled periodic payments of both principal and interest.

Table 80 contains an example of loan amortization schedule. The firm borrows loan from Citibank. The loan amount is € 10.000 and the annual interest rate 5%.

Table 80 – *An example of loan amortization*

Loan Amortization Schedule

Enter values		Loan summary	
Loan amount incl Cap'd int.	€ 10.000,00	Scheduled payment	
Annual interest rate	5,00 %	eduled number of payments	5
Loan period in years	5	Actual number of payments	5
Number of payments per year	1	Total early payments	€ -
Start date of loan	01/01/14	Total interest	€ 1.500,00
Optional extra payments	€ -		

Lender name: Citibank

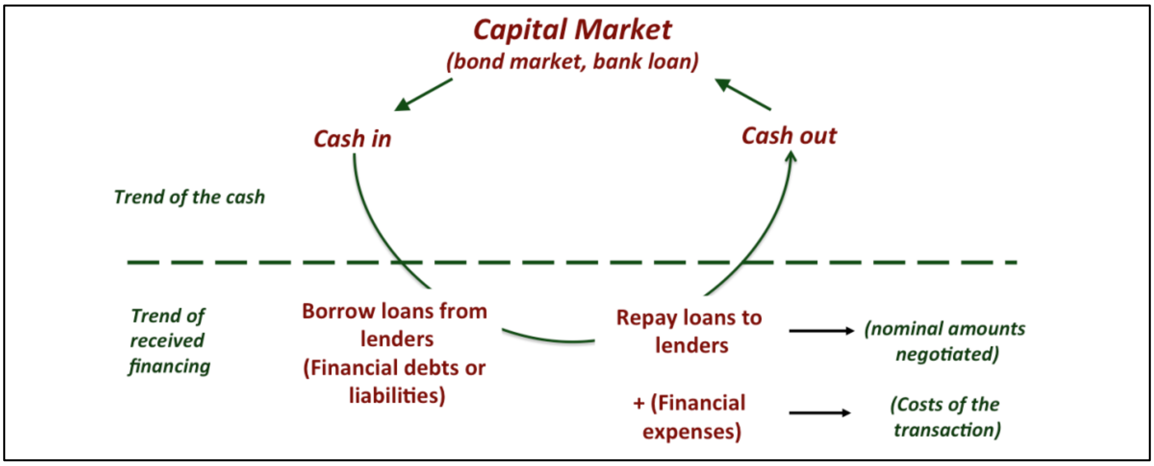
PmtNo.	Payment Date	Beginning Balance	Scheduled Payment	Total Payment	Principal	Interest	Ending Balance	Cumulative Interest
1	01/01/15	€ 10.000,00	€ 2.500,00	€ 2.500,00	€ 2.000,00	€ 500,00	€ 8.000,00	€ 500,00
2	01/01/16	8.000,00	2.400,00	2.400,00	2.000,00	€ 400,00	6.000,00	900,00
3	01/01/17	6.000,00	2.300,00	2.300,00	2.000,00	€ 300,00	4.000,00	1.200,00
4	01/01/18	4.000,00	2.200,00	2.200,00	2.000,00	€ 200,00	2.000,00	1.400,00
5	01/01/19	2.000,00	2.100,00	2.100,00	2.000,00	€ 100,00	0,00	1.500,00

Source: Our elaboration

The circuit of borrows loans (Table 81) starts from the broken line that separates the trend of cash (above the line) from the trend of received financing (below the line).

[8] However, in this course of FoBA we give to the business entity a different objective (human needs satisfaction) Chapter II, and the profit is a condition that allow the firm to survive and growth.

Table 81 – *The circuit of borrow loans*



Source: (Cavalieri, 2008)

The firm records a cash inflow (**positive financial change**) and a financial debt (**negative financial change**) when it borrows loans from the lenders: in the example of Table 80, when the firm received € 10.000 from the Bank (1/1/2014). From that moment it has the availability of the money that could be invested for the acquisition of factors of production.

The circuit ends with the repay of loans to lenders (the nominal amount negotiated, the so-called principal) and with the cash out for the financial expenses (costs of the debt). Every year the firm must repay a part (i.e. the principal) of the loan € 2.000 plus the accrued interest that represents the financial expense of the loan. The interests are calculated on the residual debt (the ending balance column of Table 80): the first year is equal to € 500 (€ 10.000*5%) (see the interest column of Table 80); the second year is 400 (€ 8.000*5%), and so on.

Following some types of debts:

a) secured and unsecured debt;
b) private and public debt;
c) bonds.

A debt obligation is considered **secured**, if creditors have recourse to the assets of the company on a proprietary basis or otherwise ahead of general claims against the company. **Unsecured debt** comprises financial obligations, where creditors do not have recourse to the assets of the borrower to satisfy their claims.

Private debt comprises bank-loan type obligations**. Public debt** is a general definition covering all financial instruments that are freely tradable on a public exchange or over the counter, with few if any restrictions.

A **basic loan** or '**term loan**' is the simplest form of debt. It consists of an agreement to lend a fixed amount of money, called the principal sum or principal, for a fixed period of time, with this amount to be repaid by a certain date. In commercial loans interest, calculated as a percentage of the principal sum per year, will also have to be paid by that date, or may be paid periodically in the interval, such as annually or monthly.

Such loans are also colloquially called **bullet loans**, particularly if there is only a single payment at the end – the 'bullet' – without a 'stream' of interest payments during the life of the loan.

A **bond** is an instrument of indebtedness of the bond issuer (borrower or debtor) to the holders (lender or creditor).

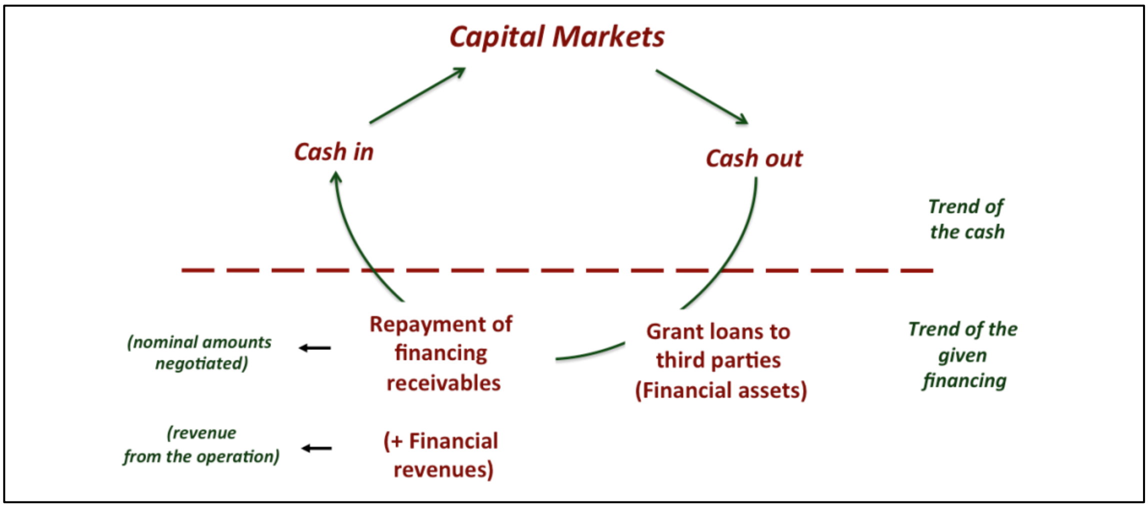
It is a debt security, under which the issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay them interest (the coupon) and/or to repay the principal at a later date, termed the maturity.

Bonds have a fixed lifetime, usually a number of years; with long-term bonds, lasting over 30 years, being less common. At the end of the bond's life the money should be repaid in full. Interest may be added to the end payment, or can be paid in regular instalments (known as coupons) during the life of the bond.

5. *The circuit of grant loans*

The third group of operations is the **granting of loans to third parties** (e.g. other firms that needs money). The company may engage in contracts through which grants to third parties the availability of money, for a certain period of time, defined conditions and operating procedures (technical forms).

Table 82 – *The circuit of the grant loans*



Source: (Cavalieri, 2008)

The circuit of grant loans starts from the broken line that separates the trend of cash (above the line) from the trend of given financing (below the line).

The firm records a cash outflow when provides grant financing to third parties. From that moment the borrower has the availability of the money that could be invested for the acquisition, for example, of factors of production.

The circuit ends when the firm receives cash from the third parties, i.e. the repayment of the nominal amount negotiated, (the principal) plus the financial revenues (the interest).

6. *Relation between the financing and investment circuits and financial need*

It has been observed how the circuit of received financing, both from owners and financial institutions, shows an opposite trend than the production and grant loans' circuits: the first one moves from cash in to cash out while the second ones, in turn, move from cash out to cash in (Table 83).

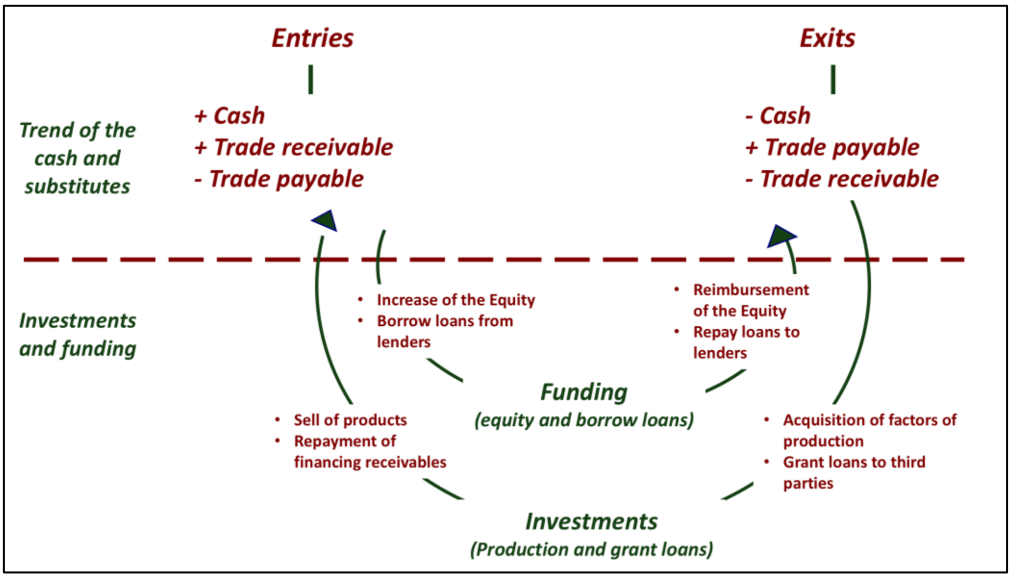
It could be useful now to deepen examine the relations between the considered flows:

– The circuit of production and that of grant loans have been joint into a single circuit known as "**investments circuit**". It means that, in both situations, cash is invested respectively for the acquisition of input and the granting of loans: we always will refer to "productive destinations" of the available resources. The equity and debt received financing, then, are classified in one single circuit known as "**financing circuit**". It considers in fact financial instruments coming from external sources, regardless of their juridical differences. It refers to financial assets coming from owners or financial providers which are made available to corporate economy;

– The financing circuit stokes the investment circuit and the latter, in turn, absorbs cash (cash out for input acquisitions or granted loans);

– The investment circuit, then, gives back cash to corporate economy (cash in for selling output and granted loans repayment); such assets are useful to reinvest money in firm's activities or to payback debts.

Table 83 –*Correlation between investment and financing circuits*



Source: (Cavalieri, 2005)

This movement could be considered as feasible as longer as cash in is higher or even not lower than cash out over time.

The breakdown of the circuits' equilibrium above mentioned could appear in the moment in which corporation starts to generate negative results, in other words, it recovers less than it invests.

A consequence could be the reduction of future cash flow as well as the increment of financial provision, hence, an increment in received financing will occur.

Therefore, it is possible to assert that corporate financial provision is strictly related to corporate cash flow. In accordance to a specific period of time or a specific investment project, we can define financial provision as: the amount of financial resources needed to stoke scheduled investments, regardless of resources already available.

We could even refer to the concept of "total financial provision" including an amount of financial resources exactly equivalent to the total amount of scheduled investments in a specific period of time. Such concept, however, is less significant than that previously proposed which consider the "residual financial provision" as the amount of needed financial resources coming from received financing (from owners or financial institutions).

The residual financial provision is a net amount of monetary resources because it does not consider those assets that the financing circuit gives back to corporate economy under the form of revenues or credit's incomes.

Therefore, the cash in closing the investment's circuit would ensure a "natural recovering" of part of the so-called corporate financial provision.

The combination of the financing and investment circuits has to occur both for the extent of monetary resources to be used in investment programs as well as for their time and lasting utilization.

It is important to realize right quantitative and temporal relations between the corporate financial provision useful to perform expected programs and the monetary resources needed to cover such investments. Here the evidence of a strict interdependence between the production activity and the received financing used to implement it.

7. *Firms operations as system of values: financial and economic aspects of operations. Financial and economic changes*

Firms' operations could be classified according to different criteria; by referring to transactions with markets (purchase market, sale market, capital market…) it is possible to distinguish operations in:

– ***External operations***: put firm in related transactions with external actors (employees, customers, suppliers etc.);

– ***Internal operations***: does not exist the relation between firm and external parties (for example the process of transformation of input in output).

In the discussed field, transactions show the characteristics below:

– The presence of two or more parties (the firm and a second actor);
– The transfer of a good or service from one party to the other one;
– A monetary or, in some cases, nature exchange moving in opposite directions;
– The presence of a correlation between two performances;
– The possibility to measure the value of transacted performances.

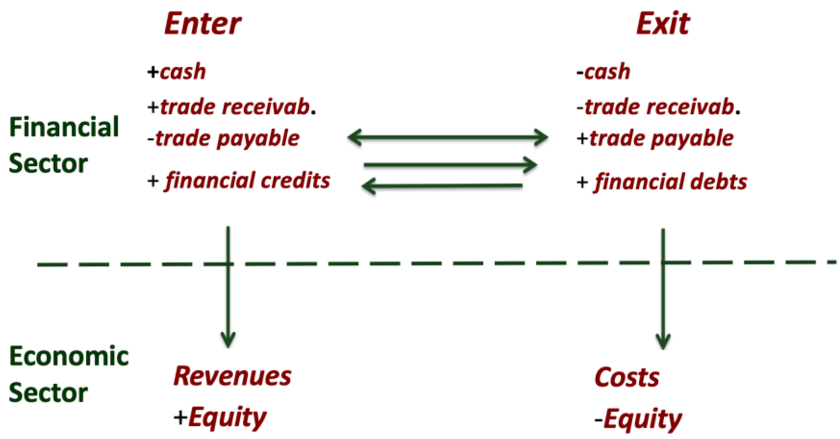
Once identified the typical firm's operations, the operation circuits model focuses its attention in particular on external operations. This because it is in these kind of business phases that it could be possible to make a reliable evaluation of the purchased input and the sold output, by serving of cash as unit of measurement.

The operations' system is transformed, in this way, in values' system. Such values are expressed in terms of cash in and cash out.

According to the most used approach, the external operations steps (purchase of the general input "cash" or specific factors of production on the purchase market, selling of final products on the sale market) are analyzed by considering their effects from two main standpoints: **financial** and **economic** ones ().

The need to observe business under a financial perspective is related to the need to consider cash flows, debts and credits' movements determined by the external operations (input purchasing, selling output, financial loans, etc.).

Table 84 –*The model: operations, values and changes*



Source: (Cavalieri, 2005)

We have a *negative* financial change when one of these changes occurs:

– decrease in cash or current account availability;
– increase in debts (trade payable or financial debts);
– decrease in credits (trade receivable or financial credits).

While, a *positive* financial change occurs in the moment in which there is a:

– increase in cash or current account availability;
– increase in credits (trade receivable or financial credits);
– decrease in debts (trade payable or financial debts).

Now, it is important to underline the existing difference between trade payable/receivable and financial credits and debts. The former are such kind of credits/debts arising from purchasing and selling operations and are a way to temporarily substitute payments and cash in (the term "trade" payable/receivable is strictly linked to the fact that they are related to the traditional operations of the production's circuit).

While, financial debts/credits, arise as a consequence of autonomous cash negotiations, in other words, with granted and borrowed loans (circuit of borrow loans and grant loans).

Therefore, the operations of purchasing specific inputs, seen from a financial point of view, give rise to negative financial changes: decrease in available cash or an initial trade payable (paid at the expiration date).

The operations of selling products/services on the sale market, hence, give rise to positive financial changes consisting in a cash in or trade receivable's take out, always subject to expiration.

Going on in explaining the two main standpoints of external operations, consider the economic aspect means to consider the contribution of the same operations to the creation/destruction of shareholders' wealth.

From the economic side, external operations could measure costs and revenues: costs reflect negative economic variations while, revenues, positive ones.

The acquisition of factors of production implies an investment as well as the consumption of corporate wealth; the amount of cash out coming from these kinds of operations could be useful to understand the costs of the purchased inputs.

Thus, the acquisition of a product/service determines, from the financial side, a negative change and, from the economic side, a cost of acquisition of the same amount.

The economic side of business operations is connected to the transfer of wealth (investment) done in order to acquire factors of production, while, in the financial point of view, it will occur a cash out or the rise of a debt, paid at the expiration term.

On the other hand, the transfer of final products or services from the circuit of production to the sale market generates the recovering of the supported costs or, in other words, a revenue measured by the amount of cash in.

Therefore, this operation is translated into a positive economic change (revenue) and a positive financial change (cash in or trade receivable paid at the expiration term).

As previously discussed, together with the circuit of production we have to refer to the circuit of received financing (from owners or from third financial institutions).

Whatever the financing form is, the operations coming from the received financing circuit determine an increase in cash available and so, a positive financial change.

In the moment in which an increase in the available cash occurs, due to a borrowed loan, the positive financial change is compensated by a negative financial one related to the debt incurred.

At the expiration term, when the amount of debt has to be repaid, a positive financial change (reduction of financial debts) compensated by a negative financial one (cash out) will occur.

While, if the cash in is due to received financing by owners, together with the positive financial change it will measure a positive economic change of capital (concerning an increase in economic wealth not linked to the implementation of external operations).

Finally, we have also to consider the circuit of grant loans.

The granting of loans gives rise to a positive financial change (financial credit) compensated by a negative financial change (cash out).

At the expiration date, when the credit has to be cashed in, a negative financial change (decrease in financial credits) will be compensated by a positive financial one (cash in).

Table 85 shows the evidence of all possible changes generated by the typical business operations.

Table 85 – *All possible changes generated by the typical business operations*

POSITIVE FINANCIAL CHANGES	NEGATIVE FINANCIAL CHANGES
+ Cash	- Cash
+ Financial credits/Trade receivables	- Financial credits/Trade receivables
- Financial debts/Trade payables	+ Financial debts/Trade payables

NEGATIVE ECONOMIC CHANGES (*COSTS AND EQUITY*)	POSITIVE ECONOMIC CHANGES (*REVENUES AND EQUITY*)
+ Costs of input's acquisition (*negative economic income change*)	+ Revenues of sold products/services (*positive economic income* ***change***)
+ Costs for interests payable (*negative economic income change*)	+ Revenues for interests receivables (*positive economic income* ***change***)
- Equity (*negative economic capital change*)	+ Equity (*positive economic capital* ***change***)

7.1. *Changes' analysis*

The ability of a firm to create value does not depend only on external operations but even on the set of business internal ones.

However, the measurement of the external operations' value is a way to understand the real value creation or disruption as a consequence of business activities management.

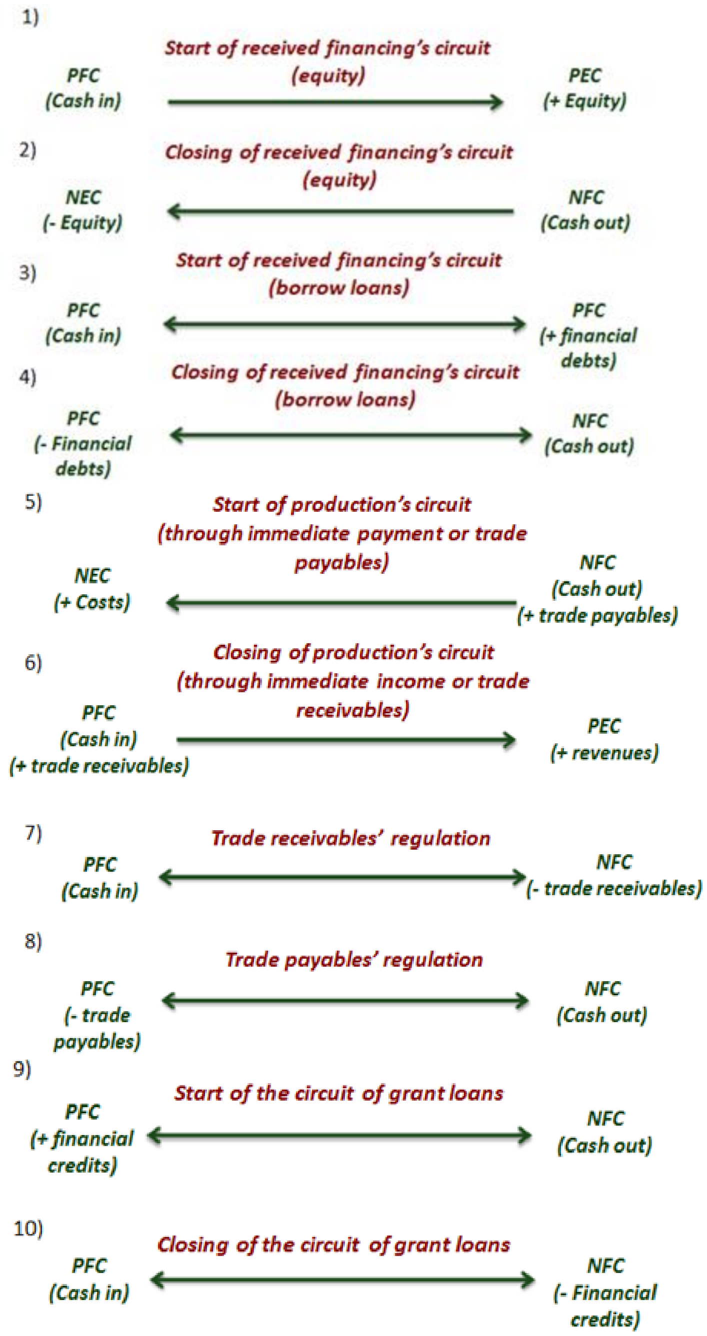
This is why a fundamental role is played by the analysis of external operations' changes in determining business management's results.

Each external operation determines at least one financial change and, at the same time, it could occur an economic change too, as well as another financial change with an opposite value.

Now, practically speaking, we have to report all positive financial changes in the left section and, the negative financial ones in the right section of the changes' graph.

The negative economic value and the positive economic value will be placed respectively in the left and right side of the same scheme.

At this point, it is possible to schematize the analysis of changes referring to the starting and ending phase for each of the four circuits above discussed (production, grant loans, received financing from owners/lenders) as well as for the subsequent income/payment of possible trade receivables/payables.

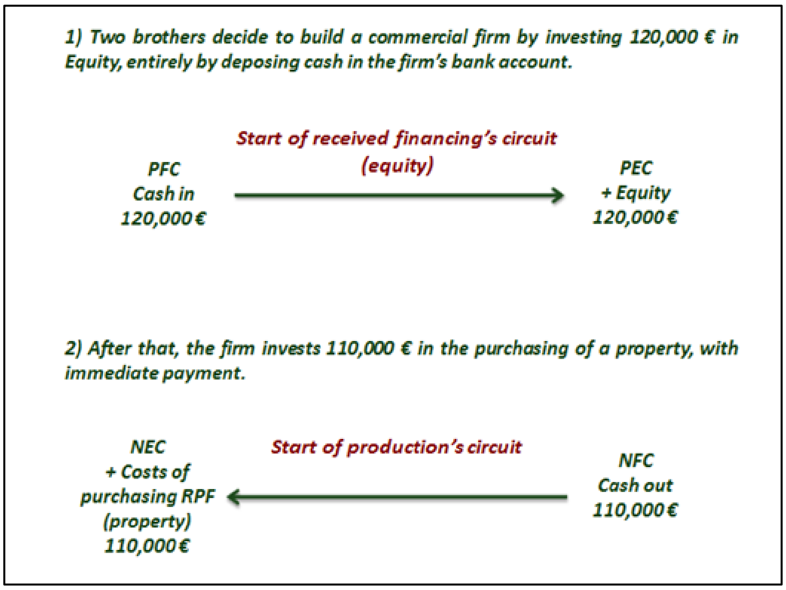


Once the logic of the changes' analysis has been defined, it is needed to focus on some important considerations.

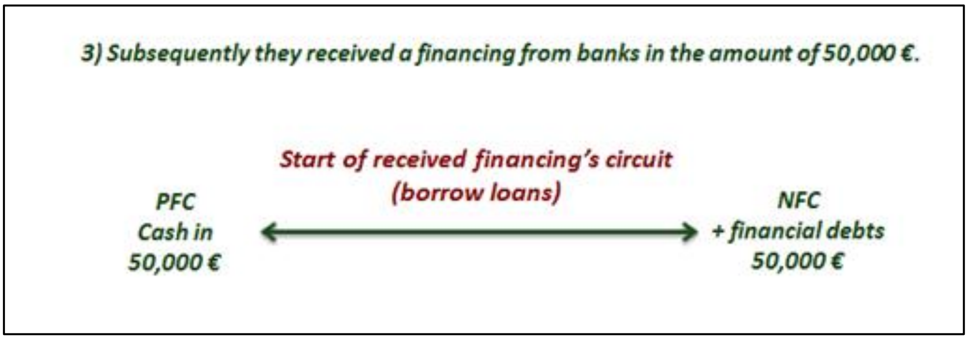
The first one refers to economic changes (costs and revenues) coming from transactions with third parties. As it could be grasped, in order to align internal and external information flows (see for example lenders, financial administration, suppliers etc.), it is needed to periodically determine (at least once a year) the business economic result. The second consideration refers to the definition of the amount of costs and revenues attributable to a specific economic period in the analysis of the business results.

7.2. *Some examples of changes' analysis*

Now we can start to consider the following examples of changes' analysis, with teaching aims.

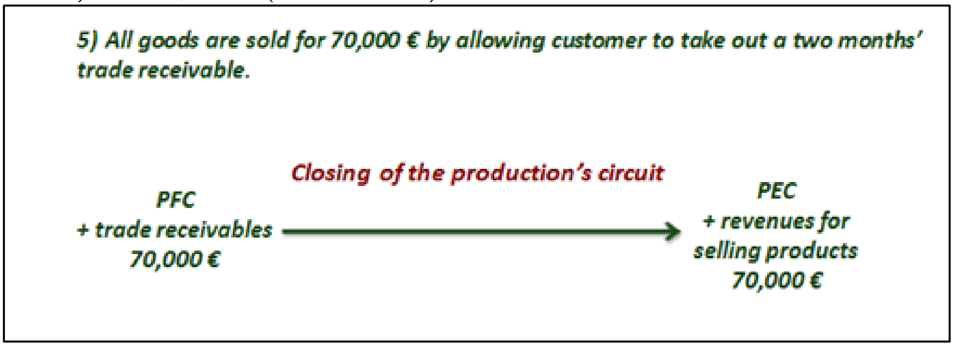


By the way, at this point the company's assets are not only composed by cash but even by 10,000 € of financial means and by a property whose value is 110,000 € (representing the available factors of production). All this by considering always the initial received financing by owners of 120,000 €.

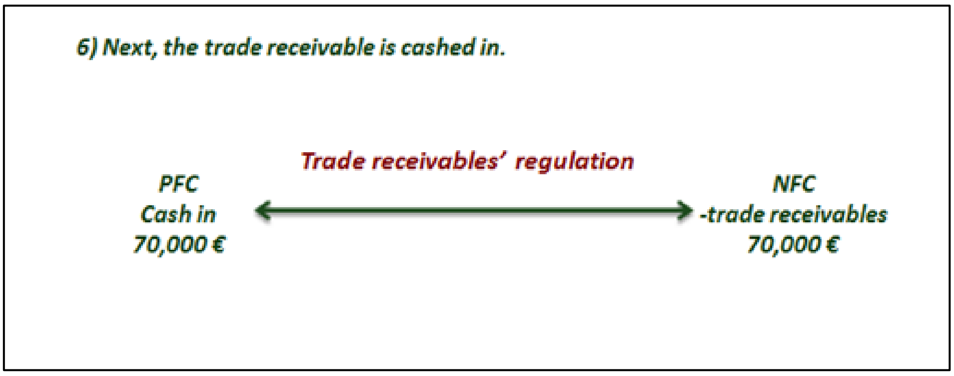


At this point, the company has available a property which is worth for 110,000 €, monetary resources for 60,000 €; always considering the received financing for 120,000 € (from owners) and 50,000 € (from lenders).

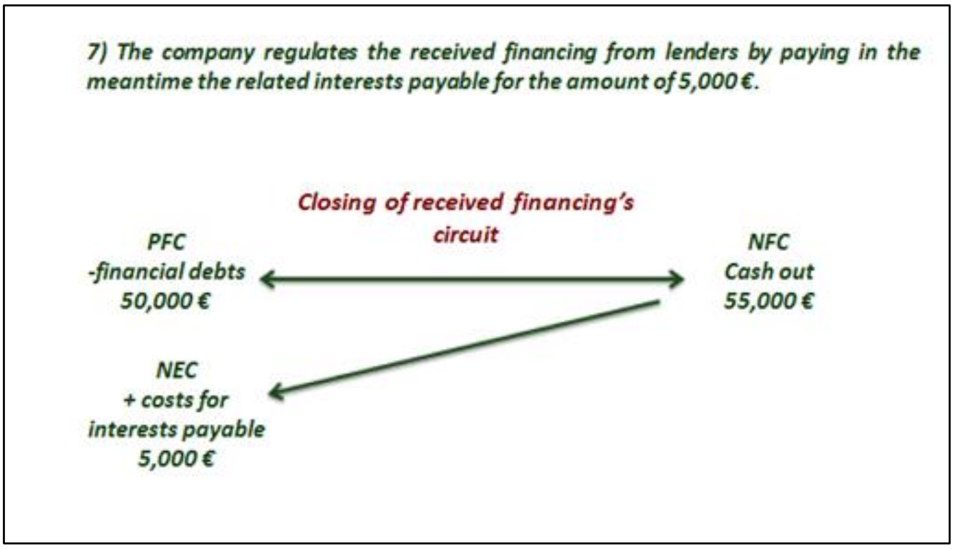
Now, the company has available a property for 110,000 €, goods for 50,000 € and 10,000 € of monetary resources, always considering an amount of received financing for 120,000 € (from owners) and 50,000 € (from lenders).



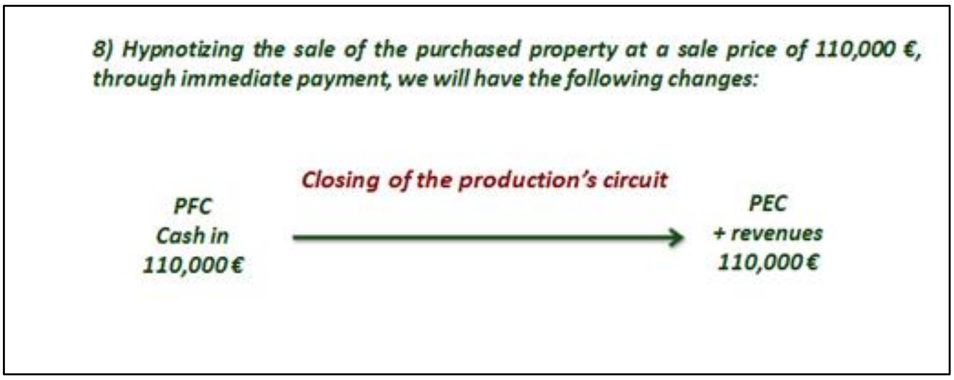
Company, at this point, owns a property which is worth for 110,000 €, 10,000 € of monetary resources, a trade receivable for 70,000 €; always considering received financing for 120,000 € and 50,000 € respectively from owners and lenders (it is important to notice that, given 170,000 € of total received financing, there are cash, credits and property for a total amount of 190,000 €. Therefore, the results of business operations would have generated a value for 20,000 €, amount that, in turn, reflects the difference between the purchasing costs and the price of goods sold).



Again, the company now owns a property for 110,000 €, monetary resources for 80,000 €; considering received financing for 120,000 € (owners) and 50,000 € (lenders).



Going forward company owns a property of 110,000 €, financial means for 25,000 €, given an amount of received financing for 120,000 € from owner (adding to the amount of received financing 120,000 € the value of the property, we will have a total amount of 135,000 €, thus, the new value created is 15,000 €, representing the difference between costs and revenues of the goods sold less the interest payable).



This last change could reflect the final step of business activity, since all circuits have been closed. The company has the availability for 135,000 € in monetary resources; given received financing for 120,000 € (equity) the business operations have created value for 15,000 €, representing the differences between costs and revenues of final products (less the interests payable). However, the owners' remuneration will be higher than the initial capital invested.

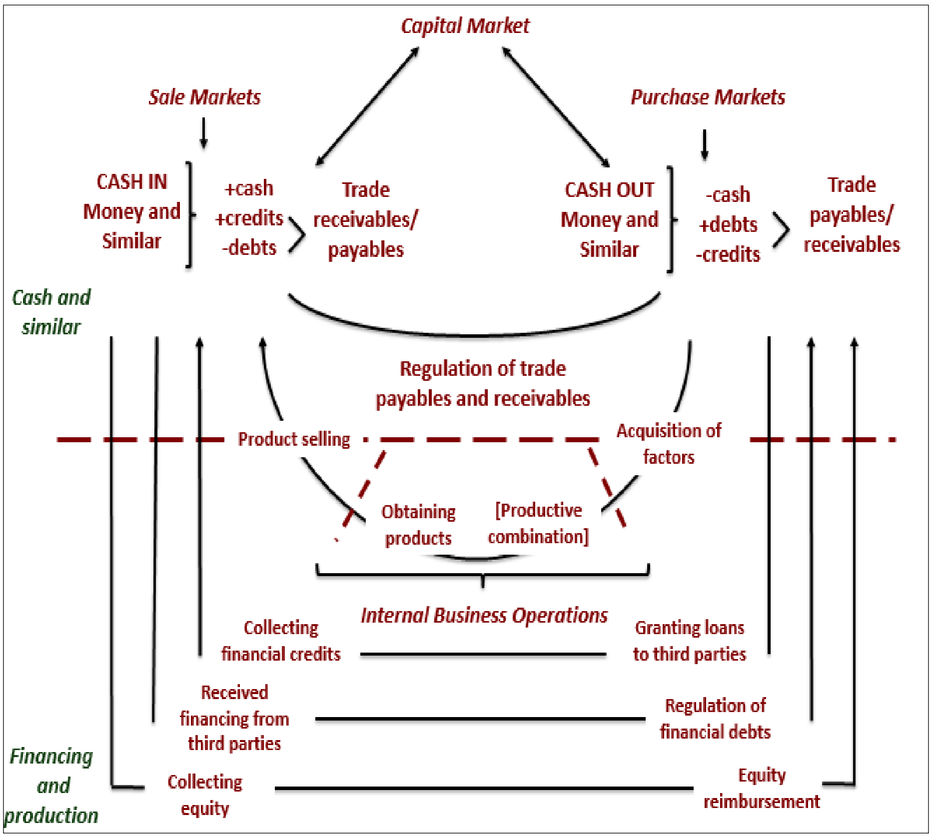
It is possible to conclude that, in the day-by-day business operations, it is not possible to wait for the closure of all circuits involved in order to determine the business's results (creation/destruction of the initial wealth). Different needs from different actors imply the periodical determination of the economic result. Therefore, practically it occurs that the results are defined before the end of all circuits initially activated.

8. *The total scheme of the business entity operations*

The characteristics of the scheme (Table 86) are as follow:

a) All operations are grouped according to their belonging to the circuit of production or the circuit of received financing/grant loans. The reason lies in the possibility to observe the different trend of the circuit of production and that of grant loans in respect to the circuit of received financing and, to catch the awareness that all circuits fuel each other's;
b) All transactions implemented by the firm are separated into two sides of the scheme. The internal business operations, concerns the transformation of factors of production in the final product (productive combination);
c) When considering cash in and cash out we refer even to trade payables and receivables;
d) The horizon line divides ideally all operations belonging to different circuits from the effects that the same operations have on cash and trade receivables and payables;
e) The operations of debts and credits' regulation are included above the horizon line where the effects of such operations are considered. For example, the payment of a trade payable determines a cash out (as well as it could determine a reduction of credits) that is compensated by the resolution of the debt itself;
f) The restitution of the equity are foreseen for an amount that is different from the conferred one because it has to consider profit (positive or negative) form management operations that has to be added or detracted from the initial capital. The regulation of received financing and grant loans are foreseen for amount that are higher than the nominal value of the debts/credits, since the interests that have to be paid or collected;
g) The operations belonging to the circuit of received financing have to be considered as operations of acquisitions from third parties for a specific period of time, acquisition that implies the related costs (financial duties). Analogously, the operations belonging to the circuit of grant loans, for a specific period, have to be considered as operations of transfer of financial means to third parties, which implies the collection of the related earnings (financial returns).

Table 86 – *Complete representation of business operations*



The reason of these statements lies in the fact that the "availability of money" acquires the characteristic of "specific factor" of production, which could be acquired or transferred on the capital market. Looking from this perspective, the operations we are referring to would logically be included in the circuit of production: the firm purchases and sells "availability of money", being just this one the core business of all firms working as financial mediator.

However, this logic if better interpreted can be applied for any kind of firms. All companies, through financial operations purchase or transfer financial means' availability; the only difference is that, for firms which do not work as financial mediator, these activities are not typical but instrumental or collateral.

Overall, there is nothing impeding to include these activities in the circuit of production; this would allow reducing the representation of company's activities to the circuit of received financing from owners and the circuit of production. The latter would include even the operations of transfer and acquisition of financial means' "availability" (obviously, such representation would not allow catching the opposite sense of rotation of circuits as well as their ability to fuel each other's).

9. *Operations, values and change*

Let now introduce the values' changes analysis considering real examples of the firm typical lifecycle. The following are the possible operations that a firm can implement during its potentially indefinite life:

1. Establishment of the firm through owners' investment (initial equity)
2. Get financing from banks/others financial institutions in order to start the productive process, by being committed in the payment of a defined amount of interest payable, at the financing's expiration date
3. Acquire on the Purchase Market factors of production useful to implement the process of transformation of the inputs in final outputs (goods or services)
4. Sell the outcomes on the Sale Market
5. Grant money to third parties under a defined amount of interest receivables to be cashed at the financing' expiration date

9.1 Some examples

In order to implement values changes analysis, start with the following suggestions:

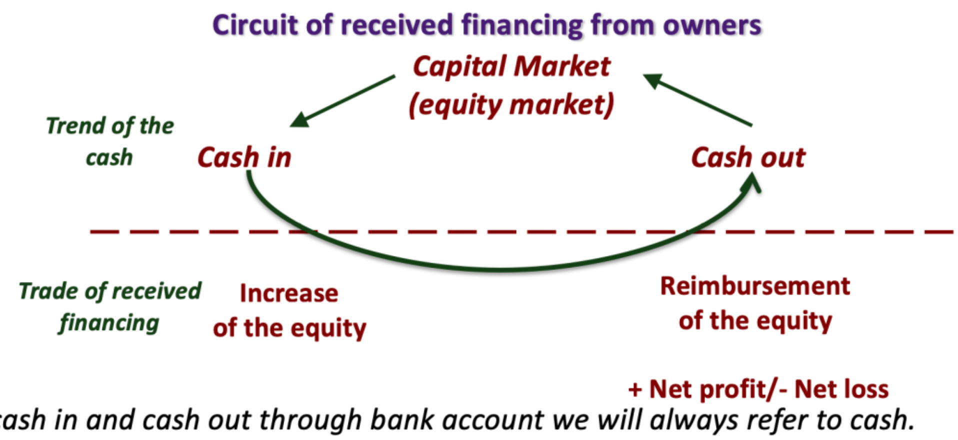
a) Read carefully the available data to understand the actors involved in the transactions
b) This will make you able to understand the kind of operations, thus, the Amaduzzi's circuit involved in transactions

Trace 1.

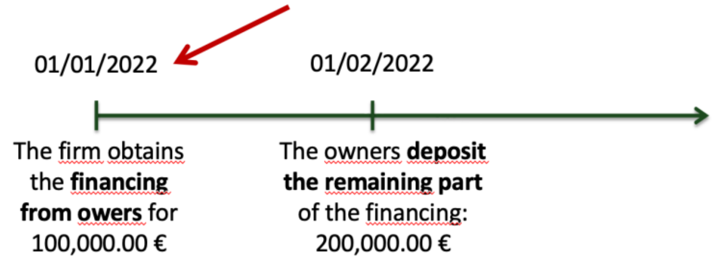
[1] On 01/01/22, the firm «Gamma SpA» has been established with an initial capital of 300,000.00€. Contextually the owners have deposited on the firm's bank account* an amount of 100,000.00 € [2] by being committed to deposit the remaining part the following month.

The first step before recording transactions is to understand the circuit involved in the operation.
So, you have to answer the following question: "Which is the circuit to which the operation is linked?"

In this case we answer as follow:



The second step is to keep in mind is the *time trend* of the operation.



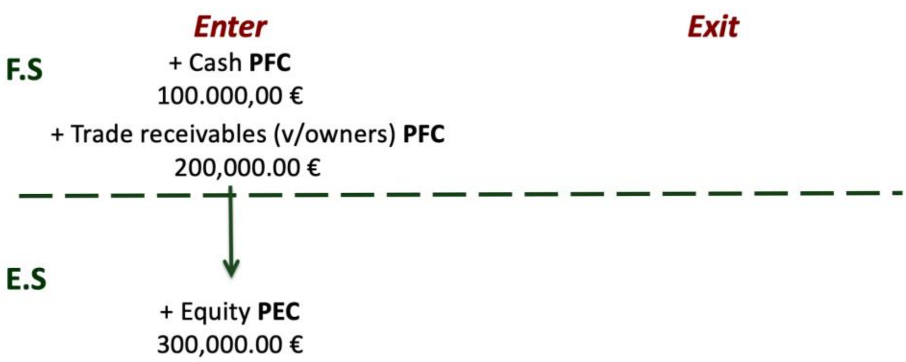
The transaction we are referring to is composed of two period of recording as the timeline above suggest.

Reminder for practice

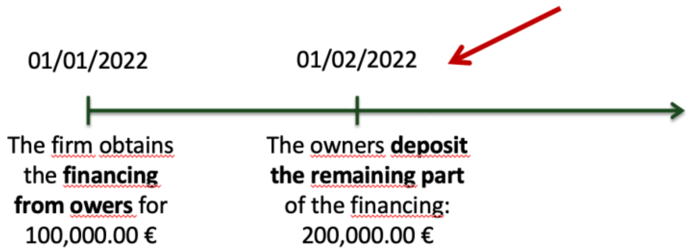
Before starting the analysis of transactions remember to draft the horizon line useful to separate the Financial and Economic sectors, then, highlight the former (F.S) above the line and the latter (E.S) below. In the same way, highlight the "enter" and "exit" side respectively in the left and right side of the framework. All the values changes analysis start from recording an operation in the financial sector above the line, with an increase (+) or decrease (-) in cash or similar (trades receivables/payables-financial debts/credits). The positive financial change above the line can measure in turn another financial change (negative) or a positive economic change below the line. Moreover, it can also compensate a negative financial change.

The analysis for the first period (01/01/2022) follows:

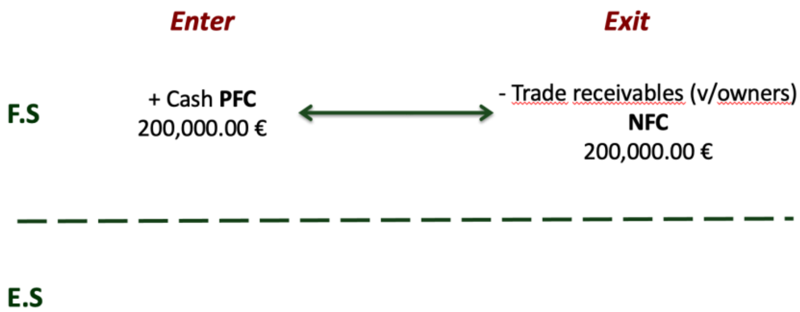
[1] On 01/01/22, the firm «Gamma SpA» has been established with an initial capital of 300,000.00€. Contextually the owners have deposited on the firm's bank account* an amount of 100,000.00 €.



Now, let's go through the second period (one month later) of the timeline of operations, the moment in which the owners are committed to deposit the remaining part of the initial capital on the bank account, by decreasing their trade receivables.



[2] On 01/02/22 owners deposit the remaining part of the financing for 200,000.00 €

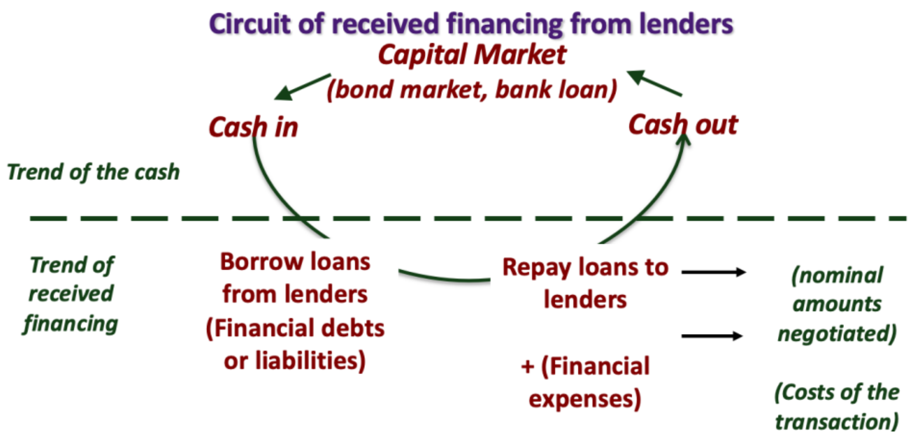


As shown, this second analysis record a compensation of two financial changes of the same amount.

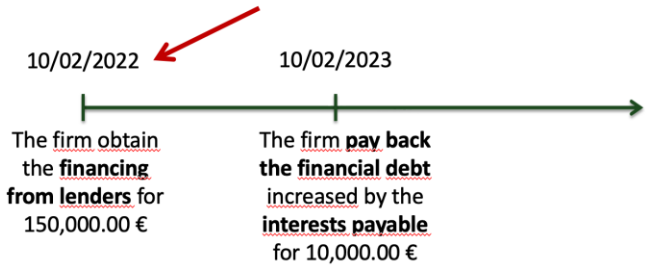
Trace 2.

[1] On 10/02/22 the firm has obtained a loan for 150,000.00 € from a financial institutions, deposited on the firm's bank account. **[2]** The amount of borrowed money, increased for 10,000.00 € by the matured interests payable, will be reimbursed on 10/02/23 in one single solution.

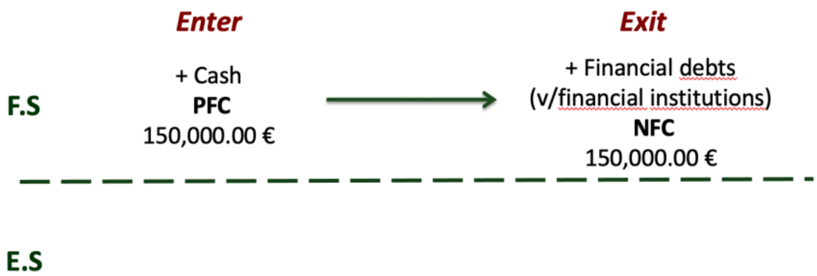
The analysis starts with the identification of the circuit involved:



Then, let's go through the time trend of the operations. These transactions too are spread through two different period:



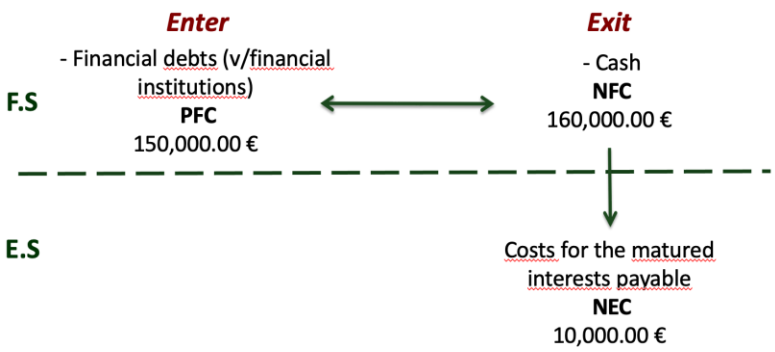
[1] On 10/02/22 the firm has obtained a loan for 150,000.00 € from a financial institutions, deposited on the firm's bank account.



The value change analysis of the first period shows the recording of two financial changes, a positive one that measures a negative one in the right side of the framework (exit).

[2] On 10/02/2023 The amount of borrowed money, increased for 10,000.00€ by the matured interests payable, will be reimbursed in one single solution.

The changes analysis for the second period follows:



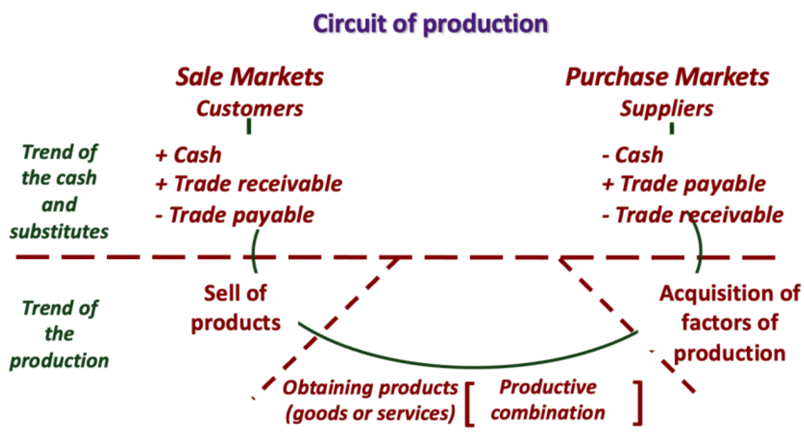
If in the first period the negative financial change was measured by the positive one, at the moment of the reimbursement of the loan the cash out (negative financial change) will compensate the decrease of financial debts (positive financial change). Here also an economic change is recorded, referred to the costs for payables interests.

Let's now introduce an example of value changes analysis that is not parted in two different period of time.

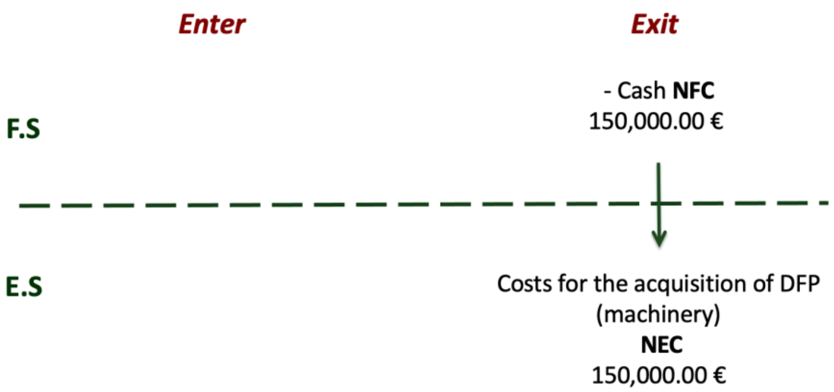
Trace 3.

It is purchased a machinery for 150,000.00 €. The payment is regulated through bank.

By reading carefully the data it is possible to identify the circuit involved in the transaction:



The solution follows:



10. *First considerations on the capital structure of the firm*

The company's capital could be considered as a set of positive or negative conditions aimed to production. It is defined as the total amount of economic utilities available for production (positive components, assets) and the whole set of debts the company has taken on with third parties (negative components, liabilities). These negative and positive components of the company's capital acquire significance and worth according to their productive "destination", *being mutually tied by an instrumental relation to the production activity.*

Capital, in all its components, is present during the entire life cycle of the company until it "works". The company activity – considered as a set of coordinated operations - gives rise to a series of consequential transformation in the capital compositions. Indeed, business operations tend to:

– Transform the generic factor "money" in specific factor of production (goods and services) through procurement;

– Transform factor of production in products through the productive combination;

– Transform again products in financial means trough sale;

– Adjust the level of available skills through the acquisitions of new experience and know how.

Each operation implemented by the company is able to modify the quantitative and qualitative capital composition.

However, is not correct to consider capital transformation only because of company operations. Being the capital components addressed to the production activity (the latter conferring them significance and worth) the potential internal and external modifications of operational conditions, which influence the production processes, could generate consequential modifications in the "destination" and "value" of the capital components.

The value of the equity, in fact, could be determined as the jointly economic utility that all assets and liabilities composing it are expected to manifest.

Since this expected complementary economic utility is none other than the company expected cash flow, seems to be evident that the capital of a "working" company (also known as "economic capital" or "economic value of capital") has to be a unit value defined according to such expected cash flow (expected income).

Apart from the economic value of capital determined as explained, it is needed to attribute a value to all categories of outstanding investments (done for the acquisition of factors of production) at the end of a specific timeframe. Moreover, it is needed to understand the sources from which the financial means useful to do such investments have been gleaned.

This evaluation process of the "investments" and the "sources of financial means" is instrumental to the determination of the amount of new income generated in the reference timeframe.

The economic capital as described above as a clear different configuration in respect to the economic capital as generally considered, in fact:

a) We do not address to the economic capital as a unique value (the company value) but to values conferred to different class of investments (assets) and obligations (liabilities) which constitute "elements" of the outstanding productive processes at the end of a specific timeframe. As said, the evaluation of such "elements" is instrumental to rationally define the income of the period.

b) The positive components (assets) are constituted by the set of tangible and intangible goods available for the production activity (gross capital). It refers to such investments done by the company that, in the period in which it is observing and evaluating capital, are expected to be recovered (acquired but not yet used factors of production, factor of production partially used in productive processes, final product not yet sold, given financing that has to be refunded), as well as money available in that moment but not yet invested and trades receivable that, temporarily, replace it.

The negative components are constituted by obligations taken on with third parties (financial debts or trades payable not yet reimbursed, anticipated revenues).

Evaluated the amount of liabilities by which the company capital is composed it is possible to determine the net capital, considered as the remaining part of the value of company assets after the repayment of all company's obligations.

We refer to the capital determined in this way as the company Equity. It is possible to represent the company Equity through a table. In the left side of the table there is the list of the outstanding "investments" of the considered timeframe, while, in the right side of the table the "sources of financial means" useful to invest.

Consider the relations below:

$$A = L + E$$
$$A - L = E$$

Where:

A = Assets

L = Liabilities

E = Equity

Table 87 – *All possible changes generated by the typical business operations*

ASSETS **[Outstanding investments in the considered timeframe (expected to be recovered)]**	***LIABILITIES AND EQUITY*** **[Source of the invested financial means]**
Gross capital Given but not yet collected Obligations taken on with third parties not yet reimbursed Available money not yet invested in production Trade receivable Financial credits } Given but not yet collected Acquired not yet used factors of production Acquired partially used factors of production Semi-finished products, final products not yet sold	***Obligations with third parties*** Trade payable Financial debts } Obligations taken on with third parties not yet reimbursed Anticipated revenues (service to be carried out) ***Net Capital (Equity)***

The invested capital that is expected to be recovered (Gross capital), less the obligations taken on by the company with third parties, give rise to the Net capital (Equity) which corresponds to the capital conferred (in cash or in kind) by the owners, increased or diminished of the income generated until the reference timeframe (Savings capital):

$$A = IC$$
$$GC - L = NC = E + SC$$

Gross capital ***(Obligations with third parties)***	**GC** **L**
Net Capital **(Equity)**	**NC**

Equity **(Conferred in cash or in kind by owners)** **Savings Capital** **(Generated and available income)** ***(Negative income with diminished capital)***	**E** **SC**
Net Capital **(Equity)**	**NC**

Value to be subtracted are indicated in *italic*

Where:

GC = Gross capital

E = Equity

SC = Savings capital

a) Some components of the capital of a working company (know-how, experience, management skills) acquire relevance according to the positive income flow and, thus, affect the "economic capital" height.

However, *such resources tied to knowledge have not been acquired from third parties through monetary transaction*; they are not investments that have to be recovered thanks to future expected income.

By the way, they are an optional result of the business activities implemented by the company and, for this reason, it is sure that they will affect the company final outcome.

Such intangible resources, even if affect the company value, could not be considered among the positive component of capital (among the investments not yet recovered).

Pay attention that, the value attributable to the capital of a working company, is obviously different to the value of all the elements composing the capital of a company that has to be liquidated ("Liquidation capital"). In this latter case, in fact, the available assets have lost every kind of "destination duty" toward the production activity of the company. For this reason, their value is only calculated in accordance to their attitude to be sold.

In other words, the liquidation capital is the expected value coming from the direct selling of each asset on the market, after it has been scrapped from the productive process.

10.1. *Income and capital structure referred to the entire firm's lifecycle*

Considering the entire firm's lifecycle (t0 – tz), it is possible to consider as total income the increasing or diminishing of the equity due to all implemented operations:

It has to assume the following hypothesis:

1) At the end of the considered period the business is completely ceased, it means that:

– All factors of production have been completely used or, if not used, they have been sold because scrapped from production;

– All production processes have been accomplished; all products have been sold;

2) In the considered period (t0 - tz) there were not changes in the currency purchasing power.

If the above hypothesis 2) was not verified, the total income assessment would require specific corrective actions in order to homogenize the measured variables. In this way it would be possible to express costs, revenues final and initial capital in a single unit of measure – money - having the same purchasing power.

In accordance to the two listed conditions 1) and 2) it would be yet possible to affirm that the difference between the total costs supported to purchase all factors of production used in business (investments) and all revenues coming from the selling of all products obtained through the productive combination (recovery) is equal to the total income.

However, it is needed to go straight by supposing that:

3) All kind of credits have been collected; all kind of debts have been paid back; there is not any kind of outstanding risks that could represent the reason for future costs or losses;

In light of these premises, the capital at the end of the firm's lifecycle (tz) is presented as exclusively composed by a financial component, that is money, available again for the recovering of all investments and the regulation of all credits and debts.

Moreover, if the premises just expressed would be expanded with the introduction of the following:

4) The initial capital (t0) has been conferred totally in cash;

5) During the entire firm's lifecycle no more provisions have been done as well as any kind of equity reimbursement or income withdrawal;

It would be possible to assessing the firm's total income even by considering these calculations:

– Difference between the conferred capital at time t0 and the final capital at time tz;

– Difference between the total cash in and the total cash out of the timeframe t0 – tz (except that one referred to the equity capital).

Indeed, the way to calculate total income as difference between initial and final firm's capital would not be reliable whether some additional provisions or withdrawal occurred.

Therefore, only if all proposed conditions, from 1) to 5), occur, total income would be assessed according to one of the following process:

$$TI = tzC - t0C$$

$$TI = \sum_{t=0}^{tz} \sum_{k=1}^{m} Q_k P_k^t - \sum_{t=0}^{tz} \sum_{i=1}^{n} f_i \, p_i^t$$

$$TI = \sum_{t=0}^{tz} E^t - \sum_{t=t0}^{tz} U^t$$

Where:

TI = Total Income

tzC = Capital at time tz

t0C = Capital at time t0

$Q_k \, P_k$ = Revenues from selling products (sold quantity × selling price)

$f_i \; p_i$ = costs for acquisition of factors of production (purchased quantity × purchasing price)

E = cash in (except that referred to the capital initially conferred)

U = cash out (except that referred to the final capital returned at time tz)

Such processes are listed through an ascending order according to their complexity and the amount of information they provide: from a simple difference between two amount of money available at time t0 and tz, it shift to the analytical consideration of all implemented investments and recovering; this could be useful to highlight the management economic trend.

Finally, considering the differences between the total cash in and cash out, it is possible at the same time to catch the financial and economic management trend.

We can represent the total income in a table with two close sections (accounting form) that are filled with quantities related to positive components (revenues) and negative components (costs) and that reduce the differences between these two quantities (positive income or losses) at a breaking even point (balance) where the table presents lower values.

The firm's capital at time tz (tzC) could be reported in a similar table where, a section is dedicated to the amount of available money and the outstanding investments at time tz (assets or available products) and the other one is committed to show the "sources" from which the firm drawn the financial means useful to invest (received financing from third parties or from the owners).

The two tables follow:

TOTAL INCOME (t0 - tz)	
Negative components	**Positive components**
Costs supported in the period t0 - tz	**Revenues obtained in the period t0 – tz**
Profit **(Positive income)**	***Loss*** **(Negative income)**

FINAL CAPITAL (tz)	
Investments (available products) (Credits)	**Sources of financial means (Debts and equity)**
(Financial sector) **Cash**	**Revenues obtained in the period t0 – tz**
(Economic sector)	
	Equity: **t0 Capital ± income t0 - tz (Profit/Loss)**

The assessment of the total income measure – possible to determine only in the moment in which firm decides to cease its activities and, moreover, in accordance to specific procedures which care about the real conditions of the business - does not have practical utility in order to know the real results coming from the business activities.

Indeed, the concept of total income is not more than a guideline used to approach another concept much more relevant in the field of management control. We are referring to the period-income.

Among the main reasons pushing economic actors to assess the level of income referred to specific periods of the firm's lifecycle there are the following:

- The income referred to a particular period of the firm's lifecycle represents a terse parameter useful to check the goodness of all implemented strategies;
- The measure of this new value generated in the reference period as a result of management implementation is considered as a limit for owners (and other actors whose profit is in some ways linked with the income of the period) to withdraw wealth from firm's cash;

- It is needed to provide to external stakeholder information about the ability of the firm to generate income in different period of its lifecycle as well as information about the composition of the firm's capital overtime;
- It is needed to be compliant to law, which is different as different are the typology and size of firms, by editing periodical and annual balance sheets;
- It is needed to assess the taxable income, depending a lot on the values used to determine the income of the considered period.

TOTAL INCOME (t0 - tz)

Negative components		*Positive components*	
Costs of acquisition		*Revenues*	
Products:	500€	Prod. Sold:	800€
Other:	100€		
	600€		
Profit:	200€		
	800€		800€

FINAL CAPITAL (tz)

Investments		*Sources of financial means*	
(Financial sector)			
Cash	1200€		
(Economic sector)		*Equity*	
		t0 Capital	1000€
		Total income	200€
	1200€		1200€

Cash Flow	Cash in	Cash out	Residual
Constitution	1000€		1000€
Acquisition of factors		600€	400€
Selling products	800€		1200€
Capital restitution		1200€	

FINAL CAPITAL AND TOTAL INCOME DETERMINATION

The firm Y, during its lifecycle, implemented the following operations:

Foundation:
In-cash equity provision for 1000 €
- Mr. A 600€
- Mr. B 200€
- Mr. C 200€

Costs for the acquisition of factors of production, 600 € by cash
- Products 500 €
- Other factors 100 €

Collecting revenues from selling products, 800 € in cash.

Firm's cessation and capital restitution
Capital restitution by cash for 1200 €
- Mr. A 720€
- Mr. B 240€
- Mr. C 240€

t0: Firm constitution **tZ**: Firm cessation **t**: Firm lifecycle

10.2. *Income and capital structure referred to the first period of the firm's lifecycle*

10.2.1. Costs and revenues allocation: derivative and original costs and revenues

In the management of any kind of business each operation is mutually related with the previous and the following ones. Every time operations are planned and then implemented, costs and revenues that have been respectively sustained and collected interlace each other.

It means that the income determination which refers to a period ranging from tn-1 and tn, has to be done by considering such part of costs and revenues that have to be addressed to the "economic accrual" of that specific period. We will shift from the concept of original costs and revenues to the concept of derivative costs and revenues.

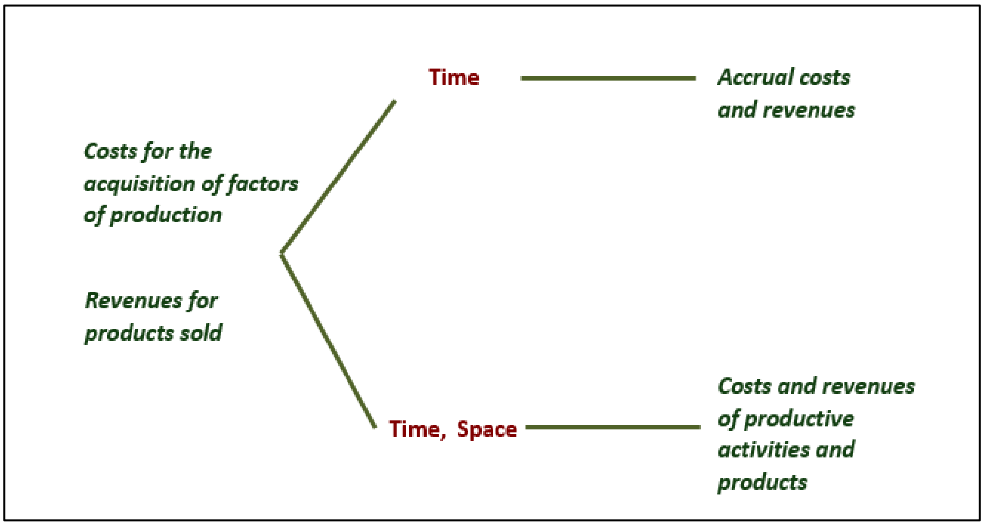
The "original costs" refer to the costs supported for the acquisition of factors of production, deriving from the product between their quantity and price. They are even called "exit-cost" because are measured by financial cash out.

While, the "derivative costs" (even called "imputation-costs") come from the rational reclassification of original costs according to two variables: time and space.

Thus, the "period costs" come from a reclassification of the factors of production's original costs according to the variable time; while, the "costs of productive activities or the costs of products" come from a reclassification, based first of all on variable time and then space, of the original costs of factors of production.

Such reclassification is useful to shift from the costs of acquisition of factors of production to "period costs" or "costs of specific production activities" and "specific products".

The same considerations could be done for what concern "original revenues" related to the products selling, deriving from the product between sold quantities and selling price. They are even called "enter-revenues" because are measured by a financial cash in.



While, the "derivative revenues" (even called "imputation-revenues"), come from the reclassification of original costs according to both variables time and space. These reclassifications are useful to shift from revenues of product sold to "period revenues" or "revenues of specific productive activities".

10.2.2. Accrual accounting

"Accrual accounting is an accounting method that measures the performance and position of a company by recognizing economic events regardless of when cash transactions occur. The general idea is that economic events are recognized by matching revenues to expenses (the matching principle) at the time in which the transaction occurs rather than when payment is made (or received). This method allows the current cash inflows/outflows to be combined with future expected cash inflows/outflows to give a more accurate picture of a company's current financial condition" (Investorpedia).

YouTube 23 – *Cash accounting and accrual accounting*

Type	Title	Length (hh:mm:ss)	Study/Watch
Lesson	Cash accounting	00:03:58	Study
Lesson	Accrual accounting	00:04:50	Study

The scission per-period of costs and revenues that are common to more than one period is not so easy but in the same time essential in order to know the economic results reached in each period of the firm life cycle.

Therefore, it is needed to pinpoint that criterion useful for the accountant in this process as well as the logic to be pursued.

With this aim, it is important to introduce the accrual accounting, thus, the useful conditions to identify costs and revenues applicable to a specific period of the firm's lifetime. The difference between these two quantities is equal to the income of the considered period.

The problem could be faced by following two different rules.

The **first** one sees the costs and revenues of a specific period, whose difference will give rise to the income of the considered period, as related to the productive processes that have been started from the firm, even if these processes are not yet completed.

According to this logic it will be useful to "integrate" collected revenues (as well as supported costs) with costs and revenues that have to be respectively supported and collected in future to accomplish the started processes.

These last processes at the end of the considered period result to be outstanding processes because the deriving products are not yet sold and the related revenues not yet collected and/or, the costs to complete the performance and legitimate revenues not yet supported.

The **second** logic defines as accrual costs and revenues such costs and revenues related to the processes ended in each period considered: the "ended" productive processes of a specific period are such processes that have been closed because all related revenues have been collected and all related performances implemented by the firm.

According to the principle of revenues realizations: the accrual revenues are such revenues financially collected after the implementation of the related performance by the firm.

According to the principle of inherence costs: since the collected revenues, the accrual costs are such costs related to the implemented performances.

As a consequence, the "outstanding processes" concern productive processes whose revenues have not yet been collected and, such processes in which the firm has to implement the related performances (totally or in part) even if revenues have already been cashed in.

Costs and revenues related to outstanding processes, at the end of the period could not be considered as accrual quantities because they belong to the following periods in which processes will be closed thanks to the revenue's realization and performance implementation.

Therefore, outstanding costs and revenues have to be pushed back to future period, here the problems about the boundaries of such postponement.

In defining the components of income and capital's schemes, we will follow the second logic above explained. Anyway, the loss on the outstanding processes are an accrual value of the period in which the risk of these losses occurs (even if processes are not closed).

10.1. *Derivative costs (space reclassification): direct vs common and fixed vs variable*

"The essential difference between direct costs and indirect costs is that only direct costs can be traced to specific cost objects. A cost object is something for which a cost is compiled, such as a product, service, customer, project, or activity. These costs are usually only classified as direct or indirect costs if they are for production activities, not for administrative activities (which are considered period costs).

The concept is critical when determining the cost of a specific product or activity, since direct costs are always used to compile the cost of something, while indirect costs may not be assigned to such a cost analysis. It can be too difficult to derive a cost-effective methodology for the assignment of indirect costs; the result is that many of these costs are considered part of corporate overhead or production overhead, which will exist even if a specific product is not created or an activity does not occur.

Direct costs tend to be variable costs, while indirect costs are more likely to be either fixed costs or period costs.

Using Direct Costs and Indirect Costs in Pricing

At a minimum, direct costs should always be included in the derivation of a product's price, since the established price must always equal or exceed its direct cost; otherwise, every sale will generate a loss. Pricing based just on direct costs makes the most sense in situations where there is an opportunity to sell a few extra units on a one-time sale with excess production capacity. Indirect costs should also be included in the derivation of a product's price when setting long-term rates, where product sales must cover both direct and indirect costs.

Examples of Direct Costs and Indirect Costs

Examples of direct costs are direct labor, direct materials, commissions, piece rate wages, and manufacturing supplies. Examples of indirect costs are production supervision salaries, quality control costs, insurance, and depreciation" [9].

"Fixed costs are costs that do not change with the level of production. That is whether the level of production is high or low one has to incur the same amount of costs. For example, if you rent out a mini bus that has a seating capacity of 25 and only 10 people manage to go on a trip, you will still have to pay the same amount of rental for the bus. Examples of fixed costs are salaries, rent and equipment's depreciation.

Variable costs are costs that change with the level of production. This means the more the products and services are offered the more the costs and vice-verse. For example, if you make school uniforms and you produce 100 of them the first month and 500 of them in the second month, it will mean that the variable costs of making the uniforms will be higher in the second month than in the first month. Variable costs help the business calculate how much it costs to produce one product or offer a service. Examples of some of the variable costs for making school uniform are; cloth, buttons and thread. More raw materials will be used on 500 school uniforms than on 100 of them"[10]

10.2. *Break even analysis*

"Break Even Analysis in economics, business, and cost accounting refers to the point in which total cost and total revenue are equal. A break-even point analysis is used to determine the number of units or dollars of revenue needed to cover total costs (fixed and variable costs).

Formula for Break Even Analysis

The formula for break-even analysis is as follows:

Break even quantity = Fixed costs / (Sales price per unit – Variable cost per unit)

Where:

- Fixed costs are costs that do not change with varying output (e.g., salary, rent, building machinery).
- Sales price per unit is the selling price (unit selling price) per unit.

---

[9] Source: https://www.accountingtools.com/articles/the-difference-between-direct-costs-and-indirect-costs.html

[10] Source: http://oasis.col.org/bitstream/handle/11599/693/SSBM-Module_5.pdf?sequence=6&isAllowed=y

- Variable cost per unit is the variable costs incurred to create a unit.

It is also helpful to note that sales price per unit minus variable cost per unit is the contribution margin per unit. For example, if a book's selling price is $100 and its variable costs are $5 to make the book, $95 is the contribution margin per unit and contributes to offsetting the fixed costs.

Example of Break Even Analysis

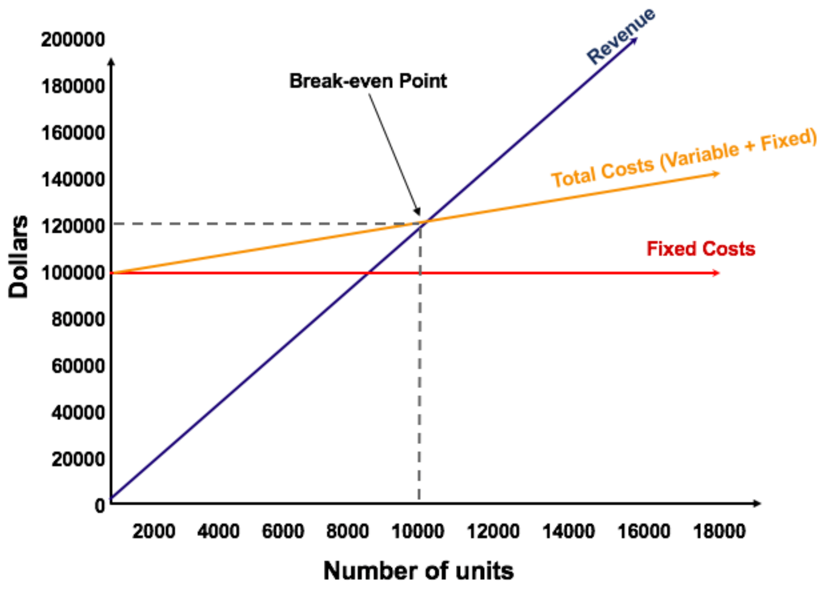
Colin is the managerial accountant in charge of Company A, which sells water bottles. He previously determined that the fixed costs of Company A consist of property taxes, a lease, and executive salaries, which add up to $100,000. The variable cost associated with producing one water bottle is $2 per unit. The water bottle is sold at a premium price of $12. To determine the break even point of Company A's premium water bottle:

Break even quantity = $100,000 / ($12 – $2) = 10,000

Therefore, given the fixed costs, variable costs, and selling price of the water bottles, Company A would need to sell 10,000 units of water bottles to break even.

Graphically Representing the Break-Even Point

The graphical representation of unit sales and dollar sales needed to break even is referred to as the break-even chart or Cost Volume Profit (CVP) graph. Below is the CVP graph of the example above:



Explanation:

- The number of units is on the X-axis (horizontal) and the dollar amount is on the Y-axis (vertical).
- The red line represents the total fixed costs of $100,000.
- The blue line represents revenue per unit sold. For example, selling 10,000 units would generate 10,000 x $12 = $120,000 in revenue.
- The yellow line represents total costs (fixed and variable costs). For example, if the company sells 0 units, then the company would incur $0 in variable costs but $100,000 in fixed costs for total costs of $100,000. If the company sells 10,000 units, the company would incur 10,000 x $2 = $20,000 in variable costs and $100,000 in fixed costs for total costs of $120,000.
- The break-even point is at 10,000 units. At this point, revenue would be 10,000 x $12 = $120,000 and costs would be 10,000 x 2 = $20,000 in variable costs and $100,000 in fixed costs.
- When the number of units exceeds 10,000, the company would be making a profit on the units sold. Note that the blue revenue line is greater than the yellow total costs line after 10,000 units are produced. Likewise, if the number of units is below 10,000, the company would be incurring a loss. From 0-9,999 units, the total costs line is above the revenue line" [11].

[11] https://corporatefinanceinstitute.com/resources/knowledge/modeling/break-even-analysis/

CHAPTER FIVE

LEGAL FORMS OF BUSINESS ENTITIES

1. *Objectives and Assignments of this chapter*

After reading this chapter, you will be able to:

- Choose the best legal form to run a business (i.e. sole proprietorship, partnership, corporation);
- Describe the major advantages and disadvantages of each legal form of business entity;
- Decide what is the most suitable legal form in order to finance your business idea;
- Describe the minimum content of the financial statements of the business entity;
- Evaluate the liabilities in conducting a business entity;
- Discuss the liability of the business entity using its financial statements;
- Analyze the most important aspects of business groups.

Following the Assignments of this chapter:

Assignment 21 – The "Bio fruit experience" failure

Assignment 22 – Use the primary interest framework to increase the profit of Fiat

2. *Unincorporated and incorporated business. The concept of "legal entity"*

As discussed in Chapter I (§ 4), the economic entity is established to perform an economic activity oriented to satisfy human needs and create sustainable value. To give practical effect to that activity the firm must be able to acquire input from the external environment and sell the products to the customers. The exchanges between the company and the market involve **contracts** that are disciplined by the law (e.g. purchase agreement, contract of sale, invoice, receipt).

In order to subscribe contracts, i.e. to operate (e.g. acquire inputs, sell outputs), **a person who takes responsibility arising from contracts is needed**. For example, if a business entity does not pay the debt to its creditors (e.g. suppliers or lenders), who takes the responsibility?

The Amaduzzi circuits analyzed in the previous chapter have shown several transactions between the business entity and the external markets. For instance, in the circuit of production (Chapter IV, § 2) the exchanges take place between the company and its customers and suppliers; in the capital market, between the company and its lenders and borrowers.

The **legal entity** is the entity that owns, by law, the rights and obligations arising from the business. The **legal identity** allows performing this important function (i.e. the possibility to stipulate contracts) and, therefore, allows the existence of the firm and the conduct of the operations necessary for its survival.

The legal identity is, therefore, a prerequisite for carrying out the economic activity [1]. In this regards, two forms of business entities can be distinguished: unincorporated and incorporated business (Table 88).

Table 88 – *Legal entities (or legal types of business entities)*

Legal forms of business entities	Legal entity	Unincorporated or Incorporated business
Sole proprietorship	Physical person (the sole proprietor)	Unincorporated business (the business is not recognized as a separate legal entity)
Partnership	Juridical person **without** juridical personality	Unincorporated business (the business is not recognized as a separate legal entity)
Corporation	Juridical person **with** juridical personality	Incorporated business (the business is recognized as a separate legal entity)

Source: Our elaboration

The **unincorporated business** is a business that does not possess a separate legal identity from its owner(s), while the **incorporated business** is a business that possesses a separate legal identity from its owner(s).

The **sole proprietorship** and the **partnership** are unincorporated business, while the **corporation** is an incorporated business.

YouTube 24 – *Business organizations*

Type	Title	Length (hh:mm:ss)	Study/Watch
Lesson	Advantages and Disadvantages of Business Organizations	00:09:58	Study

3. *Choosing the legal structure of the business* [2]

The business structure chosen by the entrepreneur will have legal and tax implications. Following the questions you need to ask in order to choose the legal structure of the business entity.

– How easy is it to set up and operate?
– What are the tax advantages and disadvantages?
– What are your potential legal liabilities?
– What happens to the business if you should die?
– How easy will it be to liquidate the business?

4. *Sole proprietorships*

[1] However there are some organizations that exchange with a non visible market (the so called shadow economy) like the criminal organizations. See the special content secton of these teaching notes.

[2] Source: https://www.theamericancollege.edu/assets/pdfs/fa251-class1.pdf and http://hhs.rogersschools.net/common/pages/DisplayFile.aspx?itemId=4464028

A sole proprietorship, or simply proprietorship, is a type of unincorporated business entity owned and run by one person, which legally has no separate existence from its owner (in Italy it is called "*ditta individuale*"). It is a "sole" proprietorship in the sense that the owner has no partners.

It is natural to start a business with sole proprietorship because it is the simplest and most numerous forms of business. Even some big multinational corporations (e.g. Ikea) start as sole proprietorships.

A sole proprietor may run the business directly or may hire others to run it. In the latter case it is always the sole proprietor's decisions that determine the firm's destiny.

Normally, the sole proprietor performs most of the major functions such as overall managers, sales managers and finance managers. That is why in a sole proprietorship it is extremely easy to reach the system effect, i.e. one of the attributes of the *azienda* (Chapter I, § 7).

The proprietorship finds its roots in primitive economic society, when each person depended for survival on his/her own work.

All debts of the business are debts of the owner.

The person who sets up the company has **sole responsibility for the company's debts**.

A sole proprietorship essentially refers to a **natural person** (an individual) doing business in his or her own name and in which there is only one owner. Common examples include: many restaurants; barber shops; taxi drivers; flower shops; dog kennels; independent grocery stores.

Since the dimension of the business is small, **the management of the business is entirely in the hand of the owner**, thus he/she has the decision-making autonomy (the second attribute of the *azienda*). His/her interest is normally aligned with the business. In other words, the primary interest of the business coincides with the primary interest of the entrepreneur.

4.1. *Advantages and disadvantages of sole proprietorships*

What are the *advantages* of sole proprietorships?

Simplicity: starting this form of business is quite simple. It involves almost no requirements expect for occasional business licenses and fees. Similarly, no legal action is required to terminate the business. If you have a business idea, so if you individuate some needs of potential customers that are not satisfied yet, you have only to decide to go into business and then do it.

Many sole proprietorships are ready to business as soon as they set up operations. A proprietorship can be run on the Internet, out of a garage, and so on.

When a sole proprietor wants to quit for whatever reason, he or she simply satisfies any outstanding contracts and financial obligations and takes on no new business.

Autonomy: there is no boss to criticize a sole proprietor's work. There is no partner who must be consulted on decisions and who may begrudge splitting the profits. There is no board of directors to second-guess the decisions of the sole proprietor or enforce a distasteful policy. This flexibility means that the owner can make an immediate decision if a problem arises.

Sole gain: related to this aspect of the proprietorship is the fact that all profits belong to the sole owner. He or she does not have to share the profits with other owners. Just as all of the responsibilities of the business fall solely on the owner, so do all the benefits. The possibility of suffering a loss exists, but the lure of profits makes people willing to take risks.

Single tax: The proprietorship does not have to pay separate income taxes because the business is not recognized as a separate legal entity. The owner still must pay individual income taxes on profits taken from the sole proprietorship, but the business itself is exempt from any tax on income.

What are the ***disadvantages*** of sole proprietorships?

Unlimited liability: The main disadvantage of a sole proprietorship is that the owner has unlimited liability. This means that *the owner is personally and fully responsible for all losses and debts of the business*. If the business fails, the owner's personal possessions (house and car of the sole proprietor) may be taken away to satisfy business debts. In other terms there is no distinction between the sole proprietor's business assets and liabilities and his or her personal assets and liabilities.

If the sole proprietor dies or becomes disabled, and if there isn't adequate insurance or other funds to pay off the debts and pay an income to the family, the family can be completely wiped out financially. There is not legal protection against the claims of business creditors.

Limited resources: The **capital available** to a sole proprietorship is **limited by the personal financial resources of the owner** and his or her **ability to obtain credit and borrow money**. The sole proprietor has no way to raise funds from outside investors without ceasing to be a sole proprietorship. For this reason, the sole proprietorship is not practical in large business ventures that demand major capital input. Banks and other lenders usually do not want to lend money to new or very small businesses. As a result, the proprietor often has to raise financial capital by tapping savings, using credit cards, or borrowing from family members.

The sole proprietorship form is also **limited in terms of business talent and ability**. The success of the business generally is tied to the ingenuity, initiative, resourcefulness, and managerial abilities of the sole owner. Even if a sole proprietor is a skilled manager, the business probably will decline any time this person is sick or disabled. In addition, a sole proprietor typically would be reluctant to undertake projects that require a variety of specialized technical skills.

Size and efficiency: A retail store, for example, may need to hire a minimum number of employees just to open during normal business hours. It may also need to carry a minimum inventory – a stock of finished goods ands and parts in reserve – to satisfy customers or to keep production flowing smoothly. Because of limited capital, the proprietor may not be able to hire enough personnel or stock enough inventory to operate the business efficiently.

Difficulty of attracting qualified resources: Because the proprietorship tends to be small, employees often have to be skilled in several areas. In addition, many top high school and college graduates are more likely to be attracted to positions with larger, well-established firms than small ones.

Business dies with the sole proprietor: The business entity legally ceases to exist when the owner dies, quits, or sells the business.

4.2. *Raising money in a sole proprietorship. An introduction to the financial statements through an example: The "Bio fruit experience"*

Once you have your business idea, you should raise money to finance it. Following an example that describes how the entrepreneur Jones raises money for its sole proprietorship.

The Jones' personal wealth is € 80.000 and his business idea is: "*selling fruits close to the University of Tor Vergata, giving students the best bio fruits experience at low price*". **The business idea came after a market survey**, which showed a strong interest of people for bio-products. Then Jones elaborates the WHY of its business.

The name of the sole proprietorship (that is also the name of the business) is "Bio fruits experience".

Following the what, how and why of the business:

– The **WHAT**: selling bio-fruit;

– The **HOW**: selecting every day the best bio-fruit from the top wholesaler in Rome and sell it to students of the University Tor Vergata;

– The **WHY**: giving to some students (those who love bio products) the possibility to find a *high quality* bio fruits at a *low price* and *near to their University*.

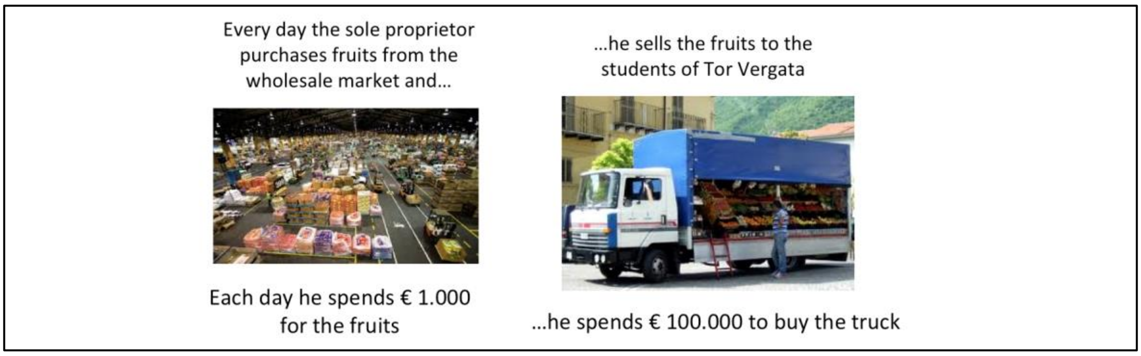
Following the transformation process:

– Every day Jones purchases fruit from the wholesale market, selling it to students of Tor Vergata;

– Each day he invests € 1.000 to purchase the fruits;

– He invests € 100.000 to by the truck.

Table 89 – *The* "Bio-fruits experience" *business*



Source: Our elaboration

After receiving the licence to operate, Jones needs money to by the fruits of the first day and the truck. Where can he get the money?

The Jones personal wealth is € 80.000 but he can just use € 61.000 of that amount. So the personal wealth not invested in the business is equal to € 19.000 (the value of the Jones' car € 13.000 and € 6.000 in a bank account).

He decides to borrow € 40.000 from the bank. The bank approves the loan because in case of business failure the sole proprietor can sell the truck and use his personal wealth (selling his car) to repay the loan.

Now we can put all the amounts in the financial statements of the sole proprietorship. Not all the business entities have the obligation to present the financial statement. For instance, while the sole proprietorships do not have that obligation corporations have to.

Financial statements are composed by different documents, but for now we want just to introduce the **balance sheet** (or statement of financial position) and the **income statement** [3].

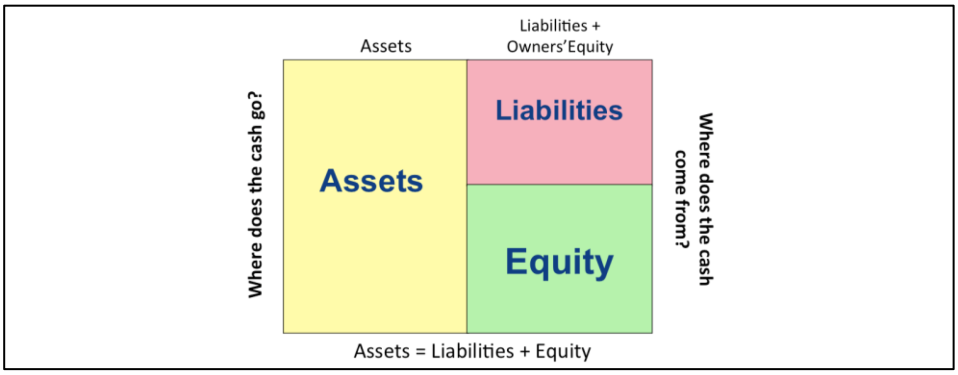
Balance sheet

The balance sheet (or capital structure, Chapter IV, § 10) describes where the enterprise stands at a specific date.

In the left side of the balance sheet (Table 90) there are the assets that indicate where the cash go (e.g. inventories, property, plant, equipment), while in the right side we have the liabilities and the equity, i.e. where the cash come from (e.g. bank loans, equity). Table 91 contains a balance sheet with assets and liability description.

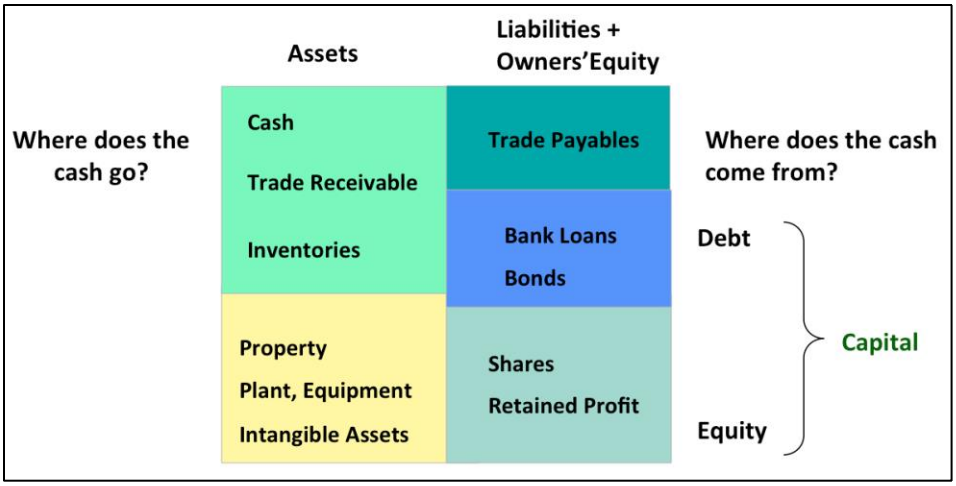
The **equation of the balance sheet** is that Assets are always equal to Liabilities plus Equity. We can also say that Assets minus Liabilities are equal to Equity.

Table 90 – *The balance sheet*



Source: Our elaboration

Table 91 – *The balance sheet with the assets classification*



Source: Our elaboration

[3] A part of the Module II (performance measurement) of the course is dedicated to the financial statements of business entities.

In particular, these are the definitions:

– **Assets**: something valuable that an entity owns, benefits from, or has use of, in generating income;

– **Liabilities**: a claim against the assets, or legal obligations of an organization, arising out of past or current transactions or actions;

– **Equity**: is the capital paid into or invested in the business by the proprietor/shareholders.

YouTube 25 – *Balance sheet*

Type	Title	Length (hh:mm:ss)	Study/Watch
Lesson	Investopedia Video: Intro To The Balance Sheet	00:01:10	Study
Lesson	Introduction to Balance Sheets	00:09:53	Study

In Table 92 and Table 93 the balance sheet of Fiat is shown.

Table 92 – *Assets of Fiat*

Consolidated Statement of Financial Position (*)

(€ million)	Note	At 31 December 2012	At 31 December 2011
ASSETS			
Intangible assets		19,284	18,200
Goodwill and intangible assets with indefinite useful lives	(14)	12,947	13,213
Other intangible assets	(15)	6,337	4,987
Property, plant and equipment	(16)	22,061	20,785
Investments and other financial assets:	(17)	2,290	2,660
Investments accounted for using the equity method		1,510	1,579
Other investments and financial assets		780	1,081
Leased assets		1	45
Defined benefit plan assets		105	97
Deferred tax assets	(11)	1,736	1,690
Total Non-current assets		**45,477**	**43,477**
Inventories	(18)	9,295	9,123
Trade receivables	(19)	2,702	2,625
Receivables from financing activities	(19)	3,727	3,968
Current tax receivables	(19)	236	369
Other current assets	(19)	2,163	2,088
Current financial assets:		807	789
Current investments		32	33
Current securities	(20)	256	199
Other financial assets	(21)	519	557
Cash and cash equivalents	(22)	17,657	17,526
Total Current assets		**36,587**	**36,488**
Assets held for sale	(23)	55	66
TOTAL ASSETS		**82,119**	**80,031**

Source: Our elaboration

Table 93 – *Liabilities and equity of Fiat*

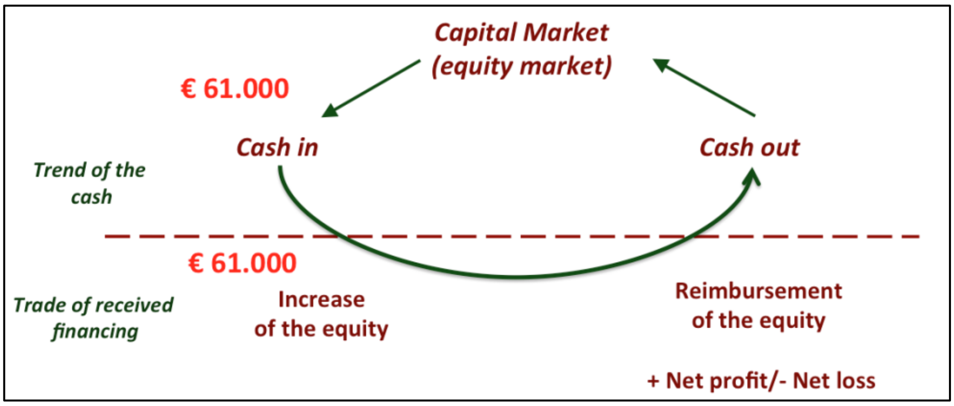
(€ million)	Note	At 31 December 2012	At 31 December 2011
EQUITY AND LIABILITIES			
Equity:	(24)	13,173	12,260
Equity attributable to owners of the parent		9,059	8,727
Non-controlling interests		4,114	3,533
Provisions:		15,484	15,624
Employee benefits	(26)	6,694	7,026
Other provisions	(27)	8,790	8,598
Debt:		27,889	26,772
Asset-backed financing	(28)	449	710
Other debt	(28)	27,440	26,062
Other financial liabilities	(21)	201	429
Trade payables	(29)	16,558	16,418
Current tax payables		231	230
Deferred tax liabilities	(11)	802	760
Other current liabilities	(30)	7,781	7,538
Liabilities held for sale		-	-
TOTAL EQUITY AND LIABILITIES		82,119	80,031

Now we describe how the following operations impact on the balance sheet of the sole proprietorship "Bio fruit experience".

First operation: Jones **invests € 61.000 of his money in the business.**

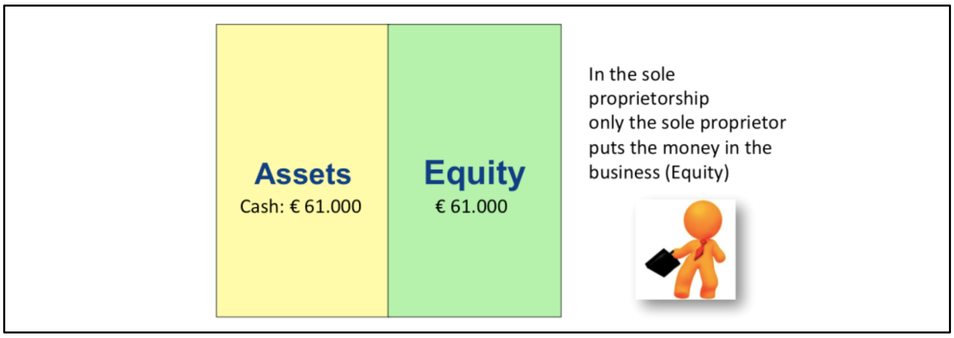
The circuit of received financing from the owner shows an increase of cash (above the line) and equity (below the line). After that operation the balance sheet of the sole proprietorship shows two values: the cash in the left side and the equity in the right side, for the same amount (€ 61.000).

Table 94 – *The circuit of received financing from owners after the sole proprietor put his money in the business*



Source: Our elaboration

Table 95 – *The balance sheet of the sole proprietorship "Bio fruit experience" after the sole proprietor put his money in the business*

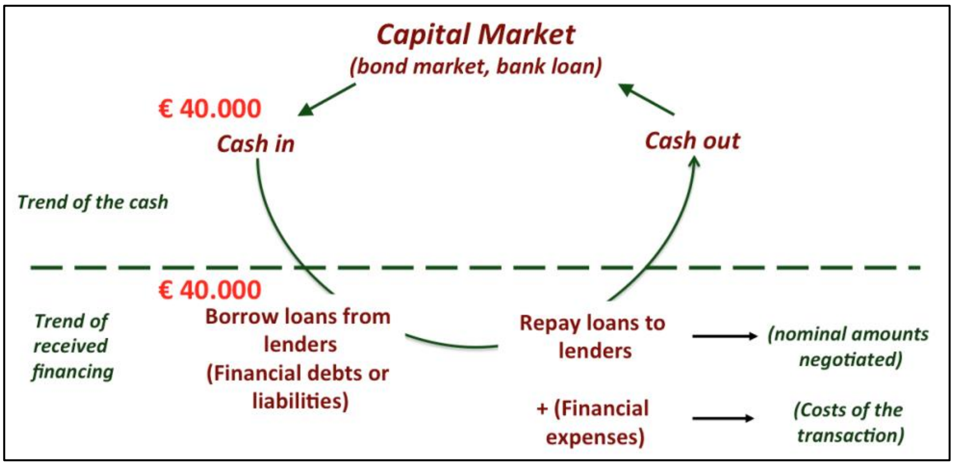


Source: Our elaboration

Second operation: Jones **obtains a loan from a bank** of € 40.000.

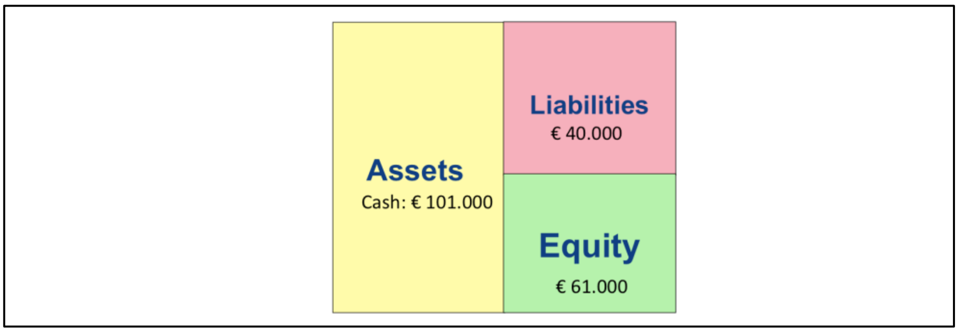
The circuit of received financing from the lenders shows an increase of cash (above the line) and financial debs (below the line). After this operation the cash increases to € 101.000 while on the right side of the balance sheet a liability for € 40.000 is recorded.

Table 96 – *The circuit of received financing from lenders after the firm borrows a loan from the bank*



Source: Our elaboration

Table 97 – *The balance sheet of the sole proprietorship "Bio fruit experience" after the bank loan*

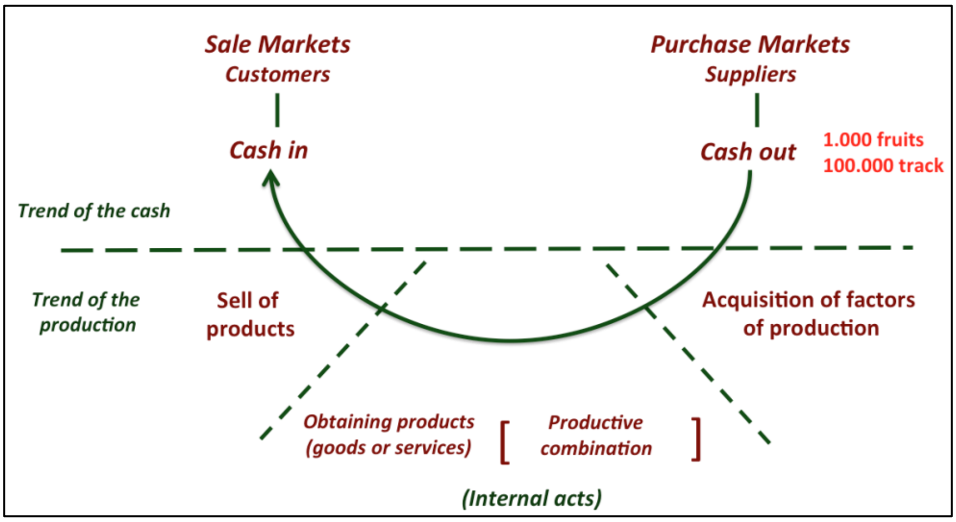


Source: Our elaboration

Third and fourth operation: Jones **buys the truck** and the fruits spending € 101.000.

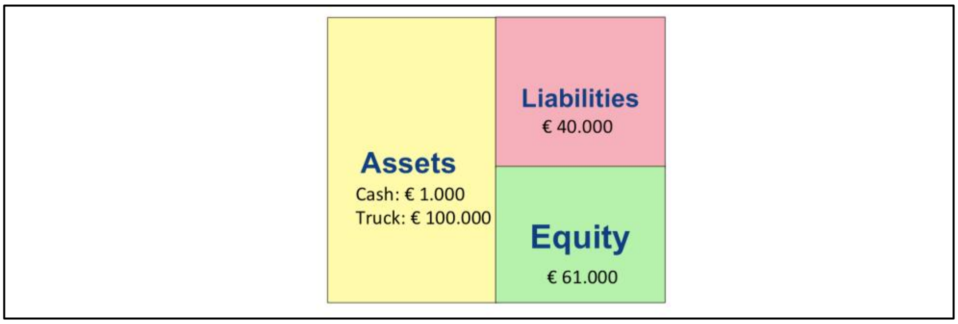
The circuit of production shows a decrease of cash (above the line). After the first operation (the truck) the cash decreases to € 1.000 since it is invested in the truck, while after the second (the fruits) the cash goes to zero.

Table 98 – *The circuit of production after buying the truck and fruits*



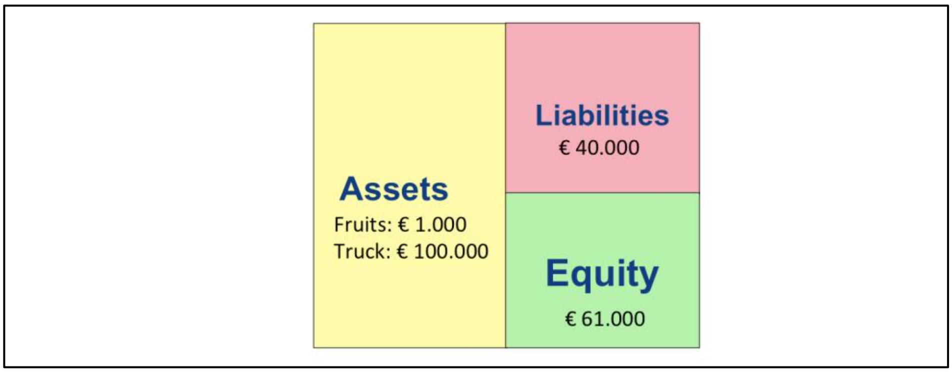
Source: Our elaboration

Table 99 – *The balance sheet of the sole proprietorship "Bio fruit experience" after buying the truck*



Source: Our elaboration

Table 100 – *The balance sheet of the sole proprietorship "Bio fruit experience" after buying the fruits*



Source: Our elaboration

Income statement

The income statement **depicts the revenue and expenses for a designated period of time**. Net profit (or net loss) is simply the difference between revenues and expenses.

Table 101 – *The income statement for the first day*

Factors of production	Annual investments	Number of transactions	Financing needs
Goods (fruits)	€ 300.000	300	€ 1.000
Truck	€ 100.000	1	€ 100.000
	€ 400.000		€ 101.000

It is assumed that the sole proprietorship buys bio fruit in cash at the wholesale markets for a daily amount of about € 1,000, and sells in the day to the students of "Tor Vergata" University. Working days 300. The other categories of costs, while present in reality, are neglected for simplicity

The income statement for the first day

Average daily revenues		**1300**
(-) Expenditures:		
Expenditures for goods (average)	€ 1.000	
Use of the structure (ammortization of the truck)	*€ 80	€ 1.080
Daily income (profit/loss)		**€ 220**

(*) Assuming the use of the truck for 4 years, with a final recovery for the sale of the used truck equal to € 4.000. The net value is € 96.000, resulting in a loss of value of the annual average of € 24,000 (€ 96.000/4 years) and a daily loss of € 80 (24,000 / 300 working days), which is recovered by revenues

Source: Adapted from Cavalieri and Ferraris Franceschi (2008, pp. 221-222)

In Table 102 the income statement of Fiat is shown. The margin EBIT is an indicator of a company's profitability, calculated as revenue minus expenses, excluding tax and interest. EBIT is also referred to as "operating earnings", "operating profit" and "profit before interest and taxes (PBIT)."

YouTube 26 – *Income statement*

Type	Title	Length (hh:mm:ss)	Study/Watch
Lesson	Introduction to the income statement	00:15:26	Study

Table 102 – *The income statement of Fiat*

Consolidated Income Statement (*)

(€ million)	Note	2012	2011 (**)
Net revenues	(1)	83,957	59,559
Cost of sales	(2)	71,474	50,704
Selling, general and administrative costs	(3)	6,731	5,047
Research and development costs	(4)	1,835	1,367
Other income/(expenses)	(5)	(103)	(49)
TRADING PROFIT/(LOSS)		**3,814**	**2,392**
Result from investments:	(6)	107	131
Share of the profit/(loss) of investees accounted for using the equity method		94	146
Other income/(expenses) from investments		13	(15)
Gains/(losses) on the disposal of investments	(7)	(91)	21
Restructuring costs	(8)	15	102
Other unusual income/(expenses)	(9)	(138)	1,025
EARNINGS BEFORE INTEREST AND TAXES (EBIT)		**3,677**	**3,467**
Financial income/(expenses)	(10)	(1,641)	(1,282)
PROFIT/(LOSS) BEFORE TAXES		**2,036**	**2,185**
Income taxes	(11)	625	534
PROFIT/(LOSS) FROM CONTINUING OPERATIONS		**1,411**	**1,651**
Post-tax profit/(loss) from Discontinued Operations		-	-
PROFIT/(LOSS)		**1,411**	**1,651**

Source: Our elaboration

Cash flow statement

In financial accounting, a cash flow statement, also known as statement of cash flows, is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents, and breaks the analysis down to operating, investing and financing activities. Essentially, the cash flow statement is concerned with the flow of cash in and out of the business. The statement captures both the current operating results and the accompanying changes in the balance sheet. As an analytical tool, the statement of cash flows is useful in determining the short-term viability of a company, particularly its.

YouTube 27 – *Cash Flows statement*

Type	Title	Length (hh:mm:ss)	Study/Watch
Lesson	Statement of Cash Flows Explained	00:17:30	Study

Table 103 – *The statement of cash flow of Fiat*

Consolidated Statement of Cash Flows (*)

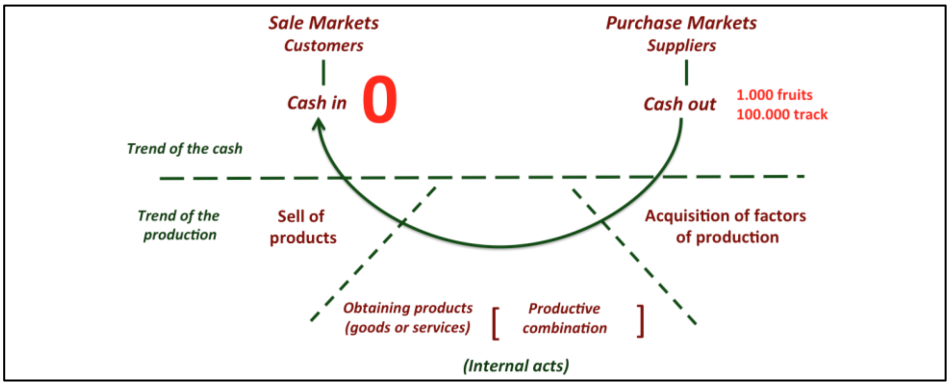
(€ million)	Note	2012	2011(**)
A) CASH AND CASH EQUIVALENTS AT BEGINNING OF THE YEAR	(22)	17,526	11,967
B) CASH FLOWS FROM/(USED IN) OPERATING ACTIVITIES DURING THE YEAR:			
Profit/(loss) for the period		1,411	1,651
Amortisation and depreciation		4,134	3,358
(Gains)/losses on disposal of:			
Property, plant and equipment and intangible assets		14	21
Investments		91	(21)
Other non-cash items	(31)	47	(1,106)
Dividends received		89	105
Change in provisions		77	(116)
Change in deferred taxes		(72)	(19)
Change in items due to buy-back commitments	(31)	(51)	(62)
Change in operating lease items	(31)	(10)	(28)
Change in working capital		714	1,412
TOTAL		6,444	5,195
C) CASH FLOWS FROM/(USED IN) INVESTING ACTIVITIES:			
Investments in:			
Property, plant and equipment and intangible assets	(31)	(7,534)	(5,528)
Investments in consolidated subsidiaries		-	(22)
Other investments		(24)	(120)
Cash and cash equivalents from consolidation of Chrysler, net of consideration paid for the additional 16% ownership interest	(31)	-	5,624
Proceeds from the sale of:			
Property, plant and equipment and intangible assets		118	324
Investments in consolidated subsidiaries		-	29
Other investments		21	96
Net change in receivables from financing activities		(24)	(1,218)
Change in current securities		(64)	(14)
Other changes		(30)	(29)
TOTAL		(7,537)	(858)
D) CASH FLOWS FROM/(USED IN) FINANCING ACTIVITIES:			
New issuance of bonds		2,535	2,500
Repayment of bonds		(1,450)	(2,448)
Issuance of other medium-term borrowings		1,925	2,149
Repayment of other medium-term borrowings		(1,528)	(3,895)
Changes in net financial receivables from Fiat Industrial group		-	2,761
Net change in other financial payables and other financial assets/liabilities		197	143
Increase in share capital		22	41
Dividends paid		(58)	(181)
(Purchase)/sale of ownership interests in subsidiaries	(31)	-	(438)
TOTAL		1,643	632
Translation exchange differences		(419)	590
E) TOTAL CHANGE IN CASH AND CASH EQUIVALENTS		131	5,559
F) CASH AND CASH EQUIVALENTS AT END OF THE YEAR	(22)	17,657	17,526
of which: Cash and cash equivalents included as Assets held for sale		-	-
G) CASH AND CASH EQUIVALENTS AT END OF THE YEAR AS REPORTED	(22)	17,657	17,526

Source: Our elaboration

Liquidation of the business immediately after starting it

We now assume that unfortunately the "*Bio fruit experience*" was not a good business idea. Thus Jones decides to liquidate the business the first day, since nobody wants his fruits.

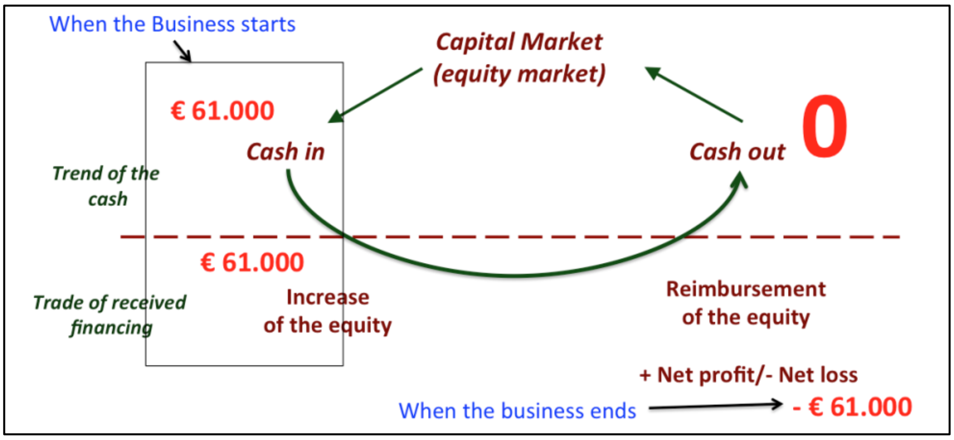
Table 104 – *The failure of the* "Bio-fruit experience"



Source: Our elaboration

However, he sells the truck obtaining just € 30.000 (so the liquidation price is much lower that the buying price equal to € 100.000). Jones looses the entire amount invested to buy the fruit because he was not able to sell it. Thus the cash obtained after the liquidation is just € 30.000. All the equity is lost and now the problem is that he still has a debt with the bank equal to € 40.000 that can be reimbursed just for € 30.000 (the amount obtained after the liquidation of the assets).

Table 105 – *The lost of equity*



Source: Our elaboration

Since the legal entity is a sole proprietorship (unincorporated business) "**all debts of the business are debts of the owner**", the sole proprietor has to use a part of his personal wealth, i.e. the amount initially not invested in the business (€. 19.000), to pay the difference (10.000). Reminding that only € 6.000 of the € 19.000 is represented by cash, Jones has to sell its personal car, obtaining € 13.000.

Thus, after the business is failed the personal wealth of the sole proprietor move from € 80.000 to € 9.000.

Remember, "the most serious disadvantages of the sole proprietorship is its unlimited liability. As a sole proprietor, you are responsible for all business debts. Should these exceed the assets of your business, your creditors can claim your personal assets--home, automobile, savings account, and investments. In other words, the law basically treats the business and the owner as one and the same".

Assignment 21 – The "Bio fruit experience" failure

5. *Partnership*

When two or more people agree to combine their resources and skills for mutual profit, they form a partnership (in Italy the so called "*società di persone*") [4]. **A partnership**, then, **is a voluntary association of two or more persons, each contributing money, property, skills, Labor**, etc. The partners must agree on a division of the ownership and profits based on the relative value of each partner's contributions.

A partnership is a type of business entity in which partners (owners) share with each other the profits or losses of the business undertaking in which all have invested.

Partnership is an unincorporated business owned by two or more people.

Like a proprietorship, a partnership is relatively easy to start. Because more than one owner is involved, formal legal papers called articles of partnership are usually drawn up to specify arrangements between partners. The articles of partnership may specify that the profits be divided equally or by any other arrangement suitable to the partners. Individual who join as partners must be very careful because they are financially responsible for personal as well as business debts of their partners (except for those debts specifically exempted in the partnership contract).

There are two basic types of partnerships: general partnerships and limited partnerships.

General partnership: is the usual type where each partner is fully active in the firm with a voice in its management. Each is an agent of the other partner (or partners) with full authority to act for the firm within the scope of its business activities. Each is fully liable for the debts of the business, and each shares in the profits.

Limited partnership: it has at least one **limited partner** and one **general partner**. The limited partner is not legally liable for all the financial obligations of the firm. Instead, this partner's liability is limited to the amount of his or her investment in the venture. A limited partner has no voice in management, no involvement in the day-to-day running of the business. In essence, the limited partner is largely an investor in the firm. A general partner is one who has unlimited liability and is active in managing the partnership.

5.1. *Advantages and disadvantages of partnerships*

What are the ***advantages*** of the general partnership?

Simplicity: like the sole proprietorship, the first advantage of the partnership is its ease of establishment. Even the costs of the partnership articles, which normally involve attorney fees and a filing fee for the state, are minimal if they are spread over several partners.

[4] Click on the following link to download a partnership agreement form: https://www.marsdd.com/mars-library/general-partnership-agreement-sample-template/.

Easy to manage: Generally, each partner brings different areas of expertise to the business: one might have a talent for marketing, another for production, another for bookkeeping and finance, and yet another for shipping and distribution.

Easier to attract financial capital: Partnership can usually attract financial capital more easily than proprietorships. They are generally little bigger and, if established, have better chance at getting a bank loan. If money cannot be borrowed, the existing partners can always take in new partners who bring financial capital with them as part of their price for joining the business.

As contrasted with sole proprietorships, partnerships permit a pooling of talent and a sharing of risk. For example, two people may decide to open a wholesale distributorship. They pool their financial resources to lease space and purchase inventory. One partner may have a knack for dealing effectively with people. The other is more detail oriented and excels at the bookkeeping.

Slightly lager size: the larger size often makes for more efficient operations. In some areas, such as medicine and law, a relatively small firm with three or four partners may be just the right size for the market. Other partnerships, such as accounting firms, may have hundreds of partners offering services around the world.

Partners taxes: Any losses or profits of the partnership pass directly to the partners as personal income for income tax purposes. This means that any partnership losses can be used by the partners to offset income from other sources, thereby reducing their individual income tax bill. This is unlike a corporation, where corporate losses can be used only to offset the past or future profit of the company.

What are the ***disadvantages*** of the general partnership?

The unlimited personal liability of the partners: Business debts can devour all of the business assets. If the debts cannot be satisfied out of these partnership assets, creditors can attack the personal assets of every partner. This is the same as the unlimited liability feature of a sole proprietorship. It is more complicated, however, because more owners are involved. As a result, most people are extremely careful when they choose a business partner.

In the case of a limited partnership, the limited partners have limited liability. This means that the investor's responsibility for the debts of the business is limited by the size of his of her investment in the firm. If the business fail and large debts remain, the limited partner loses only his or her original investment, leaving the general partners to make up the rest.

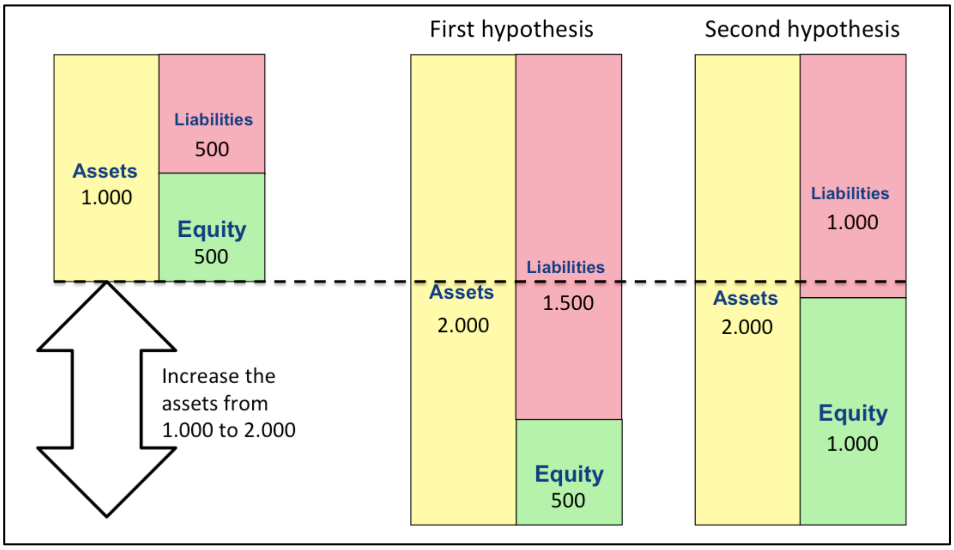
Limited life: The death of a partner may automatically end the partnership – with serious consequences to all concerned. These consequences can be avoided if an ownership transfer (buy-sell agreement) is implemented and funded. Sometimes partners discover that do not get along, and they either have to learn to work together or leave the business. If the partnership is large, it is fairly easy for these types of problem to develop, even though everyone thought they would get along well in the first place.

5.2. *Raising money in a partnership*

As the business grows, its founders or members may need to modify the initial form to reflect new and changing circumstances. They similarly must decide on the capital structure, determining how the business will be financed initially. The capital structure usually will be some mix of equity capital and debt. The more risky the business venture is thought to be, the more equity the lenders (e.g. banks) of the debt financing will want to see in the capital structure.

Table 106 shows a situation where the firm has to increase the assets from 1.000 to 2.000.

Table 106 – *Increase the assets using only liabilities or both equity and liabilities*



In the first hypothesis we can imagine that a sole proprietor does not have the money to increase the equity, thus he/she borrows money from a bank. The liabilities increase to 1.500.

In the second hypothesis the investment in assets are financed increasing both equity (500) and liabilities (500). This solution is often the only practicable because the business is too risky so the lenders want to see more equity in the capital structure.

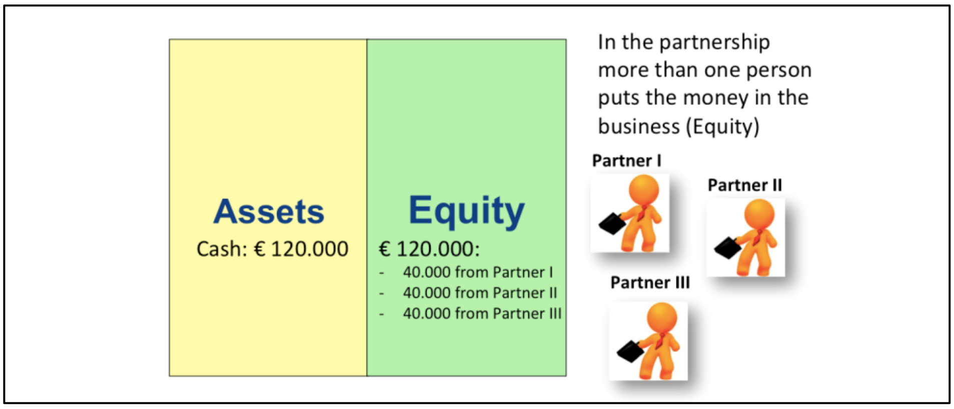
In the second hypothesis, for what concern the equity we can imagine two situations:

– the sole proprietor decides to ask the money to some of his/her friends moving from a sole proprietorship to a partnership;

– he/she has money to put in the business, so it is not necessary to form a partnership.

One of the advantages of the partnership is the possibility to attract financial capital from different partners.

Table 107 – *The balance sheet of the partnership "Bio fruit experience" after the three partners put their money in the business*



Source: Our elaboration

6. *Corporation*

A corporation (in Italy the so called "*società di capitali*") has been defined by Ames and Angell in their work Private Corporations as "a body, created by law, composed of individuals united under a common name, the members of which succeed each other, so that the body continues the same notwithstanding the change of individual who compose it, and is, for certain purposes, considered as a natural person".

From this definition, we may derive the following important facts about corporate form:

– A corporation is created by the law;
– A corporation is invisible and intangible. It cannot be seen, as can the buildings and machinery owned by the corporation;
– A corporation is an intangible artificial being – an entity separate and independent form the owners of its capital stock.

Because a corporation is a separate legal entity, certain characteristics distinguish it from the sole proprietorship and partnership. Since it is a separate legal entity some scholars of commercial law state that the shareholders of a corporation are not owner of that business entity, instead they are owner of the shares.

Limited liability of stockholders: The corporate form of business enables persons to own part of a business and yet limit their losses (in case of failure) to the amount of their investment in the capital stock. This is true even if the assets of the corporation are not sufficient to pay its own debts.

Unlike a sole proprietorship or partnership, a corporation is a very formal and legal arrangement. People who would like to incorporate, or form a corporation, must file for permission from the national government or the State where the business will have its headquarters.

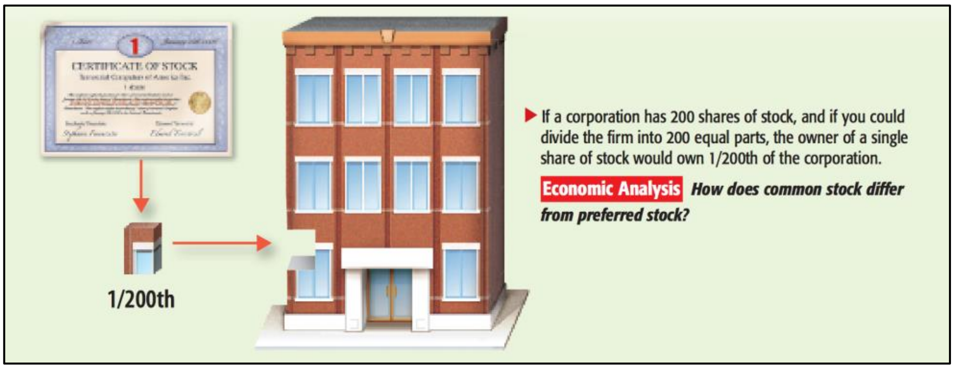
If approved, a chapter – a government document that gives permission to create a corporation – is granted. The charter states the name of the company, address, purpose of the business, and other features of the business.

When and investor purchases stock, he/she becomes an owner with certain ownership rights (voting and cash flow rights). The extent of these rights depends on the type of stock purchased, common or preferred.

Common stock represents basic ownership of a corporation. The owner of common stock usually receives one vote for each share of stock. This vote is used to elect a board of directors whose duty is to direct the corporation's business by setting broad policies and goals. The board also hires a professional management team to run the business on a daily basis. If a corporation has a total of 200 shares of stock, and if you could somehow divide the firm into 200 equal parts, the owner of a single share of stock would own 1/200th of the corporation. A common stockholder, then, owns part of a company's plant and equipment and has a voice in how the business is managed.

Preferred stock represents nonvoting ownership shares of the corporation. These stockholders receive dividends before common stockholders receive theirs. If the corporation goes out of business, and if some property and funds remain after other debts have been paid, preferred stockholders get their investment back before common stockholders. Because the stock is nonvoting, preferred stockholders do not have the right to elect members to the board of directors.

Table 108 – *The common stock*



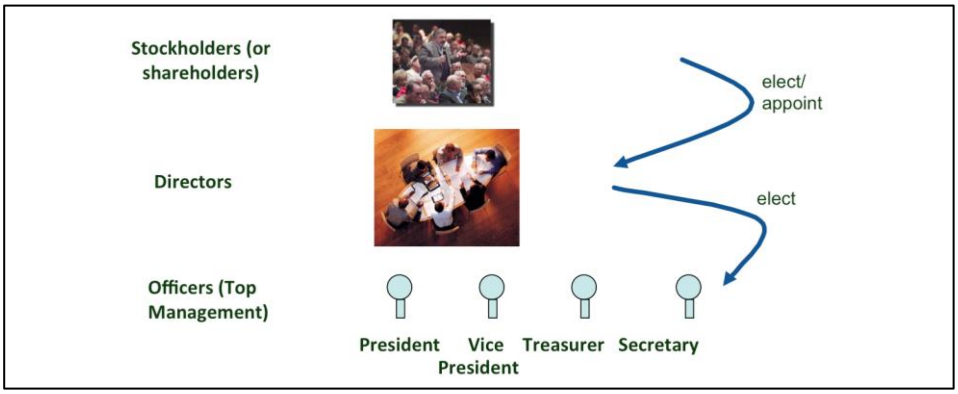
Source: http://hhs.rogersschools.net/common/pages/DisplayFile.aspx?itemId=4464028

In theory, a stockholder who owns a majority of a corporation's common stock can elect board members and control the company. In some cases, the common stockholder might even elect himself or herself, and other family members, to the board of directors.

6.1. *The basics of corporate structure*

Corporate structure is the foundation of any business. The three main elements are shareholders meeting, board of directors, managers.

Table 109 – *Corporate structure*



Source: Our elaboration

Stockholders, directors and managers are all internal stakeholders.

YouTube 28 – *Basics of corporate structure*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	The Basics of corporate Structure	00:02:50	Study
Documentary	Understanding A Company's Corporate Structure	00:01:07	Study

Shareholders and entrepreneur

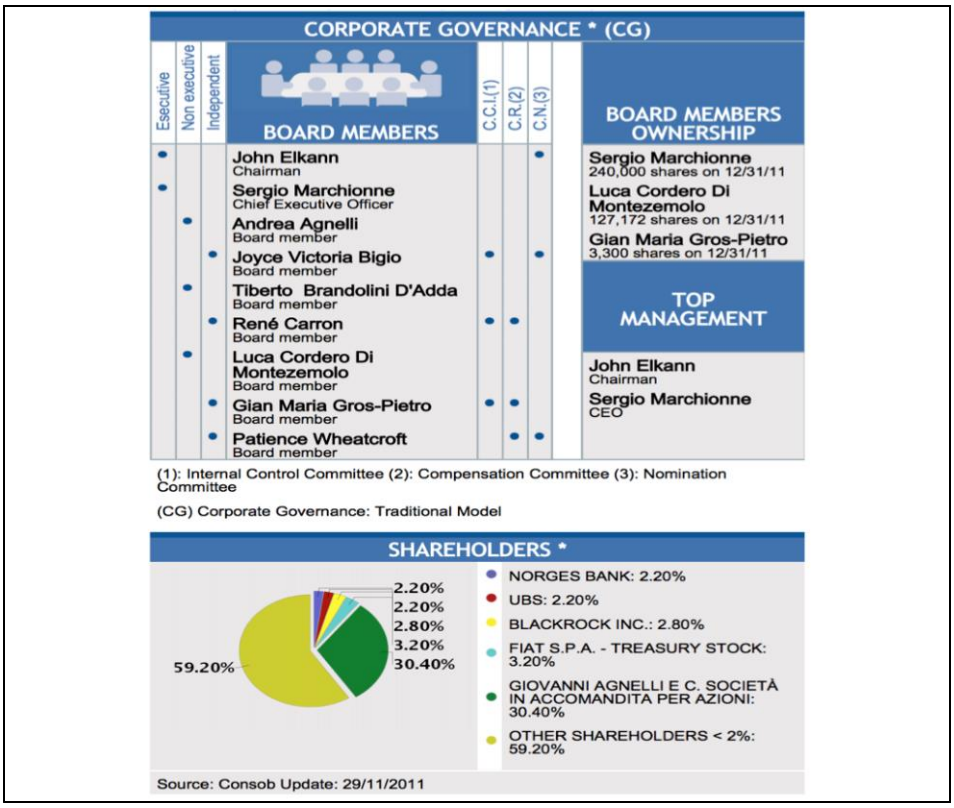
Normally big corporations (especially if listed) have two different types of shareholders: ***majority shareholders*** and ***minority shareholders***. The **majority shareholder has the control of the corporation**. The control is generally presumed by reason of the ability to appoint the majority of the board of directors – having more than 50% of the voting rights, i.e. a *de jure* control. However, the concept of control also includes what is often referred to as *de facto* control. An example of *de facto* control might be a situation in which the controlling party holds less than 50% of the voting rights of a corporation but it is enough to force the latter to act in accordance with its wishes.

A minority shareholder is a shareholder whose proportion of shares is too small to confer any power to exert control over corporate action. Normally minority shareholder are not qualified in the sense that they are not interested in running the business but instead to obtain the dividends and the capital gain (i.e. an increase of share value).

The majority shareholder (i.e. the control of the corporation) can be in the hands of an individual or a family, of a State, of a coalition of shareholders. In the so-called **public companies** the shares are so diffuse that no shareholders has the exclusive control. Indeed in such corporation the control is in the hand of the managers. Thus, ***the ownership is completely separated from control***.

In firms with a majority shareholder, there are cases where the controlling owner decides to delegates the exercise of the control power to someone else. This is the case of Agnelli family that controls Fiat through the corporation "*Giovanni Agnelli e C. Società in Accomandita per Azioni*", owning the 30.4% of the shares (*de facto* control).

Table 110 – *Corporate board and shareholders of Fiat*



Source: Our elaboration

The family decides to delegate the management of the firm to an external manager, i.e. the Chief Executive Officer Sergio Marchionne (Table 110). When it happens, we can say that ***the control (Agnelli family) is separated from the management of the firm (Marchionne)***.

This aspect is fundamentals, since the owner, also the controlling ones, may not be the one who manages the firm. In other terms, the entrepreneur could be also a manager without shares. This also happens in the limited partnership, where the limited partner (owner of the business entity together with the unlimited partners) has no voice in management, no involvement in the day-to-day running of the business.

Summarising, the ownership can be distinguished by the control and direction of the firm:

– The *owner* (shareholder) is an individual or a company (including a corporation) that legally owns one or more shares of a firm. Company's shareholders collectively own that company;

– The *control* is the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities;

– The *direction* is the exercise of the control power. It consists in strategies formulation and implementation.

Shareholders meeting

A shareholders' meeting is an annual meeting of everyone who has purchased shares in a corporation. The meeting is usually scheduled around the public release of the annual financial statements. It provides an opportunity for shareholders to vote on key issues, such as the direction of the company (election of board of directors), the decisions made over the last year and the financial results. In public companies there are sometimes hundreds and hundreds of shareholders attending the meeting, personally or by proxy.

YouTube 29 – *Shareholder meeting*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Ray Rogers addressing Coca-Cola CEO Muhtar Kent at the 2011 Shareholders Meeting	00:08:37	Watch
Documentary	Apple Shareholder Meeting 1984-The First Macintosh	00:02:33	Watch

Board of directors

A **board of directors** is a group of people elected (or appointed) by the owners of a corporation who have decision-making authority, voting authority, and specific responsibilities which in each case is separate and distinct from the authority and responsibilities of owners and managers of the business entity.

Typical duties of boards of directors include:

– governing the organization by establishing broad policies and objectives;
– selecting, appointing, supporting and reviewing the performance of the chief executive;
– ensuring the availability of adequate financial resources;
– approving annual budgets;
– accounting to the stakeholders for the organization's performance.

Directors are the members of a board of directors. Directors must be individuals. Directors can be owners, managers, or any other individual elected by the owners of the business entity. Directors who are owners and/or managers are sometimes referred to as inside directors, insiders or interested directors.

The chairman of the board

The **chairman** is selected by the company's board to lead the board of directors, preside over meetings, and lead the board to consensus from the disparate points of view of its members. The chair is the presiding director over the other directors on the board and is expected to be fair, a good listener, and a good communicator.

The function of the chairman of the board is clearly defined: he or she heads the board of directors, which regulates the company but is not involved in the actual operation of the company.

'President' is a title that essentially means 'the head of a company'. Particularly with medium-sized and large companies, it is often essentially honorific (i.e. it does not have any specifically defined functions), so one often sees combinations such as 'President and CEO' or 'President and COO', where 'CEO' and 'COO' do have well-defined functions.

It's perfectly possible for the chairman of the board to also be the president of a company, but it's more common for an executive to hold that title. In relatively small companies in North America, it is quite common for a single person to hold the positions of CEO and Chairman of the Board as well as the title 'President'.

The managers

The manager is someone who works with and through other people by coordinating their work activities in order to accomplish organizational goals. The managerial levels are:

a) *First-line Managers:* Managers at the lowest level manage the work of non-managerial employees directly or indirectly involved with the production or creation of the organization's products.

b) *Middle Managers:* Managers between the first-line level and the top level of the organization who manage the work of first-line managers

c) *Top Managers:* Managers at or near the top level are responsible for making organization-wide decisions and establishing plans and goals affecting the entire organization (e.g. the Chief Executive Officer).

A **chief executive officer** (**CEO**) or **chief executive** is one of the highest-ranking corporate officers (executives) or administrators in charge of total management.

YouTube 30 – Motorola Chairman and *CEO*

Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Motorola Solutions Chairman & CEO Greg Brown on Communication	00:13:15	Watch

Table 111 – *Managerial levels*

Source: Internet

6.2. *Private and public limited corporations*

The private limited company is a type of incorporated firm which (like a public firm) offers limited liability to its shareholders but which (unlike a public firm) places certain restrictions on its ownership.

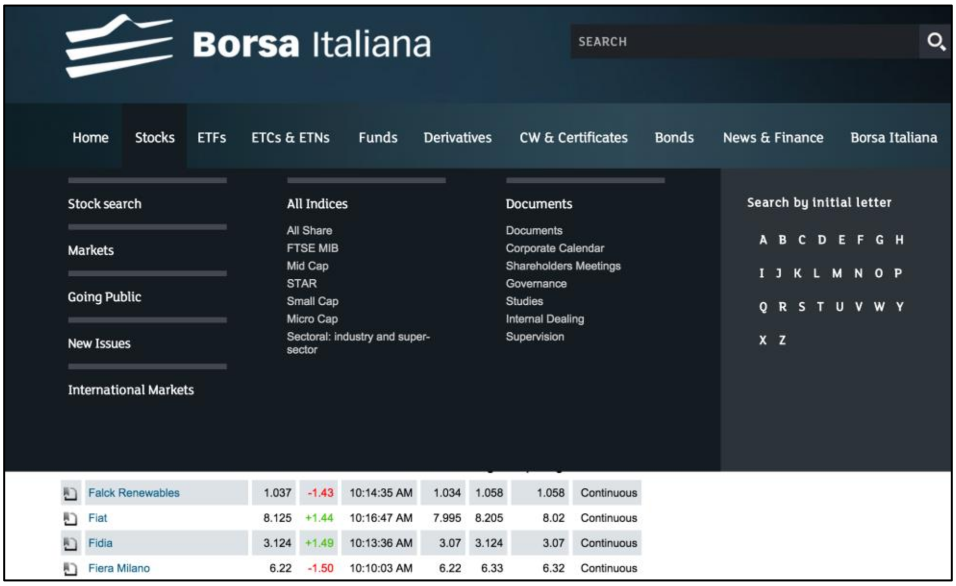
The major restrictions are:

– Stockholders cannot sell or transfer their shares without offering them first to the other stockholders for purchase;

– Stockholders cannot offer their shares to the general public over a stock-exchange.

In contrast, a public limited company (Plc, sometimes known as a "listed" company) offers its shares for sale upon the open market— it is "listed" upon the stock exchange (NYSE of New York, Borsa Italiana in Italy) (Table 112).

Table 112 – *Borsa Italiana*



Source: http://www.borsaitaliana.it/

A "listed" company is a company whose stock trades on a stock exchange, and conforms to listing requirements.

The major characteristics are:

– Plcs are also owned by shareholders;
– Unlike a private company, shares in a plc can be bought by anyone (i.e. you or me!);
– Shares are bought and sold on the stock exchange;
– Plcs are very large companies, often operating all over the world;
– The shareholders do not run the business – this is done by the managers.

6.3. *Advantages and disadvantages of corporations*

What are the ***advantages*** of the corporation?

Easier to raise capital: The main advantage of a corporation is the ease of raising financial capital. If we think to Apple, Coca Cola, Fiat, Eni, etc., they are corporations that raise billion of funds to run their economic activities (Table 113).

Table 113 – Amount of assets, liabilities and equity of some corporations

Corporation	Total assets	Total liabilities	Total equity	Equity/assets
Apple (USA)	207,000,000,000	83,451,000,000	123,549,000,000	60%
Coca Cola (USA)	90,055,000,000	56,882,000,000	33,173,000,000	37%
Google (USA)	110,920,000,000	23,611,000,000	87,309,000,000	79%
Wal-Mart (USA)	204,005,000,000	127,005,000,000	77,000,000,000	38%
Fiat (ITA)	87,214,000,000	74,630,000,000	12,584,000,000	14%
Telecom (ITA)	96,760,000,000	73,251,000,000	23,509,000,000	24%

Source: Yahoo Finance, http://finance.yahoo.com/

If the corporation needs more capital, it can sell additional stock to investors. The revenue can then be used to finance or expand operations. A corporation may also borrow money by issuing bonds. A bond is a written promise to repay the amount borrowed at a later date. The amount borrowed is known as the principal. While the money is borrowed, the corporation pays interest, the price paid for the use of another's money.

***Management specialization allows for increased* economicità**: A second advantage of a corporation is that the directors of the corporation can hire professional managers to run the firm. This means that the owners, or stockholders, can still own a portion of the corporation without having to know a great deal about the business itself.

Limited liability: A third advantage is that the corporation provides limited liability for its owners. This means that the corporation itself, not its owners, is fully responsible for its debts and obligations. To illustrate, suppose a corporation cannot pay all of its obligations and goes out of business. Because of limited liability, stockholder losses are limited to the money they invested in stock. Even if other debts remain, the stockholders are not responsible for them.

Because limited liability is so attractive, many firms incorporate just to take advantage of it. Suppose MR. Winters, who owns the hardware store and the auto repair business, now decides to set up each business as a corporation. If the hardware business should fail, his personal wealth, which includes the automobile repair business, is safe. Mr Winters may lose all the money invested in the hardware business, but that would be the extent of his loss.

Unlimited life: Another advantage is the unlimited life, meaning that the corporation continues to exist even when ownership changes. Because the corporation is recognized as a separate legal entity, the name of the company stays the same, and the corporation continues to do business.

Ownership is easily transferred: The ease of transferring ownership is also a strength of the corporation. If a shareholder no longer wants to be an owner, he/she simply sells the stock to someone else, who then becomes the new owner. As a result, it is much easier for the owner of a corporation to find a new buyer than it is for a sole proprietor or a partnership.

What are the ***disadvantages*** of the corporation?

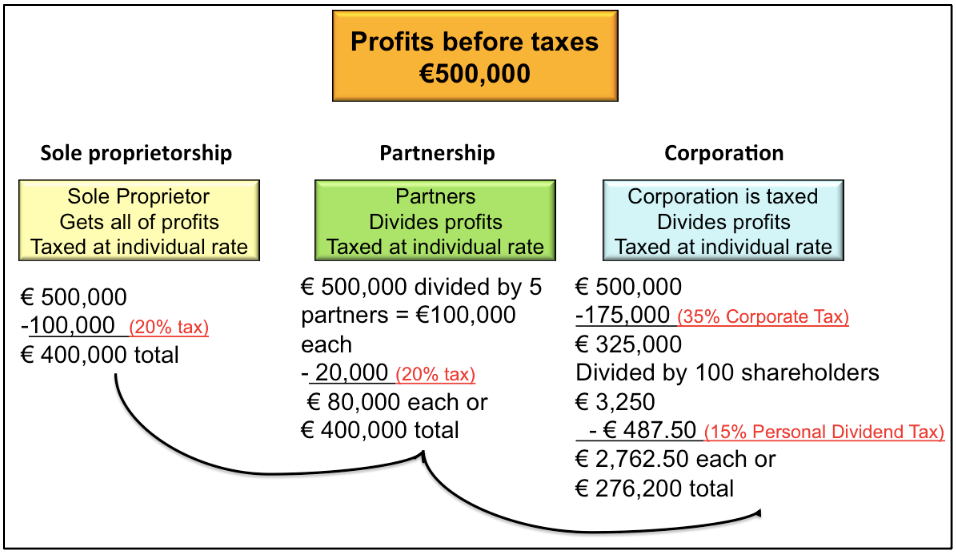
Difficulty and expense of getting a charter: Depending on the state, attorney's fee and filing expenses can cost several thousand of euro. Because of this expense, many people prefer to set up proprietorships or partnerships.

Agency problem due to separation of ownership and management. The owners have little to say in how the business is run after they have voted for the board of directors. This is because the directors turn day-to-day operations over to a professional management team, resulting in the separation of ownership and management. This is different from the proprietorship and partnership, where ownership and management are one and the same.

Double taxation: A third disadvantage is the double taxation of corporate profits. Stockholders' dividends are taxed twice-one as corporate profit and again as personal income. This tax status is a consequence of the corporation's special status as separate legal entity. This also means that the corporation is required to keep detailed records of sales and expenses so that it can compute and pay taxes on its profits.

Table 114 contains an example of taxation.

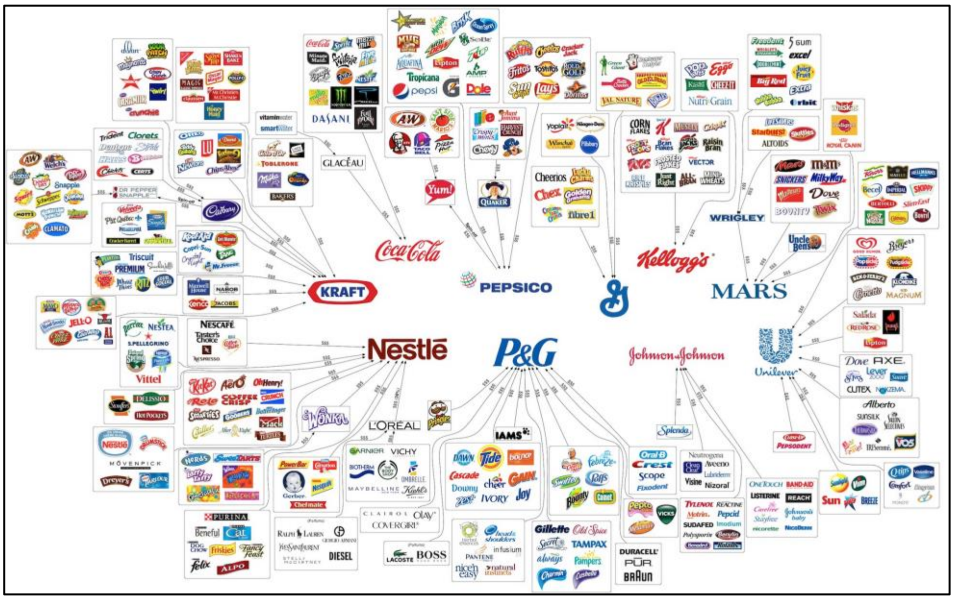
Table 114 – *Sole proprietorship, partnership and corporation taxation*



7. *Multinational corporation*

"Multinational Corporations (MNC) or Multinational Enterprises (MNE) are organizations that are owned or control productions of goods or services in one or more countries other than the home country. For example, when a corporation is registered in more than one country or has operations in more than one country, it may be attributed as MNC. Usually a large corporation which produces or sells goods or services in various countries. It can also be referred as an International Corporation, or a "Transnational Corporation", or perhaps best of all, as a "Stateless Corporation" (Wikipedia).

Table 115 – *The brands of big multinationals firm*



YouTube 31 – *Multinational corporation*

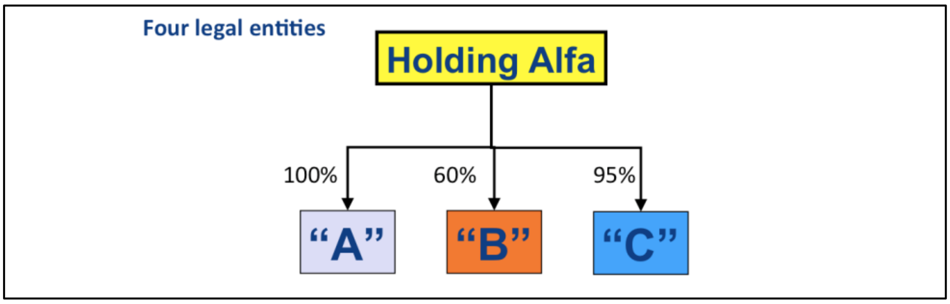
Type	Title	Length (hh:mm:ss)	Study/Watch
Documentary	Multinational corporations	00:08:04	Study

8. *The business group. A multiplicity of legal entities and one economic entity*

Large corporations (e.g. multinational corporation) in most countries are not freestanding legal entities, but belong to business groups. Many scholars have documented the presence of business groups around the world.

We define the business group as a collection of formally independent firms (legal entities) under single common administrative and financial control of a holding company. In Table 116 there are four legal entities (one holding and three subsidiaries) and for each legal entity a board of directors.

Table 116 – *Business group structure*



Source: Our elaboration.

Since the single legal entities normally are sub-system of the group, and do not have full decision-making power, the whole group is considered as an *azienda*. Indeed, even if the group is composed by many legal entities (e.g. corporations), normally it is managed as a single economic entity, especially if the activities of the subsidiaries are strongly integrated. However **the concept of economic entity does not coincide with that of *azienda***. Indeed while the former is connected to the entity that prepare the consolidated financial statement (*infra*, § 8.2) (i.e. in a consolidate financial statement the group is always an economic entity), the latter derives from the discipline of *economia aziendale*, and require the presence of the three attributes discussed in Chapter I (§ 6). Thus an economic entity: could be a single *azienda*, a part of an *azienda*, or could contain more *aziende*.

In this regard, Hsieh et al. (2010) see the group as a "collection of legally independent corporate entities that are established under the same control and ownership, each not only sustaining independent firm objectives, but also acting to meet the shared goals of the business group" (p. 560). Chung (2003) states that "although business groups exhibit slight differences in various contexts, they all share one organizational characteristic – group firms with distinct corporate identities and legal status do not operate as isolated units in the market but forge institutionalized relationships with each other and work coherently as an entity" (p. 37).

These definitions are particularly useful for our purpose, because despite the presence of formally independent legal entities (independent corporations), ***the business group is considered as a single economic entity***. The main assumption is that the business group, as a single economic entity, allows the reduction or even the removal of important transaction costs (Coase, 1960; Williamson, 1985) [5]. The reduction of these costs is one of the reasons

[5] "A transaction cost is any cost involved in making an economic transaction. For example, when buying a good or buying foreign exchange, there will be some transaction costs (in addition to the price of the good.

The cost could be financial, extra time or inconvenience.

Transaction costs could involve.

– *Paying a margin to an intermediary*. For example, when buying foreign exchange a broker may take a commission of 0.5% of total purchase;

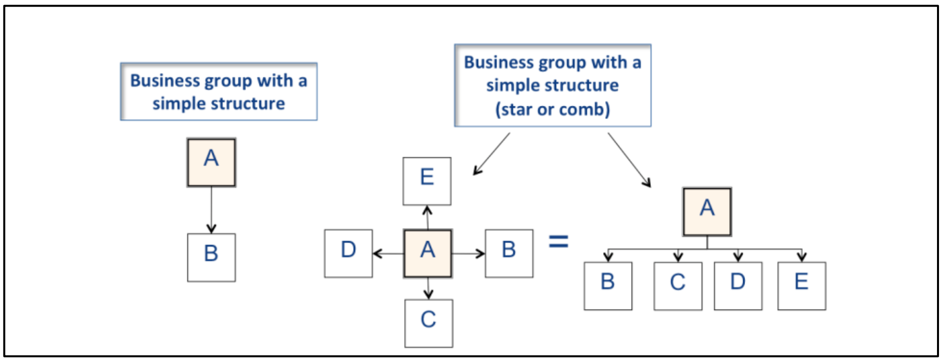
– *Search costs*. When purchasing foreign exchange, you will look around for the dealer with best commission rate;

– *Contract costs*. For transactions, you may need to sign a contract to specify what the parties need to stick to. This can involve bargaining to gain best contract and ensuring the contract is honoured. If there is little respect for property rights, these transaction costs may be quite significant. (e.g. if you have to take a landlord to court to complete purchase of house).

for the establishment of business groups, especially in developing economies, where markets have a high degree of inefficiency (Claessens et al., 2006).

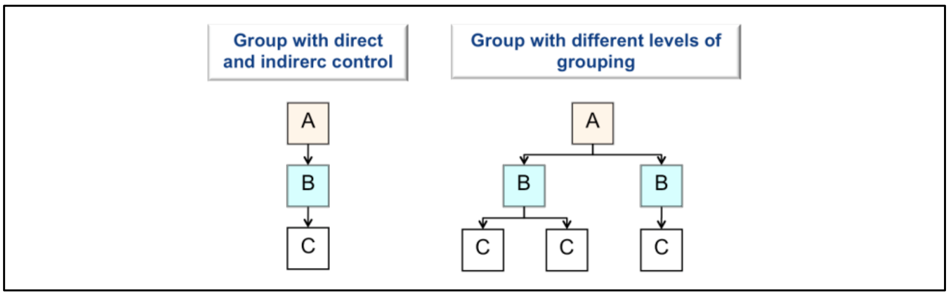
Table 117 and Table 118 show two different structures of business group.

Table 117 – *Business group whit simple structure*



Source: Our elaboration.

Table 118 – *Business group whit complex structure*



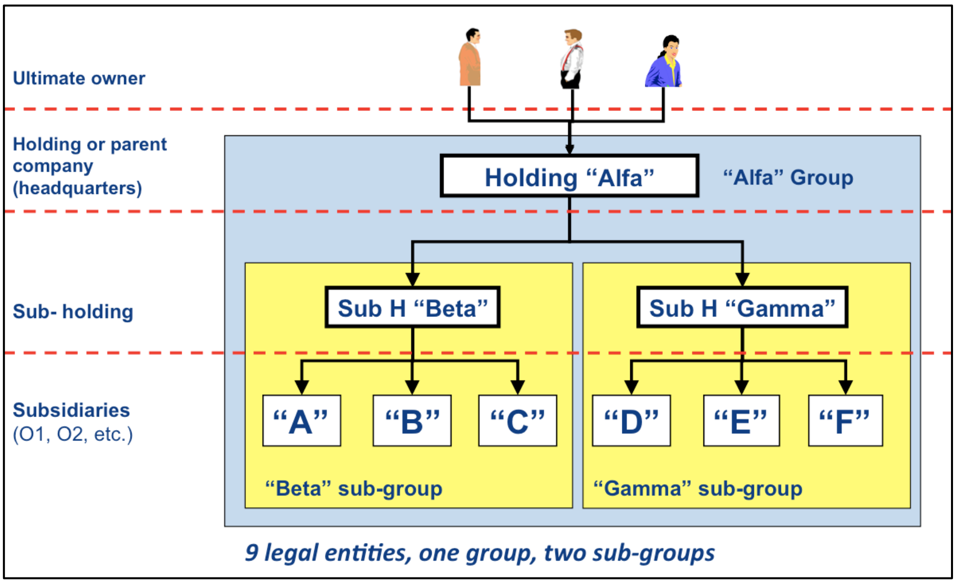
Source: Our elaboration.

Table 119 shows an example of a multilevel group, characterized by the presence of two sub-holdings (Beta and Gamma). Sub-holdings are firms that control other companies and in turn are controlled by an holding of by other sub-holdings.

In a simple barter economy, transaction costs will be greater because of problems, such as searching and finding someone to trade with. Money helps to reduce transaction costs.

Transaction cost theory suggests that the growth of firms is partly explained by the desire to reduce transaction costs from the market mechanism and concentrate production within a firm". *Source*: http://www.economicshelp.org/blog/glossary/transaction-costs/.

Table 119 – *An example of multilevel group*



Source: Our elaboration.

There are two types of holding companies: pure and operating.

A **pure holding company** is a company that owns other companies' outstanding stock. It usually refers to a company that does not produce goods or services itself, rather its *only* purpose is owning shares of other companies. Holding companies control management and operations of subsidiaries by influencing or electing its board of directors.

The ***operating holding company*** does the work of both holding company and operating company and for this reason they are also termed as mixed holding company. It engages in business activities on its own account over and above the function of holding control over the subsidiaries.

The ***Corporate headquarters*** is the entity at the top of a corporation to take full responsibility for the overall success of the corporation, ensures Corporate Governance. Corporate headquarters are a key element of a corporate structure and cover different corporate functions such as strategic planning, corporate communications, tax, legal, marketing, finance, HR, IT.

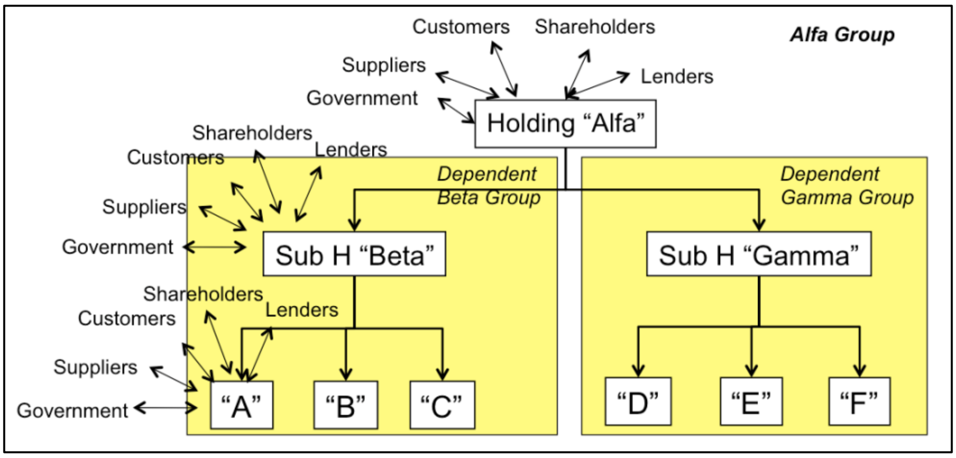
8.1. *The interest of the whole group and the holding liabilities. Pierce the corporate veil*

Even if the group is a single economic entity, **it does not have a personal liability**, in the sense that **the group as a whole is not considered as an incorporated business**.

The law has for the most part treated parent companies and their subsidiaries as separate legal entities (Padfield, 2004). It means that each legal entity within the group has its own stakeholders. Normally if we consider an operating subsidiary, it finds its stakeholders mainly within the group. For instance, in Table 120 company "A" can see the supplier in company "B" (or "D"), the shareholder in the Sub-Holding Beta and the lender in the Holding "Alfa".

Parent companies are not traditionally held liable for the debts or actions of their subsidiaries. However, under corporate law of some countries, a court may "pierce the corporate veil" of the parent if it finds an appearance of impropriety through questionable share transfers or other fraudulent means of avoiding the subsidiary's liabilities (Erens et al., 2008). In other words, when the group is managed as a *single economic entity*, all the legal entities of a group may be treated as a *single legal entity*.

Table 120 – *The stakeholders of the business group*



Source: Our elaboration.

The Italian 'Corporate Law Reform' (Legislative Decree No. 6/2003) has introduced some corporate rules for the regulation of business groups. These rules are related to the "management and coordination activity" (*attività di direzione e coordinamento*) exercised by the parent over its subsidiaries.

The **headquarters-subsidiaries relationship** is often based on the centralization of the decision-making power in the parent company, in order to manage the group as if it were a single economic entity and then to reach the system effect allowing subsidiaries to bring different benefits (e.g. scope and scale economies, financial synergies).

However, complying with the group's policy may have negative consequences for subsidiaries, for example when the interest of the group conflicts with that of the single subsidiary and consequently with its stakeholders (e.g. minority shareholders and creditors).

Under Article 2497 of the Italian Civil Code, a specific liability of parent companies with directing and coordinating power (directing company) over their subsidiaries (directed legal entities) for damages incurred by the latter is expressly maintained. In particular, legal entities which, in carrying out management and coordination activities on other companies, act in the interest of their own or third parties' business, in breach of the principle of correct corporate management, are directly liable: (i) with the minority shareholders of the directed and coordinated companies and (ii) with the creditors of the same companies. Thus, the Italian Group Regulation pierces the corporate veil of the parent, treating the group as a single legal entity.

The Italian group regulation aims to advert and discourage the activities imposed by the parent without considering the interests of the subsidiaries and its stakeholders.

This law is significant at least for two other reasons:

1) it is based on the theory of compensatory advantages;
2) it requires the disclosure of the management and coordination activity by the holding company.

With regard the point 1), article 2497, paragraph 1, provide that: '*In the light of the overall outcome of the management and coordination activity, the liability of the parent company is excluded if no damage occurs, or such damage is entirely removed/eliminated, including by means of transactions targeted to such purpose*'.

Therefore, as part of a group certain detrimental transactions to the subsidiaries and its outsiders, ordered by the parent company, could be justified by benefits that expropriate subsidiaries and outsiders receives because of the belonging to a business group.

This concept encompasses the theory of 'compensatory advantages' that have led to heated discussion in Italian law doctrine (Cariello, 2006; Denozza, 2000; Fasciani, 2007; Rossi et. al., 2002), for which the prejudicial impact of the parent company's decision may eventually be offset by the benefits arising from the directed companies' participation in the group structure (such as easier access to financing, participation in cash pooling agreement, and the possibility to share services within the group, as well as to exploit scale economies). Consequently, the apparent diseconomy of intra-group transactions, viewed as isolated transactions, may find its justification in the context of costs and benefits of achieving the interest of the whole group.

In Table 120, if parent company "Alfa" orders to directed and coordinated subsidiary "Beta" to sell goods to company "Gamma" at lower price than the market price because of the latter is in financial distress and it is important to do that in the interest of the group (and so also in the interest of Beta), the liability of parent "Alfa" is excluded when the damage is offset by certain benefits.

In particular, as seen above, Article 2497, paragraph 1, states the possibility of removing the damage through specific transactions designed to eliminate what the directing activity has not been able to compensate.

Nevertheless, according to Article 2497, paragraph 1, this compensatory transaction (i.e. the transactions engaged to eliminate the damage) it is necessary when the '*overall outcome of the management and coordination activity*' does not compensate the damage to the subsidiaries.

The overall outcome of the directing activity could be a source of benefits or damages. Indeed, this activity may itself be an advantage when it allows the directed companies to achieve results that otherwise they are not able to reach. There are many possibilities to distribute advantages within a group: for example, the transfer of know-how among subsidiaries, the mere possibility of being able to rely on a subsidiary to solve an operating problem or the benefits in terms of image and market penetration. These are intragroup relationships that create value even if transactions are not carried out.

The Italian law regulation gives an extraordinary opportunity to know if it happens. Indeed, it allows analysing the parent-subsidiaries relationship in order to understand whether the controlling company also manages and coordinates its subsidiaries.

In particular, the Article 2497-bis of the Italian Civil Code requires (point 2) that the submission to directing activity be expressly indicated in the company's correspondence and official documents, including the notes to the financial statements and the management report of the directors.

8.2. *The concept of economic entity in the consolidated financial statement. The De Benedetti case*

The conception of business group as a single economic entity is mainly referred to the consolidated financial statements, i.e. "the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity" (IFRS 10) [6], without considering the borders of the legal entities.

Thus in a business group each legal entity presents its financial statement, moreover the group presents its consolidated financial statements.

To be consolidated, a legal entity must be controlled by its parent company. The control is the power to govern the financial and economic activity of the corporation.

Therefore, the accounting standard requires the parent (the investor) to consolidate a subsidiary legal entity (the investee) when it is substantially controlled, even if the parent does not exert its power. Indeed, control is the ability to use the power (i.e. the existing rights that give the current ability to direct the relevant activities) while management is the exercise the control power (i.e. the exercise of the decision-making power, see Di Carlo, 2013b).

Consolidated financial statements of a group of companies must be prepared as if the entire group constitutes a single economic entity, a single *azienda*, in order to avoid the misrepresentation of the scale of group's activities.

It is therefore necessary to eliminate the effects of any inter-company transactions and balances during the consolidation of group accounts such as the following:

– Inter-company sales and purchases;
– Inter-company payables and receivables;
– Inter-company payments such as dividends, royalties & head office charges.

Inter-company transactions must be eliminated as if the transactions had not occurred in the first place. Examples of adjustments that may be required to eliminate the effects of inter-company transactions include:

– Elimination of unrealized profit or loss on the sale of assets member companies of a group;

– Elimination of excess or deficit depreciation expense in respect of a fixed asset purchased from a member company at a price that was higher or lower than the net book value of the asset in the books of the seller.

[6] International Financial Reporting Standards (IFRS) are designed as a common global language for business affairs so that company accounts are understandable and comparable across international boundaries. They are a consequence of growing international shareholding and trade and are particularly important for companies that have dealings in several countries. They are progressively replacing the many different national accounting standards. The rules to be followed by accountants to maintain books of accounts which is comparable, understandable, reliable and relevant as per the users internal or external.

Table 121 – *Example of consolidated financial statements*

XYZ PLC is a company specializing in the manufacturing of fertilizers. At the start of the current accounting period, XYZ PLC acquired DEF PLC, a chemicals producer.

Following is a summary of the financial results of the two companies during the year:

	XYZ	DEF
	$m	$m
Sales	120	50
Cost of Sales	(60)	(20)
Gross Profit	60	30
Operating Expenses	(20)	(10)
Net Profit	40	20

XYZ PLC purchased chemicals worth $20m from DEF PLC which it used in the manufacture of fertilizers sold during the year.

Consolidation of XYZ Group's financial results will require an adjustment in respect of the inter-company sale and purchase in order to conform to the single entity principle.

Consolidated financial results of the two companies will be presented as follows:

		XYZ Group
		$m
Sales	(120 + 50 - 20)	150
Cost of Sales	(60 + 20 - 20)	(60)
Gross Profit		90
Operating Expenses	(20 + 10)	(30)
Net Profit		60

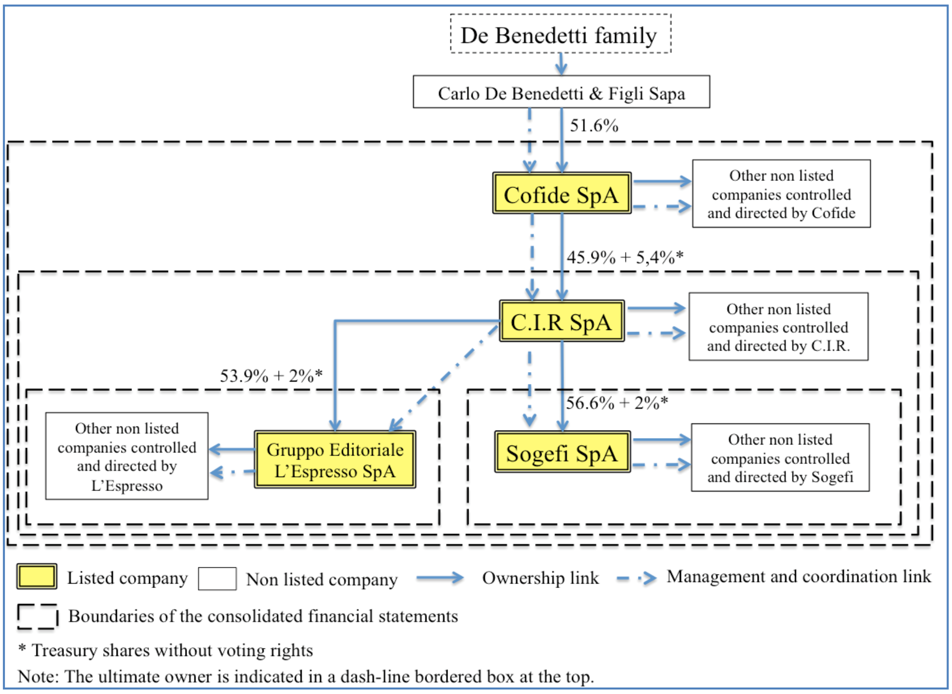
Since XYZ Group, considered as a single entity, cannot sell and purchase to itself, the sales and purchases in the consolidated income statement have been reduced by $20 m each in order to present the sales and purchases with external customers and suppliers.

If we ignore the single entity concept, XYZ Group's financial results will present sales of $170 m and cost of sales amounting $80 m. Although the net profit of the group will be unaffected by the inter-company transaction, the size of the Group's operations will be misrepresented due to the overstatement.

Source: http://accounting-simplified.com/financial/concepts-and-principles/single-economic-entity.html.

Table 122 represents the group controlled by De Benedetti family.

Table 122 – *De Benedetti business group*



Source: Our elaboration.

It operates in unrelated sectors. Cofide is the pure listed holding of De Benedetti group. CIR is a Cofide investment subsidiary active in the energy sector, media, automotive components, healthcare and financial investments (private equity, venture capital, non performing loans, start-ups). Sogefi is a CIR subsidiary and it is one of the major international groups operating worldwide in the sector of automotive components. Gruppo Editoriale L'Espresso (hereinafter, L'Espresso) is also a CIR subsidiary and it is one of the leading media groups in Italy with interests in publishing, radio, advertising, internet businesses and television. Consolidated of Cofide group combines financial statements of listed companies C.I.R., Sogefi, L'Espresso and all their subsidiaries, while that of CIR combines Sogefi and L'Espresso.

Consolidated of Cofide group combines financial statements of listed sub–groups C.I.R., Sogefi, L'Espresso, while that of CIR combines Sogefi and L'Espresso sub–groups.

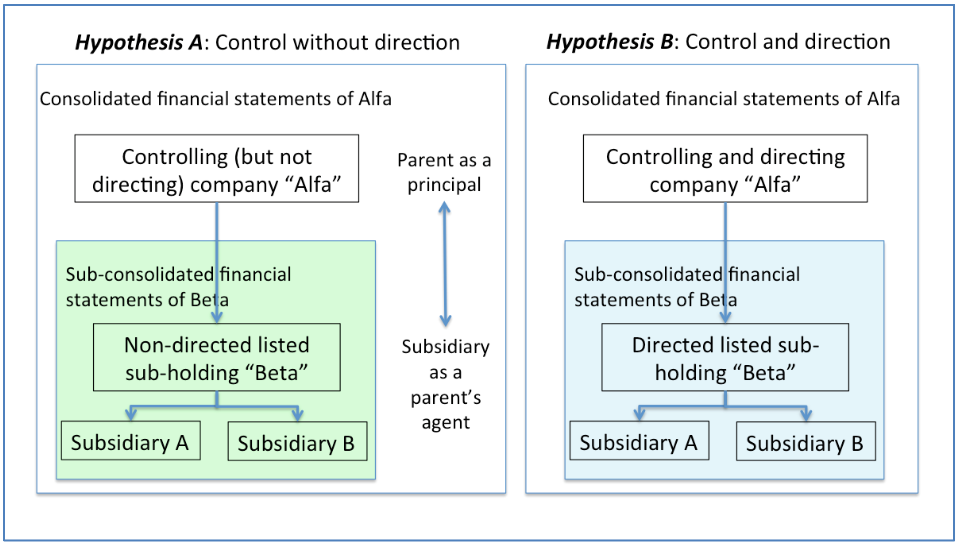
Thus if we consider the boundaries of the economic entity as the boundaries of the consolidating area, we have at least four economic entities. The firs economic entity contains the holding Cofide and all its subsidiaries, the second start from the holding C.I.R. and contains that company and its subsidiary, the third and the four are the consolidation areas of Gruppo Editoriale l'Espresso (and its subsidiaries) and Sogefi (and its subsidiaries).

8.3. *Separation between control and management in business groups*

In a business group the control is separated from the management when the parent (listed or not listed) company delegates the exercise of the decision-making power to the subsidiaries (see, Table 123, Hypothesis A).

We can also say that the delegation of the decision-making power proves that the subsidiary is the parent's agent. That delegation raises the headquarters–subsidiary agency problem, mainly studied in multinational enterprises (Kim et al., 2005), since the interests of the subsidiaries may not always be aligned with those of the parent or whit that of the group as a whole.

Table 123 – *Control with and without direction activity*



Source: Our elaboration.

Subsidiary autonomy can be defined as the decision-making rights that are granted by the parent (Gammelgaard et al., 2012). A subsidiary possesses high autonomy when it exercises the power to direct the operational and/or strategic decisions. Low autonomy arises when the parent largely makes such decisions. Some scholars make this distinction, clarifying that autonomy 'may either be delegated by headquarter or developed by the subsidiary' (Young and Tavares, 2004: 228), while decentralization concerns delegation. However, for this study we use the terms decentralization (of the parent) and autonomy (of subsidiary) synonymously, without make a distinction between the two.

Following the IFRS 10, it means that even if the parent has the ability to '*direct the relevant activities*' of its subsidiaries – and for that reason the consolidated financial statements are requested – the former may decide to delegate the management to the latter.

Nevertheless, despite the possibility of the parent to separate control from management of the subsidiaries, scholars on corporate governance normally consider the group as single economic entity with a unitary direction activity exercised by the holding company.

The main assumption is that the group facilitates the reduction or even the removal of important transaction costs, since the corporate hierarchy performs more efficiently than is possible through the market governance of transactions (Coase, 1960; Williamson, 1985). The costs reduction is one of the reasons for the establishment of business groups, especially in developing economies, where markets have a high degree of inefficiency (Claessens et al., 2006; Goto, 1982; Khanna and Palepu, 1999; Khanna and Yafeh, 2007; Leff, 1978).

REVIEW QUESTIONS

Following, the review questions for this Chapter.

1) What are the advantages of the sole proprietorship?
2) Finding the right partner or partners is essential in a partnership. What is the difference between a general partnership and a limited partnership?
3) Which of the following is a characteristic of sole proprietorship?
   - The equity is represented by shares
   - More than one partner participate to the business
   - Double taxation of the profit
   - None of the previous answers is correct

4) The corporation is a legal form for
   - Business entities
   - Non-business entities
   - Foundations
   - Associations

CHAPTER SIX [1]

FUNCTIONS AND ORGANIZATIONAL STRUCTURE

1. *Objectives and Assignments of this chapter*

After reading this chapter, you will be able to:

- Define organizational structure
- Describe the different types of organizational structure
- Describe the relationship between strategy and structure
- Identify the appropriate organizational structure in order to achieve the system effect (attribute of the azienda)

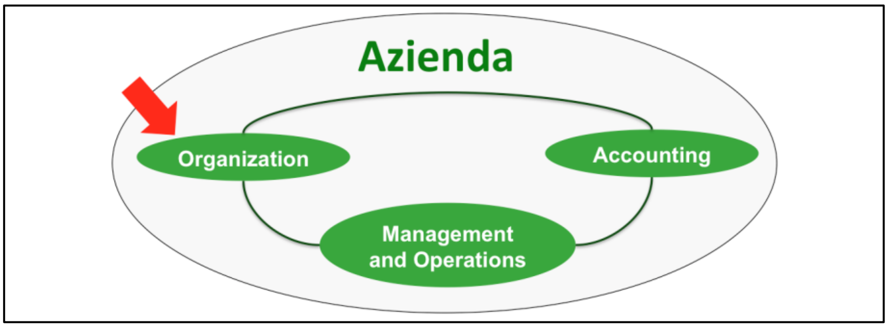
Following the Assignments of this chapter and Chapter Seven:

Assignment 23 – Chapter VI and VII

2. *Defining organizational structure and design*

As discussed in Chapter I (§ 7), one of the attributes of the business entity is the systemic coordination. In order to be a system the business entity needs an organizational structure. Moreover, the organization is one of the three sub-systems of the "*Economia Aziendale*" (Table 124). According to that discipline, the organization is the combination of personnel and equipment, broken down into structures and procedures for efficient management.

Table 124 – *The three sub-systems of* Economia Aziendale



[1] The author of this Chapter is Niloofar Karzemargi, except § 1, part of § 2 and 6, written by Emiliano Di Carlo.

As the operating structure (e.g. machinery, equipment) also **the organizational structure can become obsolete**, for example when the size and the complexity of the firm increase and it is not possible to concentrate all the decision making power in a single point of the organization (Chapter IV, § 3.4).

Organizational structure specifies the firm's formal reporting relationships, procedures, controls, and authority and decision-making processes. A firm's structure specifies the work to be done and how to do it, given the firm's strategy or strategies. Thus, organizational structure influences how managers work and the decisions resulting from that work.

In other terms, "think of structure as the skeleton supporting the organization and giving it shape. Just as each bone in a skeleton has a function, so does each branch and level of the organizational chart. The various departments and job roles that make up an organizational structure are part of the plan to ensure the organization performs its vital tasks and goals. Organizational structures help everyone know who does what. To have an efficient and properly functioning business, you need to know that there are people to handle each kind of task. At the same time, you want to make sure that people aren't running up against each other. Creating a structure with clearly defined roles, functions, scopes of authority and systems help make sure your people are working together to accomplish everything the business must do.

To create a good structure, your business has to take inventory of its functions. You have to identify the tasks to be accomplished. From these, you can map out functions. Usually, you translate these functions into departments.

For example, you have to receive and collect money from clients, pay bills and vendors, and account for your revenues and expenditures. These tasks are all financials and are usually organized into a finance or accounting department. Selling your products, advertising, and participating in industry trade shows are tasks that you can group under the umbrella of a marketing department.

With differing ways to organize the tasks, you can always choose something less traditional. But in all cases, organizational structure brings order to the list of tasks" [2].

Organizational structure can play an important role in an organization's success. The process of organizing — the second management function — is how an organization's structure is created.

Managers seek structural designs that will best support and allow employees to effectively and efficiently do their work. Before looking at the elements of organizational structure and design, some important terms should be defined.

Organizing is the process of creating an organization's structure. That process has several purposes.

Purposes of Organizing
– Divides work to be done into specific jobs and departments
– Assigns tasks and responsibilities associated with individual jobs
– Coordinates diverse organizational tasks

[2] Source: http://smallbusiness.chron.com/purpose-organizational-structure-3812.html

– Clusters jobs into units
– Establishes relationships among individuals, groups, and departments
– Establishes formal lines of authority
– Allocates and deploys organizational resources

An **organizational structure** is the formal arrangement of jobs within an organization.

Organizational design is the process of developing or changing an organization's structure. It involves decisions about six key elements: **work specialization, departmentalization, chain of command, span of control, centralization/decentralization,** and **formalization**. We need to take a closer look at each of these structural elements.[3]

Work specialization

Work specialization is the degree to which tasks in an organization are divided into separate jobs. Most managers today see work specialization as an important organizing mechanism but not as a source of ever-increasing productivity.

The essence of work specialization is that an entire job is not done by one individual but instead is broken down into steps, and each step is completed by a different person. As seen in Chapter IV, § 3, each productive process can be split in different stages.

Individual employees specialize in doing part of an activity rather than the entire activity.

YouTube 32 – *Work specialization*

Documentary	Work Specialization in Organizations	00:04:45	Watch

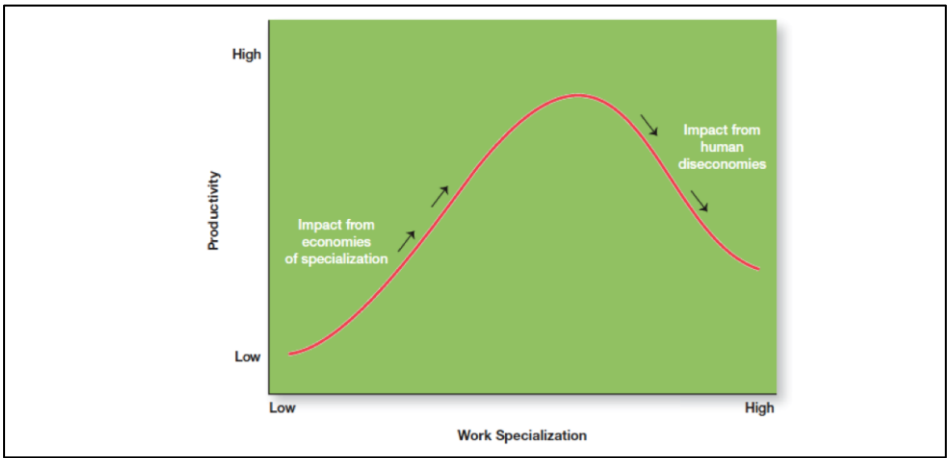
* You can click on the title, and register for free trial on the website.

Early proponents of work specialization believed that it could lead to great increases in productivity. At the beginning of the twentieth century, that generalization was reasonable.

Because specialization was not widely practiced, its introduction almost always generated higher productivity. But, as Table 144 illustrates, a good thing can be carried too far.

[3] See, for example, R. L. Daft, Organization Theory and Design, 10th ed. (Mason, OH: South-Western College Publishing), 2009.

Table 125 – *Economies and diseconomies of work specialization*



Source: S. E. Humphrey (2007)

At some point, the human diseconomies from division of Labor—boredom, fatigue, stress, low productivity, poor quality, increased absenteeism, and high turnover—exceed the economic advantages (Humphrey, 2007, pp. 1332–1356).

TODAY'S VIEW

Most managers today continue to see work specialization as important because it helps employees be more efficient. For example, McDonald's uses high work specialization to get its products made and delivered to customers efficiently and quickly— that's why it's called "fast" food. One person takes orders at the drive-through window, others cook and assemble the hamburgers, another works the fryer, another gets the drinks, another bags orders, and so forth. Such single-minded focus on maximizing efficiency has contributed to increasing productivity. In fact, at many McDonald's, you'll see a clock that times how long it takes employees to fill the order; look closer and you'll probably see posted somewhere an order fulfillment time goal. At some point, however, work specialization no longer leads to productivity. That's why companies such as Avery-Dennison, Ford Australia, Hallmark, and American Express use minimal work specialization and instead give employees a broad range of tasks to do.

Assignment 23 – Chapter VI and VII

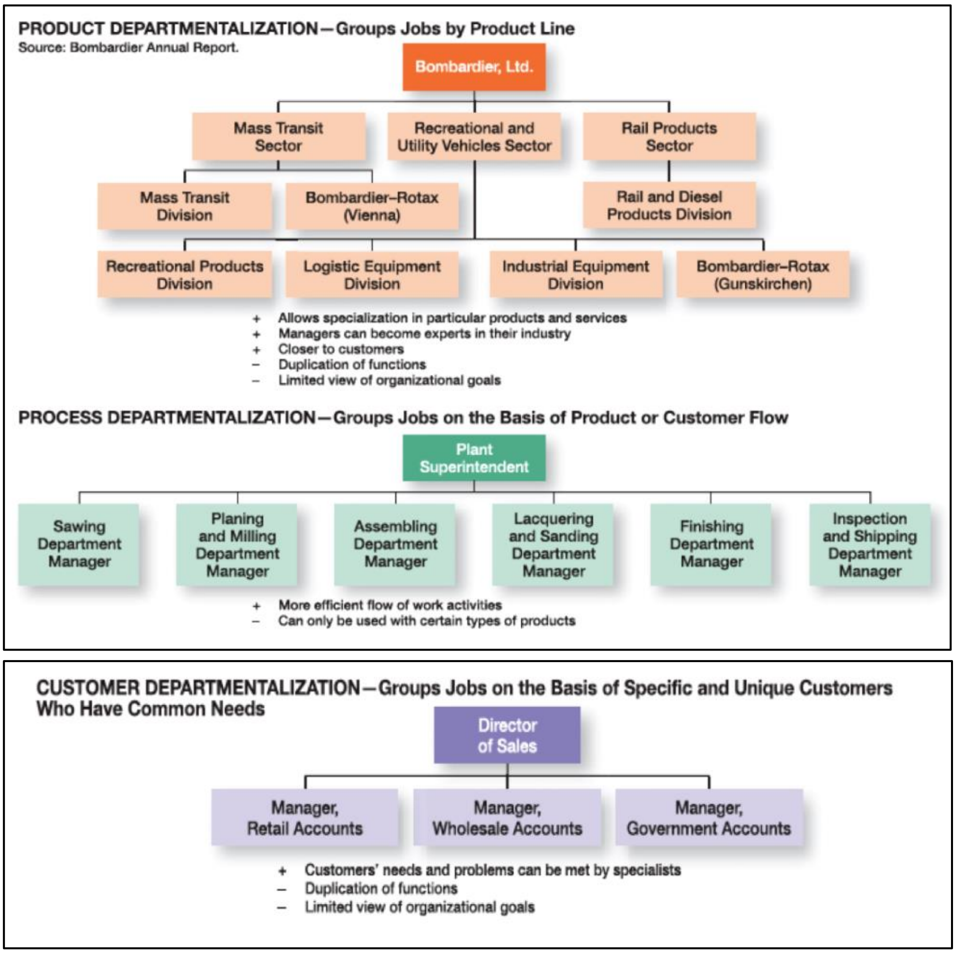
Departmentalization

Once jobs have been divided up through work specialization, they have to be grouped back together so that common tasks can be coordinated. The basis by which jobs are grouped together is called departmentalization. Every organization will have its own specific way of classifying and grouping work activities.

Functional departmentalization groups jobs by functions performed. This approach can be used in all types of organizations, although the functions change to reflect the organization's objectives and work activities. **Product departmentalization** groups jobs by product line. In this approach, each major product area is placed under the authority of a manager who's a specialist in, and is responsible for, everything having to do with that product line. **Geographical departmentalization** groups jobs on the basis of territory or geography such as southern, midwestern, or northwestern regions for an organization operating only in the United States; or for a global company, maybe U.S., European, Canadian, and Asian-Pacific regions. **Process departmentalization** groups jobs on the basis of product or customer flow. In this approach, work activities follow a natural processing flow of products or even of customers. Finally, **customer departmentalization** groups jobs on the basis of common customers who have common needs or problems that can best be met by having specialists for each.

Table 126 illustrates each type of departmentalization as well as the advantages and disadvantages of each.

Table 126 – *The Five Common Forms of Departmentalization*



Source: Robbins, Management, 11th edition.

TODAY'S VIEW

Most large organizations continue to use combinations of most or all of these types of departmentalization. For example, a major Japanese electronics firm organizes its divisions along functional lines, its manufacturing units around processes, its sales units around seven geographic regions, and its sales regions into four customer groupings. Black & Decker organizes its divisions along functional lines, its manufacturing units around processes, its sales around geographic regions, and its sales regions around customer groupings.

Chain of command

The chain of command is the continuous line of authority that extends from the upper organizational levels to the lowest levels and clarifies who reports to whom. Three related concepts include authority, responsibility, and unity of command.

We can't discuss the chain of command without discussing three other concepts: **authority**, **responsibility**, and **unity of command**.

AUTHORITY. Authority was a major concept discussed by the early management writers; they viewed it as the glue that held an organization together. Authority refers to the rights inherent in a managerial position to tell people what to do and to expect them to do it.[4] Managers in the chain of command had authority to do their job of coordinating and overseeing the work of others. Authority was related to one's position within an organization and had nothing to do with the personal characteristics of an individual manager. The rights and power inherent in one's formal organizational position were the sole source of influence and that if an order was given, it would be obeyed. Another early management writer, Chester Barnard, proposed another perspective on authority. This view, called the acceptance theory of authority, says that authority come from the willingness of subordinates to accept it. (Barnard, 1968, pp. 165–166)

If an employee didn't accept a manager's order, there was no authority. Barnard contended that subordinates will accept orders only if the following conditions are satisfied:

– They understand the order;
– They feel the order is consistent with the organization's purpose;
– The order does not conflict with their personal beliefs;
– They are able to perform the task as directed.

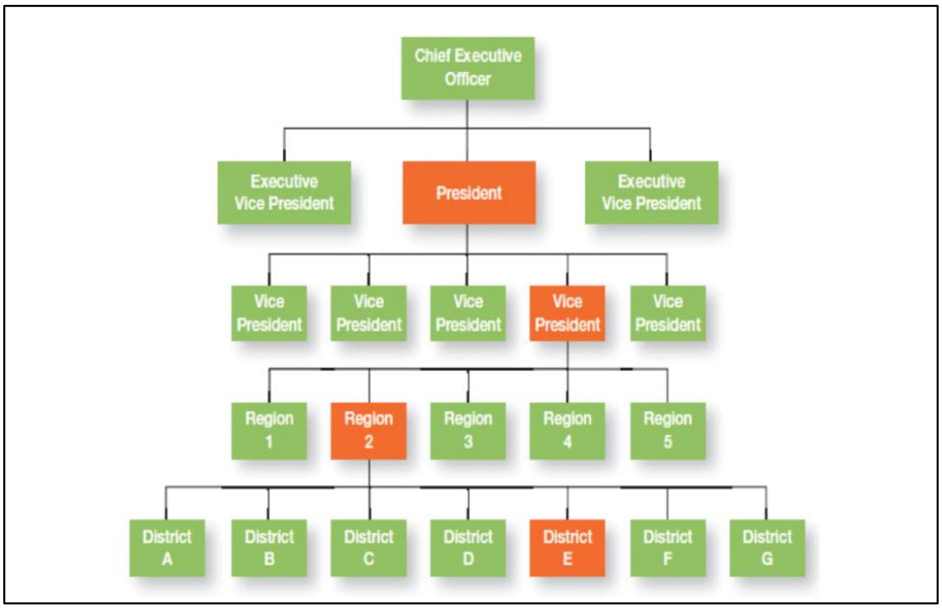
Barnard's view of authority seems to make sense, especially when it comes to an employee's ability to do what he or she is being told to do. For instance, if my manager (my department chair) came into my classroom and told me to do open-heart surgery on one of my students, the traditional view of authority said that I would have to follow that order.
Barnard's view would say, instead, that I would talk to my manager about my lack of education and experience to do what he's asked me to do and that it's probably not in the best interests of the student (or our department) for me to follow that order. However, it does point out that simply viewing a manager's authority as total control over what an employee does or doesn't do is unrealistic also, except in certain circumstances like the military where soldiers are expected to follow their commander's orders. However, do understand that Barnard believed most employees would do what their managers asked them to do if they were able to do so. The early management writers also distinguished between two forms of authority: line authority and staff authority. Line authority entitles a manager to direct the work of an employee.

It is the employer–employee authority relationship that extends from the top of the organization to the lowest echelon, according to the chain of command, as shown in Table 146. As a link in the chain of command, a manager with line authority has the right to direct the work of employees and to make certain decisions without consulting anyone. Of course,

[4] For a discussion of authority, see Kahn and Kram (1994, pp. 17–50).

in the chain of command, every manager is also subject to the authority or direction of his or her superior.

Table 127 – *Chain of command and line authority*



Source: Robbins, Management, 11th edition.

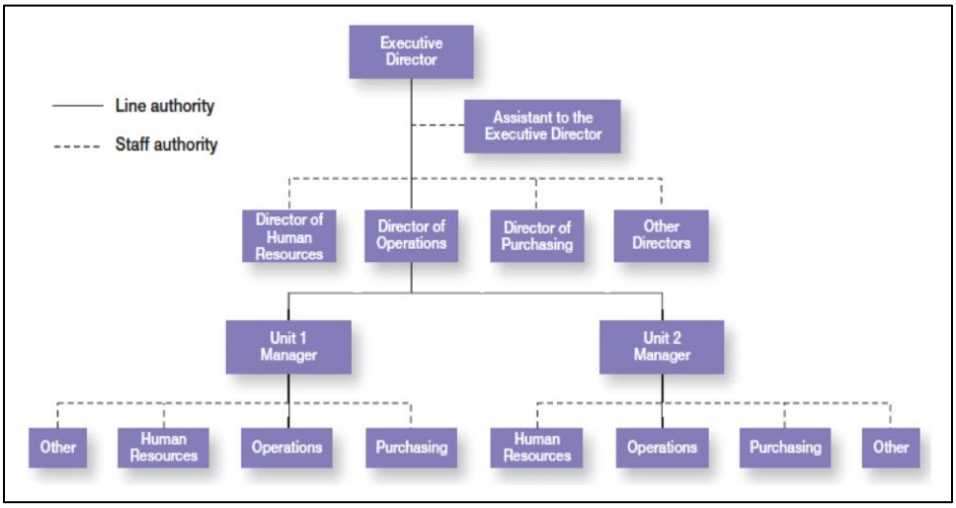
Keep in mind that sometimes the term line is used to differentiate line managers from staff managers. In this context, line refers to managers whose organizational function contributes directly to the achievement of organizational objectives. In a manufacturing firm, line managers are typically in the production and sales functions, whereas managers in human resources and payroll are considered staff managers with staff authority. Whether a manager's function is classified as line or staff depends on the organization's objectives.

As organizations get larger and more complex, line managers find that they do not have the time, expertise, or resources to get their jobs done effectively. In response, they create staff authority functions to support, assist, advise, and generally reduce some of their informational burdens. For instance, a hospital administrator who cannot effectively handle the purchasing of all the supplies the hospital needs creates a purchasing department, which is a staff function. Of course, the head of the purchasing department has line authority over the purchasing agents who work for him. The hospital administrator might also find that she is overburdened and needs an assistant, a position that would be classified as a staff position.

Table 128 – *Line Versus Staff Authority*

illustrates line and staff authority.

Table 128 – *Line Versus Staff Authority*



Source: Robbins, Management, 11th edition.

RESPONSIBILITY. When managers use their authority to assign work to employees, those employees take on an obligation to perform those assigned duties. This obligation or expectation to perform is known as responsibility. And employees should be held accountable for their performance! Assigning work authority without responsibility and accountability can create opportunities for abuse. Likewise, no one should be held responsible or accountable for work tasks over which he or she has no authority to complete those tasks.

UNITY OF COMMAND. Finally, the unity of command principle (one of Fayol's 14 management principles) states that a person should report to only one manager. Without unity of command, conflicting demands from multiple bosses may create problems as it did for Damian Birkel, a merchandising manager in the Fuller Brands division of CPAC, Inc. He found himself reporting to two bosses—one in charge of the department-store business and the other in charge of discount chains. Birkel tried to minimize the conflict by making a combined to-do list that he would update and change as work tasks changed. (Gunn, 2003, p. 121)

TODAY'S VIEW

Although early management theorists (Fayol, Weber, Taylor, Barnard, and others) believed that chain of command, authority (line and staff), responsibility, and unity of command were essential, times have changed (Ashkenas, 2007, pp. 101–109)

Those elements are far less important today. For example, at the Michelin plant in Tours, France, managers have replaced the top-down chain of command with "birdhouse" meetings, in which employees meet for five minutes at regular intervals throughout the day at a column on the shop floor and study simple tables and charts to identify production bottlenecks. Instead of being bosses, shop managers are enablers (Morais, 2007, pp. 146–150).

Information technology also has made such concepts less relevant today. Employees can access information that used to be available only to managers in a matter of a few seconds. It also means that employees can communicate with anyone else in the organization without going through the chain of command. Also, many employees, especially in organizations where work revolves around projects, find themselves reporting to more than one boss, thus violating the unity of command principle. However, such arrangements can and do work if communication, conflict, and other issues are managed well by all involved parties.

Span of Control

How many employees can a manager efficiently and effectively manage? This question of span of control is important because, to a large degree, it determines the number of levels and managers an organization has. Wider spans are more efficient in terms of cost. However, at some point, wider spans reduce effectiveness. That is, when the span becomes too large, employee performance suffers because managers no longer have the time to provide the necessary leadership and support.

TODAY'S VIEW

The contemporary view of span of control recognizes that there is no magic number. Many factors influence the number of employees that a manager can efficiently and effectively manage. These factors include the skills and abilities of the manager and the employees, and the characteristics of the work being done. For instance, managers with well-trained and experienced employees can function well with a wider span. Other contingency variables that determine the appropriate span include similarity and complexity of employee tasks, the physical proximity of subordinates, the degree to which standardized procedures are in place, the sophistication of the organization's information system, the strength of the organization's culture, and the preferred style of the manager. (Van Fleet, 1983, pp. 546–552)

The trend in recent years has been toward larger spans of control, which is consistent with managers' efforts to speed up decision-making, increase flexibility, get closer to customers, empower employees, and reduce costs. Managers are beginning to recognize that they can handle a wider span when employees know their jobs well and when those employees understand organizational processes. For instance, at PepsiCo's Gamesa cookie plant in Mexico, 56 employees now report to each manager. However, to ensure that performance doesn't suffer because of these wider spans, employees were thoroughly briefed on company goals and processes. Also, new pay systems reward quality, service, productivity, and teamwork (Anders, 2008).

Centralization and Decentralization

One of the questions that need to be answered when organizing is "At what organizational level are decisions made?" ***Centralization is the degree to which decision-making takes place at upper levels of the organization***. If top managers make key decisions with little input from below, then the organization is more centralized. On the other hand, the more that lower-level employees provide input or actually make decisions, the more decentralization there is.

Keep in mind that centralization-decentralization is not an either-or concept. The decision is relative, not absolute—that is, an organization is never completely centralized or decentralized. Early management writers proposed that the degree of centralization in an organization depended on the situation (Fayol, 1949, pp. 19–42). Their goal was the optimum and efficient use of employees. Traditional organizations were structured in a pyramid, with power and authority concentrated near the top of the organization. Given this structure, historically centralized decisions were the most prominent, but organizations today have become more complex and responsive to dynamic changes in their environments. As such, many managers believe that decisions need to be made by those individuals closest to the problems, regardless of their organizational level.

In fact, the trend over the past several decades—at least in U.S. and Canadian organizations— has been a movement toward more decentralization in organizations (Zabojnik, 2002, pp. 1–22). Table 129 lists some of the factors that affect an organization's use of centralization or decentralization [5].

Table 129 – *Centralization or Decentralization*

More Centralization	More Decentralization
• Environment is stable. • Lower-level managers are not as capable or experienced at making decisions as upper-level managers. • Lower-level managers do not want a say in decisions. • Decisions are relatively minor. • Organization is facing a crisis or the risk of company failure. • Company is large. • Effective implementation of company strategies depends on managers retaining say over what happens.	• Environment is complex, uncertain. • Lower-level managers are capable and experienced at making decisions. • Lower-level managers want a voice in decisions. • Decisions are significant. • Corporate culture is open to allowing managers a say in what happens. • Company is geographically dispersed. • Effective implementation of company strategies depends on managers having involvement and flexibility to make decisions.

Source: Robbins, Management, 11th edition.

TODAY'S VIEW

Today, managers often choose the amount of centralization or decentralization that will allow them to best implement their decisions and achieve organizational goals (Kenis and Knoke, 2002, pp. 275–293). What works in one organization, however, won't necessarily work in another, so managers must determine the appropriate amount of decentralization for each organization and work units within it. As organizations have become more flexible and responsive to environmental trends, there's been a distinct shift toward decentralized decision-making (Amar, 2009, pp. 22–24). This trend, also known as employee empowerment, gives employees more authority (power) to make decisions. In large companies especially, lower-level managers are "closer to the action" and typically have more detailed knowledge about problems and how best to solve them than do top managers.

Formalization

Formalization refers to the degree to which jobs within the organization are standardized and the extent to which employee behavior is guided by rules and procedures. If a job is highly formalized, then the person doing that job has a minimum amount of discretion over what is to be done, when it's to be done, and how he or she could do it. Employees can be expected to handle the same input in exactly the same way, resulting in consistent and uniform output. In organizations with high formalization, there are explicit job descriptions, numerous organizational rules, and clearly defined procedures covering work processes. Where formalization is low, job behaviors are relatively unstructured and employees have a great deal of freedom in how they do their work. Because an individual's discretion on the job is inversely related to the amount of behavior in that job that is preprogrammed by the organization, the greater the standardization, the less input the employee has into how work

[5] See, for example, Mintzberg (1983) and Child (1984).

is done. Standardization not only eliminates the possibility that employees will engage in alternative behaviors, it even removes the need for employees to consider alternatives.

3. *Organizational design decisions*

Organizations are not all structured in exactly the same way. A company with 30 employees isn't going to look like one with 30,000 employees. But even organizations of comparable size don't necessarily have similar structures. What works for one organization may not work for another. How do managers decide what organizational design to use? That decision depends upon certain contingency factors.

3.1. *Mechanistic and organic organizations*

The mechanistic organization is a rigid and tightly controlled structure. It's characterized by high specialization, rigid departmentalization, narrow spans of control, high formalization, a limited information network (mostly downward communication), and little participation in decision-making by lower-level employees. This organizational design tries to minimize the impact of differing personalities, judgments, and ambiguity because these human traits are seen as inefficient and inconsistent. Although no pure form of a mechanistic organization exists in reality, almost all large corporations and governmental agencies have at least some of these mechanistic characteristics.

In direct contrast to the mechanistic form of organization is the organic organization, which is as highly adaptive and flexible a structure as the mechanistic organization is rigid and stable. Rather than having standardized jobs and regulations, the organic organization is flexible, which allows it to change rapidly as needs require. Organic organizations have division of Labor, but the jobs people do are not standardized. Employees are highly trained and empowered to handle diverse job activities and problems, and these organizations frequently use employee teams. Employees in organic-type organizations require minimal formal rules and little direct supervision. Their high levels of skills and training and the support provided by other team members make formalization and tight managerial controls unnecessary. Basic organizational design revolves around two organizational forms that are described in Table 130 (Morand, 1995, pp. 831–872).

Table 130 – *Mechanistic versus organic organizations*

Mechanistic	Organic
• High specialization	• Cross-functional teams
• Rigid departmentalization	• Cross-hierarchical teams
• Clear chain of command	• Free flow of information
• Narrow spans of control	• Wide spans of control
• Centralization	• Decentralization
• High formalization	• Low formalization

Source: Robbins, Management, 11th edition.

YouTube 33 – *Mechanistic & Organic organizational structures*

Documentary	Mechanistic & Organic Organizational Business Structures	00:06:55	Watch

* You can click on the title, and register for free trial on the website.

Assignment 23 – Chapter VI and VII

4. *Common organizational designs*

What organizational designs do Ford, Toshiba, Procter & Gamble, and eBay have? In making organizational design decisions, managers have some common structural designs from which to choose. In designing a structure to support the efficient and effective accomplishment of organizational goals, managers may choose to follow more traditional organizational designs. These designs—the simple structure, functional structure, and divisional structure—tend to be more mechanistic.

4.1. *Simple structure*

The simple structure is a structure in which the owner-manager makes all major decisions and monitors all activities while the staff serves as an extension of the manager's supervisory authority.

Typically, the owner-manager actively works in the business on a daily basis. Informal relationships, few rules, limited task specialization, and unsophisticated information systems describe the simple structure. Frequent and informal communications between the owner-manager and employees make it relatively easy to coordinate the work that is to be done (Mintzberg, 1983, p. 157).

The simple structure is matched with focus strategies and business-level strategies as firms commonly compete by offering a single product line in a single geographic market. Local restaurants, repair businesses, and other specialized enterprises are examples of firms relying on the simple structure to implement their strategy.

Its strengths are its flexibility, speed, and low cost to maintain. Its major drawback is that it's most effective in small organizations.

Normally this structure characterises the sole proprietorship form of business, because of the small dimension of the business. The sole proprietor is responsible.

As the small firm grows larger and becomes more complex, managerial and structural challenges emerge. For example, the amount of competitively relevant information requiring analysis substantially increases, placing significant pressure on the owner-manager. Additional growth and success may cause the firm to change its strategy. Even if the strategy remains the same, the firm's larger size dictates the need for more sophisticated workflows and integrating mechanisms. At this evolutionary point, firms tend to move from the simple structure to a functional organizational structure.

4.2. *Functional structure*

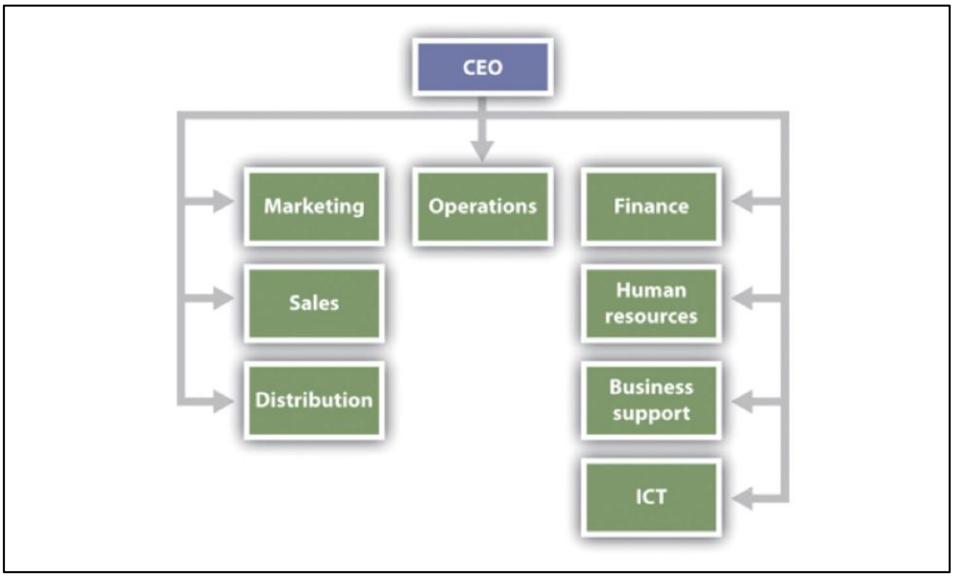
The functional structure is a structure consisting of a chief executive officer and a limited corporate staff, with functional line managers in dominant organizational areas, such as production, accounting, marketing, R&D, engineering, and human resources (Table 131).

This structure allows for functional specialization, thereby facilitating active sharing of knowledge within each functional area. Knowledge sharing facilitates career paths as well as the professional development of functional specialists. However, a functional orientation can have a negative effect on communication and coordination among those representing different organizational functions. Because of this, the CEO must work hard to verify that the decisions and actions of individual business functions promote the entire firm rather than a single function.

The functional structure supports implementation of business-level strategies and some corporate-level strategies (e.g., single or dominant business) with low levels of diversification.

Its strengths are cost-saving advantages from specialization (economies of scale, minimal duplication of people and equipment) and employees are grouped with others who have similar tasks. Its major drawback are that pursuit of functional goals can cause managers to lose sight of what's best for overall organization, and functional specialists become insulated and have little understanding of what other units are doing.

Table 131 – *Functional organizational structure*



Source: Robbins, Management, 11th edition.

4.3. *Multidivisional structure*

The multidivisional (M-form) structure consists of operating divisions, each representing a separate business or profit center in which the top corporate officer delegates responsibilities for day-to-day operations and business-unit strategy to division managers (Table 132). Each division represents a distinct, self-contained business with its own functional hierarchy.

As initially designed, the M-form was thought to have three major benefits:

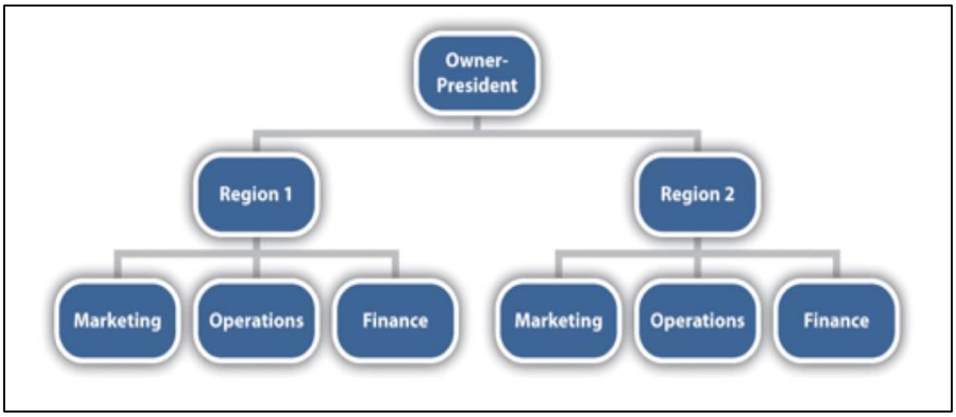
(1) it enabled corporate officers to more accurately monitor the performance of each business, which simplified the problem of control;

(2) it facilitated comparisons between divisions, which improved the resource allocation process; and

(3) it stimulated managers of poorly performing divisions to look for ways of improving performance." Active monitoring of performance through the M-form increases the likelihood that decisions made by managers heading individual units will be in shareholders' best interests. Diversification is a dominant corporate-level strategy in the global economy, resulting in extensive use of the M-form.

Used to support implementation of related and unrelated diversification strategies, the M-form helps firms successfully manage the many demands (including those related to processing vast amounts of information) of diversification. Chandler viewed the M-form as an innovative response to coordination and control problems that surfaced during the 1920s in the functional structures then used by large firms such as DuPont and General Motors. Research shows that the M-form is appropriate when the firm grows through diversification. Partly because of its value to diversified corporations, some consider the multidivisional structure to be one of the 20th century's most significant organizational innovations.

Table 132 – *Multidivisional Organizational structure*

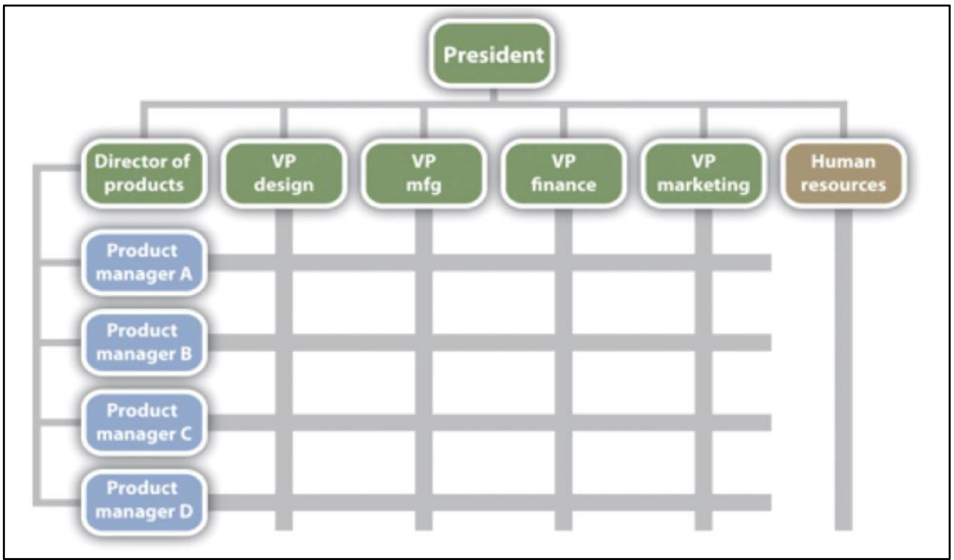


Source: Robbins, Management, 11th edition.

4.4. *Matrix structure*

The matrix structure is an organizational structure that assigns specialists from different functional departments to work on one or more projects being led by project managers (Table 133). Each project is managed by an individual who staffs his or her project with people from each of the functional departments. The addition of this vertical dimension to the traditional horizontal functional departments, in effect, "weaves together" elements of functional and product departmentalization- hence, the term matrix. Employees in a matrix organization have two managers: their functional department manager and their product or project manager, who share authority. The project managers have authority over the functional members who are part of their project team in areas relative to the project's goals. However, decisions such as promotions, salary recommendations, and annual reviews remain the functional manager's responsibility. To work effectively, project and functional managers have to communicate regularly, coordinate work demands on employees, and resolve conflicts together.

Table 133 – *Matrix organizational structure*



Source: Robbins, Management, 11th edition.

Assignment 23 – Chapter VI and VII

5. *The organizational structure of big corporations*

Top managers of most organizations typically put a great deal of thought into designing an appropriate structure. What that appropriate structure is depends on four variables (contingency variables): the organization's strategy, size, technology, and degree of environmental uncertainty.

5.1. *The organization's strategy*

An organization's structure should facilitate the achievement of goals. Because goals are influenced by the organization's strategies, it's only logical that strategy and structure should be closely linked. More specifically, structure should follow strategy. If managers significantly change the organization's strategy, they will need to modify the structure to accommodate and support the change (Chandler, 1962).

Alfred Chandler studied several large U.S. companies over a period of 50 years and concluded that changes in corporate strategy led to changes in an organization's structure. He found that these organizations usually began with a single product or product line that required only a simple or loose form of organization. However, as these organizations grew, their strategies became more ambitious and elaborate and the structure changed to support the chosen strategy. Most current strategy frameworks tend to focus on three dimensions: (1) innovation, which reflects the organization's pursuit of meaningful and unique innovations; (2) cost minimization, which reflects the organization's pursuit of tightly controlled costs; and (3) imitation, which reflects an organization's seeking to minimize risk and maximize profit opportunities by copying the market leaders. What structural design works best with each? Innovators need the flexibility and free-flowing information of the organic structure, whereas cost minimizers seek the efficiency, stability, and tight controls of the mechanistic structure. Imitators use structural characteristics of both—the mechanistic structure to maintain tight controls and low costs and the organic structure to pursue new and innovative directions.

5.2. *Size and structure*

There's considerable evidence that an organization's size significantly affects its structure. For instance, large organizations—those with 2,000 or more employees—tend to have more specialization, departmentalization, centralization, and rules and regulations than do small organizations. However, the relationship isn't linear. Rather, size affects structure at a decreasing rate; that is, size has less impact as an organization grows. Why? Essentially, once an organization has around 2,000 employees, it's already fairly mechanistic. Adding an additional 500 employees to a firm with 2,000 employees won't have much of an impact. On the other hand, adding 500 employees to an organization that has only 300 members is likely to result in a shift toward a more mechanistic structure.

5.3. *Technology and structure*

Every organization has at least one form of technology to convert its inputs into outputs. Generally, organizations adapt their structures to their technology. The processes or methods that transform an organization's inputs into outputs differ by their degree of routineness. In general, the more routine the technology, the more standardized and mechanistic the structure can be. Organizations with more non-routine technology are more likely to have organic structures.

The initial research on technology's effect on structure can be traced to Joan Woodward, who studied small manufacturing firms in southern England to determine the extent to which structural design elements were related to organizational success (Woodward, 1965). She couldn't find any consistent pattern until she divided the firms into three distinct technologies that had increasing levels of complexity and sophistication. The first category, *unit production*, described the production of items in units or small batches (art works, made-to-order goods…); The second category, *mass production*, described large-batch manufacturing (electronic goods, vehicles…). Finally, the third and most technically complex group, process production, included continuous process production (chemical pants, oil refineries). A summary of her findings is shown in Table 134.

Table 134 – *Woodward's findings on technology and structure*

	Unit Production	Mass Production	Process Production
Structural characteristics:	Low vertical differentiation	Moderate vertical differentiation	High vertical differentiation
	Low horizontal differentiation	High horizontal differentiation	Low horizontal differentiation
	Low formalization	High formalization	Low formalization
Most effective structure:	Organic	Mechanistic	Organic

Source: Robbins, Management, 11th edition.

Other studies also have shown that organizations adapt their structures to their technology depending on how routine their technology is for transforming inputs into outputs. In general, the more routine the technology, the more mechanistic the structure can be, and organizations with more nonroutine technology are more likely to have organic structures (Rousseau and Cooke, 1981, pp. 3–38).

5.4. *Environmental uncertainty and structure*

Some organizations face relatively stable and simple environments; others face dynamic and complex environments. Because uncertainty threatens an organization's effectiveness, managers will try to minimize it. One way to reduce environmental uncertainty is through adjustments in the organization's structure. The greater the uncertainty, the greater the need for the flexibility offered by an organic design. On the other hand, in stable, simple environments, mechanistic designs tend to be most effective. The evidence on the environment-structure relationship helps to explain why so many managers are restructuring their organizations to be lean, fast, and flexible. Global competition, accelerated product innovation by competitors, and increased demands from customers for high quality and faster deliveries are examples of dynamic environmental forces. Mechanistic organizations are not equipped to respond to rapid environmental change and environmental uncertainty.

6. *Legal entities map in multidivisional structure*

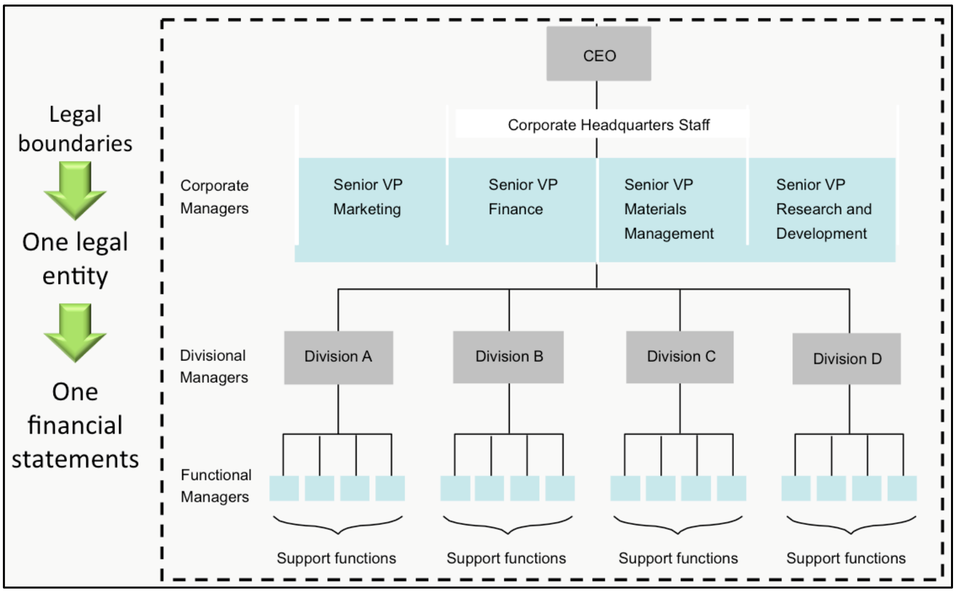
Big firms, in particular those who have a multidivisional structure, are characterised by the presence of many corporations that, being controlled by the same company, belong to the same business group.

The following tables show the relevance of considering the legal entities map for the analysis of the multidivisional organizational structure.

The difference among the following three tables is only in the legal entities map, since the organizational structure (multidivisional) is the same.

In particular, Table 135 shows a company with a multidivisional structure (four divisions and the headquarter) contained in a single legal entity (see the legal boundaries). The results of that company are simply the sum of the performance of the four divisions. Since there is a single legal entity a single board of directors governs the company, and the results are reflected in the financial statements of that legal entity.

Table 135 – *One legal entity and a plurality of businesses*



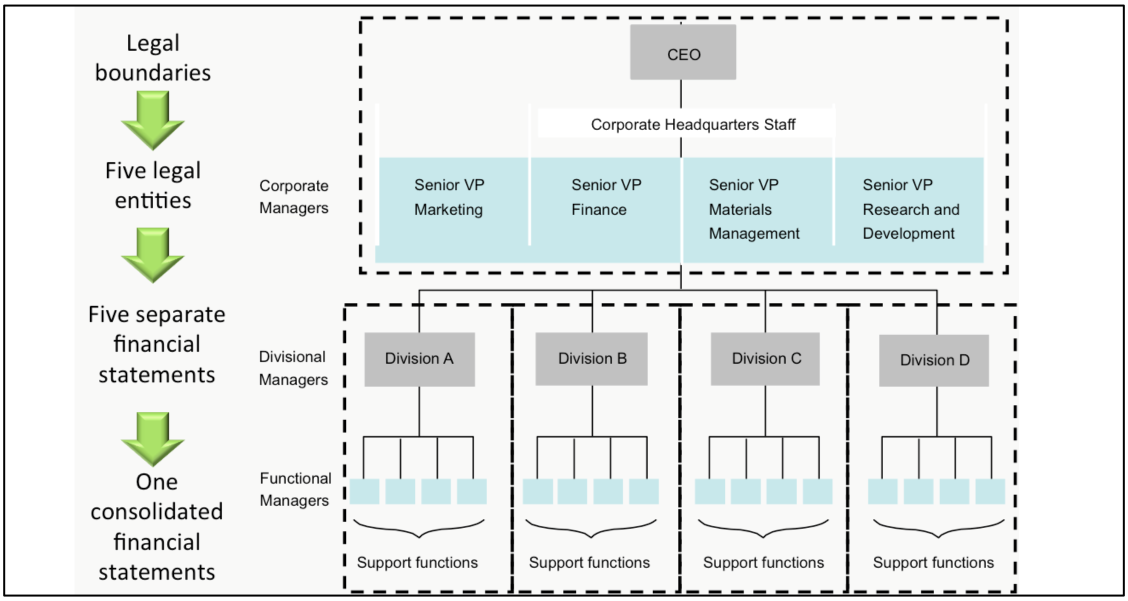
Source: Our elaboration.

In Table 136 the same organizational structure is run using five legal entities: one for the corporate headquarter (i.e. the holding company), and the others for the divisions. Since the divisional managers are employed in the subsidiaries it can be said that the holding delegates the decision making power to the subsidiaries. In other words subsidiaries are the parent company's agents (see Chapter V, § 8.3, Table 123, Hypothesis A).

Moreover, each legal entity has its own board of directors and financial statements. In addition, that group presents the consolidated financial statements in which the group is considered as a single economic entity. However, if the divisions operate in unrelated business with their own objective, we can say that they are autonomous systems. The presence of the systemic coordination and decision-making autonomy allow considering the subsidiaries as well as the holding company as *aziende*. This aspect is fundamental since each legal entity has its own legal liability and economic responsibility.

In this case, Table 136 contains one economic entity – since for the accounting standards the consolidation area delimits the boundaries of an economic entity – and five *aziende*. We also have five boards of directors and five financial statements, one for each legal entity.

Table 136 – *Five legal entities with decision-making power in the subsidiaries*

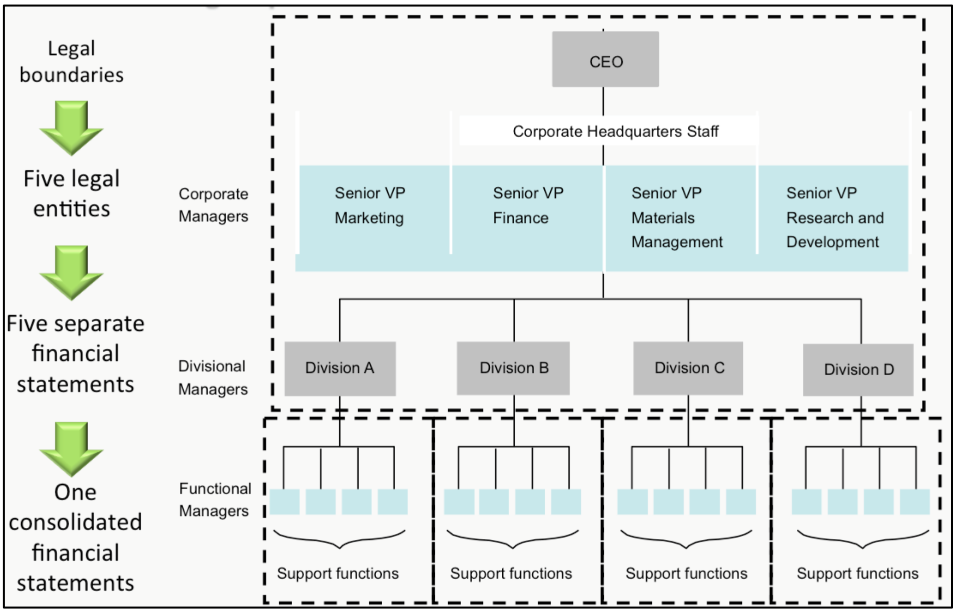


Source: Our elaboration.

Finally, in Table 137 there are five legal entities as in Table 136, however there is a relevant difference: in this case the divisional managers are employed in the holding company and they direct, from the holding company, the functional managers that are employed in the subsidiaries. Thus the holding exercises a direction and coordination activity over its subsidiaries. Since the subsidiaries do not possess a decision-making autonomy they cannot be considered as *aziende*. This aspect is fundamental in terms of legal and economic responsibilities. The subsidiaries board are not autonomous boards being directed by the holding, and for some regulation that situation allows to pierce the corporate veil (see *supra*, § 8.1), in the sense that the parent is responsible for the damage that the direction activity can cause the stakeholders of the subsidiaries. In Italy the business group regulation asks subsidiaries to disclose if they are directed by their holding company (see Chapter V, § 8.1).

Moreover, from the economic point of view the performance represented in the financial statements of the subsidiaries are strongly affected by the direction activity of the holding.

Table 137 – *Five legal entities without decision-making power in the subsidiaries*

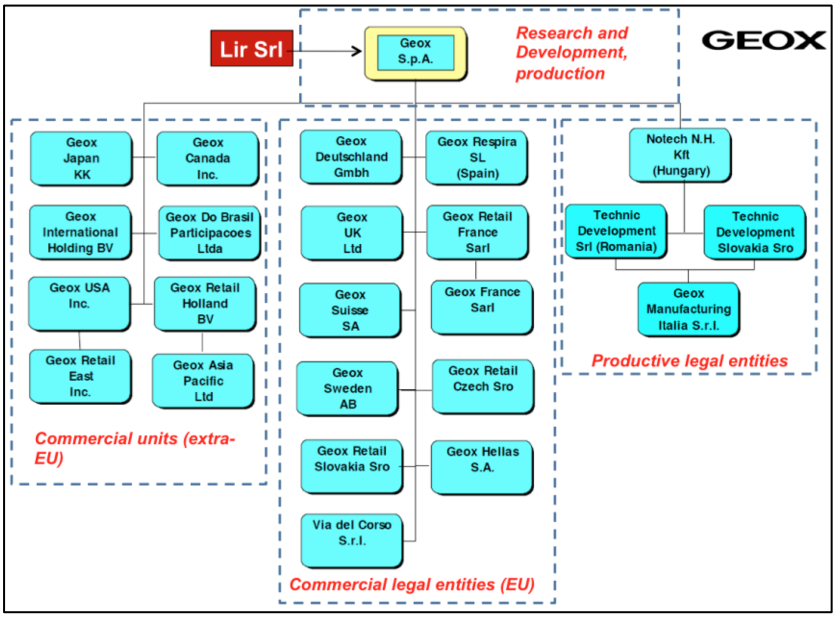


Source: Our elaboration.

Concluding there are cases where also functional managers operate in distinct legal entities, for instance when a business group create legal entities to conduct functions as finance, commercial, production, etc. all around the world.

Table 138 contains the legal entities map of GEOX group. Since the activity of the subsidiaries is strongly integrated the group can be considered as a single *azienda* with a functional structure. The commercial function is exercised using several legal entities around the world.

Table 138 – *Legal entities map of GEOX group*



Source: Our elaboration.

TODAY'S VIEW

The evidence on the environment-structure relationship helps explain why so many managers today are restructuring their organizations to be lean, fast, and flexible. Worldwide economic downturns, global competition, accelerated product innovation by competitors, and increased demands from customers for high quality and faster deliveries are examples of dynamic environmental forces.

REVIEW QUESTIONS

Following, the review questions for this Chapter.

Open-ended questions

1) Define what is meant by span of control? How has it been affected by organizational changes in recent years?
2) Describe the five bases for functional departmentalization organizational structure.
3) What are the purposes for organizing?
4) What are the differences between Mechanistic and Organic Organizations?
5) Explain how the organization's strategy, size, technology, and degree of environmental uncertainty affect organizational structure?

Multiple Choices

6) Which of the following term is not the purpose of organizing;
   - Generate higher productivity
   - Assigns tasks and responsibilities associated with individual jobs
   - Coordinates diverse organizational tasks
   - Establishes formal lines of authority

7) Which of the following term is not characteristic of Decentralization;
   - Flexibility
   - Stable environment
   - Employee empowerment
   - Geographically dispersed organization

CHAPTER SEVEN [1]

STRATEGIES

1. *Objectives of this chapter*

After reading this chapter, you will be able to:

- Define the concept of strategy
- Describe the three different levels of strategy (corporate, competitive, functional)
- Describe the relationship between strategy and organizational structure

2. *What is Strategy?*

2.1. *Definition of strategy*

Table 139 shows the strategy definitions of three leading strategy theorists: Alfred Chandler and Michael Porter, both from the Harvard Business School, and Henry Mintzberg, from McGill University, Canada. Each points to important but distinct elements of strategy.

Table 139 – *Strategy definitions*

The words '**strategy**' and '**strategic decisions'** are typically associated with issues like

[1] This Chapter is attributable to Niloofar Karzemargi.

these:

– The long-term direction of an organization.
– The scope of an organization's activities.
– *Advantage for the organization over competition*. Advantage may be achieved in different ways and may also mean different things. For example, in the public sector, strategic advantage could be thought of as providing better value services than other providers, thus attracting support and funding from government.
– *Strategic fit with the business environment.* Organizations need appropriate positioning in their environment, for example in terms of the extent to which products or services meet clearly identified market needs. This might take the form of a small business trying to find a particular niche in a market, or a multinational corporation seeking to buy up businesses that have already found successful market positions.
– *The organization's resources and competences.*[2] Following 'the resource-based view' of strategy, strategy is about exploiting the strategic capability of an organization, in terms of its resources and competences, to provide competitive advantage and/or yield new opportunities. For example, an organization might try to leverage resources such as technology skills or strong brands.
– *The values and expectations* of powerful actors in and around the organization. These actors – individuals, groups or even other organizations – can drive fundamental issues such as whether an organization is expansionist or more concerned with consolidation, or where the boundaries are drawn for the organization's activities. The beliefs and values of these stakeholders will have a greater or lesser influence on the strategy development of an organization, depending on the power of each.

Overall, the most basic definition of strategy might be 'the long-term direction of an organization'. Thus the strategy is strongly connected to the second and third attribute o the *azienda*, i.e. the decision-making autonomy and the *Economicità*, in particular the aspect of the strategic effectiveness.

Table 140 – *Strategy decisions*

Strategic decisions are about:
• The **long-term** direction of an organisation • The **scope** of an organisation's activities • Gaining **advantage** over competitors • Addressing changes in the **business environment** • Building on resources and competences (**capability**) • **Values and expectations** of stakeholders
Therefore they are likely to:
• Be **complex** in nature • Be made in situations of **uncertainty** • Affect **operational** decisions • Require an **integrated** approach (both inside and outside an organisation) • Involve considerable **change**

However, the characteristics described above can provide the basis for a fuller definition:

[2] The question 'What is strategy?' has been discussed in Whittington (1993/2000); Porter (1996, pp. 61–78); and Fréry (2006).

Strategy is the direction and scope of an organization over the long term, which achieves advantage in a changing environment through its configuration of resources and competences with the aim of fulfilling stakeholder expectations.

Therefore some implications of this definition are:

– *Complexity* is a defining feature of strategy and strategic decisions and is especially so in organizations with wide geographical scope, such as multinational firms, or wide ranges of products or services.

– *Uncertainty* is inherent in strategy, because nobody can be sure about the future.

– *Operational decisions* are linked to strategy. This link between overall strategy and operational aspects of the organization is important for two reasons. First, if the operational aspects of the organization are not in line with the strategy, then, no matter how well considered the strategy is, it will not succeed. Second, it is at the operational level that real strategic advantage can be achieved. Indeed, competence in particular operational activities might determine which strategic developments might make most sense.

– *Integration* is required for effective strategy. Managers have to cross-functional and operational boundaries to deal with strategic problems and come to agreements with other managers who, inevitably, have different interests and perhaps different priorities.

– *Relationships and networks* outside the organization are important in strategy, for example with suppliers, distributors and customers.

– *Change* is typically a crucial component of strategy. Change is often difficult because of the heritage of resources and because of organizational culture.

2.2. *Levels of strategy*

Levels of strategy inside an organization, strategies can exist at three main levels.

Corporate-level strategy is concerned with the overall scope of an organization and how value is added to the constituent businesses of the organizational whole. Corporate-level strategy issues include geographical scope, diversity of products or services, acquisitions of new businesses, and how resources are allocated between the different elements of the organization. Being clear about corporate-level strategy is important: determining the range of businesses to include is the basis of other strategic decisions.

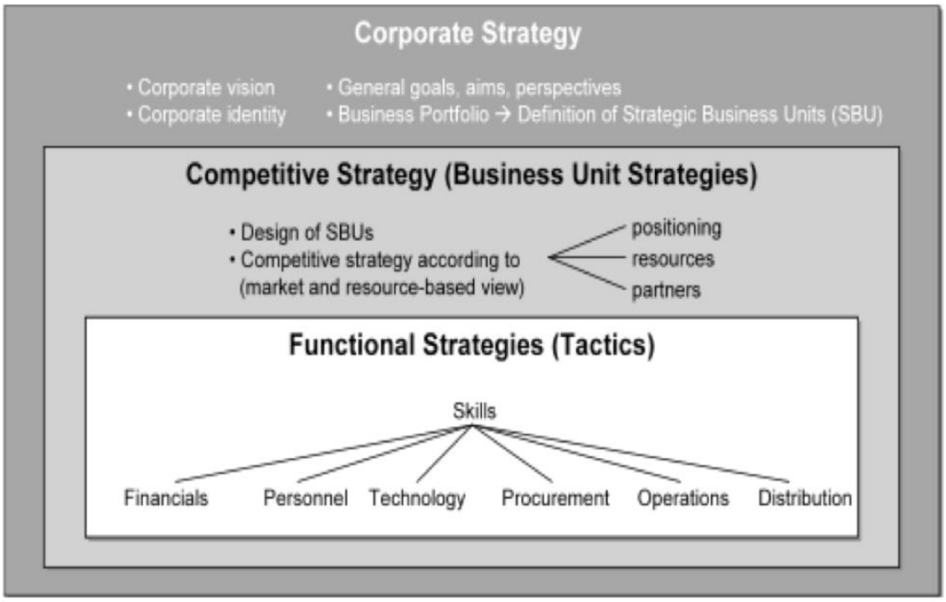
Business-level strategy is about how the individual businesses should compete in their particular markets (for this reason, business-level strategy is often called 'competitive strategy'). These individual businesses might be stand-alone businesses, for instance entrepreneurial start-ups, or 'business units' within a larger corporation. Business-level strategy typically concerns issues such as innovation, appropriate scale and response to competitors' moves. In the public sector, the equivalent of business-level strategy is decisions about how units (such as individual hospitals or schools) should provide best-value services. Where the businesses are units within a larger organization, business-level strategies should clearly fit with corporate-level strategy.

So whereas, corporate-level strategy involves decisions about the organization as a whole, strategic decisions relate to particular **strategic business units** (SBU) within the overall organization. A strategic business unit is a part of an organization for which there is a distinct external market for goods or services that is different from another SBU. Of course, in very simple organizations with only one business, the corporate strategy and the business-level strategy are nearly identical. None the less, even here, it is useful to distinguish a corporate-level strategy, because this provides the framework for whether and under what conditions other business opportunities might be added or rejected.

Where the corporate strategy does include several businesses, there should be a clear link between strategies at an SBU level and the corporate level. The corporate strategy with regard to the brand should support the SBUs, but at the same time the SBUs have to make sure their business-level strategies do not damage the corporate whole or other SBUs in the group.

Operational strategies are concerned with how the components of an organization deliver effectively the corporate- and business-level strategies in terms of resources, processes and people. In most businesses, successful business strategies depend to a large extent on decisions that are taken, or activities that occur, at the operational level. Operational decisions need, therefore, to be closely linked to business-level strategy. They are vital to successful strategy implementation.

Table 141 – *Levels of strategy*



Source: Internet

This need to link the corporate, business and operational levels underlines the importance of integration in strategy. Each level needs to be aligned with the others.

3. *Strategic management*

The term **strategic management** underlines the importance of managers with regard to strategy. Strategies do not happen just by themselves. Strategy involves people, especially the managers who decide and implement strategy. Thus this book uses strategic management to emphasise the human element of strategy.

The strategic management role is different in nature from other aspects of management. An operational manager is most often required to deal with problems of operational control, such as the efficient production of goods, the management of a sales force, the monitoring of financial performance or the design of some new system that will improve the level of customer service.

These are all very important tasks, but they are essentially concerned with effectively managing resources already deployed, often in a limited part of the organization within the context of an existing strategy. Operational control is what managers are involved in for most of their time. It is vital to the success of strategy, but it is not the same as strategic management.

For managers, strategic management involves a greater scope than that of any one area of operational management. Strategic management is concerned with complexity arising out of ambiguous and non-routine situations with organization-wide rather than operation-specific implications. This is a major challenge for managers who are used to managing on a day-to-day basis the resources they control. It can be a particular problem because of the background of managers who may typically have been trained, perhaps over many years, to undertake operational tasks and to take operational responsibility.

Strategic management can be thought of as having three main elements: understanding the *strategic position of an organization, making strategic choices for the future* and *managing strategy in action*. As this chapter is about the fundamentals of strategy, it concentrates on the first element, position.

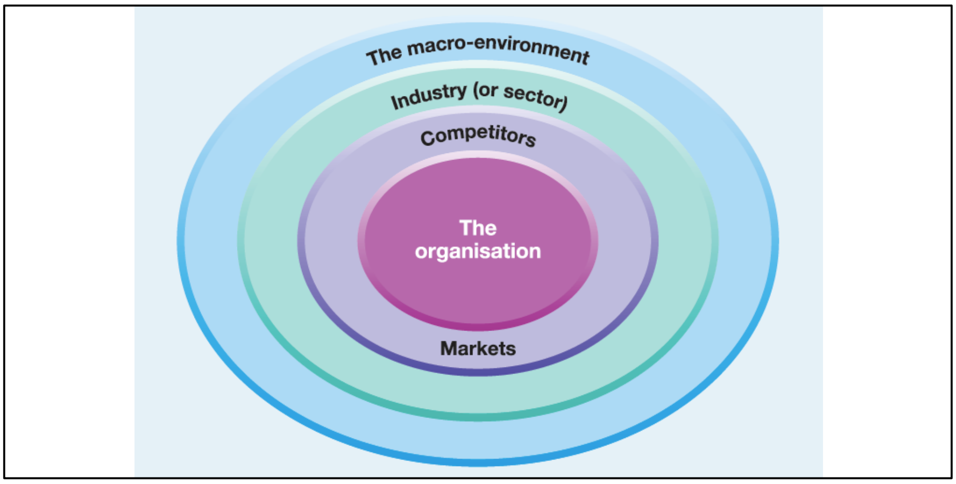
3.1. *Strategic position*

Understanding the strategic position is concerned with identifying the impact on strategy of the **external environment**, an **organization's strategic capability** (resources and competences) and **the expectations and influence of stakeholders**.

The environment. The organization exists in the context of a complex political, economic, social, technological, environmental and legal world (Table 142). This environment changes and is more complex for some **organizations** than for others. How this affects the organization could include an understanding of historical and environmental effects, as well as expected or potential changes in environmental variables. Many of those variables will give rise to opportunities and others will exert threats on the organization or both. The environment is what gives organizations their means of survival. In the private sector, satisfied customers are what keep an organization in business; in the public sector, it is government, clients, patients or students that typically play the same role. However, the environment is also the source of threats: for example, hostile shifts in market demand, new regulatory requirements, revolutionary technologies or the entry of new competitors. Environmental change can be fatal for organizations.

Assignment 23 – Chapter VI and VII

Table 142 – *The environment*



Source: G.Johnson, Fundamentals of strategy

The macro-environment is the highest-level layer. This consists of broad environmental factors that impact to a greater or lesser extent on almost all organizations; *political, economic, social, technological, environmental ('green') and legal.*

Industry, or sector, forms the next layer with this broad general environment.

This is made up of organizations producing the same products or services. Economic theory defines an industry as 'a group of firms producing the same principal product'[3] or, more broadly, 'a group of firms producing products that are close substitutes for each other' (Porter, 1980). This concept of an industry can be extended into the public services through the idea of a sector. Social services, health care or education also have many producers of the same kinds of services, which are effectively competing for resources. From a strategic management perspective it is useful for managers in any organization to understand the competitive forces in their industry or sector since these will determine the attractiveness of that industry and the likely success or failure of particular organizations within it.

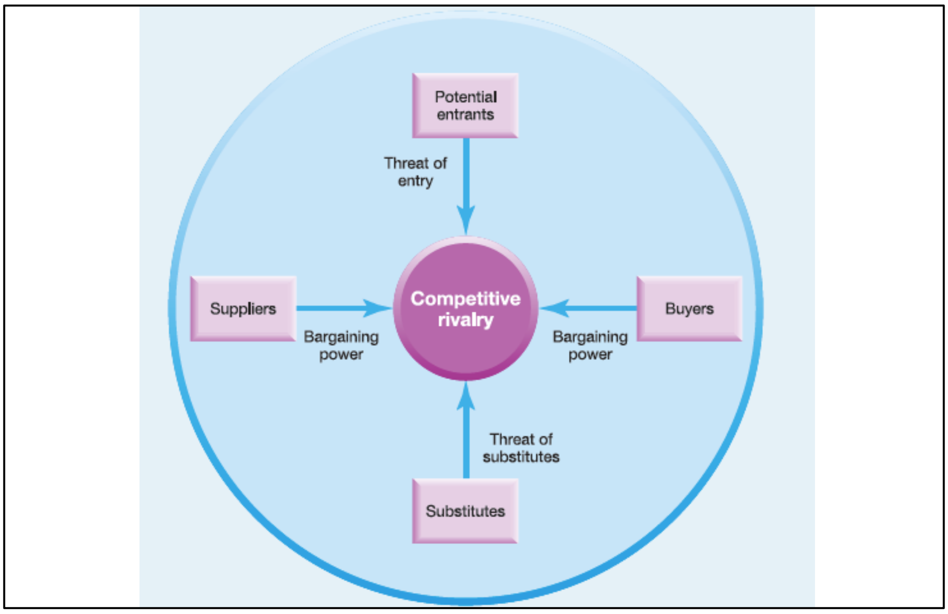
Porter's five forces framework[4] was originally developed as a way of assessing the attractiveness (profit potential) of different industries. The five forces constitute an industry's 'structure' (see Table 143).

---

[3] Rutherford, Routledge Dictionary of Economics, 2nd edition, Routledge, 1995.

[4] Porter, reference 4, Chapter 1. C. Christensen, 'The past and future of competitive advantage', Sloan Management Review, vol. 42, no. 2 (2001), pp. 105–109 provides an interesting critique and update of some of the factors underlying Porter's five forces.

Table 143 – *The five forces framework*



Source: Adapted with the permission of The Free Press, a Division of Simon & Schuster Adult Publishing Group, from Competitive Strategy: Techniques for Analyzing Industries and Competitors by Michael E. Porter.

It can provide a useful starting point for strategic analysis even where profit criteria may not apply: in most parts of the public sector, each of the five forces has its equivalents. The five forces are: the *threat of entry* into an industry; the *threat of substitutes* to the industry's products or services; the *power of buyers* of the industry's products or services; the *power of suppliers* into the industry; and *the extent of rivalry* between competitors in the industry. Porter's essential message is that where these five forces are high, then industries are not attractive to compete in. There will be too much competition, and too much pressure, to allow reasonable profits.

The strategic capability of the organization – made up of resources and competences. One-way of thinking about the strategic capability of an organization is to consider its strengths and weaknesses (for example, where it is at a competitive advantage or disadvantage). The aim is to form a view of the internal influences – and constraints – on strategic choices for the future.

Strategic capability can be defined as the resources and competences of an organization needed for it to survive and prosper. Perhaps the most basic concept is that of *resources*. **Tangible resources** are the physical assets of an organization such as plant, people and finance. **Intangible resources** are non-physical assets such as information, reputation and knowledge. Typically, an organization's resources can be considered under the following four broad categories: *Physical resources, Financial resources, Human resources, Intellectual capital.*

The efficiency and effectiveness of physical or financial resources, or the people in an organization, depends not only on their existence but also on how they are managed, the cooperation between people, their adaptability, their innovatory capacity, the relationship with customers and suppliers and the experience and learning about what works well and what does not. These are all competences, by which is meant the skills and abilities by which resources are deployed effectively through an organization's activities and processes.

Here **core competences** (Gary Hamel,1990, pp. 79–91) are taken to mean the skills and abilities by which resources are deployed through an organization's activities and processes such as to achieve competitive advantage in ways that others cannot imitate or obtain. For example, a supplier that achieves competitive advantage in a retail market might have done so on the basis of a unique resource such as a powerful brand, or by finding ways of providing service or building relationships with that retailer in ways that its competitors find difficult to imitate – a core competence.

Stakeholder expectations on an organization's purposes. Purpose is encapsulated in an organization's vision, mission and values. Stakeholders are those individuals or groups who depend on an organization to fulfil their own goals and on whom, in turn, the organization depends. An underlying issue raised by this chapter is whether the strategic purpose of the organization should be determined in response to a particular stakeholder, for example, shareholders in the case of a commercial enterprise, or to broader stakeholder interests – at the extreme society and the social good (Chapter I, § 5).

The consolidating steel industry
Five forces analysis helps understand the changing attractiveness of an industry.

For a long time, the steel industry was seen as a static and unprofitable one. Producers were nationally based, often state owned and frequently unprofitable – between the late 1990s and 2003, more than 50 independent steel producers went into bankruptcy in the USA. The twenty-first century has seen a revolution. For example, during 2006, Mittal Steel paid $35bn (£19.6bn; A28bn) to buy European steel giant Arcelor, creating the world's largest steel company. The following year, Indian conglomerate Tata bought Anglo-Dutch steel company Corus for $13bn. These high prices indicated considerable confidence in being able to turn the industry round.

New entrants
In the last 10 years, two powerful groups have entered world steel markets. First, after a period of privatization and reorganization, large Russian producers such as Severstal and Evraz entered export markets, exporting 30 million tonnes of steel by 2005. At the same time,
Chinese producers have been investing in new production facilities, in the period 2003–2005 increasing capacity at a rate of 30 per cent a year.
Since the 1990s, Chinese share of world capacity has increased more than two times, to 25 per cent in 2006, and Chinese producers have become the world's third largest exporter just behind Japan and Russia.
Substitutes
Steel is a nineteenth-century technology, increasingly substituted for by other materials such as aluminium in cars, plastics and aluminium in packaging and ceramics and composites in many high-tech applications.
Steel's own technological advances sometimes work to reduce need: thus steel cans have become about one-third thinner over the last few decades.
Buyer power
Key buyers for steel include the global car manufacturers, such as Ford, Toyota and Volkswagen, and leading can producers such as Crown Holdings, which makes one-third of all food cans produced in

North America and Europe. Such companies buy in volume, coordinating purchases around the world. Car manufacturers are sophisticated users, often leading in the technological development of their materials.
Supplier power
The key raw material for steel producers is iron ore. The big three ore producers – CVRD, Rio Tinto and BHP Billiton – control 70 per cent of the international market. In 2005, iron ore producers exploited surging demand by increasing prices by 72 per cent; in 2006 they increased prices by 19 per cent.
Competitive rivalry
The industry has traditionally been very fragmented: in 2000, the world's top five producers accounted for only 14 per cent of production. Most steel is sold on a commodity basis, by the tonne. Prices are highly cyclical, as stocks do not deteriorate and tend to flood the market when demand slows. In the late twentieth century demand growth averaged a moderate 2 per cent per annum. The start of the twenty-first century saw a boom in demand, driven particularly by Chinese growth. Between 2003 and 2005, prices of sheet steel for cars and fridges trebled to \$600 (£336; A480) a tonne. Companies such as Nucor in the USA, Thyssen-Krupp in Germany as well as Mittal and Tata responded by buying up weaker players internationally. New steel giant Mittal accounted for about 10 per cent of world production in 2007. Mittal actually reduced capacity in some of its Western production centers.

3.2. *Strategic choices*

Strategic choices involve the options for strategy in terms of both the *directions* in which strategy might move and the *methods* by which strategy might be pursued. For instance, an organization might have a range of strategic directions open to it: the organization could diversify into new products; it could enter new international markets; or it could transform its existing products and markets through radical innovation. These various directions could be pursued by different methods: the organization could acquire a business already active in the product or market area; it could form alliances with relevant organizations that might help its new strategy; or it could try to pursue its strategies on its own.
Typical strategic choices are as follows:

Business strategy. There are strategic choices in terms of how the organization seeks to compete at the individual *business level*. Typically these choices involve strategies based on *cost* (for example, economies of scale) or *differentiation* (for example, superior quality).
Crucial is deciding how to win against competitors (for this reason, business strategy is sometimes called 'competitive strategy'). The fundamental question here, then, is how should the business unit compete?

Corporate strategy and diversification. The highest level of an organization is typically concerned with corporate-level strategy, focused on questions of portfolio scope. The fundamental question in corporate-level strategy is therefore which businesses to include in the portfolio. This relates to the appropriate degree of *diversification,* in other words the spread of products and markets. Corporate-level strategy is also concerned both with the relationship between the various businesses that make up the corporate portfolio of the business and with ho the corporate 'parent' (owner) adds value to the individual businesses.

International strategy. Internationalization is a form of diversification, but into new geographical markets. It is often at least as challenging as product or service diversification. Here the fundamental question is: where internationally should the organization compete?

Innovation strategies. Most existing organizations have to innovate constantly simply to survive. Entrepreneurship, the creation of a new enterprise, is an act of innovation too. A fundamental question, therefore, is whether the organization is innovating appropriately.

Mergers, acquisitions and alliances. Organizations have to make choices about methods for pursuing their strategies. Many organizations prefer to grow 'organically', in other words by building new businesses with their own resources. Other organizations might develop through mergers and acquisitions or strategic alliances with other organizations.

4. *Business strategy*

Organization's strategy gives an idea about what the organization wants to achieve and the process how they want to achieve it. It basically includes the purpose of the entire organization, its goals and objectives as well as the plans and methods that they are considering so that they can achieve this. A strategy also involves the determination of the entire basic long term goals as well as objectives of the organization. At the same time, it adopts the courses of action that is necessary and the allocation of all the resources needed to achieve the goals. And then, here comes business strategy.

A business strategy is a report that shows the plans of the entire business. It is a plan that is often used so that they can attract financing from big investors as well as creditors. This is a plan designed to give information regarding a new venture so that they can convince financial backers to invest in the said business. It describes the market opportunities that the business intends to develop, the process on how they are going to do it and the resources that are required to make it possible.

An essential first step in business performance management is creating a business strategy which in turn sets the way forward and the parameters for business intelligence strategy or infrastructure. The creation of strategy usually involves several steps, here the most important ones are illustrated;

Setting Mission. The general notion of mission has already discussed in Chapter II, § 2. From organizational perspective, a mission is a general expression of the overall purpose of the organization, which, ideally, is in line with the values and expectations of major stakeholders and concerned with the scope and boundaries of the organization. It is sometimes referred to in terms of the apparently simple but challenging question: 'What business are we in?'

Setting Vision. A vision or strategic intent is the desired future state of the organization. It is an aspiration around which a strategist, perhaps a chief executive, might seek to focus the attention and energies of members of the organization.

Setting Goals. Goal usually means a general aim in line with the mission. It may well be qualitative in nature. On the other hand, an objective is more likely to be quantified, or at least to be a more precise aim in line with the goal. In this book the word 'objective' is used whether or not there is quantification.

SWOT Analysis. SWOT Analysis is the most renowned tool for audit and analysis of the overall strategic position of the business and its environment. Its key purpose is to identify the strategies that will create a firm specific business model that will best align an organization's resources and capabilities to the requirements of the environment in which the firm operates. In other words, it is the foundation for evaluating the internal potential and limitations and the probable/likely opportunities and threats from the external environment. It views all positive and negative factors inside and outside the firm that affect the success.

Self-Study. Mission

"Dell's mission is to be the most successful computer company in the world at delivering the best customer experience in markets we serve. In doing so, Dell will meet customer expectations of:

- Highest quality
- Leading technology
- Competitive pricing
- Individual and company accountability
- Best-in-class service and support
- Flexible customization capability
- Superior corporate citizenship
- Financial stability"

Self-Study. Vision

To find the best examples of **vision statements**, consider these statements made by some of the world's most innovative and successful companies:

Apple Computer

"We believe that we are on the face of the earth to make great products and that's not changing. We are constantly focusing on innovating. We believe in the simple not the complex. We believe that we need to own and control the primary technologies behind the products that we make, and participate only in markets where we can make a significant contribution. We believe in saying no to thousands of projects, so that we can really focus on the few that are truly important and meaningful to us. We believe in deep collaboration and cross-pollination of our groups, which allow us to innovate in a way that others cannot. And frankly, we don't settle for anything less than excellence in every group in the company, and we have the self-honesty to admit when we're wrong and the courage to change. And I think regardless of who is in what job those values are so embedded in this company that Apple will do extremely well."- Tim Cook, CEO of Apple Computer (Quoted on CNN Money.com).

PepsiCo

"PepsiCo's responsibility is to continually improve all aspects of the world in which we operate - environment, social, economic - creating a better tomorrow than today. Our vision is put into action through programs and a focus on environmental stewardship, activities to benefit society, and a commitment to build shareholder value by making PepsiCo a truly sustainable company." (Quoted from Pepsi Co.com.)

Self-Study. SWOT Analysis

SWOT summarises the key issues from the business environment and the strategic capability of an organization that are most likely to impact on strategy development. This can also be useful as a basis against which to generate strategic options and assess future courses of action.

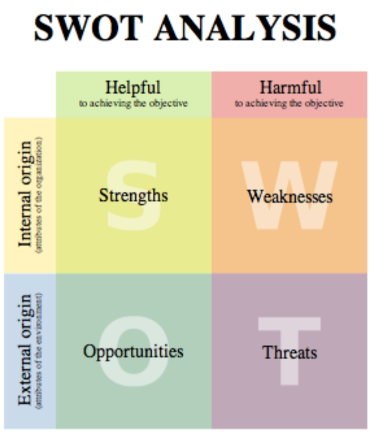
The aim is to identify the extent to which strengths and weaknesses are relevant to, or capable of dealing with, the changes taking place in the business environment.

Strengths - Strengths are the qualities that enable us to accomplish the organization's mission. These are the basis on which continued success can be made and continued/sustained. Strengths can be either tangible or intangible. These are what you are well-versed in or what you have expertise in, the traits and qualities your employees possess (individually and as a team) and the distinct features that give your organization its consistency. Strengths are the beneficial aspects of the organization or the capabilities of an organization, which includes human competencies, process capabilities, financial resources, products and services, customer goodwill and brand loyalty. Examples of organizational strengths are huge financial resources, broad product line, no debt, committed employees, etc.

Weaknesses - Weaknesses are the qualities that prevent us from accomplishing our mission and achieving our full potential. These weaknesses deteriorate influences on the organizational success and growth. Weaknesses are the factors which do not meet the standards we feel they should meet. Weaknesses in an organization may be depreciating machinery, insufficient research and development facilities, narrow product range, poor decision-making, etc. Weaknesses are controllable. They must be minimized and eliminated. For instance - to overcome obsolete machinery, new machinery can be purchased. Other examples of organizational weaknesses are huge debts, high employee turnover, complex decision-making process, narrow product range, large wastage of raw materials, etc.

Opportunities - Opportunities are presented by the environment within which our organization operates. These arise when an organization can take benefit of conditions in its environment to plan and execute strategies that enable it to become more profitable. Organizations can gain competitive advantage by making use of opportunities. Organization should be careful and recognize the opportunities and grasp them whenever they arise. Selecting the targets that will best serve the clients while getting desired results is a difficult task. Opportunities may arise from market, competition, industry/government and technology. Increasing demand for telecommunications accompanied by deregulation is a great opportunity for new firms to enter telecom sector and compete with existing firms for revenue.

Threats - Threats arise when conditions in external environment jeopardize the reliability and profitability of the organization's business. They compound the vulnerability when they relate to the weaknesses. Threats are uncontrollable. When a threat comes, the stability and survival can be at stake. Examples of threats are - unrest among employees; ever changing technology; increasing competition leading to excess capacity, price wars and reducing industry profits; etc.



Source: Wikipedia

5. *Strategies and organizational structure*

Strategy and structure have a reciprocal relationship. This relationship highlights the interconnectedness between strategy formulation and strategy implementation. Once in place, structure can influence current strategic actions as well as choices about future strategies. Regardless of the reciprocal relationships between strategy and structure, those choosing the firm's strategy and structure should be committed to matching each strategy with a structure that provides the stability needed to use current competitive advantages as well as the flexibility required to develop future advantages. This means, for example, that when changing strategies, the firm should simultaneously consider the structure that will be needed to support use of the new strategy.

There is evidence of strong correlations between business-level strategy (i.e., low-cost or differentiated) and the optimal form of organizational structure. For example, a low-cost strategy is typically used by companies that limit the size of their product line as part of their effort to remain focused on reduction of production and marketing expenses. These companies do not have to worry about managing expansive and diverse product lines nor do they typically attempt to cater to specific customer groups. They also avoid the race to be first to market with new products and generally follow a strategy of low-price imitation once competitors have established the market that reduces the need for cross-functional coordination. Because of all these factors a low-cost business-level strategy can usually be implemented and sustained with a fairly simple functional-based organizational structure. On the other hand, a differentiated strategy calls for a large product line, customization to the needs of specific customer groups, and continuous innovation with respect to product development. As such, a company pursuing a differentiated business-level strategy will generally find it best to use a more complex organizational structure, with the type of structure being driven by the factor that is more important in the company's specific differentiation strategy. For example, if product diversity is paramount the company should adopt a product division structure; if identifying and satisfying the needs of customer segments is most important than a market or geographic structure would serve the company best; and a matrix structure or product teams should be used when success depends primarily on rapid development and introduction of new technologies and products.

Companies may design their organizational structure in ways that allow them to simultaneously pursue different business-level strategies based on what the managers of a particular unit believe is best suited for the products that they oversee. It is possible for a company to create two separate product divisions and have one of those divisions pursue a differentiated strategy for its products while the other manages a group of products that will compete through low-cost business-level strategies. In many cases the products that emerge from each group will be complimentary and it may be possible to bundle them when approaching potential customers.

While there has been much discussion of creating and using organizational structures that facilitate differentiation and/or cost reduction, managers must not forget the need to satisfy the unique requirements of key customer groups. Simply put, customers don't care how companies organize their businesses, they simply want to know that contracts will be performed and expectations will be fulfilled. Business-level strategists need to be mindful of the drawbacks associated with the traditional practice of using function-based alignments of people and other resources (e.g., sales and marketing, procurement, or manufacturing departments). While using functions as the primary dimension when organizing a company's business activities can be useful in achieving the benefits of task-based specialization, including the development of function-based core competencies, and can result in substantial savings through economies of scale, it also can quickly become a hindrance in developing new products and services if a functional department continues to focus on its own goals and ignores the need to cooperate with other departments in order to deliver the new product or service to customers at the lowest price and highest level of quality. For example, the procurement department may decide to purchase the raw materials for a new product from a particular vendor because the vendor provided the lowest price and this fits the specific goals and budget of that department. However, if the materials turn out to be defective that means that other departments, such as manufacturing and technical service, will be forced to "overspend" in relation to their budgets to make up for the decision made by the procurement department. At the end of the day the entire project may be delayed and over budget even though the procurement department achieved its budget goals.

Companies must not forget that customers do not care whether the procurement department meets it budget objectives nor do they care whether other departments had to work overtime in order to overcome problems created by bad decisions made elsewhere in the organizational structure. Moreover, customers are not interested in paying for extra costs that arise because companies don't push their departments to cooperate with one another. Companies need to bring all departments on to the "same page" in the development process. One way to do this is to carefully evaluate and define the "flow" for the development and commercialization of a new product or service as it moves throughout the company. The goal is to determine which functional departments will need to be involved and when decisions that will impact more than one department will need to be made. Companies should then make sure that a cross-functional team is put in place to manage the process and make decisions with an eye toward the greater good of the company rather than specific departments. As part of this process, incentives should be created for each department to cooperate and collaborate with other departments. When dealing with significant customers—customers that are expected to provide a large percentage of the projected sales in a particular market—consideration should be given to bringing them directly into the organizational design process to get their views on what the ultimate goals for both parties should be in managing the relationship.

6. *Strategic decision-making*

Strategic issues are ultimately decided upon in many ways. Success and failure are not always rational. There is the *sunflower syndrome*, the tendency (like sunflowers following the sun) to follow the lead of the most senior person in the decision-making process, or to try to anticipate their view even before they have expressed it. Decision makers often hold exaggerated opinions of their competence, leading to over-optimistic decisions, especially where there is little data available. At the same time, they can be risk averse, being unduly deterred by substantial downsides, even when the chances of such downsides are very slight.

Katherine Eisenhardt's research on strategic decision making in fast-moving environments suggests four helpful guidelines for managers (K.M. Eisenhardt, 1990, pp. 39–54):

– Build multiple, simultaneous alternatives. Having several alternatives on the table at the same time helps to encourage critical debate. This can help counter phenomena such as champion's bias and the sunflower syndrome. It is also faster than taking proposals sequentially, where alternatives are only sought out after a previous proposal has been examined and rejected. Examining multiple, simultaneous alternatives is a practice adopted by Barclays Bank, for example, where the rule is that proposals should never be presented in isolation, but always alongside at least two other alternatives (M. Mankins, 2004, pp. 58–65).

– Track real-time information. Eisenhardt's research found that fast decision makers do not cut back on the amount of information; they use a different type of information – real-time information. These managers prefer immediate information from current operations, rather than statistical trends and forecasts. They tend to spend a lot of time in face-to-face meetings, 'managing by wandering around' and reviewing the most up-to-date indicators, such as weekly and even daily measures of sales, cash, stocks or work-in-progress. In fast-moving environments especially, a quick decision may be better than a delayed decision, and trend data is liable to be rapidly outdated anyway.

– Seek the views of trusted advisors. Experienced managers in the organization or sector can provide fast feedback on what is likely to work or not work based on their deep knowledge from the past. They can also ask tough questions given what they have seen before. The instincts of experienced managers are faster, and often both more reliable and more credible, than lengthy analysis undertaken by junior managers or consultants.

– Aim for consensus, but not at any cost. Fast decision makers seek consensus amongst the decision-making team, but do not insist on it. Consensus can be too slow and often leads to mediocre choices based on the lowest common denominator. Fast decision makers recognise that debates cannot always be resolved to everybody's satisfaction. Eisenhardt's advice is that the CEO or other senior person should have the courage at a certain point simply to decide. Having had the chance to voice their position, the responsibility of other managers is to accept that decision as final and to get on with implementation.

Strategy as a job

Most attendants of this course will have to engage with strategy to some extent or another. Strategy is not just the preserve of top management. Middle and lower level managers have to work within their organization's strategy, meeting the objectives set by the strategy and observing the constraints. Managers have to communicate strategy to their teams, and will achieve greater performance from them the more convincing they are in interpreting it. Indeed, middle and lower-level managers can increasingly play a part in shaping strategy.

Being able to participate in an organization's 'strategic conversation' – engaging with senior managers on the big issues facing them – is often part of what it takes to win promotion (Westley, 1990).

Strategy, then, is part of many managers' ordinary jobs. However, there are specialist strategists as well, in both private and public sectors. Typically requiring a formal business education of some sort, strategic planning is a potential career route for many readers, especially after some operational experience. Strategy consulting has been a growth industry in the last decades, with the original leading firms such as McKinsey & Co., the Boston Consulting Group and Bain joined now by more generalist consultants such as Accenture, IBM Consulting and PwC, each with its own strategy-consulting arm.[5] Again, business graduates are in demand for strategy consulting roles.[6]

[5] The major strategy consulting firms have a wealth of information on strategy careers and strategy in general: see www.mckinsey.com; www.bcg.com; www.bain.com.

[6] University careers advisers can provide good advice on strategy consulting and strategic planning opportunities. See also www.vault.com.

REVIEW QUESTIONS

Following, the review questions for this Chapter.

Open-ended questions

1) What is the definition of strategy and explain what strategy decisions are about?
2) Describe the three levels of strategy.
3) Explain the impact of external environment, an organization's strategic capability (resources and competences) and the expectations and influence of stakeholders on strategy position.
4) Explain the relationship between strategy and organization structure.
5) Why managers need to understand competitive forces? And explain how managers use Porter's model for strategic analysis.

Multiple choices

6) The strategic capability of on organization is made up:
   - Resources and competences
   - Tangible resources
   - Intangible resources
   - Core competences of organization

7) Strategy choices involve:
   - Strategic methods
   - Strategic directions
   - Strategic methods and directions
   - None

ANNEXES

Table 144 – Abbreviation title of partnerships and corporations

Italy		
SNC	Società in Nome Collettivo	General Partnership
SAS	Società in Accomandita Semplice	Limited Partnership
S.R.L.	Società à Responsabilità Limitata	Private Limited Company
S.p.A.	Società per Azioni	Public Limited Company
SApA	Società in Accomandita per Azioni	Limited partnership with shares
Spain		
Ltda.	Limitada	Limited
Cía.	Compañia	Company
S.A.	Sociedad Anónima	Public Limited Company
S.C.	sociedad en commandita	General Partnership
S.C.A.	Sociedad en Comandita por Acciónes	Limited Partnership
SNC		General Partnership
S.R.L.	Sociedad de Responsabilidad Limitada	Private Limited Company
France		
E.U.R.L.	Enterprise Unipersonnelle à Responsabilité Limitée	Sole Partnership with Limited Liability
S.A.	Société Anonyme	Public Limited Company
S.A.R.L.	Société À Responsabilité Limitée	Private Limited Company
SA	Société Anonyme	Limited Company
SC	Société civile	Partnership with full liability
SCS	Société en Commandite Simple	
SNC	Société en nom collectif	General Partnership
sp	Societe en participation.	
United Kindom		
Ltd.	Limited Company	(Limited Company)
Plc.	Public Limited Company	(Public Limited Company)
United States		
LLC	Limited Liability Company	(a kind of personal company)
LLP	Limited Liability Partnership	Limited Liability Partnership
Ltd.	Limited Company	Limited Company - same as Inc. in USA
N.A.	National Association	National Association
Corp.	Corporation	(Public Limited Company)
Inc.	Incorporated	(Limited Liability Company)
Germany		
A.G.	Aktiengesellschaft	Joint Stock Company
Ges.	Gesellschaft	Company
G.m.b.H.	Gesellschaft mit beschränkter Haftung	Company with limited liability
Handelsges.	Handelsgesellschaft	Trading Company
K.G.	Kommanditgesellschaft	Limited Partnership
KGaA	Kommanditgesellschaft auf Aktien	Limited Partnership with shares
Komp.	Kompagnie	Company
OGH	Offene Handelsgesellschaft	Partnership
Luxembourg		
SA	Société Anonyme	Limited Company
S.A.R.L.	Société À Responsabilité Limitée	Private Limited Company
SENC	Société en Nom Collectif	General Partnership
SOPARFI	Société de Participation Financiére	Holding Company
Norway		
AS	Aksjeselskap	Limited Company
ASA	Allmen Aksjeselskap	Public Limited Company

DA	Selskap med delt ansar	Limited Partnership
KS	Kommandittselskap	Limited Partnership
Finland		
Ky	Kommandiittiyhtiö	Limited Partnership
OY	Osakeyhtiö	Limited Company
OYJ	Julkinen Osakeyhtiö	Public Limited Company
Sweden		
A/B	Aktiebolaget	Joint Stock Company
H.B.	Handelsbolaget	Trading Company
HB	Handelsbolag	Trading Partnership
Kb	Kommanditbolag	Limited Partnership
Denmark		
A/S	Aktieselskabet	Joint Stock Company
I/S	Interessentskab	General Partnership
K/S	Kommanditselskab	Limited Partnership
KA/S	Kommanditaktieselskab	Limited Partnership with Share Capital
Netherlands		
B.V.	Besloten Vennootschap	Private Limited Company
C.V.	Proprietary Commanditaire Vennootschap	Limited Partnership
CVoA	Commanditaire Vennootschap op Andelen	Limited Partnership with shares
N.V.	Naamloze Vennootschap	Limited Company
VOF	Vennootschap onder firma	General partnership

Special Content

CRIMINAL ORGANIZATIONS [1]

1. *Introduction*

The aim of this section is to deepen the tie that binds organized crime and economic activity, with a special emphasis on the business entities that take advantage of it. The two concepts borrowed from the Italian doctrine Economia Aziendale (Chapter I, § 6), the *azienda* and the *aziendality* are here applied for the first time to *criminal economic entities* in order to better understand their economic role in our society. Than we move from the *primary interest of the azienda as common good* theory to the primary interest of a criminal economic entity, proposing an hypothetical "criminal" mission model.

2. *Irresponsible economic activity*

Any firm that «*believes it does not have to answer to any public or private authority and public opinion, concerning the economic, social and environmental consequences of its actions apart from legal requirements*» (Gallino, 2005) is said to be managing its economic activity *irresponsibly*. This definition appears to be strictly bound to the idea of *corporate social responsibility*, according to which corporations are not only *economic and legal persons*. They are also *social institutions* whose activities interest the whole community [2] under two different profiles: first, firms should not harm society and should work according to the law; second, they should directly contribute to social well-being, as they are autonomously able to pursue aims and make the right decisions (D'Orazio, 2003). The behavior and type of governance adopted by firms influence the social system, especially when it concerns large firms whose irresponsible activity produces effects on a large scale. Therefore, firms behave irresponsibly when they exclude the interests of employees, local communities, suppliers, the State and the environment from its decisional and operative horizon. Unethical firms are not necessarily irresponsible: for example, a business which works in the field of gambling cannot be deemed ethical, considering the social impact of the addiction to which its service leads (Salaber, 2007); yet, this does not implicate that the business itself is irresponsible. On the other hand, «*a business (…) could have an ethical subject (e.g. the production of linens) and yet be irresponsible, if it engages in unethical conduct towards its stakeholders*» (Di Carlo, 2009). The border between ethicality and responsibility can thus be outlined in reference to two different parameters: *ethicality* refers to the subject of production, while *irresponsibility* refers to the firm's goals, which translates to damaging conclusions for the community.

---

[1] The author of this chapter is Gian Marco D'Urso.

[2] According to Gallino (2005), large firms weigh on environmental quality and conform our society's values, influencing areas such as law, taxes, education, communication, sports, families, religious organizations through different kinds of lobbies, ecological practices, advertising and financial support from associations and political parties.

Irresponsible behaviors have considerable social fallouts (the so-called negative externalities [3]) and are attributable to a plurality of persons involved, on different levels, in the firm's activities (e.g. clients, sponsors, users). Criminal firms are the direct progeny of irresponsible firms, since they involve illegal practices which are not only against the law, but they are also closely linked to organized crime or instituting a crime themselves. A responsible firm that generates value for the community should be able to operate a balancing between *shareholders' interests* in the short term and other *stakeholders' interests*. Contrariwise, irresponsible firms only tend to create value for themselves, to detriment of stakeholders. Furthermore, the cost of irresponsible behaviors appears not to be sustainable in the long term, affecting *durability* and the survival capabilities of the economic entity: on one hand, behaving responsibly would be more convenient in order to create a shared value with stakeholders (Porter and Kramer, 2011); on the other hand, it is also true that responsible behavior should be accompanied by the pursuit of a profit, in order to assure firm's survival and development (Beretta Zanoni, 2007).

Irresponsible firms may survive longer than responsible ones because they present easier conditions to reach to be *durable*. Moreover, irresponsible entities are facilitated by responsible firms often being crushed by the weight of the unfair competition. Responsible behavior certainly seems more convenient, when compared to irresponsible behavior, if firms work in a legit framework in which regulations tend to punish illegal practices. Therefore, legislator's actions are determinant in order to favor the creation of values and promoting righteous practices for the entire community well-being, by reassuring adequate repression mechanisms for irresponsible conducts.

3. *Shadow economy*

Revenues originated from the production of goods and services, which are subtracted from the Public Administration's direct observation and control (deliberately done in clear violation of tax regulations – *fiscal submersion* – or in inobservance of social security and labor law – *labor submersion*), end up increasing the so-called *shadow economy*. Indeed, according to Smith (1994) «*the shadow economy includes any market-based production of goods and services, whether legal or illegal, that escapes detection in the official estimates of GDP*».

The remuneration which is derived from an illegal activity flows into the *shadow economy* as much as the remuneration which is derived from a legal activity in the case it is not declared. The distance between the two cases is in the different repercussions they have on free market and in the different measures necessary to contrast the phenomenon [4]. The *shadow economy*, just like the darkest and deepest of containers, encases the *illegal economy*, which is based on the production of goods and services whose sale, distribution and possession are forbidden by criminal law provisions and the performance of activities by non-authorized personnel [5]. Inside *illegal economy,* another subset can be identified: the so-called *criminal economy*. The latter

---

[3] These are described by Bakan (2004) as «*transaction's effects on a third party who has not agreed nor taken part in the transaction itself*».

[4] An illegal activity that eludes the "rules of the game" does not necessarily damage competitive market as much as a legal activity does when relying on tax evasion or irregular labor. In a similar manner, illegal activities cannot be compared to legal activities in terms of damage caused to stakeholders and civil society.

[5] An example could be the phenomenon of unauthorized activities in health professions carried on for years without possessing any license.

involves activities that are prohibited by law and that can cause social alarm, such as drug trafficking, prostitution and extortion rackets (Di Amato, 2011). The *criminal economy* occupies a parallel market in which firms and persons who belong to organized crime often find the connivance of other economic operators, such as entrepreneurs who prefer to interact with the organized crime rather than seeking justice or contrasting it (Di Gennaro, 2013). After all, the intimidating pressures of organized crime may sometimes even lead honest entrepreneurs to sell their company to the underworld, which will transform their entities in a proper criminal company mainly used to reinvest and launder money which comes to activities such as extortion, smuggling, usury and counterfeiting (Santonastaso, 2014). The two markets – the legal and the criminal one – constitute different systems, but that are so closely linked that it is impossible for one of them not to condition the other (Di Gennaro, 2013). The integration between legal and criminal economy happens when revenues from illicit activities are laundered or invested in other criminal firms, reinserting them in the official financial circuit later on (cfr. Fantò, 1999). As for statistical surveys, the *shadow economy* remains difficult to quantify, since it includes all the non-directly observable economic activities, including those legal activities that are not registered because of inefficiencies in data collection systems (known as *statistic submersion*). Yet, this remains a matter of great importance. According to conservative calculations coming from *Confcommercio* [6], Italy's *shadow economy* stands for 272 billion of Euros a year (around 17% of its GDP[7]).

A method that can be used to obtain an economic estimate of the non-observable economy, as suggested by many authors, is *Currency Demand Approach (CDA)*: an economic estimation model which is largely used in literature, based on the realistic hypothesis that off-the-books transactions are mainly regulated by cash in order to avoid traceability[8]. The model is thus based on an econometric estimate of the excess cash demand with respect to the preference for the standard liquidity, attributable to a clear decision to carry out irregular transactions so to avoid any kind of monitoring as well as tax and social security requirements provided for by the legal framework. Profound connections between illegal activities, linked to organized crime, and shadow economy have been underlined several times (lastly by La Spina, 2013). The volume of drug trafficking, which is controlled by clans and families belonging to organized crime, are progressively expanding thanks to the increase in consumer demand.

The operations of the Italian criminal police, which have led to arrests and seizures, have not brought any visible improvement to the situation, as national anti-mafia attorney general Pietro Grasso noticed in 2010: «*the replacement of traffickers is promptly assured, clans dispose of infinite human capital; traffickers aren't necessarily associated with them, in fact they are preferably external to the clan and almost always able to escape payment mechanisms and procedures using intermediaries and channels of money laundering*». As Grasso observes, regulations appear to be inadequate in order

[6] '*Confcommercio – Imprese per l'Italia*' is a confederation of companies, professionals and autonomous workers and is the largest corporate representation in Italy, associating over 700,000 companies in the country (*www.confcommercio.it*, 2016).

[7] From the report on *shadow economy* by *Confcommercio*, presented during the "*Tasse...Le cambiamo?*" convention held in Rome on July 25 2013 and organized by the same association.

[8] This is the most used method, introduced by Cagan (1958), later perfected by Tanzi and more recently resumed by Schneider. «*Such an approach is based on the assumption that submerged transactions happen through cash, which is the only type of payment to grant anonymity […]. To isolate the excess of cash allocated by for submerged economy one estimates the demand equation for currency, which explanatory variables are some of the causes of black economy and control variables are factors such as interest rate, income and payment technology*». From "*Metodologie di stima dell'economia sommersa*" report, by Banca d'Italia (2015).

to solve such a big problem, since «*the disproportion between the richness and complexity of the law and the results that were actually achieved on the neuralgic field of repression of illicit sinking funds, along with their use for the purpose of infiltrating the legal economy, is quite evident*». As seen so far, the shadow economy is a proper "*system*" which can only be fought by adopting measures recognized by law (they may be personal, on capital, based on prevention, seizure or confiscation) and strategies to trace financial flaws. However, these means have not always revealed themselves to be decisive, mainly because of the uncertain boundaries of the "*system*" itself.

4. *Criminal economic activity*

In the second half of the past century, criminologist Edwin Sutherland (1986) complained about the scarce consideration that scholars seemed to have towards criminal economic activity. He stated: «*Economists are experts in matters which concern business, but they are not used to consider them from a criminal relevance point of view; at the same time, most sociologists take into consideration criminality, but not the kind that concerns the world of economics*». At the moment, as this paper confirms, the big picture seems to have changed in favor of a larger interest of the economic literature towards the phenomenon of criminality, in the broader sense. Moreover, economic crimes are not necessarily committed by traditional organized crime. See, for example, the so called "*white collar criminality*" (Maltz, 1976), a complex of misconducts committed in the exercise of lawful economic activities by persons who operate in private or public business sectors.

Since the field survey is certainly broad, it is due to specify that in this text the study will be mainly focused on the economic activities which are carried out (and controlled) by organized crime, which *«is an association between people with criminal intents, but also organizational formulas that often assumes the shape of a company, first of all*» (Bini, 1977).

5. *Organized crime*

We can define *organized crime* as a form of associated delinquency which assumes the presence of a stable organization made by several individuals in order to commit criminal actions used to obtain, directly or indirectly, financial or monetary advantages. In Italy, the term mainly indicates most structured criminal organizations, such as the historical *mafia,* the *camorra,* the '*ndrangheta* or the *sacra corona unita.* The phenomenon has reached such an importance that it represents an autonomous reality that deserves to be distinguished from other kinds of delinquency. The main fact to observe is that several forms of organized crime appear as proper criminal "*counter powers*", on an external and competitive basis with respect to the.

The other fact to take into consideration is that these large entities live and operate within the *legal system*, through political parties, local administrations, some sectors of the institutional apparatus and banking system (a clear example of this tendency has been the Italian case of the "*Loggia P2*"[9]).

---

[9] The *Propaganda 2*, better known as *P2*, was a masonic lodge operating in Italy. Some of its components were investigated for political conspiracy, espionage, false claims and attack towards the Italian constitution.

The criminal activity is always more and more based on a series of international and intercontinental trafficking, in which the single *territorial entity* appears often as a small segment that, both upstream and downstream, makes use of the complex chain of complicit relationships. Indeed, there are more and more cases of *inter-mafiosity*[10]: this happens particularly in Eastern Europe, the Balkans, Asia, Northern Africa and Latin America where these fellowships are especially active in the sectors of clandestine immigration, trafficking in human beings, pimping and drug smuggling[11]. The latter clearly exemplifies the complexity of modern criminal activities, since the refining and smuggling of narcotics (generally managed locally by illicit organizations) are just a part of a process which mainly takes place in different places and includes – apart from the narcotics production – a money laundering process which largely involves lawful economic activities displaced significantly far away from the traditional territorial coverage of mafia clans (Lupo, 2013).

About its structure.
Before the Second World War, in the traditional mafia, the boss's power depended on his ability to attract a more or less permanent group of people who were linked to him through a heterogeneous range of relationships, which was never made up of more than fifteen to twenty acolytes. The contemporary, entrepreneurial mafia consists of a series of vast groups of individuals (which sometimes include 70-80 male elements for each group) with a central core made up of one or more extraordinarily numerous biological families (Arlacchi, 1983). And also in these cases, family relationships progressively took over Italian organized crime, but it did not prevent it from developing semi-formal institutions designed to avoid and control internal conflicts.

About its territorial control. Criminal associations try to establish a business turnover and a certain degree of social tolerance. In most cases, these organizations exert their control power over a certain territory (a district, for example, where the typical activity is racketeering[12]). The social tolerance in these territories often implies institutional tolerance (Lupo, 2013). A classic, notorious example is the *Prohibition era* in the United States: in 1920, a law prohibited consumption and trade of alcoholic beverages, creating the perfect space for smuggling which, by many law-abiding citizens, politicians, administrators and even police officers, was not even considered as a reprehensible activity. Once *criminal organizations* obtain control of a territory, they forge strategic business alliances or, alternatively, they start to expand and begin to embezzle revenues of other existing legal or illegal businesses. Indeed, this kind of economic activity not only has to face the risk of fighting against the law, but also the risk of competing with other ruthless criminal businesses. This is why they need a certain control on both the legal and the illegal economy where they operate (Rey, 1995), through external supporting actors.

---

[10] Consolidated collaboration between endogenous and foreign mafia-like organizations (*Enciclopedia Treccani*, 2011)

[11] The phenomenon of "*inter-mafiosity*" requested an international judicial effort and cooperation: from 1993 to 2006, when the first UN *Convention on transnational organized crime*, an important harmonizing instrument between different national judicial systems, was ratified in the Italian city of Palermo.

[12] The word "*racket*" spread in the United States after the First World War to define a perverse relationship between criminals and other persons (such as entrepreneurs, politicians or police officers) who are necessary for the organized crime's development and prosperity (Witwer, 2004).

About its activites. It is necessary to distinguish between different types of criminal economic activities:

a) ***Production of goods and services prohibited by law***. It is a "crime without a victim", since it answers to an existing demand from legal consumers and therefore is a «*voluntary exchange […] of goods and services which are strongly demanded but legally prohibited*» (Shur, 1965). These activities are controlled and managed by organized crime through smaller criminal groups operating on a territorial level as "satellites". They follow a pyramidal construction that let them lower costs and increase profits, while avoiding of directly managing these activities. In this way, organized crime controls vast territories, through a pervasive and lasting ramification that can create a sort of equilibrium between criminals and non-criminal economic operators (Mezzanti and Rago, 2012).
b) ***Redistribution in revenue between involved subjects*** such as theft, extortion, robbery, fraud and corruption.
c) ***Formally legal activities, practiced by criminal subjects or with capitals of criminal origin***. This is the case of criminal infiltrations in legal economy, and it may happen for several different reasons. Some of these are «*the necessity of masking a criminal activity or giving the boss social legitimation; the search for annuity investments; […]; the need to support territorial control by providing the population with income opportunities; the convenience, deriving from the availability of illegal profits, to intervene in legal markets that can be monopolized […] and managed through extortion*» (Becchi and Rey, 1994).

Intersection between Organized Crime and Business activity. In the past, organized crime did not consider business to be a directly profitable instrument because of the direct related risks of starting and managing a company. Both these risk profiles were particularly insidious because of administrative and commercial requirements not always possessed by criminals involved in the business. Indeed, mafia-like organizations used to address intimidating pressure at owners of already established companies, who became victims subjected to their power, forced to pay a share of their profit: the so-called "*protection money*"[13] ("*pizzo*" in Italian). Therefore, the ***victim-entrepreneur's*** exercise of his legal economic activity becomes a means of profit for the criminal organization and it is used as way of gaining illicit profits. This system has also consequences for the entrepreneur, who has to address the production cost determined by profit loss caused by "*protection costs*", as well as suffering the extortion itself. Therefore, he often has to resort to illegal means, such as changing/recording transactions that simply never happen, in order to justify the loss of money in his balance sheet. Another, different role is the one of the ***conniving entrepreneur***, who pays a share of his profits to the organized criminality, but gets "*market" protection* for his activity in exchange, for example by winning contracts "driven" by criminal groups. This subject represents a pathological evolution of the extortive relationship.

It consists of a proper favors exchange that allows both parties to obtain economic benefit: the *conniving entrepreneur* inevitably increases his profits and, in turn, he feeds the criminal organization (Giordano, 2015). This behavior may obviously lead to a crime called *"collusion with mafia*" (*concorso esterno in associzione mafiosa* in Italian), which indicates sharing the crime of

[13] This phenomenon, still widespread in the southern regions of Italy, allows organized crime to use intimidation and violence as well as threats of serious repercussions in case business owners oppose to the payment of "*pizzo*", to convey a percentage of legal companies' profits to their criminal partnership.

"*mafia association*", punished by art. *416-bis* of the Italian Penal Code. The last case is the ***criminal entrepreneur,*** owner of a company that manages capital deriving from illegal proceeds directly conferred by the criminal organization itself. The *criminal entrepreneur* drives a particular type of company which plays a lawful economic, commercial or financial role while controlled by a criminal organization. This role spread during the '90s, thanks to administrative procedures simplifications and the ability to easily control investments in foreign markets, favoring infiltration of organized crime in entrepreneurial activities. Criminal enterprises give the possibility of profit maximization, reducing risks and eliminating competitors, who result in being disadvantaged since the crime, thanks to its intimidation power, can weaken them to death. There are different entrepreneurial models which are used within criminal organizations, as long as they present the characteristics of *flexibility* – the ability to allow short-period variations of the methods used to intervene in the market and in its own strategic objectives, while keeping strong the territorial monopoly that represents a proper, stable and lasting advantage (Falcone, 1991). These models are structured on different levels by involving various affiliated family groups to constitute an entity, immune from external aggressions. Furthermore, they diversify "affairs" in order to keep a separation between the criminal and the legal aspects within the activity. In this way they do not leave any traces while involving subjects who would otherwise reluctantly accept any form of cooperation with criminals. There are three types of criminal enterprises (Fantò, 1999):

- ***The legal-criminal enterprise***: the formal owners are associated with the criminal organization; the competitive method is based on intimidation; the capital is result of a criminal activity. Produced goods are lawful and activity is registered with a *legal form.*
- ***The illegal-legal enterprise***: the capital is a result of criminal activity and the *de facto* owner is associated with the criminal organization, while the titular is a person who apparently is extraneous to organized crime; he manages the enterprise following legal criteria and acting in accordance with market rules.
- ***The legal-illegal enterprise:*** formally lawful enterprise which cooperates with organized crime. The illegality of this enterprise consists of the presence of common interests, shareholders (often *de facto)* and both legal and illegal capital. A typical crime profile called "*enterprise with mafia participation".*

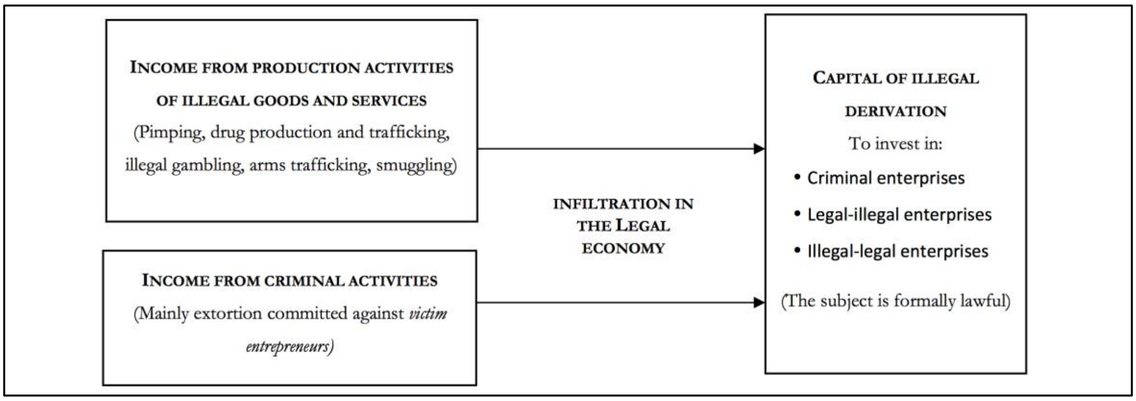
Table 145 – *Types of criminal enterprises*

ENTERPRISE	**DE FACTO OWNER**	**FORMAL OWNER**	**CONDUCT**	**CAPITAL**
Criminal	Criminal organization	Criminal organization	Intimidating method	Criminal origin
Illegal-legal	Criminal organization	Dummy agent	Market rules	Criminal origin
Legal-illegal	Participation of the criminal organization	External person	Market rules	Criminal or legal origin

Source: *personal elaboration*

It is important to notice that in all the above mentioned company types, economic activity is strictly legal, thus going back to the hypothesis of "*organized crime infiltration*" within the "*white economy".* Criminal organizations' capability of undertaking economic initiative can also be extended to at least two other cases of entrepreneurship, constituting a sort of evolution of the *conniving entrepreneur*: the **first case** is represented by an entrepreneur, formally extraneous to the criminal organization, who establishes relationships of convenience with it, accepting the services it offers and returning the favor with other services or with complementary activities, such as hiring labor force; the **second case** sees the entrepreneur establishing sporadic relationships with the criminal organization just to transact specific affairs. In both cases, there is no trace of traditional forms of competition. Intimidation, also, has nothing to do with the principle of contractual freedom. Through violence and threats, "*mafia-ran*" companies obtain factors of production at lower prices and intercept forms of immediate supply, ensuring *ex ante* contract awarding procedures, commissions or big sales without any interaction with competitors, who often obliged to either withdraw or to not submit a tender at all. In addition, almost unlimited financial resources[14] allow criminal enterprise to have no credit costs related to financing, carrying an impressive competitive advantage. In conclusion, we can reduce the relationship between illicit activities (as mentioned in the opening paragraph), legal economy and criminal economic activities with the following table.

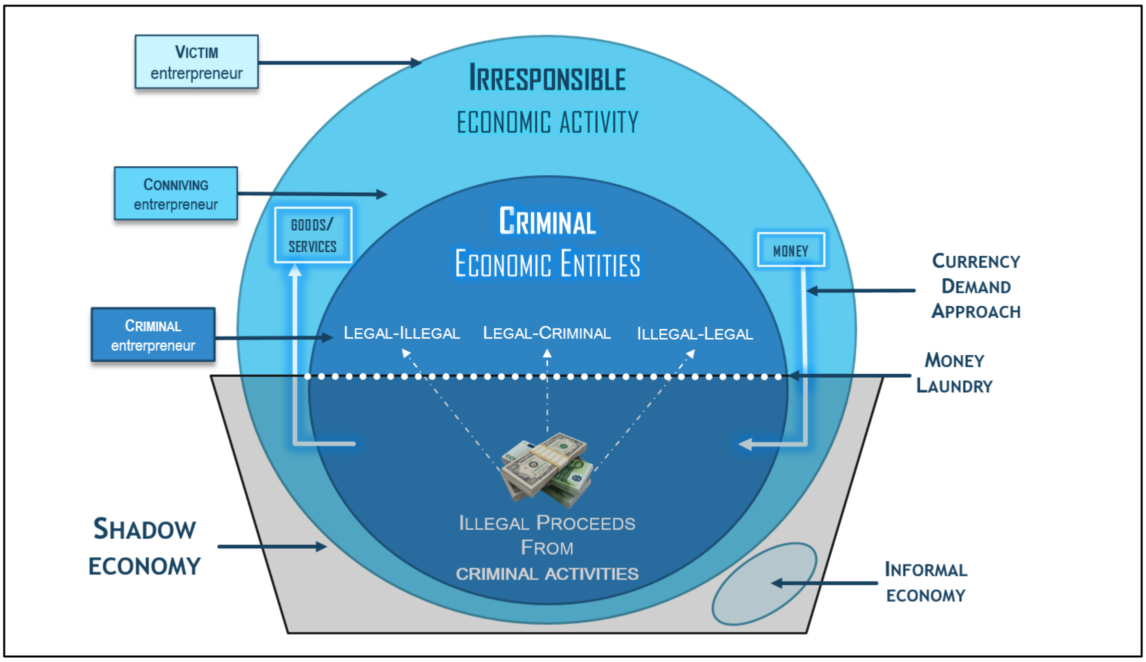
Table 146 – *Infiltration in the local economy*



Source: *personal elaboration*

[14] Criminal organization's proceeds, generated by its illegal criminal activities, can be reinvested in the target owned company with the result of a never-ending "*shadow funding activity*".

Table 147 – *Infiltration in the local economy. The "Sink" Model*



Source: *personal elaboration*

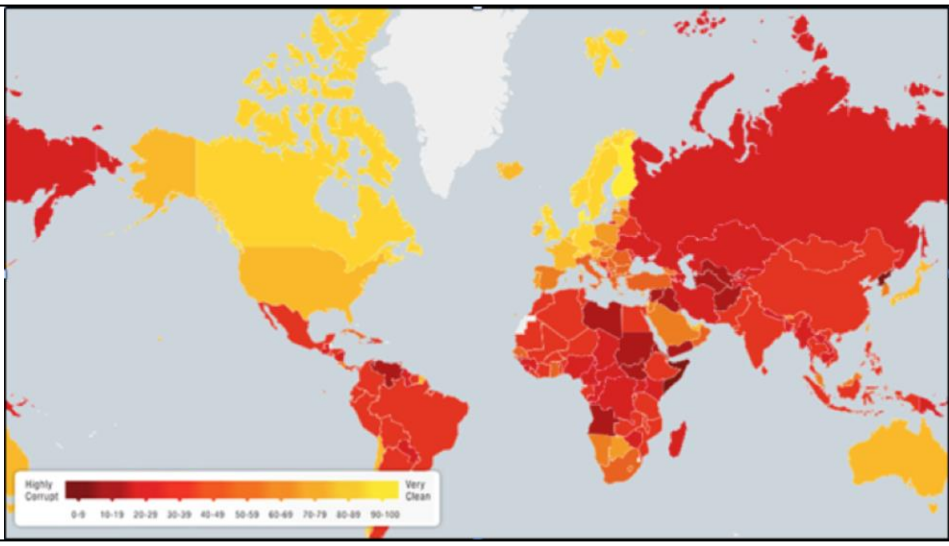
6. *Corruption*

Its presence is difficult to ignore[15], especially in our analysis, since it represents one of the most adopted methods by criminal organizations (and economic activities they manage) to prevent some stakeholders from damaging the criminal enterprise or turning them from conniving to colluded[16]. Generally, it is possible to say that corruption indicates the behavior of a person who acts contrarily to his obligation or duty in exchange for money or other advantages. *Transparency International* is an NGO that monitors corruption and developed the *Corruption Perceptions Index* (CPI), useful to compare corruption all around the world, updated and published every year.

[15] Still in 2015 «*Corruption Perceptions Index clearly shows that corruption remains a blight around the world*» said José Ugaz - Chair, Transparency International.

[16] Someone who is "*conniving*" accomplices a dishonest action while not taking active part in it. "*Colluded*" is someone who comes to secret agreements with organized crime, while holding a political or public relevant position (*Dizionario della lingua italiana,* Sabatini-Coletti).

Table 148 – *Corruption Perception Index (CPI) 2015*



Source: *personal elaboration*

This index ranks the countries with the highest corruption index and it is based on interviews with entrepreneurs[17].

As it is easily observable from the image above, there are few "honest" countries (in yellow), while many are the nations (in red) that sink in corruption that spreads among public and private sectors. Nevertheless, *Transparency International* warns that even though a country may appear to be virtuous within its borders, this does not mean that the same nation is not linked to corruption elsewhere, contributing to worsen CPI of countries already vulnerable to the phenomenon. Corruption can also be *endemic* (or environmental): this happens when it is not an isolated case, but a common or even consuetudinary act[18]. The economic agents involved in a corrupt environment could end up getting used to corruption to the point they will consider it as normal practice. The outcome is a harmful distortion for the market, as well as the moral deterioration of society. Such a system isolates and annihilates "dangerous" honest agents, since they might damage all other actors by involving non-corrupt authorities because they do not have anything to fear.

7. *The stakeholders of criminal economic entities*

It is now worth looking at the categories of stakeholders that populate the external environment of the *criminal economic entities*, to which these can either interconnect, resist or succumb. Criminal organization's stakeholders can be divided in three distinct sets*: positive, neutral* and *hostile*. Obviously, *positive stakeholders* are those whose interests are aligned with economic entity ones, while *hostile stakeholders* interests are contrary or conflicting with criminal enterprise's interests. Stakeholders qualify as *neutral* when, even though their interests are not

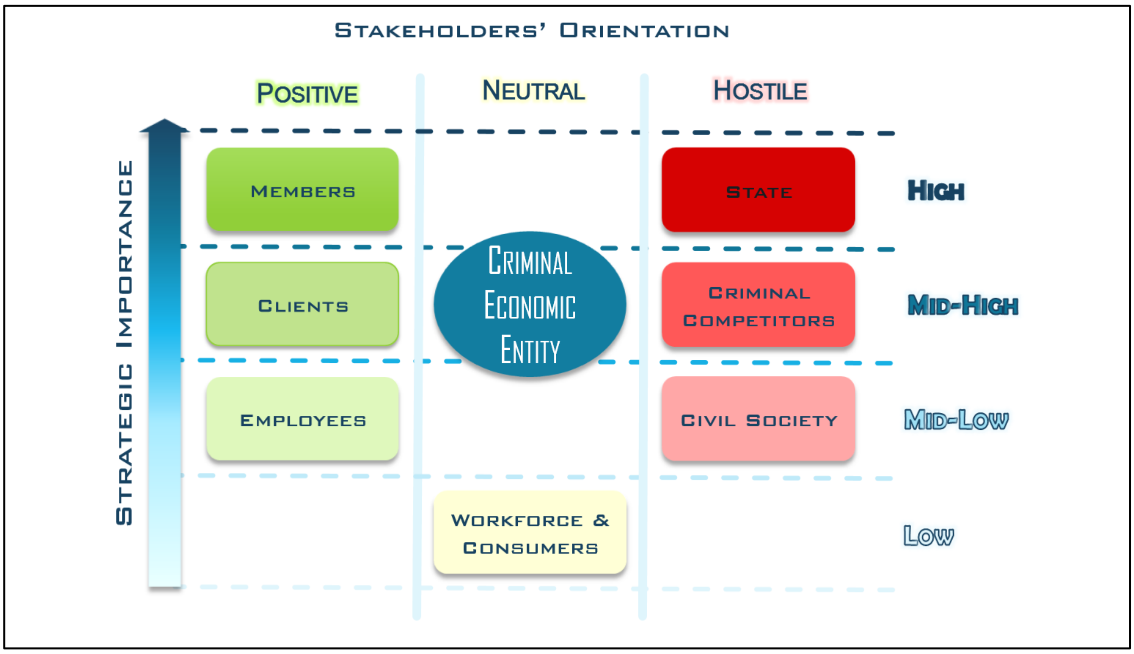
[17] Regarding its calculation technique, CPI is criticized for the unfair treatment it reserves to developing countries.

[18] The Italian system of "*Mani Pulite"*, discovered in Italy in the '90s, was described as an endemic system where many politicians cashed bribes paid by the entrepreneurs paid to obtain favoritisms.

necessarily aligned with those of the criminal economic entity (or even opposite), they are unaware of the entity's existence and danger it represents.

As for the transversal category of *corruption*, this includes *colluded* and *conniving* subjects, and they can belong to both positive and neutral stakeholder sets. To define *victims,* instead, it is appropriate to specify that this text does not agree with the definition given by the Italian legislation[19], being favorable to adopt a broader sense of the term so to include all those people who suffer moral/physical/economic damages caused by the felonious and irresponsible actions of criminal economic entities. Obviously, *victims* do not have necessary means or sufficient strength to defend or free themselves from this perverse relationship and may belong to all the stakeholders set.

Table 149 – *Stakeholders' orientation and importance for strategy setting*



Source: *personal elaboration*

8. *The three attributes of aziendality in the criminal organizations*

In the following sections the three attributes that an organization should have in order to be qualified as *azienda* are described. The attributes of systemic vision, decision-making autonomy and *economicità* allow to distinguish the *azienda* from the other types of organizations (Chapter I, § 6).

[19] The Italian Law defines "victim of terrorism and of mafia-like organized criminality" anyone, be they an Italian or foreign citizen, who has deceased or suffers permanent disability as an effect of wounds or injuries caused by such acts (see laws 13.8.1980, n. 466 - 20.10.1990, n. 302 23.12.2000, n. 388, art. 82 e 3.8.2004, n. 206).

8.1. *Systemic vision*

Recognizing a criminal economic entity as a *system* will help to better understand all those seemingly small, localized realities (which however have a devastating impact on the society) as complementary and functional economic ventures framed inside the real criminal entity's system, and of which alleged *aziendality* constitutes the object of this paragraph. Actually, common sense does not let us perceive some criminal events, like drug trafficking in a small suburban disco, or prostitution along a provincial street, as activities peculiar to an *azienda* [20]. This is different and more meaningful when we consider such activities as mere *terminals*, *interfaces* through which the criminal economic organization meets its natural *demand* [21]. These minor illegal structures we are talking about, usually belong to *governance groups* to whom we can recognize a primeval *systemic vision*. We can imagine these local activities as *branches* of the same organization, like any *Sales & Marketing* department of legal enterprises, but they can even shape up as *sub-systems* sometimes.

Moreover, there are major *interdependencies* to take into account. For example, the connection between the controlling economic activity and the *sales force*, or the links between *sales departments* and other *criminal divisions* in charge of production, procurement and distribution of the illicit product. One potentially misleading factor is that such departments or activities apparently have their own economic significance that could enable them to get free, at least apparently, from the criminal system or group that really benefits from their existence. Yet, the risk of not understanding that some activities flow into larger maneuvers could lead us to underestimate the relevance of *aziendality* in some criminal economic entities. Before confirming that some criminal activities coordinated by small or large, more or less visible and defined, groups and organizations are *systemic,* it is necessary to specify what features a *system* must enjoy in order to be considered as such: it must be (a) *dynamic,* (b) *durable,* (c) *complex,* (d) *target oriented,* (e) *open* and (f) *probabilistic* (Di Carlo, 2016). In the following lines it is questioned the existence of such features in the most tangible and common expressions of the organized and coordinate criminal economic activity.

a) ***About dynamism.*** This feature is less evident in criminal ventures. Far too often, some formal economic activities out of such groups born just to die in the shortest and most lucrative possible way. This is regardless of all *legal-legal enterprises* that are started up, managed and settled irresponsibly and for a short time, which, in author's opinion, even if registered as legal entities recognized by law, cannot be called *aziende* in any way. In

[20] Paper coverage often reveals phenomena of unorganized micro criminality (i.e. street pusher who autonomously purchased drug from bigger suppliers or entities, for example) that seem to hide the presence of corporate structures. Unfortunately, behind those isolated cases, there could be structures that enjoy their own organization and make use of people with specific tasks (lookouts, pushers, couriers) under the guidance of a real "*top management*" who steers the entire corporate structure by giving directions, setting up work shifts and even paying regular salaries to his employees.

[21] The offer of goods and services on parallel markets, as managed by the organized crime, intercepts purchasers' demand for illegal goods (which official markets are not able to supply). However, it also captures the demand of those who, especially during an economic recession, tend to purchase legal goods illegally produced (for example *counterfeited* items) as imperfect replacements for legally marketed goods. See on this '*Gli investimenti delle mafie*' ('*Mafia's investments*' in English) report written by *Transcrime* (www.transcrime.it) and financed by the Italian national operative program called '*Sicurezza per lo sviluppo – Obiettivo convergenza 2007-2013*' ('*Security for Development*', in English).

truly illegal economic activity, going back to the useful concept of *interdependence*, a venture's early death or economic ruthlessness of a venture cannot be archived as simple consequence of naivety or mismanagement, because this could seriously blur the bigger picture. There can be many reasons for leaving such *appendices* (or *sub-systems*) to stand still or to shut them down in the criminal world. Their very creation or dismantling is a form of *dynamism* of the controlling criminal economic entity that, in turn, promptly reacts to changes in the environment around it adjusting itself to maintain a long-term balance[22].

b) ***About durability.*** To better focus this feature of the criminal economic entities, the attentions should again be directed to main criminal threads that support smaller agents, like the afore mentioned local drug pusher, through recruitment, incentives' system and recognition of a salary while even promising career perspectives inside the organization[23]. Such submerged threads are not simple imitations of the large, legally recognized corporations and industrial complexes operating in the field of the *consumer goods*. Criminal *corporations* sadly differ from the latter, almost always, in the massive use of violence, of coercion and intimidation[24] they could not do without if they want to survive and impose themselves on the market. So, by means of a holistic approach, the *focus* moves from a *micro* dimension, localized and limited, to a *macro* dimension, more complex and entailing most worrying consequences. For this reason, it cannot be surprising that the data about coordinated criminal economic activities of the last one and a half century confirm that such large, powerful *conglomerates* are somehow *resilient* and *durable*. Criminal economic activities seem planned to last, as *opportunistic structures* marked by a highly adjustable and metamorphic ability. The spheres of influence, as well as the areas of activity, change in time bringing a transformation of the *modus operandi*, too. Minor structured and easily identifiable entities are often controlled by the parent criminal organizations, object of this study, whose use of strength and violence support both the entity's external ability to survive competition and the capability of keeping internal discipline intact. Moreover, criminal *conglomerates* enjoy a certain degree of immunity (that enables this to perpetuate itself), obtained by leaking inside the police forces and into the judicial frameworks. What is actually surprising is that such magnificent illegal structures, that were created in hierarchical contexts structured upon a family model, still presents the same

---

[22] Another simple example of adaptation to take into consideration relates to the criminal *piracy* linked to copyright infringement. Through the last thirty years, the most popular gaming consoles were the ones designed to use a cheap, easily playable and cloneable media (such as the compact discs or cassettes). A real criminal business developed around illegal hardware manipulation and software cloning to distribute counterfeited goods via a well-managed street hawker's network. These more or less sophisticated techniques were result of a real R&D process and evolved during the years to provide mostly aware consumers with perfect alternatives to copyrighted original goods (which prices were obviously considerably higher).

[23] The parties, acting as cells of the criminal network, are attracted into participating in organized crime with the lure of obtaining awards as incentive (money rewards, recognition in the form of career steps, ancillary benefits) or, conversely, they are obliged to participate in order not to avoid punitive consequences (threats for the party or his/her family).

[24] Intimidation is exerted both *inside* the organization - towards its members, obliging them to perform target activities and to comply with organization's rules - and, diffusely, *outside* the organization - with the aim of defying competition and any potential obstacle by hindering criminal activities. This aspect is clear in *mafia-structured* organizations where «*the strength of the intimidation exerted by membership bonds and the silence code deriving from the subjection to such an intimidating power, do not appear only outside the association, but also inside*» (Turone, 1995).

integrity[25] after several decades and generations. As well known, one of the most controversial obstacles for the *azienda*, is the *generational passage* management, and namely the shift and choice of the heirs[26]. Heirs could prove, in fact, incapable or simply not interested in the continuation of the *azienda*'s activity. This should be, in theory, even harder for the criminal economic entity, which brings more legal consequences (even more dangers) involving a real risk for the chosen *heir*, when compared with a legal *azienda*[27]. For this reason, it is rather surprising that such activities have been able to change and adjust to the society's changes (with few exceptions only), remaining always active in the civil society underworld and maintaining a diversified and broad business[28]. According to Ferrero (1968) it is in the interest of the *azienda* itself, seen as a «*durable source of present and future well-being*», to prevail over ephemeral and particular interests of the current governance. Normally, the top management "of the day" spontaneously tends to squeeze out of the corporate system the higher possible surplus in the shortest possible time. Curious enough, this typical *valu*e of *aziendality* seems to have accompanied criminal partnerships and their activities for decades. It could be interesting to further investigate and determine to what extent, the commercial "success" that such organizations have enjoyed in the last decades, can be linked to the growing and phased weakening of the legal (though irresponsible) economy. The relationship between *unemployment rate* and *organized/individual crime rate* has been widely studied, without reaching statistically convergent and conclusive results though. This is overcome by empirical observation, which demonstrates that a direct relationship between unemployment and the operation of mafia associations exists: according to a recent survey commissioned by the Italian association of farmers, *Coldiretti* ("*observatory on crime in agriculture and agri-food system*" foundation, 2014), the crisis Italy is facing in recent years produces the consequence that six out of ten *unemployed* (60%) would be willing to accept a job in an activity where organized crime has invested money to launder. This is to prove that criminal economic entities feed in crisis, since their "dirty" money becomes more and more attractive during darkest times. Moreover, annual revenues of some sectors of the illegal economy, in recent years have in fact increased. Criminal organizations can count on a potential army of nearly two million people (unemployment reached its peak levels at 12.9%, rising to 46.0% for young people) who, pushed to the economic and social margins, admit they are available to work for (and among) them (*Coldiretti*, 2014). According to the study, at

---

[25] This aspect is clear in *mafia-structured* criminal organizations: persistence of these groups in time is linked to *familial affiliation systems* that create trust bonds and follow *patriarchal autocratic models*, which do not allow individuals to enjoy personal freedom and autonomy. Being a *family* is at the very foundation of cohesion in *mafia systems*. The latter present *network models* that also include *heads* of the various affiliated families and are based on a planned and organic guidance of the various criminal activities.

[26] Criminal organizations have habits, structures and values that tend to "*educate*" whoever comes across them. Such recurring practices are repeated over time and contribute to the creation of a *sense of belonging*, passed from father to son while making new disciples who will be more inclined to participate in the criminal *partnership* in the future.

[27] This is why criminal organizations tend to choose the heirs of their *illegal businesses* by creating beforehand *brotherhood bonds*, by arranging combined marriages for example, to ease the access of new disciples and make alliances in view of a generational passage. Whoever is part of the criminal "family" is bound to respect a sort of contract, for which he/she is integral part of a single collective entity with just few to none possibilities to exit.

[28] *Diversification* takes place when different illegal activities are performed, together with money laundering into legal productive activities and investments in assets or real estates.

least 230,000 people would have no problem to commit, knowingly, some illegal actions just to have a job. The evident result is a general loosening of the moral tension in relation to the criminal underworld caused by the crisis, worsened by the lack of confidence in political institutions' ability to cope with it and a growing feeling of insecurity that affects everyday life. On the other hand, the phenomenon - demonstrated by countless criminal investigations - it is quite evident: where there are unemployment, social inequality and poverty, organized crime tends to create opportunities. Finally, more than one research claims that the field is so much more fertile for the grafting and flourishing growth of criminal economic activities in a society in distress[29].

c) ***About Complexity.*** As the criminal economic entities are organized in a functional way or present business structures strongly integrated with each other, they seem to be at least as complex as normal enterprises. Although it is much more difficult to observe these activities using the same lenses through which we look at formal enterprises operating in the sunlight, it can't be said that the criminal counterparts have just one simple balance to pursue. As ascertained before, outlaw entities are often *de facto* holders of many different criminal economic activities and smaller entities (sometimes they can even be *subsystems*) which are carried out in parallel according to the diversification and fragmentation criteria, with a widespread diffusion over the territory they control. Hence, there are several balances inside a "*criminal holding*" and, when a firm has many balances to cope with, it must be sure to pursue all of them since they all contribute differently to the one general balance (*Amaduzzi* et al.). Additionally, in a more radical way than what happens to legal entities, the complexity of such criminal conglomerates often involves internal antagonisms, which tend to make it even harsher to attain a general balance in the short and medium term without the help of an enlightened business administration.

d) ***About finalism.*** As theorized, the *azienda* is persistently oriented towards the achievement of an objective. This is unique and should be shared throughout the whole corporate hierarchy (Di Carlo, 2011). In the "lawful" business world, one of the main challenges faced (even at high corporate levels) is to share the objective amongst all parties involved. The same challenge, however, seems not to be an issue for criminal enterprises. The sense of belonging, loyalty and corporate culture appears to be the foundation of such entities, since the start of their recruiting campaigns[30]. Another unique feature of the "criminal *finalism*", later debated in the text, is that the finalism of these entities is partially unattached from the third criterion of *aziendality*, the *economicità*. Actually,

[29] At the end of the last century, a research carried out by the *Labors Foundation* (1991) in five Italian cities, showed that economic disadvantage and cultural and social marginalization brings to an increase of youth involvement in criminal activities. Youngsters were more inclined to interject the deviant model and identify themselves with it, following the rules of the organization. In reality, the methods to access such groups are not particularly selective so, if the trial outcome is favorable, the young draftee is directly included in the criminal gang to grow "professionally" inside the organization. Apparently, since then, things have not changed this much. A recent survey carried out in some schools of the metropolitan area of Naples shows that 16% of the students see *camorra* as a "tool" to solve economic problems, 41% of them believe that it is unbeatable, while few of them associate the criminal with the idea of a hero.

[30] This is rather obvious even for the legal enterprises that, at a certain stage of their life cycle, opt for choosing what appears to be an "easier path" and establish complicity relations with organized crime. The sense of identification and faithfulness to the organization finds an incentive in the recognition of immediate, direct benefits for shareholders, top managers and staff: imagine for example, obtaining "*protection*", licenses and tenders granting, tax advantages etc.

for outlaw economic realities the importance of the *economicità* can be somehow underrated, especially if compared to the lawful economic ventures. Furthermore, the Anglo-American theories on corporations' finalism, known as *stakeholders* and *shareholders' theories*, can't explain the complexity of the 'criminal' *purpose* achievement alone. In fact, both theories assume that (1) the interest of *stakeholders* (or better the majority of them) is at least *compatible* with the very existence of the entity and that (2) there are *stakeholders* who enjoy a certain level of freedom (for example, to modify their quota, give it away or increase and enter or exit permanently from the *business*). But as far as the criminal economic entities are concerned, no such conditions apply. On the contrary, sometimes the interests of *stakeholders* clash with the very existence of the entity, at the point that the same parties who contribute to its economic success may be its victims at the same time[31]. To sum up, what appears more conceivable to us is that a coordinated criminal economic entity pursue its own objectives (Bertini, 2014). This solution is suggested by the resilience and continuity with which such entities operated for decades, and it also means that they cannot be easily diverted or affected by the satisfaction of particular, fleeting, short-termed, interests. Possibly, also the theory of *Team Production*[32] finds an application in this analysis since appears to be suitable to describe the role of the *positive stakeholders* of criminal entities who contribute to their production activities.

e) ***About openness.*** Previously, the spotlights were focused on criminal business *stakeholders'* peculiarities and, in detail, on reasons they have to gravitate around the entity. The criminal enterprise is unwanted by a significant part of the surrounding environment that, just like a post-transplant rejection, reacts to the entity's presence as if it is an alien body within its mechanisms. Moreover, the environmental forces and the hostile interests that surround the outlaw organization are effectively thwarted by its internal forces[33], as well as by some external resources the organization has. These resources, for different reasons (see *corruption*), perceive a tangible value produced by the criminal economic activity, while other *stakeholders* feel the opposite. As before mentioned, the "forces" deployed by the criminal entity to contrast external resistances are often inextricably linked to it and have extraordinary strength: they are able to contrast the majority of *adverse stakeholders* (because of their specific interest, of course), successfully hiding the organization while keeping themselves within the legal boundaries[34]. It is easy to under-

[31] The most blatant example is the subject being victim of extortion carried out against him by members of organized crime: fear of retaliation brings the victim to endure without reporting the crime, thus acquiring a more or less forced complicity with the extortionists. This is the case with the *victim entrepreneurs* (i.e. those who are purely dominated by the organized crime). They pay to have protection, enforcing criminal organization economic power, without obtaining anything real if not a temporary assurance that they will be able to continue their activities.

[32] '*Team Production Theory of Corporate Law*' is the title of an article published by Professors M. Blair and A. Stout in 1999 where it is stated that, in taking care of all stakeholders' interests, firms can prevent opportunistic behaviors so to obtain a collective coordinated effort from all the actors involved.

[33] The *criminal economic entity* moves according to dynamics that tend to pursue the overriding aim of maximizing profits by engaging in criminal behavior. This causes damage to third parties, the stakeholders and the environment, without constituting the mission of the company: the same law doctrine underlines that these kind of destructive events are conceived as "accidental" and often have elusive contours, difficult to quantify (A. Alessandri, '*economic crime and confiscation of profit*', *Enciclopedia del diritto*).

[34] Organized crime takes advantage of the use of violence to cancel out the competition and all those who, in some way, may be a threat to its economic activity. This is done, however, by taking care not to nick all

stand how the existing friction between a criminal economic entity and the macro-environment has to achieve a delicate balance in order to allow its existence. The "anti-system" feature of the criminal economic entity is made ambiguous by its desperate need to obtain consent from whom it can be defended by in case of attack. The entity pursues this objective through value creation and satisfaction of potential *positive stakeholders'* needs, where other environmental forces are absent or particularly weak. Precisely, because of this peculiar ability of organized crime to survive within the macro-system while damaging it (and with the latter being unable to realize it) we define the existential principle of the criminal economic entity as "*bio-economic parasitism*". The criminal enterprise has indeed an interest in keeping the civil tissue weak but alive, as well as the "*organisms*" that dwell its vicinity, whose support it nourishes. Finally, its ability has to be considered the more developed the more it weakens the environment so to prevent it from react to his presence.

f) ***On probabilistic principle.*** In the illegal and criminal economic activity, existence and persistence of the probabilistic principle remains unchanged. Indeed, the criminal economic entities remain exposed and vulnerable to turmoil of the overlying system environment, like all the other economic activities do. However, the illegal business presents different risks than those of a legal company. At the base of risks ran by entities of this type, obviously there is an activity conducted in open violation of the law. This aspect, sometimes given for granted, actually defines the majority of the risk profiles. In addition to risks that all companies have to bear, the criminal economic entity is vulnerable to two other types of contingencies, which are peculiar to its overlying environmental system. First, it should be considered that, in addition to certain economic benefits derived from the "outlaw" status, these entities give up most of the rights and protections that the State and its institutions would guarantee to a legally recognized company. Second, be also added that the burden of a lack of protection is exacerbated by the peculiarities of the criminal environment itself, which is partly populated by stakeholders and actors who are criminals[35] as well. Finally, each coordinated and organized criminal economic entity that works for the satisfaction of needs through the production of goods and services, whatever the reference market is, has to employ human resources, carry out operations in the area and do it according to the *Economicità* criterion that enable it to continue its activities in a sustainable way.

So far we have analyzed all the properties of a corporate system applied to illegal and criminal activities. The business perspective has allowed us to observe them from an unusual point of view, but these entities assume a *systemic vision* only when an extensive branch of the underlying criminal holding is taken into account. Regarding the ability to *differentiate*, the world of organized crime makes no exception. Indeed, the same term 'organized', refers to the presence of a structure as well as a precise separation of roles[36]. These conglomerates are

---

companies, which left alive for mere coverage purposes: an apparently legal mean is necessary to mask proceeds derived from shady dealings.

[35] Criminal enterprises often use brokers to enter in contact with potential customers. For example, the waste disposal system managed by the *camorra* benefit of brokerage activities by subjects who contact polluting companies, offering them the best prices and making a deal on behalf of criminal organizations. At a later stage, *camorra* shall grant them a reward for their work and deals with the waste accumulated in storage sheds by burning it on the ground.

[36] This structure is well described in the *US RICO Act* (Racketeer Influenced and Corrupt Organizations Act), whose title 21, section 848, defines the criminal enterprise as «*any group of six or more people, where one has an*

managed leaving a certain degree of *decision-making autonomy* to their terminals. However this freedom of choice is probably less than the one we find in a multinational lawful company's branches, whose managers are selected and appointed for their competence and trust. In the criminal labor market, those who actually run the business are trusted agents of the supervising party, but not certainly selected in the open competition for their ability and preparation as it happens with directors of large companies. In reality, the selection and employment of efficient human resources, ready to carry out delicate tasks, is one of the weaknesses of criminal proto-systems. The criminal economic entity succeeds in solving this problem with "dirty" money, corruption and coercion[37]. The last may help the criminal firm to obtain qualified resources at its disposal, who can advise it towards the switch to another kind of business, marketing zone or products. On the other hand, these two techniques are closely linked together and guarantee a long-term use of the "selected" resources that, once selling themselves for liquidity, find to be *locked in* with the organization (and without much hope to get out while keeping intact personal safety or criminal record[38]). After the acquisition of strategic human resources suitable to constitute a true "network" with widespread diffusion over the controlled territory, criminal organizations may assign decision-making powers to top-trusted representatives so to take advantage of a broader guidance to support its decision centers and contributing to the organization *structuring*. Outlaw decision centers are different from those commonly identified in a lawful company because, apart from being based on a certain separation between administration and management, they must be able to operate with the necessary autonomy in order to survive (and possibly overcome) any turbulence that may affect the *heads* of the controlling organization.

To provide an exemplifying image of the criminal economic entity structure, we can think about the mythological beast known as the *Hydra of Lerna*[39]: once this beast loses one head (family, clan, top boss) there are always at least two others ready to emerge; moreover, the increase of the number of heads implies power leveling and skills sharing, so to make them ready to replace the dominant one whenever needed[40]. This process presents a temporary nature, lasting for a certain period of time, pending a summit to permanently re-establish the exercise of his power on other heads[41].

---

organizing position (or any other position of management regarding the other five), that generates income or resources, while engaging in continuous violations of the law».

[37] Corruption in political ranks often allows criminal infiltration of not professionally qualified subject to top managerial positions. Observes Gratteri (2009): «*Corruption, with its selection system, sterilizes the best intellectual potentials, not awarding meritocracy, but giving priority to group loyalty*». Therefore, they establish a real trilateral relationship among criminal organizations, political-administrative apparatus and companies, where corruption and violence constitutes the real *instrumenta regni* that allow organized crime to develop and keep their business alive.

[38] In order to facilitate the coming-out from a criminal organization so to break the veil of secrecy, Italian legislator provides specific measures to protect the so-called "*collaborators of justice*": these measures range from special housing arrangements in penitentiaries to possible transfers of residence (see the provisions contained in the *Decree of the Ministry of 23 April 2004, 161*).

[39] The *Lernean Hydra*, was a serpentine nine-headed monster recurring in Greek and Latin mythology (as described in the Hesiod's *Theogony*, Virgil's *Aeneid* and Ovid's *Metamorphoses*), that the mythological hero Hercules has to confront in the second of his *Twelve Labors*.

[40] Continuing the mythological metaphor, Hydra's heads had a botanical capacity to duplicate each time they are cut. Indeed, after the first head is cut, additional two grow back from the stump of it, even more dangerous and poisonous.

[41] As in the case of takeover, this process is often marked by a hostile character, with the difference that there is no law or code able to enforce its prohibition.

The difficulty to react rapidly and compactly to more or less radical changes is because of the existence of a single body *under* the various command centers, which requires a coordinated input from several heads before being able to move gracefully[42]. In medium-large structured *aziende*, no matter how high the degree of the decision-making decentralization is, there will always be a tendency to an inverted structure compared to the *Hydra-like* one: like an *octopus*, the one-headed body will not have to wait for an input from its tentacles to decide where to go. Of course, inputs (advises) coming from tentacles (divisions and branches) will help the head decide wisely but it is not bound to their decisions like what happens with the criminal organization. Moreover, in a *octopus* structure, management cannot be separated from the company since it is thanks to the first that the latter provides responsible answers to both internal and external existing mechanisms of shareholders and/or employees protection. There is another difference in favor of the *octopus-like* corporate structure compared to the *Hydra-like* criminal one: the first enables an *azienda* to overcome obstacles generated by markets and their geographical extension, while preserving a relative agility; the head-body (*headquarters*) is not geographically restricted nor are its tentacles (*divisions*), so the only parameters who define *azienda's* movement speed are laws and labor unions agreements. The aforementioned structural differences with *aziende* operating within the boundaries of law, also reflect in the *integration* capability of criminal enterprises. In large conglomerates such as those taken into consideration by this paper, territorial control is a key aspect for criminal owners[43] and some limits in the *integration* processes could appear acceptable. Nevertheless, these entities have developed, over time, both horizontal and vertical integration forms.

a) ***About the horizontal integration***. This is meant as the process of expansion of a company's activity towards new products, processes and know how related to its existent technological-production chain. The *horizontal integration* is implemented consistently in the criminal businesses community - see drugs, piracy and gambling[44]. A company can achieve greater *horizontal integration* through (1) the purchase of other activities, (2) accomplishing an internal growth as result of investments in new production factors or (3) mergers with kindred companies. Sometimes, this process can lead to situations of monopoly that are exactly the outcome sought after by criminal economic entities and to which these adjust its objectives. Actually, a fourth option exists for maintaining some degree of integration while remaining independent: this is done by (4) forming *horizontal alliances*. Often, in the criminal world, this option does not constitutes a real choice. It is rather the only option available to pursue the survival purpose. It is true that several

[42] Organized crime, in fact, is structured according to a well-defined internal hierarchy, with a top-down pyramidal character, which is sometimes accompanied by a reticular pattern: a system of transversal relationships around certain interests or businesses that links together the single families, clans or criminal groups (*heads*). The hierarchical structure is useful to control the area of influence and to perform activities with predatory character (theft, robbery, extortion, infiltration in public procurement). The "network" model is useful to manage the recycling practices and reinvestment of illegal proceeds. This mixed construction has been well illustrated and applied to the internal organization of the *cosa nostra* by Savona (2008) in his *"Cosa Nostra, tra organizzazione gerarchica e rete criminale"*.

[43] Territorial control is exercised through use of violence, discouraging competition and entrance barriers creation to prevent other companies from accessing the business.

[44] The process of *horizontal alliance* is well known between representatives of criminal organizations (as among the "*men of honor*" belonging to different mafias), sided by *vertical control strategies* for managing illegal traffics that generally take place on the basis of *cartels* made up of different mafia families. Control is given to families with the most effective organizational resources (what we called a *multi-head* system), biggest amounts of assets and expertise to invest along with the best logistical position in the territory.

criminal entrepreneurship sectors benefit by a certain competitive market[45], but competitors can also be criminals so that no institution or anti-trust agency has the ability to intervene in order to protect the parties involved or, most importantly, the final consumers. As imaginable this situation may lead to disputes of different nature[46] when power and resources are unequally distributed, but *alliances* (as feeble they may be) become the most beneficial solution for two separate criminal economic entities (therefore with different owners) operating in the same sector and having similar influence and power[47]. In the case of an alliance between two or more criminal entities (territorial separation, sharing "licenses" for drugs and/or services sale, etc.) we could also talk about *competition*[48]. Indeed, in absence of regulations - but in presence of a strong institutional resistance - staying united means to be stronger and, at the same time, to considerably reduce the chance of any hostile actions by competitors and stakeholders. In other cases and sectors, the monopoly of a single active criminal economic entity makes the *horizontal integration* advantageous where this manages to bring to *economies of scale* and *economies of scope*. In "legal" monopolies, national and international legislators developed some countermeasures suitable to fight monopoly pricing, but this is far more complex and costly for the *environment* when concerning the illegal counter system.

b) ***About vertical integration.*** Now, in order to deepen the vertical integration concept applied to criminal *proto-systems* it is necessary to begin from the concept of *divergent globalization*: a global process that is untied from laws and principles, with the exception of criminal uses and agreements (the so-called *black protocols*) used as unwritten bases to simplify international crime organization along with goods trafficking on a global level (Deibert, 2013). In parallel to the diversification and acceleration registered in recent decades within the legal economy, it has been observed a development of networking, diversification and investment strategies towards a bidirectional vertical integration[49] (Naim, 2005; UNODC, 2007). Globalization played a fundamental role in the "*make or buy*" [50] strategic decisional process for many underground sectors such as drugs and

[45] The reality of criminal market, it is not so far from the one of free legal markets. Competition between criminal organizations is in fact regulated by their own rules, subject to direct agreements that primarily aim to discipline the management and sharing of various illegal businesses in the territory of influence.

[46] Criminal economic entities are characterized by their constant need for expansion and enlargement: it is clear that competition by other entities, when not regulated by more or less voluntary agreements, is hard fought with all weapons the criminal enterprise can deploy, literally.

[47] Think about the powerful alliance between *'ndrangheta* from Calabria and *Sardinian organized crime* in the field of drug trafficking, emerged in 2005 and followed by the investigative operation called "*Santa Barbara*", conducted by the *Carabinieri* of Cagliari provincial command (from "Sardegna oggi", article dated 15/12/2005, available at *www.archiviostampa.it*).

[48] Term coined by the mathematician J. Neumann and the economist O. Morgenstern (1944) and taken up by J. Nash on his "*non-cooperative games*" (1951). The term *competition* means any business strategy that combines the features of competition and cooperation. It realizes among competing entities who choose to cooperate limiting to the certain activities that will be carried out jointly, in order to obtain the typical benefits of cooperation, without blocking other forms of autonomy for other specific activities.

[49] After a closer inspection, there are two types of *vertical integration*: *downstream integration* and *upstream integration*. The *downstream* (or *descending*) *integration* consists of the firm's control over a successive passage in addition to what it already holds: for example, an enterprise assembling cars opens a dealership to sell directly its own products. The *backward* (or *ascending*) *integration*, instead, exists when a company decides to take control of one step prior to what it has already done: in the same car manufacturer's case, we can imagine an acquisition of the steering wheels production plants.

[50] I.e. the option for any enterprise to buy an intermediate product outside or to produce it itself.

weapon traffic. For an Italian criminal economic entity (let's call it *E1*), for instance, pushing cocaine to local community means getting the illegal substance from the main oversea producers, criminal business organizations that produce, hold and spread cocaine through a very developed transoceanic logistic network[51]. Also, if another Italian criminal entity (*E2*) should put a new *smart drug* in the market that chemically derives from cocaine mixed with other substances, it is very difficult to implement a *vertical downstream integration*. Conversely, an *upstream integration* is more realistic if *E2* is a customer of *E1*, who imports and distributes the substance throughout the territory. In fact, if the smart drug is commercially viable, production costs advantageous and production quantity efficient, *E1* will be interested in control *E2*, in one way or another.

As observed so far, many illegal economic activities are carried out by entities that, observed at the proper "distance", possess all the features necessary to be considered systems and, therefore, to be feared as such. Even if they present, in some aspects, primitive or retrograde forms when compared to modern legal enterprises, it should be recognized how real and complex this economic organizations are: coordinated, structured and strategically conducted towards a multiple integrated business management. Indeed, despite the efforts lavished so far by legal environmental forces against these illegal entities, that can't be defined *aziende* yet, their power does not seem to misfire. *Systemic vision* can be difficult to achieve in contexts when special interests of individuals are in open contrast with its achievement or when such individuals are not motivated enough to work and cooperate for the common and primary interest of the business entity (Di Carlo, 2016). The first case, in the world of crime, concerns the "criminal top management" desire to extract from the activity some benefits that would see, in the realization of a *system*, the impossibility to be enjoyed.

Think of those companies with legal object where a *nominee*[52] is remunerated to carry on the activity while bearing alone all the responsibilities[53] while still responding to the hidden *ultimate owner*'s directives. Obviously, he spends resources with no *decision-making autonomy* and redirect revenues to the parent criminal entity. As in the case of recurring *principal-agent problem*, "dummy directors", if brave enough to challenge the power of his employer could act in their very own interest to divert some of the activity's earnings to personal bank accounts. A second case is instead connected to lack of motivation. In typical firms this is caused, for example, by insufficient or poorly designed incentives schemes (economic and non-economic) or little knowledge on the primary interest of the firm. Nevertheless, when addressing criminal entities several more problems related to motivation arise. When an employee is consciously working for an overlying criminal system, for example, the probabilities for him to be able to leave the "system" migrating to other realities for whatever reason are extremely low. On the other hand, the ethical pressure for repented employees can be extremely high. These peculiarities raise a huge issue for the criminal economic entity that imposes its *systemic*

---

[51] Drug trafficking is the main criminal activity characterized by a *re ipsa* transnationality, as it requires the physical transfer of illegal goods from the production site to the transaction place, shaping up as a cross-border crime.

[52] We are in presence of a *dummy director* whenever a so-called *hidden entrepreneur* can be identified behind his operate. The *hidden entrepreneur* is an economic subject who does not act directly in its own business, but through a *nominee* (the dummy). In this way he/she can undertake entrepreneurial activities without appearing as an exercising subject (see art. 147, Italian *bankruptcy law*).

[53] Actually, in some countries, legislators tried to address this issue by creating laws that permit judges to associate real owners to the crime, as jointly liable with the *nominee*, though he does not have any formal requirement to be considered as owner.

vision with violence, intimidation and corruption – and only in few cases, with a remuneration increase.

8.2. *Decision-making autonomy*

So far, *decision-making autonomy* was considered as binary parameter, present or absent. But in the real world, it may appear at different degrees of freedom and modalities, often making it too complicated to be evaluated properly[54]. In particular, this occurs in corporate groups (an entrepreneurial form which functioning nature is quite close to the one organized criminal economic entities) where the holding (controlling family or clan) establishes its purposes and assign specific tasks to its subsidiaries units. In the illegal entrepreneurship case, without police and investigative journalism to bring facts and scandals to light, it would be incredibly difficult for the steering-executive patterns within criminal groups to emerge. Thanks to the efforts carried out by the State, today is possible to ascertain the degrees of freedom characterizing criminal groups' activities.

Starting from the "Roman" example, the scandal called *Mafia Capitale* ("*Capital Mafia*", in English), where it was evident that criminal organizations do not operate according to criminal methodologies they normally adopt in their home territories, in which they are used to transmit the criminal message through threats, intimidation, extortion and acts of physical aggression. Although there were persons or groups representing a "direct projection" of all the traditional mafia-like organizations on the regional territory, *Lazio* region registered the presence of third criminal realities qualifying as mafia-like too. These new realities were fellowships born from a connection loosening with their former *coteries*, that gained a substantial autonomy from parent organizations (so-called "*casa madre*") forming independent associations with pre-existing primitive or autochthonous mafia partnerships[55]. As already highlighted for lawful activities (Di Carlo, 2016), it is not the ownership of control power to determine the independence of controlled units (which, regarding criminal groups, often enjoy a certain degree of *systemic vision*), but rather the exercise of such power and the competitive strategies put into practice. However, it has to be said that all criminal economic activities, even if at different levels, are managed with sufficient *decision-making autonomy* to enable them to adopt a strategic localized execution, adapted to their target audience.

A huge and organized criminal entity, coordinated and interconnected, would face enormous difficulties if it should decide to centralize the full set of management and coordination activities in a single "*control head*". An entity like this would not meet legal limits (as it operates outside the boundaries of the law), but territorial ones. This is because criminal organizations are realities that act only on the basis of deep knowledge of territories, where they carry on operations, and of local competitors and public administrations, which they must infiltrate or watch out for. For example, in the Roman case criminal entities came in contact with other local associations in order to conclude *geographically limited* agreements directed to achieve specific *ad-hoc* purposes, while being able to merge and structure themselves accordingly. Entitling a criminal economic entity as *autonomous,* when it comes to *decision-making*,

[54] Di Carlo (2009) points out that *decision-making autonomy* should not concern the choice of the purpose itself, but rather the way to reach it.

[55] This is revealed by the latest annual report (2015) by the '*Direzione Distrettuale Anti-Mafia e Anti-Terrorismo*' (the *Italian anti-mafia and anti-terrorism directorate*) about the ways in which the traditional mafias are operating in Lazio and the Italian capital.

brings to the conclusion that it may also be complex and developed enough to acquire *corporate economic personality*. The possible interferences that "criminal" decision-making autonomy may suffer can be both internal and external, and may be simplified in two big issues: the first is related, as usual, to the use of corruption and its innate bond with the criminal activities; the second is generated by the clash of families (*heads*) within the same organization (the *Hydra*). The decision-making, as we observed, is present in the organized crime since there are some entities that can be considered autonomous in their strategic objectives setting. In addition, they are able to interact with the external environment using their own personality and they are free to react to external and internal changes with sufficient autonomy. One of the key aspects of the criminal way of running a business, however, is using corruption to extend their powers and capabilities inside other bodies and entities that are external to the firm. Borrowing some knowledge from the *risk management* field, it is safe to say that this method can be as effective as it can be dangerous for the entity, a big weakness yet an incredible strength. When corrupting someone, the entity's owner is basically asking him/her to act in violation of what his/her duty is, performing something more (or less) than his/her *job description* so to help the criminal firm pursuing its objectives (i.e. win a competitive tender for a public commission).

For sure corruption deserves one dedicated paper itself, but in this place we can just say that it affects *decision-making autonomy* when a corrupt subject wants to deviate from the entity's interest, even if paid to do the opposite. This may happen in several cases, not only just when the corrupt repents[56], but also when the chosen person may be unable to keep his/her promise because of major issues regarding other professional positions in his/her institution[57]. In other words, this situation appears to be a special case of *agency problem*: *owner-corrupt-agent*. The corrupt is, at the same time, an agent for another owner and every time he/she has to choose to whom he/she should cause an agency problem. Of course, the criminal entity has plenty of methods to dissuade the corrupt to act against its interest (from benefit increase to private violence) but, since corrupt actions can be considered as integral part of the criminal strategic plan, the possibility that he/she is unable or unwilling to perform its "new task" may arise a big issue to address. The second type of possible interference to the *decision-making autonomy* of the criminal economic entity realizes when a radical change disrupts the organization structure affecting the ultimate owner of the economic entity. In the example of a rift of powers inside the controlling criminal organization, the entity may temporarily find itself under two different owners, hence losing the autonomy to which it usually operates.

8.3. *Economicità*

Criminal economic entities treated so far, since they act in a market (official or illegal), must bear some costs.

Moreover, the *economic problem* forces them to work with a limited amount of resources. However, as already observed in this paper, the criminal enterprise always acts in view to maximize remuneration of investments (Veraldi, 2009) - having no *financing costs* to bear -

---

[56] Imagine the case of the corrupt cop who, in an extremely unethical act that can be seriously harmful for his own territory, decides to "betray" the criminal company.

[57] Imagine now the effect that the sudden appointment of a new Major can have on municipalized firms, which top managers are corrupt. Top management of the firm can be replaced just before the corrupt's task is performed.

while the lawful business, by contrast, is sometimes forced to practice *cost reduction* in order to survive unfair competition conditions. Also for this reason, criminal enterprises that operate in the legal market are likely to assume a monopoly-like position, practicing highly competitive prices and using both violence and intimidation against their legit competitors. This treatment is often extended to "special" customers such as the public administration or SMEs[58], so that they will be forced to buy products from the criminal economic entity, which here assumes all the traits of a *bio-economic parasite*, as described in previous paragraphs.

Despite the fact that *economic problem* itself is a constant of the human condition and cannot be eliminated, it is possible to say that the comparison of illegal economic entities and lawful formal companies in terms of resources available could bring to unrealistic results. Materially speaking, the sad reality is that criminal enterprises (belonging to a mother organization) do not find significant limits in their financing possibilities, not to mention the systematic weakening of competitors who are victims of *usury* [59], intimidation and of twisted market competition. So, approximating this corrupted system mechanisms, it comes out that criminal enterprises can potentially exercise their activity without facing a real *economic problem*. They have to face some limits, of course, but always less than those faced by an honest company. It should (a) be recognized that the *economic problem* is basically irrelevant for these entities (whether operating in the official market or in the black one) and (b), before proceeding with the study of *economicità* in criminal enterprises, the "*ethic*" variable must be removed from the equation. Apparently, this may seem like an oversimplification of the system but, excluding the non-written criminal codes and family relationships within these organizations, it can safely be said that the latter do not give an ethical attribute ("fair" or "unfair") to their activities when it comes to take strategic profit-making decisions[60]. So, which are the consequences of both *ethic* and *economic problem* absence from the decisional horizon of a criminal economic entity, and how this reflects on its *economicità*?

a) Strategic effectiveness in absence of the ethical problem. As a first aspect of *economicità*, the *strategic effectiveness* makes the company tend towards winning objectives so to guide it in the most satisfying way as possible towards its primary *purpose*. So far, it has been stressed many times how complex the *criminal business system* is and, specifically, criminal economic entities are. The attribute of *system complexity*, together with *limited rationality* of individuals[61] who act within its mechanisms, helps us to understand that it is not always possible to identify the best choice to make in order to ensure the economic

---

[58] Acronym for small and medium enterprises.

[59] The practice of *usury* worsens the market situation. This fact not only exposes the honest entrepreneur to an accounting falsification practice (hence, fraud), but forces him to choose between the better of two evils harmful for his activities. It seems plausible to assume that, in order to recover money he poured into organized crime (the criminal entity's *ultimate owner*), he has to choose between reducing expense for raw materials (therefore, affecting products' final quality) or increase selling prices.

[60] This does not mean that top management of these bodies is not able to make choices and implement strategies appearing "ethical" to outer eyes; but it rather means that for these subjects, ethics, common good and people are just irrelevant elements in decision-making.

[61] Proposed by H.A. Simon (1966) as an alternative basis for the mathematical model of the decision-making process, the *limited rationality* is the concept according to which individual rationality is limited by the information he possesses, the cognitive limitations of his mind and the limited amount of time that he has in order to take a decision.

activity's survival and development, since this would imply the presence of *perfect information*[62], which neither criminal entities enjoy in a real market. So, however improbable it may be making the very best choice for the company, it is always possible to identify the best choice among those of which the management is aware of. As mentioned before, this decision-making process seems a lot simpler for criminal economic entities. In addition to having (1) no ethical dilemmas to deal with, they are also (2) able to circumvent law or act openly in its violation, while minimizing the chances of being sanctioned thanks to practices such as *corruption*. If this double benefit is added to their (3) extensive knowledge of reference market and to their (4) total economic, operational and moral independence from those stakeholders who normally are able to deal significant damage to the criminal business if threatened by the entity[63], it is quite evident how the difficulty to pursue their *goals* while chasing their *final purpose* (by satisfying their own *primary interest*) becomes infinitely lower than the difficulty faced by an honest company. To make things worse, whenever the criminal entity finds itself in front of two or more strategic alternatives with different negative impacts on the population, it will have no hesitation to choose the most profitable one in terms of financial return (that can be also the most harmful). Obviously, if there were no risks or managerial difficulties for *criminal entrepreneurs*, probably no one would choose the path of legality. Truth is that the life of a criminal economic entity runs fewer risks, but potentially devastating when compared to those encountered by a legally recognized company, whether internal or external[64]. In the criminal environment, before any strategic decision is taken, an entity has to consider carefully what effects/reactions it could generate/boost on/from its *hostile stakeholders* who possess enough power to be classified as credible *threats* for its economic activities: we refer, in particular, to police forces (State) and other *criminal competitors*. Police forces should be crucial for *criminal business intelligence*, as they are capable of terminating all (or part of) its activities in a matter of hours, if they get too close to the criminal enterprise. This primarily occurs through seizures, arrests and even destruction of corporate assets. As part of the strategic guidance, criminal corporate governances should be able to know how to identify *information breaches* in Police forces from where to draw precious insights and predict (or manipulate) their movements (see infiltrates, colluded, corrupt people etc.). With respect to criminal competitors instead, although in theory they could be able to jeopardize the biological life of their affiliates, they proved to be far more predictable. As noted by the *Italian Anti-Mafia Prosecutor General's Office* in the aforementioned case of "*Roma Capitale*", criminal organizations maintain constant relationships with each other. They know clan clashes can become real wars and generally "lethal" solutions become less convenient for both parties, especially in case they have similar strength. Moreover, wars are terribly "noisy", inevitably "attracting" for the unwelcome attention of police. About the criminal strategic choice of *extra-economic objectives* it is possible to say that their

---

[62] It represents a corollary of *perfect competition*. In a market with *perfect information*, we assume that consumers and producers are aware of cost, quality and prices of products linked to and the deriving utility for all the economic agents in the market, as well as the effects of financial policies (the so-called *perfect knowledge*).

[63] Specifically, we refer to consumers and civil society who, if damaged directly (i.e. poor quality or harmful products) or indirectly (i.e. questionable company policies and environmental damages) can negatively affect any company through reputation damage, whether it is publicly or privately held.

[64] With *internals risks*, we mean all those risks generated from operations that are entirely under the corporate control and only internally could they be solved (changes at the top, fights between families / clans, etc.). *Externals risks* originate from the environment and require greater efforts in terms of resources if the criminal economic entity wants to mitigate them.

satisfaction assumes way less importance for a criminal economic entity then what happens for licit firms that necessitate taking care of stakeholders (Onida, 1971; Di Carlo, 2016). This starts from the fact that criminal realities often live in the shadow, taking advantage of parasitic dynamics within market and society, and manage to limit short-term damages caused by their choices at the extra-economic level. As for their exposure to environmental damages (in a broad sense) they created, there is no treatise in this text but it may be discussed in future releases.

b) Operational efficiency in absence of economic problem. An efficient production represents a valid objective for every company. *Operational efficiency* goes to reduce *production factors* (*inputs*) used, while preserving quality standards of *outputs*. Now, for an irresponsible economic activity such as the criminal one, the need to "sell again" the same product at the same target of consumers, does not necessarily apply[65]. This makes the meaning of efficiency relative. Think about the phenomenon of street hawkers and their sunlight trading of counterfeit goods (which sometimes infiltrates the official channels): there will be no one hearing complaints if the product reveals to be harmful or defective[66]. The total absence of liability in many forms of criminal entrepreneurship makes criminal economic entities disinterested regarding the qualitative aspect than those companies on which owners and employees put their face on. This does not means that criminal economic activities rise just to harm consumers, on the contrary, it can be said that some for illegal businesses there is remarkable attention to *operational efficiency* in a strict sense. This is the case of drugs production and the trafficking. Criminal organizations operating in this sector always work to meet a huge demand, but also very exigent: creating a low quality drug (even harmful to the point of being lethal) causes consumers to abandon the substance in favor of another in the market (or to die using it), so to force the business suffering from losses. In this case, saving on productive factors is possible only through logistic optimization and investment in *research and development*, just like for many legal sectors. Thanks to a developed R&D department, criminal productive organizations are constantly creating new substances therefore creating new consumer needs to meet. R&D could solve the longstanding problem of the scarce natural substances needed for drugs production by creating chemical variants in laboratory, less expensive and easily replicable.

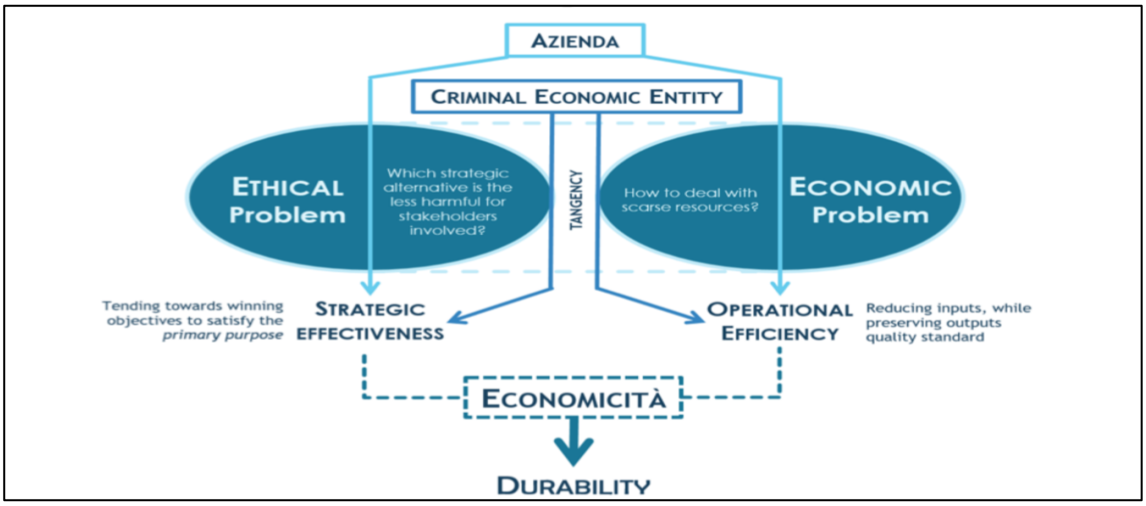
Once again, according to this analysis, it seems evident how these entities are very close to what might be defined as an *azienda*, but yet something very different and darker. Regarding the criterion of *economicità*, not only they pursue it with only profits maximization in mind, but it is also easier for them to achieve it if compared to the legitimate enterprises. Depending on activity type, there are substantial differences also within the same criminal world. In every criminal reality taken so far into consideration, a specific degree of *aziendality* exists. *Economicità*, in the legal world, is undoubtedly the criterion of *aziendality* that suffers interferences

[65] Criminal conglomerates, apart from having greater ease in accessing financial resources, achieve a high level of differentiation and diversification that allows them not to be bound to a particular product beyond its profitability.

[66] This person may be *conscious* of purchase made, and therefore willing to accept the risk of a product that may have a duration and yield by far lower than that of standard quality (but at an extremely lower price). Alternatively, he can be completely *unaware* of what he really bought, falling into the category of the "cheated", because he pays a fine imitation at the same price of the original product.

from particular interests most. The same happens with economic ones. When private benefits are extracted, directly affecting firm's *economicità*, this also reduces its *durability*. If a company's mechanisms present recurring interferences of this type, it also forgoes its *systemic vision* and, consequently, the entity can't be defined an *azienda* anymore. For criminal entities instead, it is guessable that *economicità* can be "waived" or "skipped" in favor of pure personal and even non-economic interests (hence, can be interfered with) without letting the entity's *durability* suffer. One excellent example is brought by criminal attitude to monopoly: it is not uncommon that, in order to beat its competitors or conquer a new target segment, the entity may sell its goods at a way lower price than production cost, even for prolonged time if necessary. Actually, the criminal organization behind the entity is able to bear financing costs and operative losses thanks to illegal proceeds coming from its own other activities.

Table 150 – *Economicità in criminal economic entities*



Source: *personal elaboration*

9. *The criminal interest*

After analyzing the definition of *azienda* and *aziendality*, this paragraph proposes to outline the *predominant interest* of a criminal economic entity by starting from the *primary interest theory*. The Italian doctrine of *Economia Aziendale* provides once again the necessary tools to continue the analysis of the criminal economy[67]. In fact, community's welfare is built through the *aziende*, only value generating sources, and therefore of paramount importance in the economic environment (Cavalieri, 2010). The *azienda* is a *finalistic system* (Di Carlo, 2016), and we had the possibility to disclose the same character in the criminal economic entities. Therefore, the definition of *azienda*'s *final purpose* assumes critical importance (Canals, 2010) in order

[67] Necessities to draw from the *Economia Aziendale* are, according to us, basically three: (a) the evident limits of the aforementioned anglo-saxon theories (Ghoshal, 2005); (b) its focus on the *azienda* and the equilibrium conditions for its development and survival applicable to both profit and non-profit entities; (c) its proven ability to link ethics with strategic corporate decisions (Costa e Ramus, 2012; Signori and Rusconi, 2009).

to take strategic solutions[68], especially in the aftermath of a global financial crisis and the collapse of confidence in financial markets. Choosing that *purpose* should guide management towards the *common good* (that will soon be deepen), mitigating *moral hazard* against the *azienda* by the various stakeholders, whose particular interest may be temporary and therefore dangerous for its *durability*. The *final purpose* is unique[69], and combined with survival and development conditions necessary to pursue it, we have the *azienda*'s *primary interest* (Di Carlo, 2016). According to *primary interest theory*, survival and development conditions are recognized in the *sustainable value* creation. Today it is clear how sustainable economic growth can happen only through «*sustainable growth of companies that can, according to their behaviors, promote, slow down or prevent development*» (Cavalieri, 2010). In the irresponsible company, *final purpose* coincides with that of a particular stakeholder, conflicting more or less a directly with the *common good* of the community[70]. Therefore, it is the *purpose* to make irresponsible, or even criminal, an enterprise, determined by a "*reference shareholder*" attracted by easy profit. *Primary interest theory* discussed so far helps to measure existing distances between the special prevailing interest in a criminal enterprise and *azienda*'s proper one. It appears that, despite the high rate of *aziendality* occasionally shown (Chapter I, § 11), these companies cannot be qualifies as *aziende*, since they see their *primary interest* - meeting human needs in a sustainable manner – constantly mortified by particular interests in short-term profit maximization. Reaching a strategic equilibrium is far from simple for criminal enterprises. However, the three equilibria to meet according to Amaduzzi and Cavalieri, remain at these entities' fingertips, because they are doped with illegal practices of money accumulation, resources procurement and external support. In fact, the same practices make the *value creation* principle inherent to *equilibrium theory* collapse. Finally, the entities we are talking about maintain the ability to remain durable despite their failure to meet a sustainable value creation condition and *economicità*. Criminal environment is extremely complex because of a high hostility rate towards criminal entities operating within, and it would be impossible for the criminal entrepreneur to satisfy the *normative approach* since he is bound to the fulfillment of a plurality of its stakeholders' needs. If this is not enough, also the *stakeholder theory* fails in the outlaw case since these entities live because of certain stakeholders' hostility. Think about the relationship between organized crime and state: mafia-like organizations is not going to last for long without the State, politics and civil society interferences. These stakeholders are indeed formally hostile but they always have to: (a) run the risk of corruption; (b) deal with the critical decay generated by organized crime; (c) spend energies and resources to keep territory - the tissue from which criminal enterprises generate profit - alive. A completely depleted land could cede space to episodes of violence, minor crimes and feuds between rival gangs, but it will not be able to accommodate an entire, wealthy, organized criminal system. Operating on a living, wealthy tissue is of paramount importance for crime. Think also about the fact that these productive entities bother to act only if their hostile stakeholders are lacking or weak, so to take advantage from disbursing certain goods and services only (drugs smuggling, waste disposal, weapons, etc.). The complete absence of these *necessary hostile stakeholders* would lead, instead,

[68] According to Keay (2008), indeed, identification of *purpose* provides some guidelines for managers in carrying out their tasks, as well as control tools and governance mechanisms needed to achieve this purpose. Once the company's *final purpose* is defined, it is also possible to prevent its coincidence with the *purpose* of one of its stakeholders (Koslowski, 2000).

[69] The *uniqueness* and *univocità* (to have just one meaning) of the *purpose* is meant to avoid providing management with a vague and ambiguous *purpose* that can be misinterpreted or used opportunistically.

[70] Think of *Expo*, *Mose* and *Mafia capitale* Italian cases.

these organizations to overcome too much onerous community needs (infrastructures, health, police, etc.) to gain real profit[71]. Finally, also the concept of *common good* appears to be definitely unattainable for a company that puts profit before needs satisfaction and human's health. While one could argue the presence of the creation of *apparently positive* value[72] for a minority of *non-hostile stakeholders* (illegal goods customers, abusive workforce and entity's shareholders) is even more evident the economic, social and cultural impoverishment these organizations cause while carrying out their activities. Borrowing Argandoña's definition of *transcendent goods*, it seems difficult to consider these companies being capable of transmitting such goods, at least as Argandoña conceived them. Should these companies produce and transmit *transcendent goods*, these are all those negative values and beliefs that endanger the whole community. It seems possible to conclude saying that the predominant interest of criminal enterprises (coinciding with its ultimate owner's interest) is reaping the greatest possible profit, while taking advantage of institutional deficiencies and market weaknesses, by using any illicit means available and help from external economic (sometimes unaware) subjects.

10. *The criminal mission*

The objective of this section is to identify a general *business model* shared by the criminal economic activities through a hypothetical *mission*. The *mission* of a lawful and responsible company should be consistent with the *common good* we find in the *primary interest theory*, thus becoming an effective tool for spreading *business ethics* within the firm (Melé, 2009). However, similarly to what happens with family businesses (Tagiuri and Davis, 1992), the ownership of a criminal enterprise tends not to explicit the specific purpose for their economic activities. This occurs for different reasons: (1) maintain the utmost discretion about the entity (and activity) when this is illegal, (2) do not attract unwanted attention if it produces legal products in an illegal manner, (3) lack of managerial skills or (4) lack of attention towards its stakeholders[73]. It is clear that choices an economic entity has to make relate to the *why*, *what* and *how* to produce and sell a certain product. These basic choices are the most important aspect of the *strategic effectiveness*[74] - which the company must seek throughout its life cycle – but most of all they can determine the business' way and capability to create value[75].

---

[71] In a world where crime is unchallenged and no institutions apply the law, an organization will soon need to: (1) increase deployed forces to defend itself against other criminal competitors, (2) provide education and training to its staff and future generations, (3) give financial support to local communities so to avoid them to fall under the influence of other similar organizations. This scenario seems as unlikely as useful to show the relationship of dependency that the criminal enterprise established with most of his hostile stakeholders.

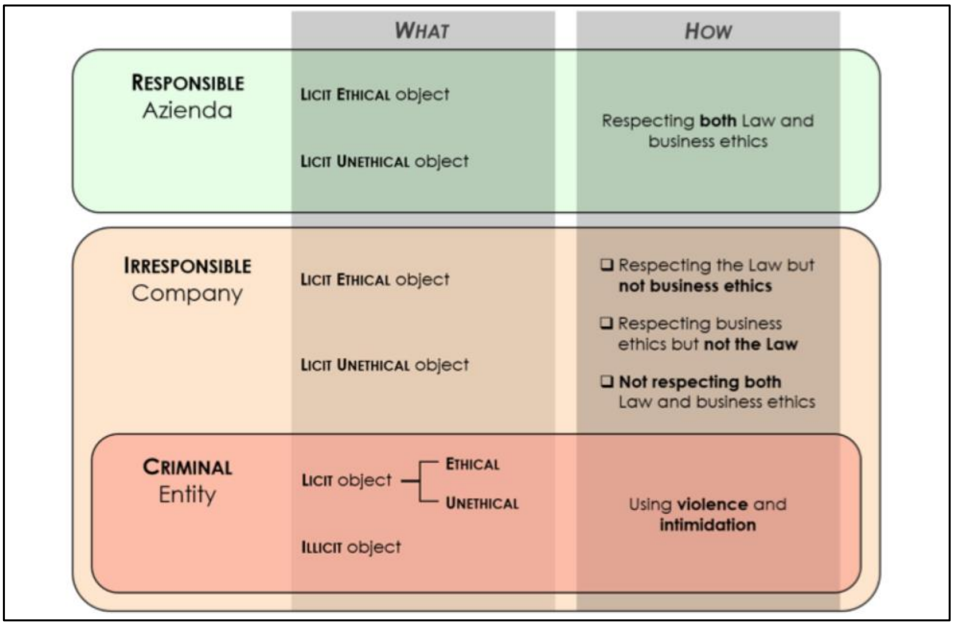
[72] We define as *apparently positive* the value generated by these companies since the same customers and employees that perceive a value undergo a series of psychophysical and financial damages, which will only be visible at a later stage.

[73] *Stakeholders* defined as *positive* and *neutral* towards the criminal enterprise (and therefore *non-hostile*), are certainly less sensitive to the company's *purpose* transparency when compared to stakeholders of any other corporation. The *positives* are willing to accept alleged criminal purposes, provided that they can benefit from them, while the *neutrals* are completely unaware of the existence or moral orientation of the entity.

[74] As seen in the previous chapter, *strategic effectiveness* together with *operational efficiency* are the elements that underpin the corporate character of *economicità*, a condition to be met in order to ensure *durability* to the system.

[75] The "*what*" and "*how*" to produce are excluded from the *primary interest* because companies should always be ready, in their own interest, to change them when they are no longer able to meet their needs, or to be consistent with the "*why*" of the corporate production (Di Carlo, 2016).

Table 151 – *Responsible, irresponsible and criminal companies based on conduct that they follow in their business model*



Source: Di Carlo (2016) – Reworking: D'Urso (2016)

In the table above, Di Carlo proposes a classification of responsible, irresponsible and criminal companies based on conduct that they follow in their *business model*, with respect to law and ethics (*what* and *how* to produce). The nature of a corporate object can be ethical or not, but this revealed to be irrelevant when discerning criminal companies from other legal types of firms. This is because the latter, in addition to an unlawful object, can easily pursue a legitimate one, be it ethical or not. Hence, it is the *final purpose* to be instrumental in tracing the boundaries between responsible corporations and criminal economic entities.

Why to produce. The criminal enterprise makes no exceptions. The gangster par excellence, *Al Capone*, during the American Prohibition era[76] said: «*Hell, it's a business... All I do is supply a public demand. I do it in the best and least harmful way I can. I can't change the conditions. I just meet them without backing up. [...] Nobody wanted Prohibition. This town* (Chicago a/n) *voted six to one against it. Somebody had to throw some liquor on that thirst. Why not me? […] I'm a businessman. I've made my money supplying a popular demand. If I break the law, my customers are as guilty as I am*» (Levell and Helmer, 1990). By doing so, he did not only claim the social and entrepreneurial role played by organized crime but, above all, he answered to the *why* of its business in a similar manner to what researchers attribute to the *azienda*. The profit resulting from the business activity should be the mean (the *how*) that allows the entity to meet the needs of customers in time (the *final purpose*, the *why*), and not vice versa (Cafferata, 2014), as proposed by the Friedman's *shareholders' theory*. Furthermore, focusing the attention on *needs* is crucial to decide *who* (marketing target) and *where* (geographical area) to serve. Satisfying human *needs* is the true and unique firm's *social purpose*, since contributing to community welfare brings to

[76] The period between 1919 and 1933, when the United States banned the manufacture, sale, import and transport of alcohol through the *Eighteenth Amendment of the American Constitution* and the *Volstead Act* ("*Prohibitionism*" by J. Rosenberg, *history1900s.about.com*, 2016).

the *common good* and it is the most acceptable *purpose* for the company's *stakeholders* (Di Carlo, 2016). In general, the needs to meet divide in two categories: those (a) of the buyers and those (b) of the subjects who participate in the productive activity (who are both *institutional* and *non-institutional* actors[77]). Criminal economic entities that are operating under monopoly conditions pay always less attention at customer needs. This is why the above stated principle assumes different dimension in the criminal business world. Apart from the apparent *social purpose* of satisfying consumers demand, it does not mean that everyone who is involved or interested in a criminal enterprise's activity is a consumers (either directly, by consuming the company's product, or indirectly, by consuming a derived product) or shares its *specific purpose*. While meeting the needs of the so called *institutional stakeholders* remains a necessity for the criminal economic entity, this obligation eventually becomes more fragile with its customers (because of *information asymmetry* that characterizes most of the criminal markets[78]) up to become null or counterproductive in case of *non-institutional stakeholders* who are mainly hostile to its activity. The necessity to know how to meet shareholders and employees' needs and expectations (*capital* and *labor*) remains the condition of survival and development for the criminal firm. If these needs remain not satisfied, there will be no convenience to participate in productive affairs and the company will be destined to disappear - although this process slow down if illegal labor, violence and intimidation are used. On the contrary, meeting the needs of its *hostile stakeholders* (such as the civil society needs for security, legality and health[79]) would mean going out of business. As already mentioned, *information asymmetry* between enterprises and customers exponentially feeds the possibility that firsts use, inappropriately, information at their disposal to detriment of the seconds. Trust-based relationships in these cases are crucial, especially for a criminal environment, where there are no protections at all nor for buyers or sellers. In this case, "*why* to produce" of criminal enterprises could not be human *needs satisfaction*, since their *durability* is not going to suffer that much. Indeed, these type of companies often force their customers to buy their products with violence and/or intimidation[80].

What to produce. The type of activity conducted to satisfy needs determines type of products produced and represents the "*what*" part of a *mission*. Every business, even when producing the same good or service, meets a *specific need* and the products can be *tangible* and *intangible* goods and services. Some large conglomerates (Unilever, Procter & Gamble, etc.) may offer a multitude of products, just like organized crime multinationals do offering (all or part of) the following goods and services: (a) drugs, arms, humans, works of art and counterfeited/stolen goods trafficking; (b) collection, transport, storage and illegal disposal of all kind of waste, often highly toxic and harmful for health and natural environment; (c) cybercrime and computer fraud; (d) food sectors, public procurement and real estate investments

---

[77] With the term "*institutional*", we refer to capital and labor and thus to company's internal resources, to be distinguished from so-called *non-institutional stakeholders* who are external agents (such as suppliers, the state, society, etc.).

[78] In contexts characterized by high *information asymmetry*, clients might not be able to tell if offered products meet their needs or not, or what are the side effects of such products. Customers sometimes realize the real necessity behind products they bought just at a later stage, when it's too late (drug habit, purchase of counterfeit goods, etc.).

[79] This refers to cases where, for example, against the satisfaction of a "niche" need, entire communities have to undergo an unwanted "service" (i.e. presence of drug dealers, public areas devastated by waste, etc.), which jeopardizes the security of future generations.

[80] Consider, for example, a public body infiltrated by mafia that has to buy goods and services from criminal enterprises. These companies, therefore, not only do not create positive value, but do not even meet needs.

sectors control; (e) management of games and bets; (f) recycle and re-use of illicit proceeds deriving from the above mentioned criminal activities. Observing the road of economic crime so far, appears evident once again how truly extraordinary the ability of this to change and innovate products offered can be. Moreover, this is done without losing sight of productivity and profitability of its activity over time. The American example, in this case, becomes useful once again: immediately after the repeal of Prohibition in 1933, mafia gangsters fled the liquor trade and managed to get into the labor racket field and gambling control[81]. In market economies, legal systems grants private entrepreneurs the freedom to organize and decide on "*what*" to produce, if the product (thus, the social object) is lawful, determined or determinable. However, this does not exclude that the economic activities carried out by criminal organizations cannot be considered companies. Indeed, these entities may produce illegal goods/services traded in black markets where the meeting of supply and demand sets prices. As previously seen, even without presenting legal subjectivity, criminal economic entities sometimes present all the three characteristics of *aziendality*: *systemic vision*, *decision-making autonomy* and *economicità*. In any case, the product (or *output*), should not to be confused with the so-called *outcome*. In fact, while *output* is objectively measurable and observable, *outcome* is not necessarily detectable and it is considerably difficult to measure, since it refers to the *utility val*ue assigned by users that is determined by the level of users' needs satisfaction[82]. *Outcome* is the result of *output* effects on consumers plus the way the company manages its capital (i.e. human, social, intellectual) and it relates to *how* it produces the good or service, which is the way the company creates value. The existence of an *outcome* becomes very important in order to judge criminal economic activities for what they really are, since we should not recognize *value creation* to an illegal entity just because it realizes a product (good or service) that is worth more than *inputs* used to make it. Also if there are no reliable tools to measure user's satisfaction of needs for weapons or drugs for example (regardless of the price paid), the uneasiness (and, thus, dissatisfaction) of who does not appeal to organized crime in order to meet his needs and suffers from the devastating impact of *criminal outcome*, is far too evident.

How to produce. The input-output transformation process is a key component of the company *business model*[83], which allows it to achieve a *competitive advantage* over competitors[84]. A *competitive advantage* is considered sustainable if it cannot be easily copied, replaced and eroded by competitors' actions, or if the continue evolution of the economic environment does not make it obsolete (Porter, 2008). It is clear how *competitive advantage* closely relates to the criterion of *economicità*, which implies the choice of "winning" *goals* and economy of resources necessary to achieving them. In turn, *economicità* depends on *who*, *how* and *when* (the *time horizon*) the *azienda* intends to create value. Even the *why* to produce a certain product

---

[81] Exactly as it happens today, gambling was considered legitimate by many at that time, although this was able to feed a huge round of illicit proceeds through bets and games falsified by criminal organizations. A well-known recent example is the infiltration of organized crime (Balkan and Italian mafias) in the Italian soccer betting system through match-fixing (the so called "Calcioscommesse").

[82] For a hospital, for example, an *output* can be the number of patients discharged in the year, while the outcome is the satisfaction level of resigned patients who have benefited from its service.

[83] Meant as the logic an *azienda* uses when creates, distributes and capture value (Baden-Fuller and Morgan, 2010; Zott, 2011).

[84] In a first approximation, *competitive advantage* of a company consists of what determines superior performances, usually in terms of profitability, compared to the average of direct competitors, over a medium to long-term period.

has inevitable repercussions on the way it is made (the *how*) and, for this reason, some consistency is needed between the *how* and *why* to produce in every *azienda*. The *business model* should follow the principle of *economicità* and a *value creation model* to guide its choices. Indeed, a model based on the *corporate primary interest* leads to a policy of *economicità* that takes into consideration both the interests of the *azienda* and its *stakeholders* in an equilibrium framework. Regarding the criminal enterprise, the business model is structured so to create value for the owner organization by ensuring that the *effectiveness* and *efficiency* lead to choices oriented to satisfy that interest only. This can lead the entity to a short-term equilibrium. The balance of a criminal economic entity should never be confused with the balance of the criminal holding or group (*the balance of the balance*s) from which this is often controlled. This equilibrium tends to remain even stable thanks to violence, intimidation, corruption and internal transactions involving enormous amounts of "dirty" money between one subsidiary and another. For the criminal "subsidiary", therefore, the overall value created seems to be negative, and not zero, as we might imagine. The criminal entity, in fact, negatively affects the majority of stakeholders involved and hampers them while rejecting its power. This remark relates to our theory of *bio-economic parasitism*, which describes the mechanism used by these type of entities in a *parasite-host relationship* from which they attempt to take full advantage in the short run while being careful not to damage its *target environment* too much, otherwise it will no longer be able to provide "nourishment" for the criminal entity. It is useful to remember how the criminal enterprise, whatever objective should it pursue, is unable to survive without many of its *hostile stakeholders*. The *what* and *why*, as mentioned earlier, can be modified over time in response to market changes or new production technology discovered, reflecting their changes on the company's *how* to produce and its capacity to cope with business risk. The criminal enterprise has not just an illegal *what* (i.e. drugs, weapons, illegal gambling), but it has also an illegal *how* to produce, an illegal *business model*. Therefore, in this case the principle of *economicità* reflects in the conduction of such business, based on *value creation* for criminal *positive stakeholders*, and drives towards assigning *objectives* to be illegally reached. Criminal's "*how*" to produce, aims at maximizing profit in the short term, satisfying the interests of a small part of its *positive stakeholders* (similarly to the *shareholders' theory*) and brings to an "artificial" equilibrium, restricting competition and upsetting markets. The presence and success of irresponsible and criminal enterprises could lead lawful companies to lose *durability* - even if characterized by a more effective and efficient business model than their outlaw counterparts – and honest entrepreneurs are not able to avoid this, since it results from external factors. For these many reasons, even if the production of criminal enterprises can reach a higher value than the sum of the consumed production factors, it is not possible to say they create sustainable value.

Table 152 – *The criminal mission*

11. *Conclusions*

The aim of this section was to investigate the role of organized crime, under the corporate profile, within the current socio-economic context of global economic crisis, uncertainty and distrust in markets. The need to observe the economic crime under the lenses of the *Economia Aziendale* comes from the limits that Law demonstrated in the ability to evaluate, alone, the business-oriented features of the current criminal economic entities. Therefore, we aimed at achieving a greater awareness of the level of *aziendality* that criminal enterprises are able to reach, so to be able to propose solutions to limit their *durability*. Among the questions that we tried to answer there are, "*what is the criminal enterprise and where does it originate? How is its "criminal" environment composed and what are the interconnections between the latter and the stakeholders that populate it? As part of their activities, may criminal enterprise be considered aziende and how do they manifest characteristics of aziendality? What is the prevailing interest in the criminal entity and how is it able to survive away from the one primary interest? How is the criminal business model structured and what are its weaknesses?*". In the following lines, in addition to resume and fix the concepts learned so far, we try to provide some guidelines, compatible with the principles of *Economia Aziendale,* useful to fight the criminal economy phenomenon. We now know the *irresponsible economic activity* as primary incubator and container of the deviated criminal entrepreneurship, direct progeny of behaviors considered legal yet irresponsible, which trample the interests of employees, local communities, suppliers, States and environment, leaving them out from their decisional and operational horizon. Social irresponsibility is certainly a broad category that includes activities and conducts going against community's well-being, and criminal activities nourish a parallel economic system called *shadow economy*. While the criminal enterprise grows from a cultural context of *irresponsible enterprise*, it builds up in the *shadow economy*, which is still difficult to observe and quantify. This economic habitat constitutes the perfect shelter for this type of activities and it is one of the elements contributing to their *durability*. Approaching to criminal economic entities, we decided to dwell on the more structured realities, which are capable of interacting at an institutional level with other economic actors, usually arising from organized crime forms. As it has been observed, these have strong ties to their local territory but they also show a strong (and growing) ability to cross national borders and constitute what we defined as *divergent globalization*. These entities simultaneously finance the production of a multitude of illegal goods and services, which revenues (the so-called *illegal proceeds*) are partly used to penetrate the legal market and generate even more revenue, irresponsibly. After a *criminal environment* analysis, starting from a simplification of the *stakeholders' salience* theory by Mitchell (1997), we introduced three main categories of stakeholders: *hostile (contrary or misaligned* interest*), positive (compatible or aligned* interest*)* and *neutral (unknown alignment)*. The first type of stakeholders is *necessary* for the criminal firm as much as the second one for pursuing its goals and activities, but this actors' type is potentially lethal to the entity's existence. *Positive stakeholders* (workforce, customers and shareholders) are functional to its economic activity instead, while *neutral stakeholders'* category includes those subjects who, although being potentially positive or negative stakeholders, do not have the opportunity to take part in the fight because they completely ignore the presence of the criminal enterprise. The analysis of those who are involved in the criminal economic activity led us to address the issue of *corruption,* which is the most used practice by criminal entrepreneurship to manipulate its hostile stakeholders, infiltrate legal businesses and promote its activity, diverting the market and threatening competition. Once we understood the context of reference, we decided to apply the concept of *aziendality* to criminal economic entities, as borrowed from the Italian doctrine *Economia Aziendale*. The definition of *azienda* helped to overcome the limitations of existing legal definitions and surpass thin boundaries between *criminal* and *informal economies*, by stating that an entity must possess at least three features in order to be considered as such: *systemic vision*, *decision-making autonomy* and *economicità*. With these notions in mind, we attempted to investigate how the characters of *aziendality* are present in organized criminal economic entities. *Systemic vision* requires coordination between human capital and resources in a *dynamic, durable, complex, open*, *probabilistic* and, above all, *purpose-oriented* way. All these features are present in the criminal enterprise, especially when it comes to the *criminal group* level. As for the *decision-making autonomy*, the line between criminal enterprise and criminal group gets thinner: it seems that the autonomy to prosecute a predetermined *final purpose* originates from the overlying criminal organization. In Italy, for example, different behaviors have been reported for Mafia and Camorra, which also reflects on the internal groups' stability making Mafia more stable than Camorra. However, as noted by the authorities in the case of *Mafia Capitale* mentioned in the text, it is undeniable that there exists the possibility for certain criminal entities to take advantage of important *decision-making* and *relational autonomy* in certain *extra-territorial contexts*. Then we noted how the principle of *economicità* (made up of *strategic effectiveness* and *operative efficiency*) is also present in criminal activities but it plays a much less important role with respect to lawful companies. It is indeed observable, as the achievement of *strategic effectiveness* - in absence of *ethical problem* - and *operative efficiency* - without having to worry about the *economic problem* - would be extremely easier for criminal economic entities than it is for other legal companies. In this way, the criminal entities tends to reinforce their huge competitive advantage over legitimate competitors trying to create *monopolies*, aided by the use of *violence* and *corruption*.

We could assume that, according to the sole criteria of *aziendality*, it is impossible to deny the complex nature of corporate criminal enterprises that makes them incredibly similar to an *azienda*. For this reason, it was necessary to go further in the analysis to understand better these entities by studying their *purpose* and the way in which they try to pursue it. In the end, therefore, we dealt with the definition of the *azienda's primary interest* - as a tool to measure the distance between the *prevailing interest* in criminal enterprise and the *primary interest* of the *azienda* as *common good* - and with the definition of its basic *business model* through a hypothetical "*criminal" mission*. At the origin of the *primary interest theory* (Di Carlo, 2016), indeed, there is the aim of proposing a universal *purpose*, which is used as a valid government principle for all classes of *aziende* through the intersection of three theories: the *corporate equilibrium theory by Amaduzzi* (1994) revised by Cavalieri (2010), the *stakeholders' theory* and the *common good theory*.

It has been noticed how the criminal enterprise fails in complying with all three main theories for just as many principal reasons: (1) the criminal economic entity's *final purpose* coincides with that of its *ultimate owner*, seeing its real and unique *primary interest* repressed – the satisfaction of human *needs* with the production of goods or services while *sustainable value* for itself and for its stakeholders (Di Carlo, 2016); (2) the lack of ethics in strategic decision making makes it a *common evil*, rather than a *common good,* both for its *positive* and *hostile stakeholders*; finally, (3) the complexity of criminal environmental systems makes it impossible to reach a *strategic interest equilibrium* when the majority of the surrounding stakeholders are potentially lethal for it.

This led us to conclude that - while an *azienda* is a productive organization using a systematic approach, independent decision making and *economicità* in order to fulfil human needs while creating sustainable value for itself and its stakeholders - the criminal economic entity is itself a productive organization. It is *systemic*, *autonomous in the decision-making process* and operates according to the principles of *economicità*. The main difference is that criminal organizations are oriented to meet *special needs and interests* through the creation of *apparent and unsustainable value* for the whole community in the long-term. This *apparent unsustainable value*, obtained from the exploitation of market flaws and hostile stakeholders' weaknesses, is another of pillar guaranteeing organized crime to persist over time. As long as there is someone who perceives the criminal ability to create value, it will be increasingly difficult to defeat.

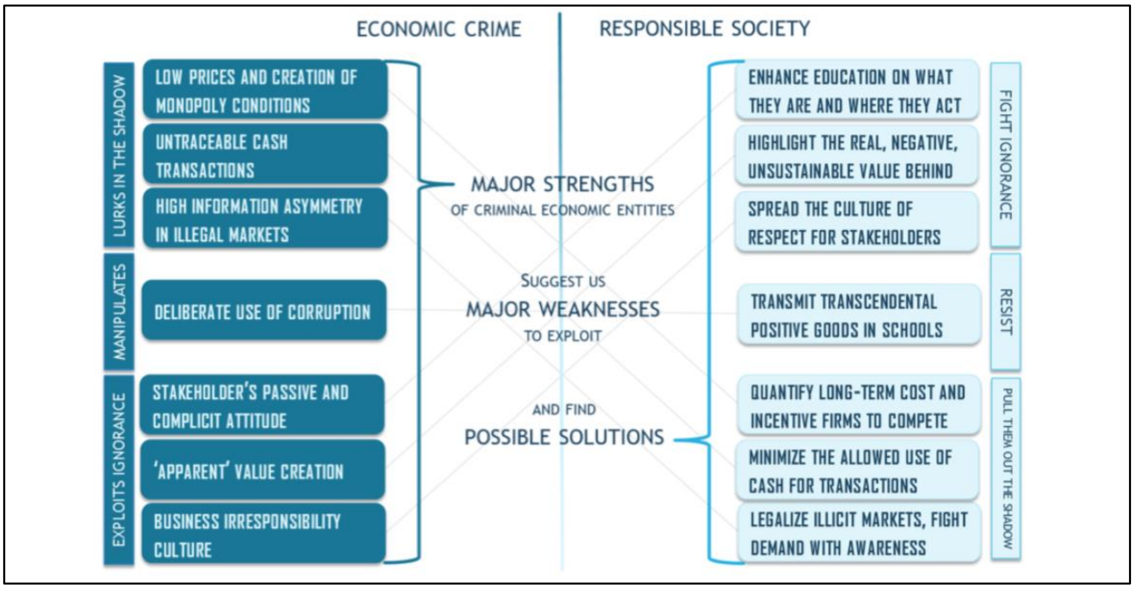
"***故曰：知彼知己，百戰不殆；不知彼而知己，一勝一負；不知彼，不知己，每戰必殆。***"

"*So it is said that if you know your enemies and know yourself, you will not be put at risk even in a hundred battles. If you only know yourself, but not your opponent, you may win or may lose. If you know neither yourself nor your enemy, you will always endanger yourself.*"

Sun Tzu, *The Art of War*, 5th century B.C.

Following the proposed analysis, it is clear how the criminal enterprise arises from a ***rooted cultural context of irresponsible entrepreneurship***, last century's legacy, in which profit and economic balance were the only variables to take into account when pursuing *durability* and financial success (failing miserably, moreover).

Table 153 – *The possible solutions*



It feeds on the ***passivity, ignorance and complicity of neutral and positive stakeholders*** and relying, in addition, to a social economic tissue already compromised and weakened by the current financial crisis that sees individuals more and more used to practices of ***corruption***. In addition, criminal economic entities make an extensive use of ***untraceable transactions*** using *cash* deriving from *illegal proceeds* as primary form of liquidity (that is, for example, the principle on which the *currency demand approach* relies on) that feeds the *shadow economy* weakening the legal one. Even in relating to its customers, inexhaustible and irreplaceable source of economic support, the criminal enterprise exploits the ***high information asymmetry level*** characterizing illegal goods markets where lack of control and regulation does not allow customers to have alternative ways to satisfy their needs. They even perceive an ***apparent value creation*** (which translates into a ***real negative value***, unsustainable in the long term). Not to mention the use of ***coercive means such as violence and intimidation*** as a common practice in partners and competitors' trading relations (i.e. usury). Finally, high level of information asymmetry, ignorance and social disease help the company ***spreading negative transcendental goods***, harmful to civil society but necessary to maintain its privileged status in the eye of people who work and live for it (thus making it more and more difficult to convince them to leave the criminal world).

The above-mentioned strengths, used by these companies to survive and strengthen their dominion, are also the largest weaknesses to exploit if we want to weaken their *durability*. Indeed, if there exists a cultural heritage of unethical behavior that originated in the past few decades of ruthless race to profit, there is also an incredible academic and social push towards a ***culture of respect for stakeholders*** involved in the economic activity and a ***greater attention to extra-economic goals setting*** by the legal companies. In fact, if lawful entities manage to communicate effectively the higher and beneficial value created by their products and services beyond the simple price (which is just a short-term cost for the customer) they should no longer fear the unfair aggressive pricing competition of criminal entities. Criminal enterprises, because of their very own nature, are not able to compete on quality. A lower cost borne by unaware customers in the short term is complemented by the incredibly high cost that they (and the whole society) will have to pay in the long one. Moreover, ***spreading***

anti-corruption practices and transcendent goods such as honesty should guide new *teachers and professors*, since the primary school classes, to mold future leaders that will be immune to the temptation of corruptive and destructive criminal organizations. Furthermore, though delicate and debated the monetary topic may be, it is hard to think of defeating these black economy giants without ***reducing to a minimum the permitted use of cash*** and also extend the traceability of micro transactions. Once *shadow economy* is weakened and its incidence reduced, it is important to ***spread culture and knowledge regarding the true nature of these criminal organizations to as many people as possible***, even those seemingly disinterested or untouched. Criminal economic entities fear their hostile stakeholders and are forced to spend a considerable amount of their (almost unlimited) resources to counter them. Nevertheless, if the entire majority block of *neutral stakeholders* is reached by accessible and responsible information, then these stakeholders could turn from *inactive/passive to active/hostile*, thus reaching an unsustainable number and strength for criminal enterprises to cope with under a strategic point of view of. Their interests indeed would be no longer easy to be ignored and trampled, as they are today, and this will cause intimidation and violence to lose a big part of their effectiveness. Lastly, with respect to the *apparent value* perceived by the demand for illegal goods, it is imperative for the State to intervene, ***wherever and whenever possible, to regulate and legalize the production and trade of these illegal goods and services.*** In this way only, and not just with prohibitions, a demand that unfortunately exists (and in no way can be defeated completely) could be met transparently and safely. Instead, we should reduce and demolish part of this demand in classrooms and families, with the help of an economic and social well-being that only the ***pursuit of the azienda's primary interest*** generates.