

What is the Firm?

Dong-Sung Cho
Seoul National University

Businessmen's View of the Firm

Last February, a lecture was given to the participants of an advanced management program at one of the North European schools. The program was attended by about 70 senior executives from Europe, the U.S. and Asia. Since each participant had typically 20 to 30 years of management experience, their combined experiences would easily amount to 1,500 years. With such a span of time, one could easily go back to the old history of the Eastern Roman Empire. Due to their extensive experience, most professors without substantial field experience would tend to feel immense psychological pressures when they were to give a lecture to the participants.

In this program, the author presented a two-hour lecture on the title of "What is the firm?" Believing that conveying his ideas to the top executives unilaterally would be an impertinence to their extensive careers. He asked the participants to give their on-the-scene views of the firm.

The question "What is the firm?" was obviously too abstract and vague, so the executives hesitated to speak up in the beginning. But with the passage of time, different voices began to come forward. He wrote down those views on the chalkboard without any modifications. Certainly their opinions represented unique characteristics of the firm based on their long field experience. After a while, the chalkboard was covered by a score of opinions as shown on <Exhibit 1>.

<Exhibit 1>

What is the firm?

- | | |
|--|---|
| * a place to make profit | * a body of common destiny |
| * a means to get maximum effect from minimum resources | * an orchestra |
| * a mixer as men, money, materials and machines are combined to make products and services | * a work-place of workaholics |
| * money-makes-money game | * a three-legged race |
| * to satisfy customers | * a place to give society what it needs |
| * means of our living | * a benefactor to mankind |
| * where you get all kinds of stresses | * an institution paying taxes to the government |
| * where you get a sense of achievement | * a job creator |
| * a test of hardship and endurance | * a place where new technologies are born |
| * a cooperative body of employers and employees | * an engine of the national economy |
| * a place where members develop their capabilities | * a means to upgrade the standard of living |
| | * like a sweeper, as it cleans up unemployment, starvation and homelessness |

After writing down the comments, he drew a vertical line separating the chalkboard into two as seen in <Exhibit 2>. Then asked the participants to point out differences between the two groups of answers. To this question, one said the left side was processes and the right side results. Another participant answered that the left side was the means and the right side objectives. Still another participant replied there were things happening within the firm as in the left side and things happening outside the firm as in the right side.

<Exhibit 2>

What is the firm?(divided)

<p>(Micro-1)</p> <ul style="list-style-type: none"> * a place to make profit * a means to get maximum effect from minimum resources * a mixer as men, money, materials and machines are combined to make products and services * money-makes-money game 	<p>(Macro-1)</p> <ul style="list-style-type: none"> * a place to give society what it needs * a benefactor to mankind * an institution paying taxes to the government * a job creator * a place where new technologies are born * an engine of the national economy * a mean to upgrade the standard of living * like a sweeper, as it cleans up unemployment, starvation and homelessness
<p>(Micro-2)</p> <ul style="list-style-type: none"> * to satisfy customers 	<p>(Macro-2)</p>
<p>(Micro-3)</p> <ul style="list-style-type: none"> * means of our living * where you get all kinds of stresses * where you get a sense of achievement * a test of hardship and endurance * a cooperative body of employers and employees * a place where members develop their capabilities * a body of common destiny * an orchestra * a work-place of workaholics * a three-legged race 	

The author stated that all the answers made sense, and then offered to explain their answers with still another term: the comments on the left side could be found when one examined the insides of the firm with a microscope; those on the right side could be seen when one observed the role of

the firm in society through a telescope. To use more scientific terms, the contents on the left side could be called microscopic views of the firm and those on the right side macroscopic views of the firm, I added. Then I made an interpretation of the participants' comments on the firm as follows.

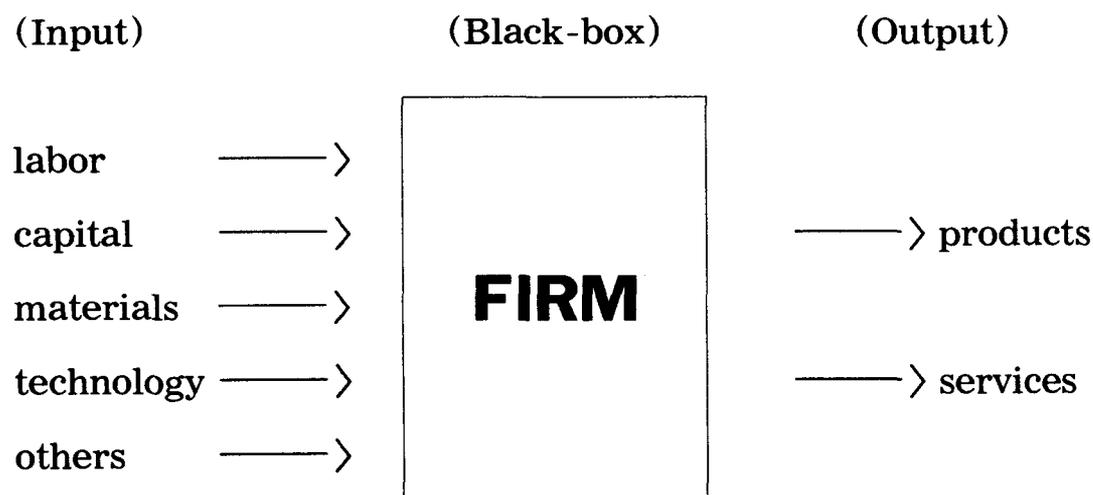
The Firm Seen Through a Microscope

Now we will discuss the firm based on a microscopic prospective. The contents on the left side of <Exhibit 2> can be further divided into three groups by drawing two horizontal lines. In other words, there are three different opinions under the microscopic perspective.

As the black-box seen in <Exhibit 3>, the firm has a role to combine such input as labor, capital, materials, technology and others to produce such output as goods and services which are totally different from the input in terms of shape, characteristics and value.

In this case, the monetary values of the output and the input can be called revenues and costs. The firm is an organization aiming at maximizing revenues, while minimizing costs for the greatest profits. This way of explanation portrays the most traditional and orthodox view of the firm. In this context, Milton Friedman, a liberal economist, pronounced that "the social responsibility of a corporation is to maximize profit¹⁾."

<Exhibit 3> Microscopic View of the Firm (1)



1) Friedman, M.(1970), "The Social Responsibility of Business is to Increase its Profits", *New York Times Magazine*, Sep. 13.

The firm is...



..a place to make profit.

The firm is...



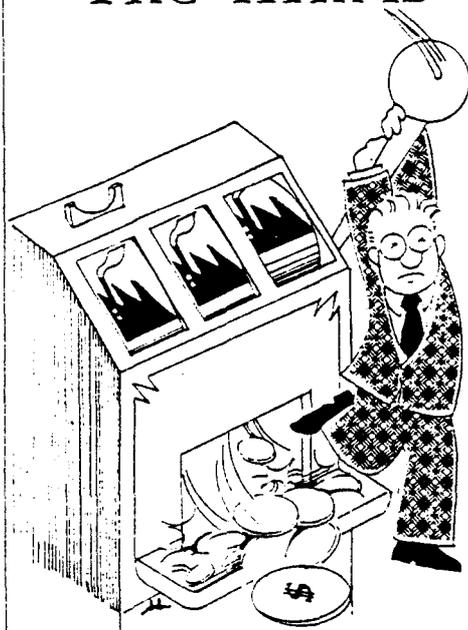
*... like a mixer.
men, money, materials and machine as input,
products and service as output.*

The firm is...



provider of various products.

The firm is...



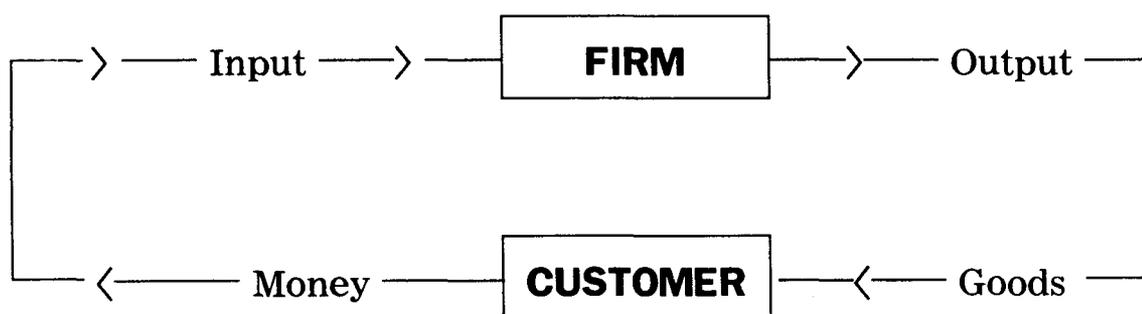
... a money-makes-money game.

Using the participants' expressions on the top left side, one can define the firm as an organization which produces goods and services by combining manpower, money, materials and other resources to make profits. This definition is as good as the basic concept of the firm used in any textbooks on management principle.

However, this traditional interpretation of the firm has in reality faced many problems. The firm often goes bankrupt, instead of becoming prosperous, if the mechanism in <Exhibit 3> is used blindly. Although there is a great number of companies which make products and services by efficiently utilizing labor, capital, materials and technology, some of them go bankrupt with mounting inventories, cash bottleneck and inability to pay wages and debts.

What are the problems hiding behind <Exhibit 3>? Indeed, isn't the first opinion defining the firm only as a manufacturing system? Yes, the firm can easily produce output which it thinks has a higher value than the input. Nevertheless, the firm cannot carry out its functions as an ongoing concern, unless the customers seek, buy and consume the output of the firm. In other words, the output from the firm and the money from the customers have to be exchanged in order for the firm to use the money to buy the input needed for the next processes, as shown in <Exhibit 4>.

<Exhibit 4> Microscopic View on the Firm (2)

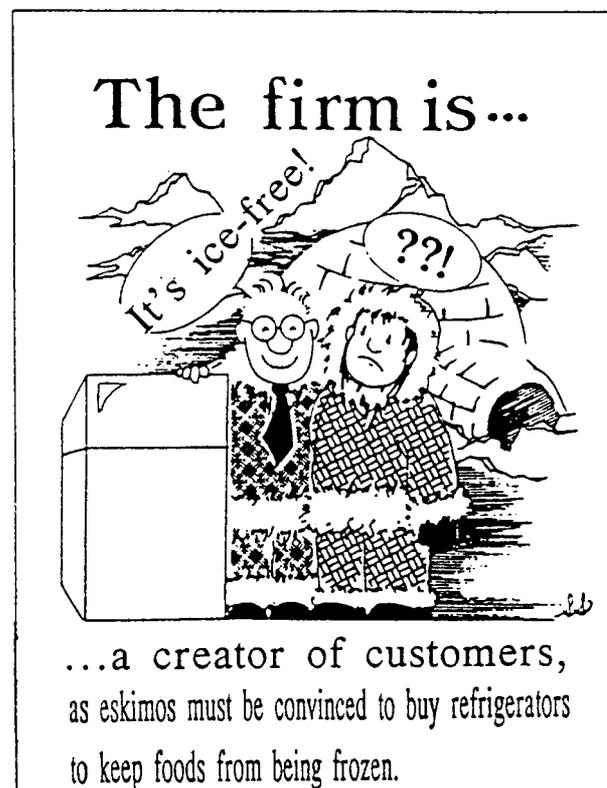
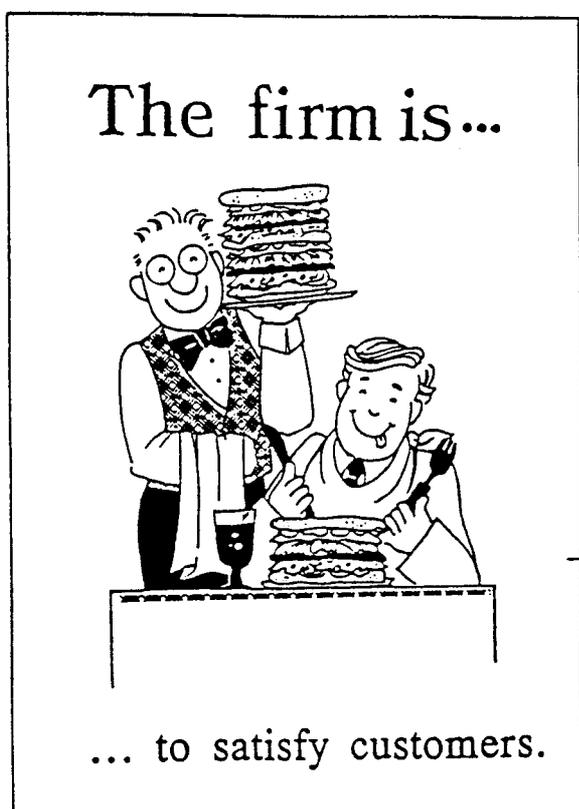


Let's take an example of the state of U.S. economy at the end of World War II to illustrate this view. During the war, production facilities were destroyed not only in the defeated nations of Germany, Italy and Japan, but in the victorious nations of the United Kingdom and France as well. Whereas,

on the American continent production facilities actually increased in order to provide the military supplies needed for the allied forces in war fronts in Europe and the Pacific. As a result, when the war was over in 1945, the per capita income of the United States was US \$3,000, the highest in the world, while the per capital income of the U.K. was US \$1,200 and France US \$900.

On the assumption that American consumers would have had big latent purchasing power based on such a high income level, American firms utilized their greatly expanded production facilities to mass-produce products for general consumers. However, American consumers continued to practice the thrift that they sustained during the war, so many firms could not sell their goods as expected and ultimately went bankrupt.

Those firms realized that they could not continue to make the same products that they used to. They had to accurately understand which products consumers wanted, and develop and produce the products accordingly. Then the firms had to inform latent consumers of the existence of such products through active advertising. The firm also had to develop a distribution system that extends from the factory gate to the consumers' front door so that they could feel the need to consume. This was marketing, and the one in charge of marketing was the manager, while the firm became the



arena in which the manager conducted marketing activities. Peter Drucker, a business professor at Claremont University in California described such views of the firm in the following brief sentence: "The role of the corporation is to create customers."

The second marketing-oriented interpretation of the firm which had been upheld by management scholars since World War II faced new challenges in the 1980s. The eminent futurologist Alvin Toffler said in his book *The Third Wave* that the agrarian society, which started some 8 thousand years ago when mankind recognized the differences of the four seasons, was transformed into the industrial society in the late 18th century with the advent of the industrial revolution.²⁾

Toffler added that in the industrial society, the firms were established, and replaced the manor of the agrarian society as the dominant force of the production. Nevertheless, the industrial society began to show its own limit as its mode of production proved not only to deplete the limited resources of the earth but also to cause environmental hazards. As a result he argued that the industrial society would be eventually transformed into the information society from the late 1970's.

What would then be the fate of the firm logically coming out of his prediction? As dinosaurs which dominated the globe some 70 million years ago became extinct because of the changes in natural environment, wouldn't the firms which dominated the industrial society be exterminated in the wake of the changes in social environment? As we have to go to the museum to see the bones of dinosaurs, wouldn't it be the case that we have to go to the museum to find traces of the firms in the future when the information society arrives?

According to Toffler, the firms in the industrial society generate profits as they turn human and material resources into products and services by throwing them into the buildings and factories which are their assets. Indeed, the firms regard materials and people simply as costs. However, in the information society, people create value by using their ideas which stem from their creative ideas and deep thoughts. As a result, people will replace buildings and factories as the asset for creating profits of the firm in the in-

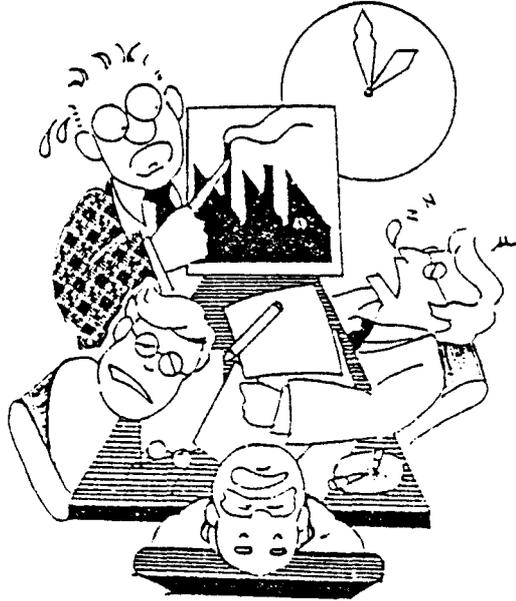
2) Toffler, A. (1980), *The Third Wave* (New: Willian Morrow and Company, Inc.)

The firm is...



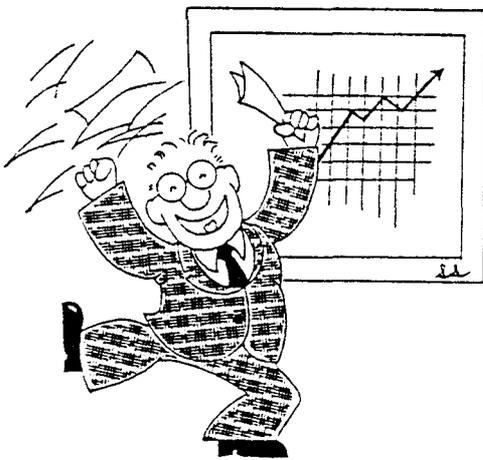
...means of our living .

The firm is...



... a test of hardship
and endurance

The firm is...



..where you get a
sense of achievement.

The firm is...



..where you get
all kinds of stresses

formation society. However, the financial statements of any firms in the industrial society today show buildings, factories and machinery as fixed assets on their balance sheets, while people are counted as personnel expenses on income statements. So the firms with this kind of view on people will be terminated when the information society arrives.

Then what should managers do to help their firms survive in the forthcoming information society? The answer is clear: they have to transform their firms to cope with the changes in social environment. To be more specific, the firms should regard people as assets, not expenses, while counting factories and buildings as expenses, not assets. Certainly, such transformation of the nature of people and other items should take place not only in the accounting sheets but also in the minds of the managers from the top executives to the workers in the factories.

The gist of such transformation of the firm can be summarized as follows: "The mission of a corporation is to develop human capacity."

The Firm Seen Through a Telescope

Now let's draw a horizontal line on the right side of <Exhibit 2>. This line means that macroscopic views on the firms can be divided in two.

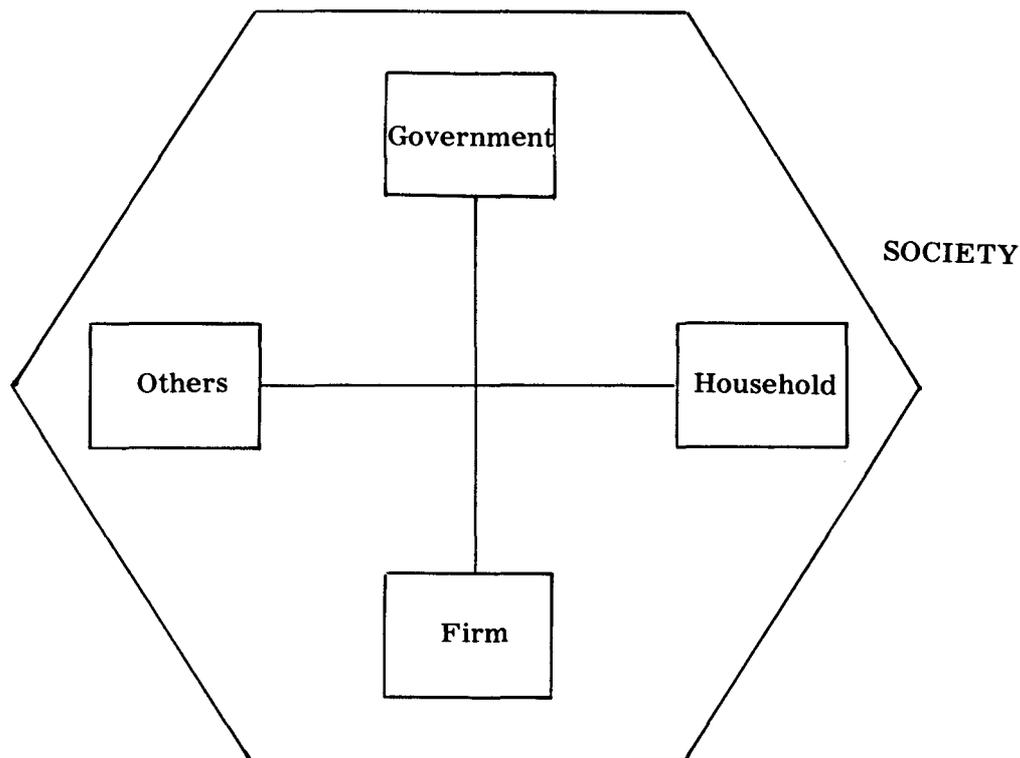
While a major concern in the microscopic views is to find the truth from the observation of the subjects, the macroscopic views are typically concerned with value judgement on the subjects. As a result, macroscopic interpretations of the firms are divided into positive and negative judgments.

<Exhibit 5> makes this point clear. The figure shows what kinds of roles the government, households, firms, schools, hospitals and other organizations play in a society. A government represents a nation externally and takes responsibility for diplomacy and defense, while maintaining social order and promoting public interests internally. A household consumes goods produced in the society, while offering labor to the society. Also, schools and hospitals work for the improvement of people's educational level and the prevention and treatment of diseases respectively.

Then what kind of roles do firms play in society? On the positive side, the firm is defined as an organization which contributes to the improvement of a society's economic status by efficiently allocating limited resources and

maximizing their added-value. In other words, no organizations in society can function better than the firms in efficiently utilizing limited resources. In this regard, social roles of the firms can be viewed as positive.

〈Exhibit 5〉 Macroscopic View of the Firm



However, there is skepticism as well. While other organizations in society such as governments, households or schools return their added value to society as a whole in a fair manner, the firms keep and accumulate their added value within their boundaries, establishing a stronger power base than before. Because of this egotism or self-centeredness of the firm, the balance among organizations within the society that was maintained in the early history of any society gradually turns into an imbalance, as the firms begin to dominate the other organizations through their accumulated power. For example, the firms can deceive consumers, exploit workers, damage the environment and decay the government with their selfish purposes.

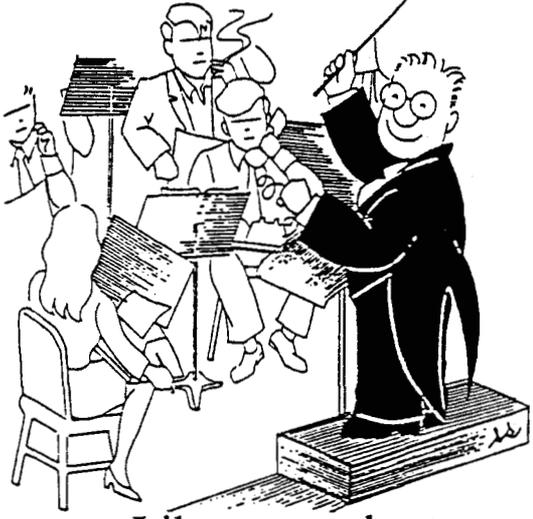
Gradually, the ill-will of the other organizations within the society against the firm accumulates, and eventually leads to their partial or total denial of the role of the firm within the society. This trend actually took place in the United States and other advanced nations in the late 19th and the early 20th

The firm is...



a cooperative body of employers and employees

The firm is...



... Like an orchestra
In an orchestra different instruments make harmony.
In a firm, different functions make profit.

The firm is...

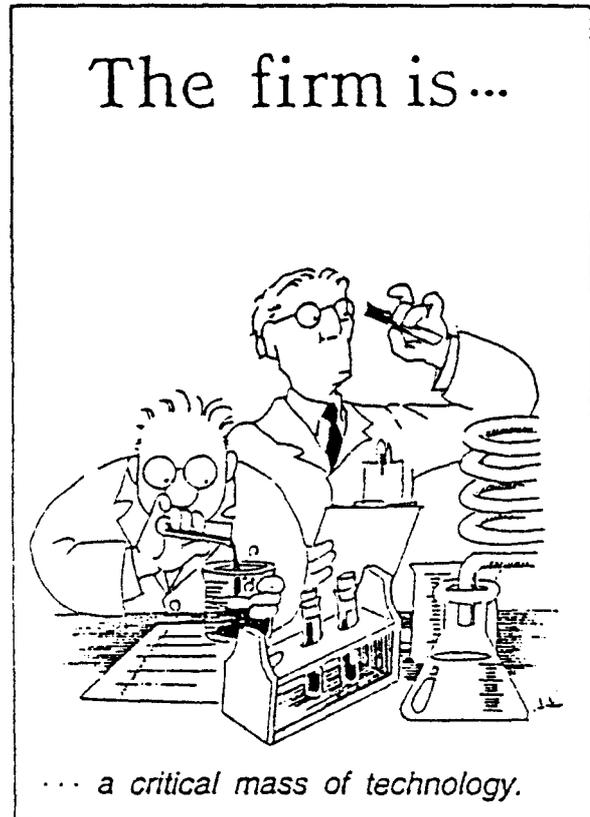
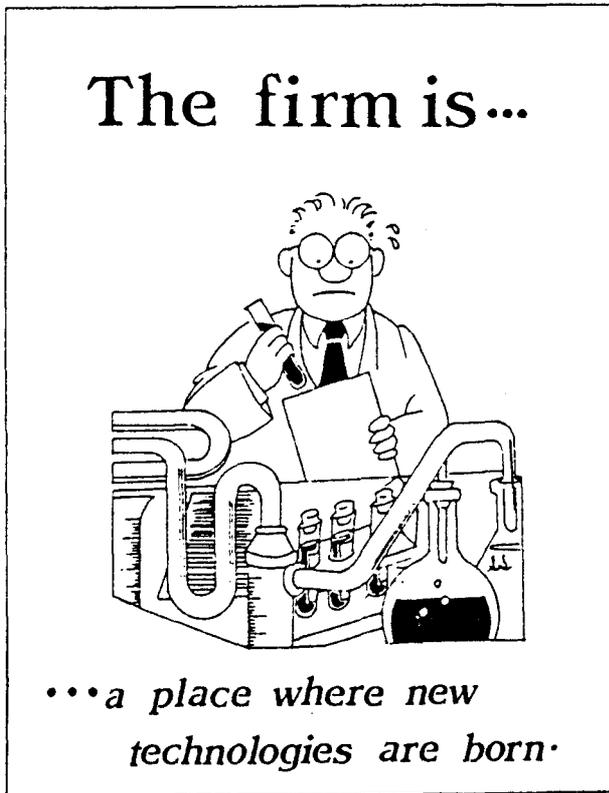
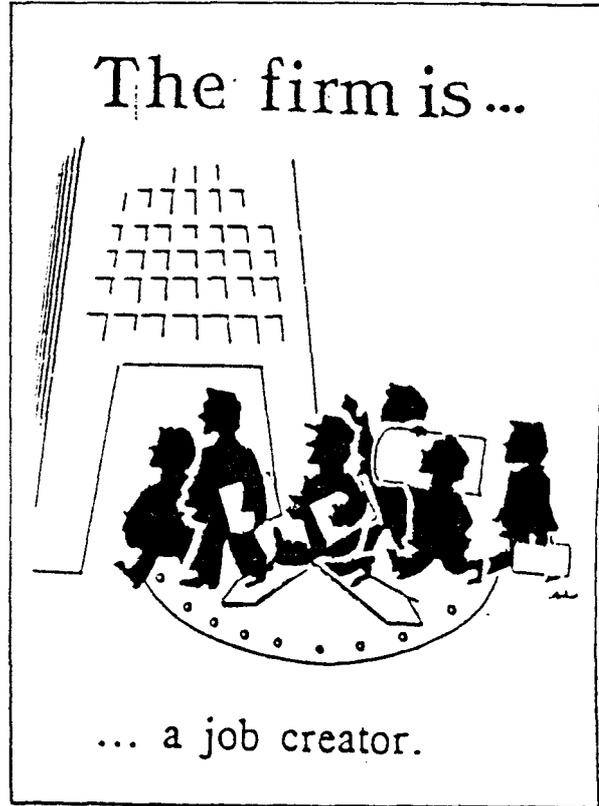
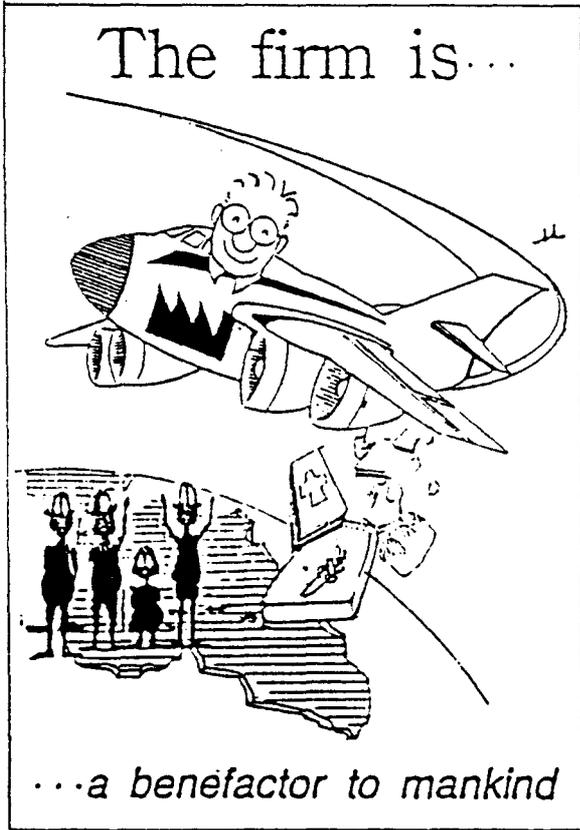


... a work-place of workaholics

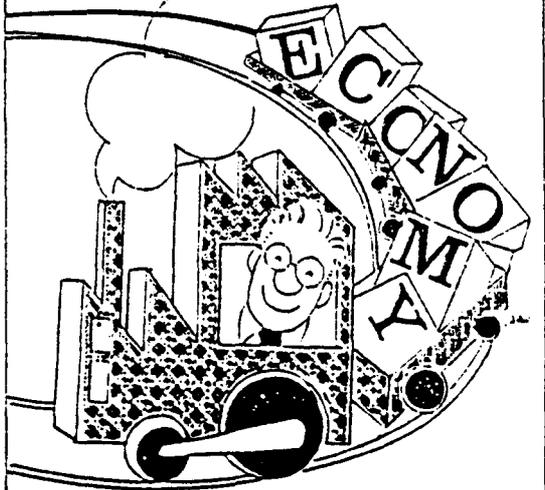
The firm is...



... a three-legged race.



The firm is...



... an engine of the national economy

The firm is...



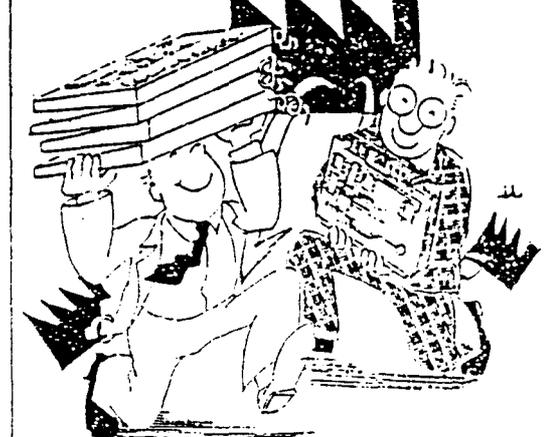
... to upgrade the standard of living.

The firm is...



... a sweeper.

The firm is...



... a work-creator

century. Japan, in the pre-World War II era, had experienced similar problems in the form of Zaibatsu, a closely-knit group of companies which had grown tremendously, causing various social problems and eventually leading the nation into war by pressuring the military.

To prevent the ill-effects of those over-grown firms, many countries use anti-trust or fair trade laws with which to regulate the firms. For example, the United States disintegrated Standard Oil Trust in 1912 based on the anti-trust law. Britain, France, Germany, Japan, Korea and other industrial and industrializing nations also regulate business activities of giant corporations by using fair trade laws, environmental protection laws and regulations protecting the businesses of small firms.

The positive and negative roles of the firms in society are not exclusive from each other in the sense that a firm which contributes to the society at one time may eventually disrupt it with the passage of time. But this change in the role of the firm in society takes place so naturally that managers in charge of the firm seldom recognize it.

Lessons for Managers

Now let's talk about the lessons for managers from both the microscopic and the macroscopic interpretations of the firm. First, the microscopic perspective based on a long view of time from the past to the present and the future maintains that the definition of the firm is changing from a manufacturing-oriented system to maximize profits to a marketing-oriented system to create customers, and eventually to a people-oriented system to develop human capacity. On the other hand, the macroscopic perspective based on a wide view of the society argues that the firm performs not only positive but also negative roles withing society.

As a result, corporate managers should have broad and far-reaching perspectives and make efforts to pursue long-term corporate growth and acquire positive social reputation. After all, the firm is not a short-term oriented organization designed only to make money and to be abandoned after that.

The Characteristics of the Managers' Views on the Firms

We have so far discussed the microscopic and macroscopic perspectives of the managers on the firm. <Exhibit 1> showed more than 20 views of the senior executives along microscopic and macroscopic perspectives. However, only one of them viewed the firm was a means to create customers within the microscopic perspective, while nobody mentioned the negative social roles of the firm within the macroscopic perspective.

The author believes the reason why only one executive said the firm as a customer-creating institution was because most businessmen were deeply entrenched with the production orientation and still did not fully appreciate the importance of marketing from their heart, although the economies in most of the industrialized countries are plagued with chronic oversupply, stemming basically from mass production.

The reason for no reference to negative social roles of the firm was undoubtedly because the attitudes of the senior executives toward the firm had been "positive." In other words, most executives had pride in the roles and functions of the firm in society and justified their *raison d'être* as managers, based on the positive aspect of the firms.

However, executives must be well aware of the fact that they can become targets of social criticism if their firms destroy social balance by causing concentration of wealth in a few hands. For that reason, executives need to make efforts to reduce negative social roles of their firm even before the government comes to grips with it, while maximizing the roles of the firms to create positive value. Executives can help usher in a constructive society with little criticism about the firms only when they fully understand what the firm is and carry out the missions bestowed upon them.