

Decision Making and Organizational Learning

Part I
Professor Rao

Decision Making

Decision making is the process by which members of an organization choose a specific course of action to respond to the opportunities and problems that confront them



The Decision-Making Process

- How are decisions made?

Classical
decision-
making
model

Administrative
decision-
making
model

15-3

Classical Decision-Making Model

Assumptions

- People have access to all necessary information
- People choose the best possible solution

Steps in the Classical Model

- List all alternatives
- List consequences of each alternative
- Rank sets from most preferred to least preferred based on personal preference
- Select alternative that results in most preferred set of consequences

Problems with the Classical Model

- Limited information is available.
- Cognitive abilities are limited.
 - Information overload
- Impossible to make the best possible decision.

Administrative Decision-Making Model

- Descriptive
- Satisficing
- Bounded rationality

Decision Making

Part II
Professor Rao

Common Biases and Errors in Decision Making

- Heuristics: shortcuts or rules of thumb used to simplify decision making.
 - Leads to biases - systematic errors that lowers decision making quality
- Common Heuristics:
 - Availability Heuristic
 - Representative Heuristic
 - Anchoring and adjustment Heuristic
- Other sources of errors
 - Risk Aversion
 - Escalation of Commitment Bias

Availability Heuristic

- The tendency to determine the frequency of an event (and its causes) by how easy these events (and causes) are to remember
- Biases based on the overestimation of frequency of
 - Events that evoke emotion
 - Vivid events
 - Recent events
- Example:
 - Risk of flying vs risk of driving

Representativeness Heuristic

- Tendency to predict the likelihood of an event occurring from the extent to which the event is typical of similar kinds of past events
- Biases
 - Failure to consider base rate (actual recorded frequency with which an event occurs)
 - Overestimating likelihood of rare event

Representativeness Heuristic

- The best student in your introductory MBA class this past semester writes poetry and is rather shy and small in stature.
- What was the student's undergraduate major:
 - Chinese studies? *Or*
 - Psychology?

Representativeness Heuristic

- The answer is b.
- Most students would offer "Chinese studies," overlooking that psychology majors outnumber Chinese studies majors 50:1.
- This example illustrates representative heuristic.

Anchoring and Adjustment Heuristic

- Tendency to make decisions based on adjustments from some initial amount
- Biases
 - Biased decisions when initial amounts (or anchor) are too high or too low
- Salary adjustments are often made from an “anchor” or initial pay. If the anchor is not reasonable, this heuristic will lead to biased decision making.

Risk Aversion

- Tendency to prefer a sure gain of a moderate amount over a riskier outcome, even if the riskier outcome might have a higher expected payoff.
- Example: Which would you choose?
 - A) 50-50 flip of a coin for \$200
 - B) A sure promise of \$50

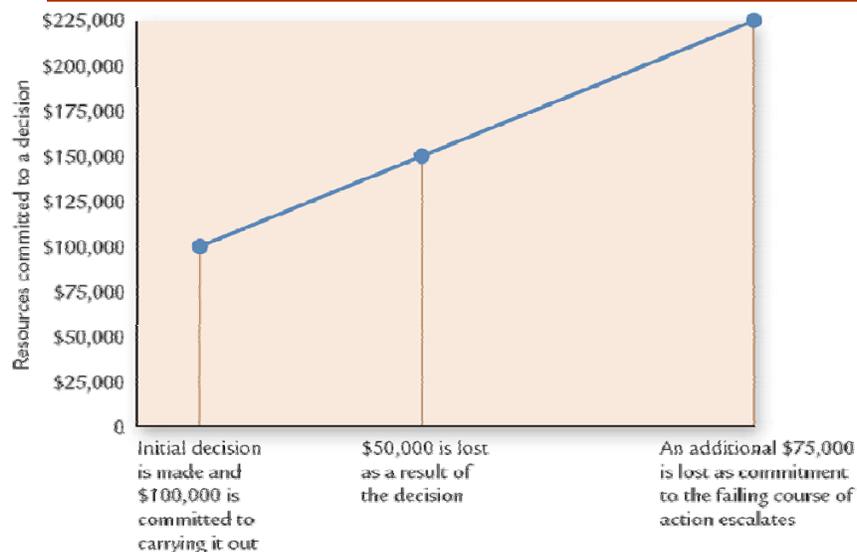
Risk Aversion

- The answer is B.
- There is a tendency to prefer the sure thing over the riskier outcome of the coin flip, even though mathematically the coin flip is worth twice as much.
- This is an example of risk aversion.

Escalation of Commitment

- Tendency of decision makers to invest additional time, money, or effort into poor decisions.
- Why?
 - Reconfirm correctness of original decision
 - Desire to recoup losses
 - Sunk costs
 - Risky behaviors increased by negative situation

Escalation of Commitment



Why Does Escalation of Commitment Occur?

- Decision makers do not want to admit that they have made a mistake
- Decision makers erroneously believe that an additional commitment of resources is justified to recoup losses
- Decision makers tend to take more risks when they frame or view decisions in negative terms (as a way to recover something that has been lost) rather than in positive terms (as a way to generate something)

Decision Making

Part III
Professor Rao

Group Decision Making

Advantages

- Availability/diversity of members' skills, knowledge, expertise
- Enhanced memory
- Greater ability to correct errors
- Greater decision acceptance

Group Decision Making

Disadvantages

- Time to make a decision
- Group conflict
- Diffusion of responsibility
- Potential for groupthink

Groupthink

- A pattern of faulty decision making that occurs in cohesive groups whose members strive for agreement at the expense of accurately assessing information relevant to the decision.
- The group becomes closed-minded, and fails to pay attention to important information.
- Result is poor decision making.

Steps for Minimizing Groupthink

- Group leader encourages thoughtfulness/criticism
- Group leader refrains from expressing own opinions and views until group has considered all alternatives
- Group leader encourages group members to gather information from outside people
- Group leader assigns devil's advocate
- Group leader holds second meeting for important decisions