MARKETING IN THE 21ST CENTURY

COMMENTARY

Developing a Customer Value-Based Theory of the Firm

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Bob Woodruff lays out a compelling argument for why customer value must be the focus of business activities and offers several useful prescriptions for how businesses may position themselves to understand the nature of customer value, how the customer's value equation may evolve, and what a business might do to create and implement a customer value delivery strategy. The objective of this commentary is to complement Woodruff's arguments by recasting and augmenting them to create a customer value-based theory of the firm. I hesitate to characterize this as a creation, though. Certainly the foundation for a customer value–based theory of the firm was laid decades ago by Alderson (1957) and Drucker (1973), among others. That foundation subsequently has been built on by the contributions of marketing theorists such as Anderson (1982), Day and Wensley (1988), Dickson (1992), Hunt and Morgan (1995), Kohli and Jaworski (1990), Slater and Narver (1995), and Webster (1992). At the same time that this important work has taken place, marketing strategy thought leaders are lamenting marketing's declining influence on the strategy dialogue (e.g., Day 1992; Kerin 1992; Varadarajan 1992; Webster 1992). I propose that an important reason for this situation is that marketing scholars have neglected to organize our theoretical frameworks into a comprehensive theory of the firm, which is the foundation and focal point for our dialogue and research.

Theory of the Firm

A theory of the firm should address three basic questions (e.g., Conner 1991; Holmstrom and Tirole 1989): (1) why do firms exist and what is their central purpose? (2) Why are there differences in the scale, scope, and types of activities between firms? (3) Why are there performance differences among firms? The search for empirical evidence that either confirms or disconfirms the explanations provided by different theories of the firm then guides the research agenda for the discipline. There is no apparent consensus across disciplines, or even within disciplines, regarding the theory of the firm because a major new theory seems to emerge every decade. In the next few paragraphs I briefly review the key elements of the four most influential theories of the firm.

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The neoclassical theory of the firm. In the neoclassical theory of perfect competition, the firm exists to combine labor and capital to produce an end product. Demand is assumed to be homogeneous, and consumers have perfect and costless information. The firm also has perfect information, and industry resources are homogeneous and completely mobile, thus flowing quickly to their highest value use. The firm's objective is profit maximization, which is accomplished by setting output at the point where marginal costs equal marginal revenues. Firm size is constrained by technological and later managerial scale factors. Although perfect competition often seems to be the policy planner's objective, this theory does not adequately explain managerial motivation or firm diversity with respect to either performance or scale.[1] Teece (1984) asserts that, on examining the neoclassical theory, "one finds a theory of production masquerading as a theory of the firm" (p. 90).

The behavioral theory of the firm. Cyert and March (1963), building on the work of Barnard (1938), March and Simon (1958), and Simon (1957), developed a behavioral theory of the firm to deal with the neoclassical assumption of firm rationality that is expressed through firm access to perfect information and through the goal of profit maximization. For example, in contrast to a goal of profit maximization, firms (i.e., their managers) may be more interested either in survival or in achieving a satisfactory level of profits that involves less risk or reflects a compromise among conflicting interests. Thus the behavioral theory views the firm as a coalition of individuals or groups, each of which has its own goals.

Firm goals are determined by bargaining among these coalition members. The bargaining is complicated by the "bounded rationality" of coalition members (there is no access to perfect information) and by the sequential attention given to setting potentially conflicting goals. Instead of perfect rationality, organizations are more likely to achieve local rationality. If this leads to decentralized decision making, local optimization may be possible but is unlikely to produce organizational optimization. The behavioral theory of the firm provides useful explanations of decision making in organizations. However, it does little to explain why firms exist or why there are performance differences among firms.

The transactions cost economics theory of the firm. Building on the seminal work of Ronald Coase (1937), who proposed that transaction cost economizing is a primary reason for the existence of a firm, Oliver Williamson (1975) developed an alternative to the neoclassical theory of the firm. The transactions cost theory begins with the proposition that markets and hierarchies (firms) are alternative mechanisms for coordinating transactions, and the choice of one or the other is based on the respective cost associated with the transaction. A transaction occurs when a good or service is transferred across a separable interface, such as when a firm purchases production materials from an independent supplier. The alternative is for the firm to integrate vertically and produce those materials itself.

The attributes of transactions that are of special interest are ones in which the potential for a contractor to act opportunistically is significant and include dependence on the owner of a specific asset, small numbers of potential contractors, and imperfect information. The criterion for organizing transactions by markets or hierarchies is cost minimization, either production costs or transactions costs. The theory predicts that firms will expand the scope of their activities when opportunistic potential is significant and will transact with contractors when threats due to asset specificity, small numbers, and imperfect information are not significant (cf. Conner 1991; Robins 1987; Seth and Thomas 1994; Teece 1984).

Transactions cost theory offers an explanation for why firms exist and why there are performance differences among them. However, limitations to this theory render it less than satisfactory for explaining performance in a dynamic and turbulent environment. This is a topic to which I will return.

The resource-based theory of the firm. Wernerfelt (1984) coined the term *resource-based view of the firm* to describe a set of propositions for looking at the firm in terms of its resource endowments. The idea of looking at the firm as a set of resources has a long tradition (e.g., Andrews 1971; Penrose 1959; Selznick 1957). Barney (1991) defines firm resources as "all assets, capabilities, organizational processes, firm attributes, information, knowledge, etc. controlled by a firm that enable a firm to conceive of and implement strategies that improve its efficiency and effectiveness" (p. 101).

Similar to the neoclassical view of the firm, the resource-based theory views the firm as an input combiner. However, the resource-based view does not include the neoclassical assumptions of perfect information, homogeneous resources, and resource mobility within industries (Conner 1991). Thus the resource-based view allows for the possibility of superior performance by a firm, based on its possession of a specific combination of resources that is valuable, rare, and difficult to imitate (Barney 1991).

Hunt and Morgan (1995) offer several refinements and clarifications to the resource-based theory in their articulation of a comparative advantage theory of competition. I do not offer the comparative advantage theory as a separate theory of the firm because it augments rather than contradicts the resource-based theory. Hunt and Morgan's important contributions include the following: there is specific recognition that industry demand is heterogeneous and dynamic; consumers have imperfect information, and obtaining information is costly; and the environment is only one of many influences on strategy and performance. Thus Hunt and Morgan integrate specific consideration of the role of heterogeneous markets and imperfect information within markets into the resource-based theory.

In this somewhat incomplete[2] and cursory review of influential theories of the firm, we begin to see a number of important trends emerging. First, there is widespread rejection of the neoclassical theory of the firm on the grounds that it is incomplete, based on flawed assumptions, and does not begin to provide satisfactory answers to the questions that a theory of the firm must address. Second, the increasing emphasis on managers as active decision makers working with imperfect information is in contrast to a deterministic model of firm conduct. Finally, and perhaps most important, is an appreciation that the market (demand side) matters and that it is not merely a theoretical construct that we can assume exists. Surprisingly, it is not until we get to Hunt and Morgan's (1995) refinement of the resource-based theory that this theme achieves prominence. I argue that, even now, the market (i.e., customer value) does not receive adequate attention in the theory of the firm. That is the topic to which I now turn.

TOWARD A CUSTOMER VALUE-BASED THEORY OF THE FIRM

The Firm's Environment

The firm faces an increasingly turbulent and complex competitive environment. The face of the marketplace is changing rapidly due to the unprecedented magnitude of demographic and socioeconomic shifts (Cravens and

Shipp 1991). Customers are very demanding. In general, they want ever-increasing levels of quality and service at lower costs. More specifically, markets have fragmented into numerous segments, each with its own unique value equation. Accompanying the fragmentation is the emergence of new media and distribution channels (Day 1994b).

Competition is intense even in oligopolistic markets, such as the long-distance telephone services market. The rate of technological change is very rapid and is often discontinuous rather than incremental, leading to relatively short product life spans (Achrol 1991). More and more markets are characterized by global competition (Cravens and Shipp 1991). Resources are distributed unevenly among competitors in a market (Day 1994a). Information technology and knowledge have increased in importance as potential sources of competitive advantage (Day 1994a, 1994b; Glazer 1991; Slater and Narver 1995). These trends are consistent with the recently articulated concept of hypercompetitive environments (D'Aveni 1994), characterized by extremely vigorous competitive action, in which sustainability of competitive advantage depends on a firm's innovative capacity (see also Jacobson 1992; Schumpeter 1934).

Why Does the Firm Exist?

No one has answered this question more clearly or more succinctly than Peter Drucker (1973), who wrote, "To satisfy the customer is the mission and purpose of every business" (p. 79). Customer satisfaction is achieved when superior customer value is delivered by the business. Firms do not exist to reduce transactions costs or maximize profits. Firms exist to provide a product or service because it is neither efficient nor effective for buyers to attempt to satisfy all their needs themselves.

Superior performance is the result of providing superior customer value; it is not an end in itself. As John Young, former CEO of Hewlett-Packard, put it, "If we provide real satisfaction to real customers—we will be profitable" (Collins and Porras 1994, p. 57). Kohli and Jaworski (1990, p. 3), in their in-depth interviews with both marketing and nonmarketing managers, found that profitability was "conspicuously absent" as a component of a customer value-focused business culture. Supporting this is Collins and Porras's finding that businesses with a long-standing reputation for excellence put more emphasis on core values than on profitability.

Why Are There Differences in the Scale, Scope, and Types of Activities Among Firms?

The customer value creation strategy of a firm substantially influences the scale, scope, and types of activities in which it engages. Customer value strategy includes (1) the establishment of appropriate market objectives, (2) the selection of the specific market segment(s) to be targeted in the broader industry setting, (3) the creation of a value proposition that establishes a position of competitive advantage, and (4) the development of capabilities that are necessary to understand customer needs and deliver the promised value (e.g., Slater 1995). A long stream of research shows that there is no inherently superior strategy (see Slater and Narver [1993] for a recent review and additional evidence for this position). Therefore, a firm's managers can develop a customer value strategy that focuses on a unique market segment or has a distinctly differentiated value proposition. A recent study suggests that customer value-focused (i.e., market-focused) businesses have a wide variety of economic objectives and employ a wide variety of strategies in the pursuit of those objectives (Slater and Narver 1996a).

Furthermore, firm performance substantially influences the scale and scope of the activities in which the firm can engage. Firms with strong performance records or with the potential to achieve superior performance can either generate capital for expansion internally or attract new capital in the debt and equity markets. Firms with a customer value focus that is complemented by appropriate resources and capabilities are best positioned to attract the capital necessary for the expansion of scale or scope of activities.

Why Are There Performance Differences Among Firms?

Superior performance requires that the firm possess a competitive advantage (Porter 1980). A firm has a competitive advantage when it possesses resources or skills that (1) enable it to deliver customer value, (2) are unique, and (3) are difficult to imitate (Barney 1991; Day and Wensley 1988; Slater 1996). Contradicting the industrial organization economics paradigm is the mounting evidence that industry differences have a negligible effect on performance compared to firm differences (Hunt and Morgan 1995).

A customer value-based theory of the firm would say that superior performance accrues to firms that have a customer value-based organizational culture (i.e., a market orientation), complemented by being skilled at learning about customers and their changing needs and at managing the innovation process, and that organize themselves around customer value delivery processes. Tangible resources play a lesser role in this theory of the firm. We need only look at the recent experiences of IBM, Compaq, and Sears to understand why. All these firms were outstanding performers at one time and built substantial resource bases. In the late 1980s and early 1990s, each lost touch with its market and saw its performance decline despite having a substantial resource base. Each has improved its performance recently by developing a better understanding of its customers and delivering greater value, not by increasing or dramatically altering its stock of tangible resources.

Market Orientation

A market orientation is "the culture that (1) places the highest priority on the profitable creation and maintenance of superior customer value while considering the interests of other key stakeholders; and (2) provides norms for behavior regarding the organizational development of and responsiveness to market information" (Slater and Narver 1995, p. 67). A growing body of research (e.g., Deshpande, Farley, and Webster 1993; Jaworski and Kohli 1993; Narver and Slater 1990; Pelham and Wilson 1995; Slater and Narver 1994) shows that there are substantial differences in the extent to which firms are market oriented, and there is a significant relationship between market orientation and multiple measures of business performance.

Continuous Learning About Customers

A market orientation is made manifest by the development of firm skills for acquiring knowledge about customers and other market participants, sharing that knowledge widely throughout the organization, achieving consensus on its meaning, and taking action to deliver superior customer value (Day 1994a, 1994b; Kohli and Jaworski 1990; Slater and Narver 1995). Managers (e.g., de Geus 1988; Stata 1989) and scholars (e.g., Day 1994a, 1994b; Glazer 1991; Sinkula 1994) are in broad agreement that a superior learning capability is an important contributor to competitive advantage.

An important distinction is that the objective is to learn about customers, not just to learn from customers. Although maintaining a constant formal and informal dialogue with customers is important, there are other ways to learn about customers and their needs. For example, the firm can learn by conducting market experiments and by carefully evaluating the results of those experiments. It can learn from others, such as consultants, universities, alliance partners, or suppliers, that have an insight into latent customer needs and technologies for satisfying those needs. Finally, the firm can learn from experience, continuously making improvements in the way it does repetitive tasks. A recent study (Slater and Narver 1996b) suggests that each of these learning styles makes a unique contribution to organizational effectiveness.

A Commitment to Innovation

In a hypercompetitive environment where sources of both product-based competitive advantage and process-based competitive advantage are quickly imitated by competitors (Dickson 1992; Ghemawat 1986; Jacobson 1992), a commitment to customer value-focused innovation is essential to sustain competitive advantage. Innovation may be concerned with the creation of new businesses within the existing business or the renewal of ongoing businesses that have become stagnant or in need of transformation. This may be accomplished through developing new products or reformulating existing ones, creating new manufacturing methods or distribution channels, or discovering new approaches to management or competitive strategy (Slater and Narver 1995).

Successful innovation is the product of a market-oriented culture coupled with entrepreneurial values. In practical terms, this means a willingness to take risks and learn from mistakes. In a recent study of discontinuous innovations, Lynn, Morone, and Paulson (1996) found that successful innovators "ran a series of market experiments—introducing a series of prototypes into a variety of market segments" (p. 15). Based on their experience with each prototype, these innovators refined their design and marketing plan and eventually introduced a successful product. To minimize the risk and maximize learning, successful innovators work intensively with lead customers to understand their latent needs (Von Hippel 1986), work collaboratively in cross-functional teams (Quinn 1985), undertake low-cost market experiments (Hamel and Prahalad 1991), and intensively study causes for project success or failure (Garvin 1993).

A Customer Value Process-Focused Organization

The central organizational challenge in the customer value-based theory of the firm is to maximize the effectiveness of the firm's customer value creation activities. These activities are most appropriately viewed as processes that cut across multiple functions in the organization. As Hammer (1996) puts it, "A process perspective on a business is the customer's perspective. . . . A process perspective requires that we start with customers and what they want from us, and work backward from there" (p. 12). Examples of these processes include the new product development process, the customer order fulfillment process, and the market sensing process (e.g., Day 1994a).

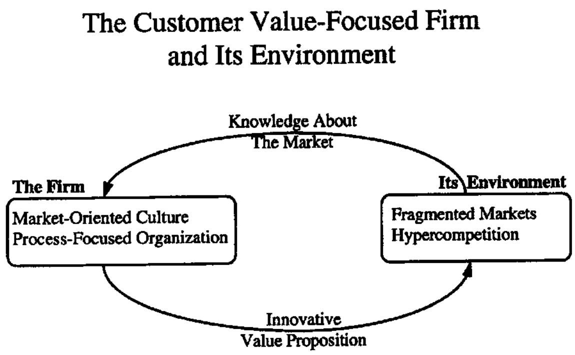
In contrast to the transactions cost economics perspective, which requires that the decision to perform a process internally or to contract for its execution be based on cost minimization, the choice in the customer value-based theory is based on which alternative produces superior value. Thus both benefits to the customer and costs must be considered. Many firms are finding that it is more effective to outsource key value delivery activities to other firms that are expert in that activity than to perform it internally. Thus the firm might focus on developing and supporting relatively few core processes "which create and maintain a real and meaningful long-term distinctiveness in customers' minds" (Quinn 1992, p. 53). For example, the Gallo Winery outsources not only grape production but also advertising and promotion, allowing it to focus on wine making and distribution. Other firms have outsourced R&D activities and service activities that are key customer value delivery processes (MacLachlan 1995). A critical consideration is whether the effective cross-functional teamwork that is required for rapid response and innovation can be maintained when important expertise is outsourced.

Figure 1 illustrates the fundamental characteristics of the customer value-focused firm, the environment it faces, and the connections between the two.

CONCLUSION

Just as it was inappropriate to characterize this as the development of a new theory of the firm, it also is premature to suggest that this commentary articulates a comprehensive customer value-based theory of the firm. The

FIGURE 1
The Customer Value-Focused Firm and Its Environment



foundation for this theory was laid decades ago, and the ideas presented in this commentary must be more thoroughly developed before it can appropriately deemed a "theory of the firm." However, as marketers, we should be committed to the proposition that the creation of customer value must be the reason for the firm's existence and certainly for its success. Thus developing this theory further and testing the propositions that comprise it should be a high priority for marketing scholars.

NOTES

1. See Anderson (1982), Dickson (1992), Holmstrom and Tirole (1989), and Hunt and Morgan (1995) for more thorough critiques of the neoclassical theory of perfect competition.
2. For example, I do not review resource dependence theory (Pfeffer and Salancik 1978) or agency cost theory (Jensen and Meckling 1976).

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