Theories of the Firm and Their Value Creation Assumptions

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Since Coase's (1937) seminal paper on 'The Nature of the Firm', strategy scholars are invested in developing so-called 'theories of the firm' (ToFs). These are theories that should answer four questions on the nature of firms: Why do firms exist? Why are their boundaries as they are? Why are they organized the way they are? and Why are they so heterogeneous? In answering these questions, at least twenty ToFs have been put forward in the last decades. These include economics-based ToFs such as principal-agent theory and transaction-cost economics; organization theory-based ToFs such as behavioral theory and bureaucratic theory; and strategy-based ToFs such as the value-chain model and stakeholder theory.

Assuming that all ToFs attempt to answer the four questions above, the question arises why we would need so many ToFs. Do we really need so many? And, if so, why? The extant literature provides a partial answer to this question by looking at complementarities between ToFs. Along that line, scholars have suggested to combine various ToFs (e.g., Coff, 1999; Foss & Foss, 2005; Pitelis, 2007). However, as these suggestions typically concern the combination of two or of three ToFs, they do not account for the fact that we have at least twenty now. Also more comprehensive reviews (e.g., Conner, 1991; Foss, 1993; Madhok, 2002) do not explain the multitude of ToFs in our literature.

To find an answer to this question, this paper provides a two-step comparison of ToFs. The first step is a bird's eye view comparison of eighteen well-known ToFs along some apparent differences. This step reveals differences between some ToFs, but it also leaves a group of ToFs that are apparently similar. In the second step we further compare this group of ToFs on their more implicit assumptions.

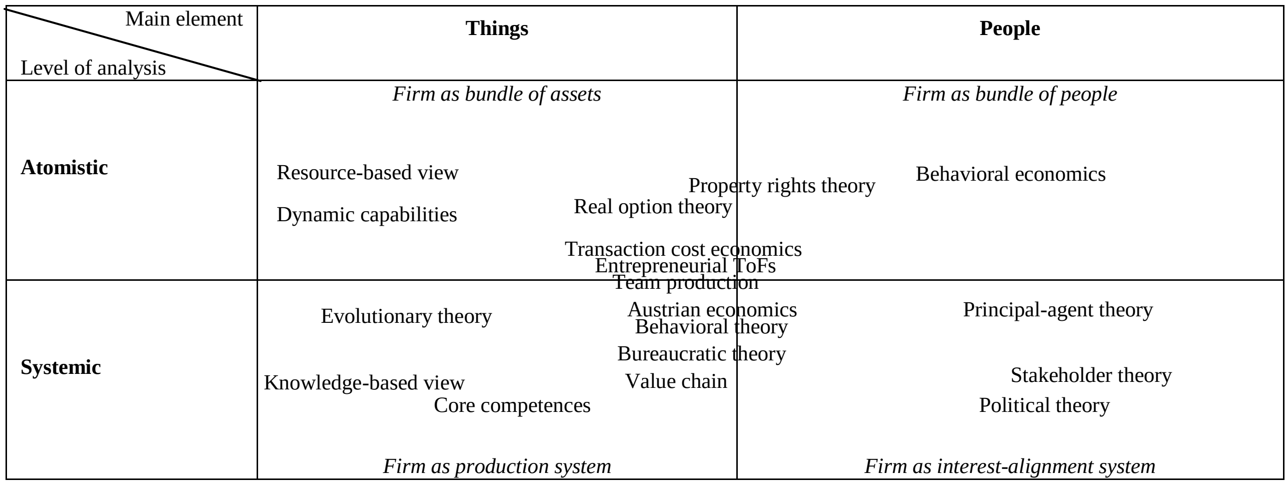
Based on this two-step comparison, we conclude that we do indeed need a variety of ToF. The reason is that the various ToFs have different assumptions on how firms create value and from which sources this value is derived. Since firms in practice also differ in the way they create value, our conclusion is that we need more than one ToF to explain this variety. The implication is that scholars engaged in the ToF debate may want to put firm value creation center stage. This, we shall argue, requires adding a fifth question to the ToF that precedes the other four questions: what value does a firm create?

A First Comparison of Theories of the Firm

Numerous ToFs have been put forward in the economic, organizational, and strategy literature of the last decades. We review eighteen of them that are well-known and highly cited. To find differences between these eighteen ToFs that would justify their existence, we compared their assumptions on what a firm *is*. Doing so revealed two dimensions on which the ToFs differ: a) whether the ToF considers things or people as the primary building block, and b) whether the ToF provides an atomistic or a systemic view on a firm. Grouping the ToFs along these two dimensions revealed five families of ToFs (see Figure 1).

The first family of ToFs consider the firm a bundle of assets. These theories focus on the individual means that firms use as a foundation for their competitive advantage – tangibles, intangibles, capital, capabilities, and the like. Such theories primarily answers the question of why firms are heterogeneous. Also focused on things are ToFs which consider the firm as a production system. Such theories emphasize that it is not sufficient for a firm to obtain assets. In addition, these assets need be combined and integrated in order to attain a competitive advantage. With their systemic perspective, these ToFs provide a more elaborate understanding of how firms are organized than the first family. The second family of ToFs at the atomistic level considers firms as bundles of contracts. This family moves the focal point of analysis away from a firm's assets toward the different human interests and intentions present in the firm. Such theories are atomistic through their focus on the conflicts of interest between different individuals in a firm. Finally, there are ToFs which consider the firm as a an interest-alignment system. Like the previous family, these ToFs take different human interests as focal point of analysis. However, rather than focusing on individual contracts, these ToFs consider the firm as a more holistic system of such contracts.

Figure 1:
A First Comparison of Extant Theories of the Firm



These four families fall largely into one of the four cells of Figure 1. As such, the two dimensions provide an effective way to differentiate at least a large share of the ToFs that circulate in our literature. However, Figure 1 also reveals a group of ToFs in the middle. Two of these ToFs – real option theory and property-rights theory – reside primarily at the atomistic level. The remaining seven all reside at the center of Figure 1. These are ToFs which consider both people and things as important elements comprising the firm and which neither have a completely atomistic nor a completely systemic view on firms. As such, these ToFs assume that the people in the firm have some freedom in their choices and actions, but that this freedom is constrained and enabled by the firm's assets and the organizational structure in place. In other words, these seven ToFs to some extent acknowledge the *agency* of the individuals comprising the firm (cf. Emirbayer & Mische, 1998).

The extent to which individuals are assumed to employ their agency differs between the seven ToFs. Bureaucratic theory, for example, presumes that it is primarily the organizational designers who can exercise their agency. Austrian economics, on the other hand, assumes that also others in the firm, such as managers, are sufficiently free such that they can exercise their agency. While there is thus a difference in degree, this is hardly a satisfying conclusion on the differences between these ToFs. It would be a stretch to say, for example, that the main difference between transaction cost economics and the value chain model lies in the extent to which these ToFs acknowledge the agency of individuals. Therefore, we make a second comparison between the remaining seven ToFs in the next section.

A Second Comparison of Theories of the Firm

The seven ToFs at the center of Figure 1 consider the firm as an organized system of people and things. When we further compare these ToFs, we can see that these have different assumptions on how firms create value. Transaction-cost economics, for example, focuses on efficiency and the reduction of costs by making make-or-buy decisions. It predicts that, if the costs of producing a product are lower than the cost of buying that product, the firm will internalize the production of that product (Williamson, 1981). As such, the firm is assumed to create value by reducing costs in comparison to the market. Other ToFs have different value creation assumptions. Bureaucratic theory assumes that value is created through standardization and rules that help to fulfill anticipated needs (Weber, 1947). Alchian and Demsetz's (1972) team production approach, on the other hand, considers value to derive from the collaboration between individuals, and Porter's (1985) value chain model assumes that value derives from the improvement and alignment of a firm's activities. Again different, behavioral theory (Cyert & March, 1963) assumes that firms create value by compensating for the individuals cognitive limitations, thereby enabling more rational decisions. On the other hand, entrepreneurial theories of the firm consider the firm to be an instrument for entrepreneurs to realize their visions (Alvarez & Barney, 2007; Witt, 2007). As such, firms are assumed to create value for the entrepreneurs that establish them. Finally, an Austrian economics perspective on firms suggests that firms create value by their capacity to bring together the judgments of various individuals (Foss, 1994; Foss, Klein, Kor, & Mahoney, 2008; Penrose, 1959).

Along this same line, we can also compare the ToFs outside the center of Figure 1. The resource-based view, for example, assumes that value is an inherent property of resources, and that firms create value by obtaining these resources at a lower price than for which they can be sold in the future (Barney, 1991). At the other end, stakeholder theory assumes that firms create value by aligning and synthesizing the interest of all stakeholders involved in a firm. As a final example here, the knowledge-based view assumes that firms create value by combining and integrating specialized tacit knowledge of individuals through rules and routines (Grant, 1996).

To make a more systematic comparison between the various 'modes of value creation' and better understand the differences and relationships between the ToFs, we can again analyze them along two dimensions (see Figure 2). The first dimension concerns the supply of value. On this dimension the ToFs differ in their assumptions on whether value is an inherent property of assets that needs to be extracted, or that value is actively created by firms. The resource-based view is based on the first assumption. It presumes that value is an inherent property of resources and that this value needs to be discovered. On the other hand, the Austrian economic view on the firm presumes that the value of assets lies in their subjectively recognized attributes. As emphasized by Penrose (1959) and other scholars following an Austrian economic approach (Connell, 2007; Foss et al., 2008; Kor, Mahoney, & Michael, 2007; Mahoney, 1995), value is a subjectively recognized attribute. This implies that the resources and capabilities or the products and services of a firm are not valuable in and of themselves, but only if someone perceives a possibility to make them valuable and actually makes them valuable.

The second dimension on which we can compare how the ToFs deal with firms' value creation concerns the demand for value. On the one hand, and adopting a Kirznerian (1973) view, there are ToFs which assume the demand for value can be anticipated and predicted. The assumption is that, somewhere in the market, there is an unfulfilled need, which needs to be discovered and then fulfilled. On the other hand, adopting a more Schumpeterian (1934) view, there are ToFs that assume the demand for value does not pre-exist, but that it is created.

Based on these two dimensions we can again compare the seven ToFs (see Figure 2). When we do so, we find substantial differences between them. For example, while bureaucratic theory assumes value is something to be extracted from the people and assets within the firm and that the demand for value can be anticipated, an Austrian economic view assumes that both the supply and the demand side of value are created.

Their may be other ways of categorizing the various forms of value creation assumed in the ToFs. The point we are emphasizing, though, is *that* the ToFs differ on their value creation assumptions. When we furthermore acknowledge that firms in practice also differ substantially in the way they create value, this suggests that we need different ToFs to be able to explain the different types of firms that appear in practice. This, in turn, suggest that different ToFs represent different types of firms. If correct, this implies that a firm's mode of value creation is an important contingency factor affecting which ToF can be used to answer the four ToF questions. In other words, based on an analysis of the way a firm creates value, we can select an appropriate ToF that can be used to explain why firm exists, why their boundaries are where they are, why they are organized as they are and why they are so heterogeneous.

Figure 2
A Second Comparison of Extant Theories of the Firm

Demand for value / Supply of value	**Predicted/discovered**	**Created**
Extracted/discovered	Bureaucratic theory Team production Transaction cost economics	
Created	Behavioral theory Value chain	Entrepreneurial ToFs Austrian economics

Value Creation and the Theory of the Firm

The notion of value has received considerable attention in the ToF literature. Particularly the RBV's notion of 'valuable resources' has triggered much debate (Kraaijenbrink, Spender, & Groen, 2010; Peteraf & Barney, 2003; Priem & Butler, 2001). A useful contribution to this debate is Bowman & Ambrosini's (2000) distinction between 'perceived use value' (the subjective value perceived by customers) and 'exchange value' (the bargained price that is paid). The distinction is useful because it emphasizes that the use value of a product/service is a perceived value and that this perceived value may differ from the price that is paid.

The creation of use value is a necessity for firms to sustain. Without it, firms would have no added value whatsoever and there would be no reason for them to exist. The fact that use value is a subjectively recognized attribute implies that the resources and products of a firm are not valuable in themselves, but only if someone perceives them as valuable. It also implies that people may perceive value differently and thus that resources and products may have a different value to different people. The implication is that value creation is, by definition, a directional activity targeted towards someone specific. This means that one cannot speak of value creation in general without indicating for whom this value is created. Furthermore, value creation is not limited to customers alone. As emphasized in stakeholder theory, firms have value for other actors as well. By buying products, firms have value for their suppliers, by paying wages they provide value to their employees, and so forth. This implies that the creation of use value is not only a directional activity; it is a multidirectional activity.

Though necessary, the creation of sufficient perceived use value is not a sufficient requirement for firms to sustain. If limited to creating perceived use value, firms would not be able to get something in return for their efforts and thus still not be able to survive. They would not be able to generate and appropriate rents, let alone profits. Therefore, the creation of exchange value is also a necessity for firm survival. While Bowman and Ambrosini (2000) limit their analysis to exchange value in relation to customers, also this notion of value can be generalized toward other stakeholders in the firm. Doing so implies that firms create both perceived use value and exchange value for various stakeholders.

A problem with current ToFs is that, despite the fact that some acknowledge the subjective character of use value, they treat value as a monolithic concept. We think this is one of the reasons why, for example stakeholder theory has not yet lived up its promise as a fruitful ToF. By its open notion of value creation it is unable to guide choices on which stakeholders to include and which ones to exclude when making firm decisions. However, when we acknowledge that firms provide different types of value, the type of value itself may help to indicate which stakeholders a firm is most likely able to satisfy. For example, a bureaucratic firm of which the primary sources of value creation are standardization and anticipation of needs, may most likely be able to satisfy stakeholders with stable and homogenous needs.

Emphasizing the role of value creation assumptions in ToFs unavoidably brings in an ethical dimension. To some extent this dimension has been brought in already. Ghoshal and Moran, for example, have criticized transaction-cost economics and principal-agent theory for being based on a too a negative model of the individual (1996; Moran & Ghoshal, 1996). Furthermore, by its reaction to a shareholder view of the firm, stakeholder theory increasingly addresses the normative side of doing business (Jones, 1995; Jones, Felps, & Bigley, 2007). When we consider the firm as a value creating system, there is another, perhaps more fundamental way in which ethics gets involved. As highlighted in Figure 2 and particularly its bottom-right cell, firms engage in the creation of both the supply and the demand for value. This means that firms to a large extent shape both what stakeholders want and what they can obtain.

This, of course, in itself is not a new observation. It is well-known that, through their marketing and branding activities and even through making products and services available, firms influence the needs and wants of customers (Willmott, 2010). For example, by providing the world with the I-phone, YouTube, Twitter and Facebook, firms have created new demands, and thereby new and adjusted norms and values – such as more democracy. Despite this widely acknowledged practice, the norm-setting character of firms is rarely taken full circle in the ToF debate (Prichard & Mir, 2010). So far, this debate almost exclusively deals with an economic perspective on value, not an ethical one. However, if firms are value creation systems, if they can create both the demand for value and its supply, and if they are the driving force behind today's society, then firms are perhaps the single most important norm-setting institutions of today. Consequently, if ToFs are supposed to show a correspondence with firms in practice, then ethics is of central importance to ToFs. The interconnectedness of economic and ethical values is a topic that goes back at least to the founding father of our capitalist society - Adam Smith (1759, 1776). Although not widespread, similar points are made in more recent debates (Anderson, 1995; Dworkin, 1980). It may be fruitful to explicitly engage in such debates in order to provide the ethical dimension of value creation a more central place in future ToF theorizing and research.

Conclusion and Implications

This paper started with the question whether we need so many theories of the firm (ToFs) as we have now and, if so, why so. Our confirmatory answer outlined above has at least four implications for the ToF literature. First and foremost, our analysis of differences between firms' value creation modes implies adding a question to the ToF debate that precedes the four other questions: what value do firms create? Adding this question implies a shift in the point of gravity in the ToF debate from the questions of firm existence, boundaries, organization, and heterogeneity, to the firm's mode of value creation.

A second implication is that there is no single theory of the firm that can answer the four questions for every type of firm. Firms in practice differ in the way they create value. Some derive their value from efficiency or smart anticipation, others from effective integration or alignment of activities, and still others from valuable resources or from creative judgments of resource attributes. Along this line, any particular ToF is perhaps best conceived of as a theory explaining the existence, boundaries, internal organization and heterogeneity of a specific type of firm. Or, in other words, if there is anything like a single ToF, it is a contingency theory with the firms' value creation mode as its primary contingency factor.

Third and related, adding value creation as an element of ToFs enables making these ToFs more specific. Once we take a firm's particular mode of value creation as a starting point, this becomes an input to the remaining ToF questions. Different modes of value creation imply different value creation activities in a firm. For example, a firm that derives its value primarily from creating demand for new kinds of value, is likely to engage more in marketing, sales, and communication activities than a firm which derives its primary value from smart make-or-buy decisions. The latter firm, on the other hand, is likely to be more engaged in purchasing and production activities. The differences between these activities is likely to have an effect on the boundaries and internal structure of a firm. Hence, bringing the value creation question into the ToF debate, may help to further specify the answers to the original ToF questions.

Finally, since value creation involves both a supply side and a demand side, bringing it into the ToF debate also explicitly brings in an ethical dimension. Through their creation of value supply and demand, firms are to a large extent responsible for the norm-setting in our society today. Therefore, rather than a peripheral issue, the relationship between economic and ethical values becomes a central issue to account for by ToFs.

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