Book Review

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Value Creation Principles: The Pragmatic Theory of the Firm Begins with Purpose and Ends with Sustainable Capitalism
by: Bartley J. Madden
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Probably my biggest irritation with neoclassical microeconomics has been its stubborn reluctance to understand and investigate the firm as the capitalist economy's basic building block. Indeed, the firm has long been pejoratively referred as the black box, not exactly a compliment for a profession whose jurisdiction is supposedly the economy. When I took my obligatory courses in the theory of the firm, I realised early on that the so-called theory had little to do with the firm; and that you could substitute any entity and obtain the same results. In fact, after these courses I knew less about the firm than I did beforehand. Adding to the frustration was that the world was changing, but the theory of the firm had ossified: its frame of reference and conceptual tools ensconced in the pre-World One era.[1] The neoclassical theory of the firm became emmeshed in its own deductive and ahistorical logic, as if economics was a 'branch of applied mathematics' [Hodgson (1999), p.8] rather than a social science.

A long-time objective of mine has been to write a pluralist book on the theory of the firm[2], but alas, founding the *IJPEE*, and three books later on economics education put this project on the proverbial back burner, and then off the stove completely. So I am thrilled that such a book is finally on the market, and that Bart Madden beat me to the punch, for he has written a much better book on the subject than I could have, or anyone else for that matter.

Madden, an independent researcher and prolific author, is that rare polymath who utilizes ideas from many disciplines. He is equally at home in management, finance, economics, medicine, philosophy, and psychology; in fact for Madden, these are not exactly separate silos. He is eager to learn, not to ossify and self-confirm, but to enlighten in order to help make the world a better place. He epitomises erudition, enthusiasm for learning, and an insightful open-mindedness.

Value Creation Principles is based on Madden's 50 years doing financial analysis, valuation model development, and portfolio management; learning how real firms work, the importance of the firm to capitalism, and the essence of sustainability long before the word came in vogue. Madden knows his stuff and he knows his firms.

Reviewing a Bart Madden book has become a pleasurable and enjoyable bi-annual task; and he is rapidly becoming one of my favorite authors. When I reviewed his most recent book (Madden, 2018). I urged him to "please survey our economy and find other areas with a disconnect between technology, democracy, and efficiency (perhaps higher education?) We need your passion, your voice, and your erudition" [Reardon, (2018), p.427]. Thankfully he responded pretty quickly, although this book has been gestating for quite some time.[3]

At only 238 pages of text, most readers will be surprised by the book's brevity. Yeah, Madden says a lot and packs the pages with interesting stuff, yet, his crisp and efficient prose is engaging and inviting, and parts read like a novel (literary, not mystery!) Madden's firms come alive, and just like a good novel, the reader is hooked, wanting to know more.

The book's seven chapters are divided into three parts: a firm's role in society; the pragmatic theory of the firm connects innovation and valuation; and value creation. Part 1, a firm's role in society, lays the groundwork for the book's four themes:

- *Pragmatic*: The book was originally titled *The Pragmatic Theory of the Firm*, then revised prior to publication, while moving pragmatic to the subtitle. Pragmatic (from the Greek word, meaning 'deed') means practical: concerned with facts or actual events. And according to the common dictionary, 'practical' has several nuanced definitions, the most apt here: 'capable of being used or put into effect; useful. "Madden's pragmatic theory of the firm connects the firm's purpose, major activities, and its long-term overall performance, with particular attention to long-term financial performance" (p.30).

- *Knowledge building*: Madden begins his book with the unequivocal statement: "I strongly believe that a firm's long-term performance is a direct result of its knowledge building proficiency" (p.15). Indeed knowledge building provides the foundation for his theory of the firm, explains how a firm produces value, and the capacity to build knowledge, and differentiates between successful and unsuccessful firms. It is of "paramount importance in determining a firm's survival and prosperity over the long term" (p.34). Knowledge building has five interlocking components: purpose, worldview, perceptions, actions and consequences, and feedback, each of which strongly influences how we build knowledge (p.32). For Madden, "knowledge building and value creation are opposite sides of the same coin" (p.64).

- *Life cycle framework*: focuses on an individual firm delivering economic returns and reinvestment during the four stages of its life cycle: high innovation, competitive fade, maturity, and failing business. This framework, Madden convincingly demonstrates, is more accurate and holistic than traditional valuation measures.

- *Systems thinking*: is a central unifying theme of all Madden's books.[4] Rather than look at one isolated component, as if each were separate entities, systems thinking is about connectedness, about how the whole system works. Systems thinking obviously proffers a different worldview, albeit much more accurate. The pragmatic theory of the firm "applies systems thinking to improve our understanding of firms and our measurement tools, and to upgrade decision-making" (p.222).

Chapter 1 expands on the concept of a pragmatic theory, while also providing a highly readable historical evolution of the theory of the firm, differentiating a pragmatic theory from other theories. As the book's subtitle reads, 'The pragmatic theory of the firm begins with purpose and ends with sustainable capitalism'. Madden defines a pragmatic firm as "a dynamic system of coordinated activities that evolves as management and employees build knowledge in order to create value for customers" (p.4). While the literature abounds with definitions of a firm's purpose, most are either deductively based, or too narrow (or both), focusing only on one stakeholder, ignoring the well-being of the others and how this interacts to affect the firm's holistic success. For Madden, a pragmatic firm has a four-part purpose rooted in the knowledge building loop:

- communicate a vision to inspire and motivate employees to make the world a better place
- survive and prosper through continual gains in efficiency and sustained innovation
- sustain win-win relationships with all the firm's stakeholders
- take-care of future generations with a genuine commitment to ensure the sustainability of the environment (pp.26–27).

And thus, "knowledge-building proficiency tied to the four-part purpose is a viable route to taking care of future generations" (p.27). Madden's emphasis on sustainability, often missing in the traditional literature, is important and will increase the applicability and reach of his book.

Chapter 2 discusses knowledge building, which not only is an end in itself and a means to increase value, but is also a metric to analyse a firm's success/failure. While each component of knowledge building is critically important, feedback emerges as "hugely important" (p.41) since it "ideally facilitates new knowledge building that is critical in directing innovation both for existing products and new products that may significantly differ from existing products" (p.194). Feedback works exceedingly well for Netflix, according to its web page:

> "We believe we will learn faster and be better if we can make giving and receiving feedback less stressful and a normal part of work life. Feedback is a continuous part of how we communicate and work with one another versus an occasional formal exercise…Feedback helps us avoid sustained misunderstandings and the need for rules" (p.187).

In building the knowledge loop Madden calls for humility (economists take notice!), "what we don't know… will open the door wider to deeper understanding" (pp.40–41).

Chapter 3 utilises knowledge-building as a general-purpose analytical metric to explain three important approaches to improving firm performance: Lean Thinking (pioneered by Toyota); the theory of constraints (developed by Eli Goldratt); and Werner Erhard's and Michael Jensen's recent ontological/phenomenological model.

Chapter 4 uses the life cycle framework as the basis for his innovation life-cycle valuation model, to connect a firm's long-term financial performance to its market valuation. The life cycle model, "stripped of any assumptions about risk and return in an assumed equilibrium environment" is superior to the capital asset pricing model (CAPM), touted by mainstream finance (p.218). Finance aficionados will appreciate the helpful addendum 'A research methodology for advancing the life cycle framework', (pp.111–120) just as economists should appreciate Chapter One's historical discussion of the theory of the firm.[5]

One of the book's more interesting chapters is Chapter 5: 'Intangible assets, brands, and shareholder returns'. Interesting because the topic is often missing in traditional economics texts. Indeed,

> "intangibles play an important role in the generation of a firm's life-cycle performance… and [as such] a prerequisite to analyzing shareholder returns in today's new economy is an insightful understanding of connectivity-enabled innovation, networks, platforms, and the increased importance of hard-to-duplicate intangible assets such as unique human capital (e.g., brands)" (p.122).

Yet, neoclassical economics and traditional accounting[6] are still mired in the ways of the Old Economy (producing physical goods with physical assets) which is problematic since intangible assets (unlike tangible assets such as machinery) typically involve considerable uncertainty as to both the magnitude and duration (life) of future benefits" (p.126). Accounting aficionados (and accounting rule-makers) will appreciate the helpful call to action 'Conceptual roadmap for handling intangible assets' (pp.133–142).

Chapter 6 discusses the firm's organisational structure which is also a source of competitive advantage and value added. The chapter is peppered with the successful case studies of the Haier Group, Morning Star, and Netflix. The Haier Group discussion impugns the common-held assumption that large firms are too big to successfully transform. The typical structure of the New Economy firm is more of a "flattened hierarchical pyramid [with] a structure focused on teams of individuals doing the work of efficiently serving customers" (p.199) creating far more value for customers and other stakeholders.

Chapter 7 summarises the book's key take-aways, nicely encapsulated in the following passage:

> "the main theme of the book is that knowledge-building proficiency is the key to long-term value creation by individuals, business units, and firms. A corollary theme is that resources are best allocated by management (including entrepreneurs) less concerned with hierarchal control mechanisms, and instead, intent on developing a knowledge-building culture keyed to innovation and constructive change. Such a culture rewards and motivates those who reveal obsolete assumptions; analyze problems to unravel root causes…that is, fast and effective traversing of the knowledge-building loop" (p.215).

Madden concludes his book by endorsing the nascent movement toward a new discipline of Progress Studies to "study the successful people, organisations, institutions, policies, and cultures that that have arisen to date, and it would attempt to concoct policies and prescriptions that would help improve our ability to generate useful progress in the future" (p.214). In this interesting new discipline, Madden's take is to emphasise the evolutionary process in which "firms build knowledge, create value, and generate progress – a bottom up concrete body of knowledge using the individual firm as the unit of analysis. This book is a step in that direction" (p.238). Indeed it is.

I do not have any criticisms of the book per se (the book was accepted by Madden's first choice, Wiley, without any changes major or minor), which is not surprising given that the book is clearly written, cogently argued, and arguably succeeds at its objective.

While the reviewer's task is to review the book actually written and not the book that the reviewer wanted to read; at the same time, the flip side of writing a succinct and pithy (and much-needed) book on such an important topic is that most readers would have liked this particular topic or that particular topic. This is a cost of writing a short and pithy book; and a natural and expected reaction: like watching a good movie, we are sad to see it end, wanting more. Yet, if Madden were to expand and write a massive Encyclopedia (like many of today's principles of economics textbooks, his book would lose its verve, its passion, its succinctness, and yes, its applicability to understand the rationale and modus operandi of any firm, large or small, local or global.

Who should read this much needed-book that discusses how the capitalist firm creates value, how and why it evolves over its life-stages, its role within capitalism, with a plethora of real-world examples about how real firms actually behave? (I think I just answered my own question: well, everyone.) Every businessperson should read this, not as a rah-rah, motivational book, but as a carefully thought-out book with workable and pragmatic principles of how firms create value based on the author's 50 years in the trenches, and couched in the context of contemporary capitalism. This important book deserves a central place in reconceptualising economics and in a new pluralist curriculum (You need not have a strong background in economics or finance to profit from this book), and it should be mandatory in the economics and MBA curricula.

Bart Madden, I hope you are surveying our economy/society finding other areas, perhaps something more in-depth about knowledge building and the economy: We need your passion, your voice, and your erudition.

Stay tuned!

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Notes

1 Lee (2010, p.205) noted that the core theoretical tools of neoclassical theory circa 1900–1910, i.e., scarcity, maximisation, utility and marginal utility, marginal product and the law of diminishing returns, supply and demand curves, the marginal productivity principle of distribution, and the core model of competition have been retained throughout the century".

2 Commemorating Martin Luther and the 500th anniversary of the commencement of the Reformation, I wrote: "Economics must become more inductive and less deductive. One is hard-pressed to find in any economics textbook empirical evidence about how real-world firms behave and how they operate. Instead we find fabricated data based on 19th century prescripts of how firms should behave. If we presume to teach about modern capitalism, we

should begin with real-world data. (That this is even mentioned underscores how dysfunctional economics has become)" [Reardon, (2017), Thesis #50, p.324].

3 I also reviewed Madden (2014) in the IJPPE, (Reardon, 2015).

4 In an earlier book, Madden identified (and explained) systems thinking as one of the four core beliefs businesses need to solve complex problems; specifically, "to address the tendency toward an excessive focus on local efficiencies that can easily degrade overall system performance, and to powerfully identify and focus on fixing the key constraints" [Madden, (2014), p.42].

5 This is not exclusionary by any means. The overall language of these sections is clear and inviting so that all can profit. And by the way, management and investment aficionados can profit from the whole book. A central theme/objective of Madden's research corpus is the dismantling of separate silo thinking; a much-needed objective.

6 For an incisive criticism of traditional accounting with a sustainability twist see Brown and Dillard (2019).