

Book Review

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Value Creation Insights: A Foundational Understanding of How Firms Build Knowledge and Create Value

by: Bart Madden

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Reviewing a Bart Madden book has become a pleasure for me; he is rapidly become one of my favourite authors, epitomising erudition, enthusiasm for learning, and an insightful open-mindedness. When I reviewed his 2018 *Free to Choose Medicine*, I exhorted 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]. He obliged, publishing three additional books, including his most recent, which I now have the pleasure of reviewing.

Madden, armed with an undergraduate degree in mechanical engineering and an MBA from Berkeley, co-founded an investment research firm in 1970, and spent decades in the trenches developing an astute understanding of how firms create value. His extensive knowledge has enabled a fruitful second career (after retirement) as a productive researcher/scholar. This book is his latest instalment on how firms create value and the important role of the firm in today’s capitalist economy.

The erudition that seeps through the book’s eight chapters wows and entices. Madden’s inquisitive mind spans the disciplines from economics to finance to psychology. A 21st century polymath, if you will, writing as if there were no silos parrying interdisciplinary scholarship.

Chapter 1 has two objectives:

- 1 to introduce the eminently useful practical theory of the firm (PTF)
- 2 to drive home the importance of systems thinking, which emerges as a major theme.

As for the need for a theory, Madden writes:

“Since a strong case can be made that firms are the engine of economic progress, economists and other researchers who study progress invariably must explain the role of firms, and hence the need for a theory. [In addition] theories shape one’s worldview, which in turn, determines how one perceives the world, identifies problems (opportunities), develops solutions (business plans) and even influences the data selected to test.” (p.6, p.7)

The effects of theory in our society’ are ubiquitous and its reach extensive. University graduates are imbued with it during their studies, and policy makers are also shaped by

prevailing theories. A theory helps elucidate what is acceptable for research and what is palatable for policy. A theory affects all actors in an economic system, so it is important to get the theory right. Mission accomplished in the opening chapter. Madden's PTF frames a workable and usable understanding for how firms build knowledge and how they create value. Construing a theory (as Keynes suggested) as a method rather than a doctrine, Madden's PTF accrues to the firm four common sense objectives: "to facilitate systems thinking; to provide clarity as to the firm's purpose; identify the critical determinant of the firm's long-term performance; and connect long term performance to market valuation and shareholder returns" (p.6).

Madden argues quite convincingly that the PTF with its emphasis on value creation, firm performance and valuation is superior to other theories of the firm. Consider, for example, the ahistorical and highly deductive neoclassical theory of the firm (widely taught in economics departments and business schools) which,

"Configures the firm as a black box that makes decisions on output and pricing based on equating marginal cost and marginal revenue [assuming of course that these can be tabulated] but says nothing about how the firm operates and its internal mechanism, leaving the theory vulnerable to being criticized as nothing more than a black box... which renders it useless for understanding." (p.6)

In turn, systems thinking, is necessary since the PTF recognises the firm as "a system; and understanding its complexities ... requires multiple perspectives that extend far beyond the homo-economics model" (p.25). The starting point for systems thinking is recognising the interrelationship between the whole and its parts.

Chapter 2 introduces the knowledge-building-loop (KBL). It is a logical necessity of the PTF, since the PTF spotlights the firm's knowledge-building proficiency as the critical determinant of long-term performance. Hence, a need for an explicit understanding of the knowing process, which is the KBL. The KBL "serves as a mental model for the process of building new knowledge [with] the goal to better understand problem solving and more broadly innovation...the child of freedom and the parent of prosperity" (p.31). The Loop's components include one's knowledge base, one's purpose, one's worldview influencing one's perception leading to actions with consequences, while soliciting feedback and learning from it.

An efficacious use of the loop requires inquisitive systems thinking, enabling one to ask better questions, while uncovering faulty assumptions often camouflaged by language, all with the goal of building knowledge and creating value. Thus, "adopting the loop as part of your problem-solving process is to upgrade your creativity in developing practical solutions to practical problems" (p.42). Madden then uses the loop to analyse how the Wright Brothers taught the world to fly. It was as if the Wright Brothers had the loop at their fingertips as they were designing and then flying their prototype! The lesson here is crystal clear: the loop and its systematic and holistic way of thinking can be effectively applied to any problem.

Chapter 3 discusses several approaches to value creation that utilise the KBL. Although one chapter cannot do justice, this brief overview works. Madden begins with imagination as an important element in creating value,

"Imagination is about developing a novel approach for a problem situation and involves questioning of assumptions, mistakes, learning, and ultimately value creation. It is not just for the development of new products and services but is applicable for all the firm's activities." (p.51)

And needless to say, imagination goes hand-in-hand with systems thinking, for it enables asking better questions and utilising constructive scepticism in order to uncover hidden assumptions. Madden rounds out the chapter by discussing design thinking and lean thinking.

A perennial question that never goes out of style is how best to structure a firm; and within the context of this book: is there a structure that best comports with the PTF. For Madden, it is a no brainer: a flatter firm (the antithesis of the traditional top down firm; think GM, US Steel) is best able to produce knowledge, to create value, to facilitate feedback, and “to promote a culture that facilitates fast and effective traversing of the knowledge building loop” (p.78). Compare this to the *modus operandi* of running a (traditional) top-down, command and control firm, where it is assumed that “important knowledge about running a business is generated by management; budgets/targets are needed to incentivize lower levels; lower levels are not to be trusted, and their knowledge is nonexistent” (p.66). Needless to say, such traditional thinking has “been rendered obsolete by today’s fast-changing world where superior results depend upon intangible (employee-created) assets and not merely scaling up tangible assets. The alternative to command-and-control is a flat organizational structure” (p.66).

Not only does Madden provide good examples of flat organisations that are large and global (Nucor, Haier; and Bayer in transition from top down to flat) evidencing that a business need not be small to be flat, but he also provides a highly useful step-by-step ‘how to’ transition from top-down to horizontal, regardless of firm size.

Madden is in a good position to accurately connect a firm’s long-term performance to market valuation and shareholder returns (a central objective of the PTF). In 1970, he co-founded Callard, Madden & Associates, an investment research firm. There, one of Madden’s myriad accomplishments was constructing a life-cycle track record (and an accompanying life cycle valuation model) that could visually track a firm’s performance over time. The track record enables users to continually learn how firms create/dissipate value over the long-term and how the stock market reflects that change in value by encapsulating the firm’s economic returns, the cost of capital, and reinvestment rates.

Chapter 5 discusses how this life cycle track record was constructed, and how it can be used today by investors, managers, boards of directors, and students for understanding the evolution of a firm’s ability to create value. Madden’s life cycle has become a resounding success, offering a consistently superior product to the existing track records driven by Wall Street’s myopic hyperfocus on quarterly earnings. The Life Cycle Track Records are the centerpiece of a proprietary global database (covering 20,000 companies) that UBS provides to large money-management organisations worldwide.

Given that an objective of PTM is to connect the firm’s long-term performance to market valuation and shareholder returns, the metrics and the valuation process of so doing should be 100% accurate or very close to it. But clearly they are not, as Madden adeptly discusses in Chapter 6. Unfortunately, the accounting powers that be (i.e., the Financial Accounting Standards Board) that determine today’s accounting standards are wedded to standards that were in vogue under the old economy (firms producing physical goods; think of US Steel, GM, etc.). Whereas the old economy was powered by tangible assets (e.g., plant and equipment, inventory, physical stores, etc.) today’s new economy is about ideas that produce mostly non-physical things, i.e., intangible assets. And, not surprisingly, “since the 1990s intangible assets have increasingly become the source for earning above-cost-of-capital returns” (p.96).

Thus, utilising accounting standards that worked well under the old economy, while parrying standards that accurately measure and track intangibles, will give false and misleading information to investors and managers, resulting in palpably incorrect decisions. However, instead of just criticising (which is easy enough here) Madden offers a realistic and workable alternative based on an intangibles accounting database, which can be readily adopted by most firms. He also discusses innovative software (freely available to all) that can track the use and value of intangible assets. After reading this chapter there should be no excuse for any firm not reporting the full and accurate value of their intangible assets.

A major feature of Madden's life-long work has been "...the application of a systems thinking lens regardless of the topic analyzed" (p.115). Chapter 7 presents a fine example of so doing: his 'free to choose medicine' proposal. This example serves as an effective 'how to' for novice readers interested in applying the systems lens. The Free to Choose (FtC) proposal, of which a variation is floating around in the Trump administration (with an earlier variation implemented in Japan) offers a fast-track option for patients with life threatening conditions to obtain drugs much quicker than the Federal Drug Administration's (FDA) current laborious regulatory process. Madden's goal is not to supplant the FDA, but to offer a quicker delivery with shortened regulatory phases, and hence a workable 'competitive alternative' (p.120). He points out that the FDA's objective to lessen the probability of death/injury of approved drugs comes at a severe opportunity cost: patients with life-threatening conditions where early access could make a difference are obtusely relegated to the 'the invisible graveyard' (p.117). Of course there are risks with the fast track, but Madden argues that they should be borne by those most affected: A fast-track decision should be made by those with the most information, i.e., doctors and their patients.

Underscoring the rationale for freedom to choose, while concomitantly undermining that of the FDA, is today's rapidly changing technology,

"Technology in 1962 was primitive compared to today's high-speed personal computers, internet, and powerful AI-driven big-data analytics applied to real world data. Couple this with patients' genetic data and drug biomarkers, and instead of crude effectiveness based on the average patient, [sub] groups of patients can be quantified and studied for treatment results and adverse side effects. The FDA's regulatory process is antiquated due to its focus on statistically significant results for the average patient in late-stage trials." (p.116)

Chapter 8, appropriately titled 'Living the life of a value creator', tersely summarises the book's major points while tying up some loose ends. Madden also makes a good argument for including this book in the business school curriculum, which as an economics professor, I fully endorse. Otherwise,

"People develop an inventory of disconnected assumptions about stock prices, earnings growth rates, maximizing shareholder value, stakeholder interests, competitive advantage, meeting or exceeding Wall Street's quarterly expectations [while assuming] that agency theory and adversarial relationships suffice as a viable theory of the firm." (p.138, emphasis added)

The chapter's appendix includes his 2021 commencement address to the Florida Atlantic University Business School, which serves as a nice précis of the book's themes along with a good pep-talk for the younger generation. Madden highlights the need for a far more realistic and real-world understanding of how business firms actually operate and

how they create value. He encourages students to create value for others as the means to create value for oneself.

Besides students, who should read this book? Well, everyone. That is, anyone who is interested in how the firm works and its role in capitalism. Managers, investors, members of the board, policymakers, and academics can all profit; and one need not have any business background.

I do not have anything negative to say about the book's content, nor how it is presented. Madden admirably succeeds at his objective of providing value creation insights. His prose is crisp and vigorous, free from academic jargon. Helpful are the book's many diagrams which efficaciously get the point across. Not to be missed are the highly illustrative and effective quotes that manifest in seamless writing from Madden to expert to Madden.

As I wrote in my 2020 review of Madden's *Value Creation Principles*: "Bart Madden, I hope you are surveying our economy/society finding other areas to write about...We need your passion, your voice, and your erudition" [Reardon, (2020), p.218].

Stay tuned!

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Notes

- 1 Madden is far from alone in making this argument; in addition to this chapter's copious citations, see Lev (2016).
- 2 For a further discussion see Madden and DeMuro (2025).