2 Value

2.1 Stakeholders in advanced economies

In advanced economies such as Europe and North America companies are increasingly becoming coalitions between stakeholders who of their own free will decide to take or maintain an interest in those companies. There are three stakeholder groups: shareholders, employees and clients.

2.1.1 The idea that value creation and distribution is related to the nature and stage of sophistication as displayed by the economic structure in which the companies operate, is widely supported. In advanced market economies (such as Europe and North America), the choice of opportunities open to capital providers, clients and specific employee categories with regard to investments, products and services, and employment is approaching infinity. Yet, various views are held with respect to the position these stakeholders have with respect to each other.

2.1.2 Here a distinction is often made between the Anglo-American model and the Rhineland model. In his book ‘Capitalisme contre capitalisme’, Michel Albert describes the differences between these models (Albert, 1992; see also Naert, 1997). In the Anglo-American view companies are the property of their shareholders. For them it is perfectly logical to do as they please with the company they own: they may even break it up and sell off the segments which are of no interest to them. The company's primary goal then is to earn money for its owners: the company as a cash flow machine for shareholders. Clients, employees and management are merely considered to be inputs for reaching financial goals (Albert, 1992).

2.1.3 In contrast, the approach of the Rhineland and Japanese models is to treat a company as a community in which the prerogatives of the shareholders must balance those of management, banks and the interests of employees. The company in itself is not considered the property of the shareholders: value distribution is not about short-term profit, to be distributed as dividend to the shareholders. In most cases the capital providers are members of the same business group or network (*keiretsu* in Japan) that the company belongs to. To demand high dividends or interest rates would therefore be counterproductive. The providers rather allow the company a long-term market perspective and permit it to take the higher financial and industrial risks that go with the introduction of new products. The pay-back will materialise as market share or even market dominance in the long run. Part of the value created goes to employees, in the form of social benefits or long-term employment guarantees (Albert, 1992)

2.1.4 Moerman (1995) distinguishes between the three most important current variants of capitalism: the Anglo-American financial capitalism, the continental (Rhineland) industrial capitalism, and the far-eastern industrial (network) capitalism. These models can be set apart according to their sequence of laws, logic, and relations. See table below.

Model	Ranked 1st	Ranked 2nd	Ranked 3rd
Anglo-American financial capitalism	Laws	logic	relations
Continental (Rhineland) industrial capitalism	Logic	relations	laws
Far-eastern industrial (network) capitalism	Relations	logic	laws

2.1.5 Although therefore there are distinct differences between various advanced economies as indicated by at these various models, the differences relate largely to the interrelations between the various stakeholders. Looking to the stakeholders themselves: the shareholders, the clients, and the employees, in all of these economies similar tendency in development can be observed.

2.1.6 Since the early days of our industrial companies, the relations with the various stakeholders have gone through a long evolution. An evolution, which in terms of speed and impact has been different in the respective economies, but is following similar lines in terms of stages and directions.

2.1.7 Shortly after the industrial evolution shareholders tended to have a strong personal link with a specific company, as this was often family-owned. Gradually however, when the capital market structure took the form we know nowadays, shareholding became more anonymous. Besides, it has become strongly internationalised, especially during the past decades. This is easily discernible when one compares the development of the market capitalisation to that of the GDP's of nations, also indicating that this process is substantially more advanced in Anglo-American economic cultures than in the 'Rhineland' and Japanese arena's (see Figure 2-1). Shareholders' investment decisions are increasingly driven by short-term capital gain, and part of the shareholders is known to decide on an almost daily basis, whether or not they will be a partner in this company. Capital providers may exercise their easy ability to switch companies as a power source, thereby forcing companies to provide high dividends and high share prices. In order to retain their shareholders companies are tempted to maximise their short-term profits to reach these desired goals.

2.1.8 Similarly to the capital markets, wherever the availability of equivalent quality products and services outstrips demand, markets for products and services are more and more evolving from a sellers' market to a buyers' market. Product and service quality are increasingly a prerequisite to participate in the business game, not a distinctive factor. For almost any product/service there is a 'equal quality' alternative. Quality becomes the 'green fee' for the market game, not the game itself. Consequently clients can select a different product or service every day, without sacrificing any product and service quality requirements. This possibility clearly erodes client loyalty.

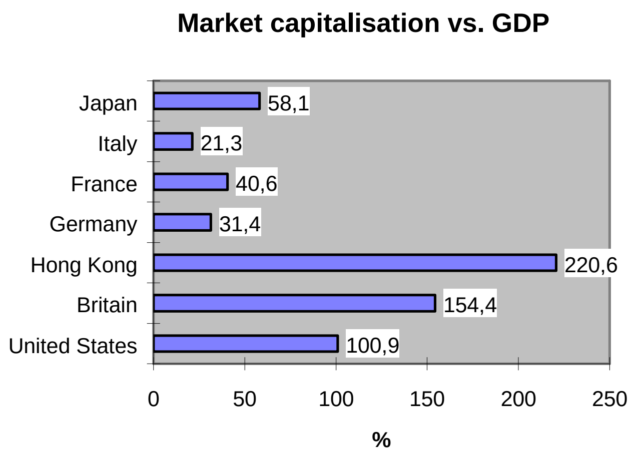

Figure 2-1: The shareholder dimension: market capitalisation versus GDP

2.1.9 This growing choice from which customers can benefit is due to a number of structural market factors, as Pine describes in his book about a paradigm shift in primarily North-American production structures (Pine, 1993):

- The increase in buyers' power, which leads to the buyer controlling the environment instead of the supplier;
- The increased competitive intensity, i.e. the larger number of suppliers fighting for market share;
- The shift from price competition to product differentiation
- The fact that markets are growing towards saturation, which in the end leads to increased variety;
- The fact that products are becoming more and more vulnerable to substitutes, which induces suppliers to increase variety in order to exactly meet customer needs;
- The higher rate of product technology change, which results in more different technologies being available and possibly more products.

2.1.10 In their book ‘Agile competitors and virtual organisations’ Goldman, Nagel and Preiss (1995) note the following:

> *“Product variety has proliferated to a bewildering degree; Seiko markets 3000 different watches, Philips sells more than 800 colour TV models”,*

and:

> *“Magazines, beer, soft drinks, and snack foods; radio stations and cable TV channels; audio and video equipment; cameras; fax machines and copiers; printers and scanners; appliances, clothing and financial, shopping, and business services all come in a bewildering array of choices aimed at constantly proliferating market niches”.*

Of course, the trend is most pervasive in modern IT and communication industries. But also service industries such as restaurants, banking and investment instruments have been affected, as have manufacturing sectors such as washing machines:

> *“The only constant is that new models and more variety are sure to appear.”*

2.1.11 This is not only true for the North-American market, to which much of the management literature refers, but also for the western European and Japanese markets, as Warnecke (1993) demonstrates. In Figure 2-2 the acceleration of product variety at BWM is displayed.

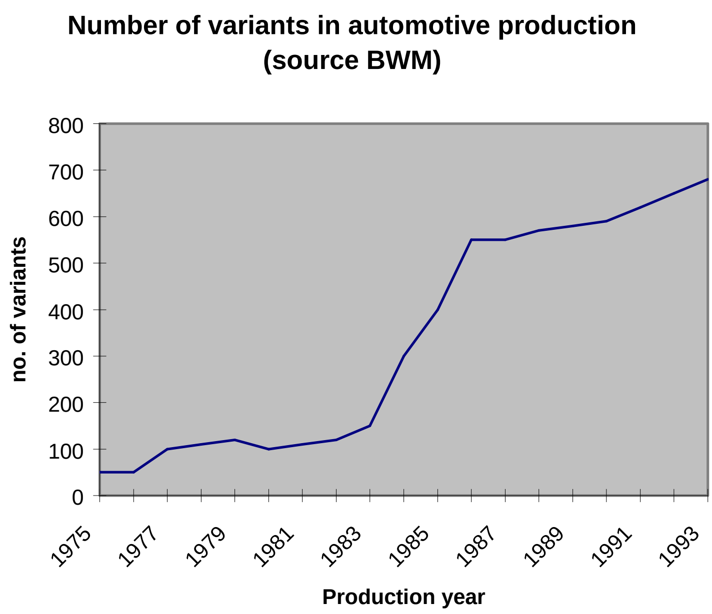

Figure 2-2: *The customer dimension: acceleration of product variety (Warnecke, 1993)*

2.1.12 A last effect, which may be more difficult to appreciate, is that nowadays employees choose more often than before which employer they want to work for. Employment duration is shortening, flexible arrangements are a rapidly growing proportion of the total employment (see Figure 2-3), outsourcing of non-core activities leads to the emergence of specialised small service providers, and most employment markets are faced with a shortage of highly qualified employees in substantial professional segments.

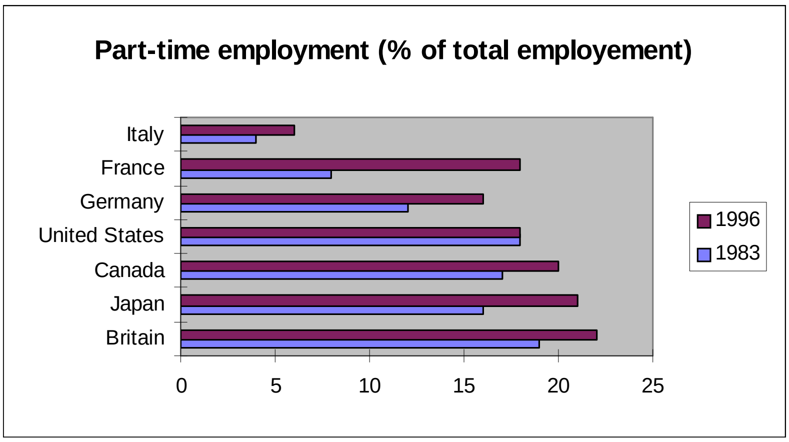

Figure 2-3: *The employee dimension: part time employment as a percentage of total employment*

2.1.13 In other words, while historically the relation between capital, labour and the market could be characterised as one of shortage, lack of choice and an imbalance of power, now all three groups of stakeholders find increasingly that they have free alternative choices for their investments, their products and services as well as their employment relations.

2.1.14 As a consequence, under conditions as described before a company is a (temporary) coalition between these stakeholders. Such business can be considered as a non-zero sum game between various stakeholders, in which different economic actors - suppliers, business partners, allies, customers - work together to co-produce value. In this way the company's key strategic task is a systematic social innovation: roles and relationships within this constellation of actors have to be continuously adjusted (Normann and Ramirez, 1993).

2.1.15 In their book 'Built to last', Collins and Porras suggest that the main ideologies of visionary companies (companies that consistently outperform the market) are concerned with serving customers, satisfying employees, making profits, serving society and 'making a contribution'. Obviously, the ideology of each individual company has its own combination of goals and attaches different values to each of them. However, for visionary companies profit is never the single most important objective. Their ideologies bring the role of oxygen to mind: there is no life without it but it is not what life is about. The authors' research indicates that no specific ideological content is required for a company to be visionary. This means that it is not so much the (ideological) distribution of value that matters, but rather the creation of value (Collins & Porras, 1994).

2.1.16 De Geus takes the point even further. In his view, profitable long-term continuity is the primary goal of a company. He labels companies that succeed in renewing themselves over many generations, 'living companies'. The most important reason why these companies reach this goal is that they do not solely focus on economics; they treat the organisation as a community of human beings that is in business to stay alive. According to De Geus companies should therefore *"... pay attention to the development of employees above all other considerations".* Another consequence that he signals is the *"optimisation of capital as no more than a necessary complement to the optimisation of people"*. In this view employee value is taken as a starting point. Here value should above all be seen as a sense of belonging, of sharing (sociological) values, development potential, and recognition. Least of all it should be considered in a financial sense. Assets and profits have 'oxygen status': necessary for life, but not its purpose (De Geus, 1997).

2.1.17 In a reaction on De Geus' article in Harvard Business Review, James Collins (1997) confirms the concurrence of most of De Geus' findings with their own research:

> *" [...] a great and enduring company does not see maximising shareholders' wealth or profit as its core purpose, and yet, paradoxically, companies that look beyond maximising profits not only last longer, they also make more money than companies that view their purpose purely in economic terms."*

He warns, however, against the misinterpretation of De Geus' article as if 'living companies' are low risk-taking and have a soft attitude towards their employees. As is confirmed by De Geus himself, 'living companies' also take great commercial risks, but they do so with their own hard-earned money. Also, the 'living companies' employee orientation does not mean they are soft, but rather that they demand high performance within the value system of a working community (Collins, 1997; De Geus, 1997).

Although the view that companies in advanced economies under conditions of free choice for respective stakeholders can be considered as coalitions of these stakeholders is certainly not uncontested, there is, we believe sufficient support to justify this view. We will consequently use this definition of the company throughout the thesis.

2.2 Coalitions of stakeholders

Continuity of such coalitions depends on the creation of value for the company as a whole and on a distribution which offers the best possible value to the individual stakeholders. It follows that strategies, which trade one stakeholder's interest against another, do not provide a basis for continuity, unless one or more stakeholders are not in a position to act in a free market relation. Therefore the principal aim of companies in advanced market economies must be to simultaneously create value for all its stakeholders: shareholders, clients and employees.

2.2.1 The literature on shareholder value takes only financial value into account (Gilchrist, 1971; Rappaport, 1986; Clarke, 1993; Guatri, 1994). Value is seen as purely financial and as a consequence can be measured objectively. Other conceptions of value, conceptions that are subjective and non-measurable, are not considered at all, the only exception being corporate governance (shareholders vs. management).

2.2.2 In his book 'Creating shareholder value: the new standard for business performance', Alfred Rappaport explicitly names maximising shareholder value as the central objective of the company:

> *"The idea that business strategies should be judged by the economic value they create for shareholders is well accepted in the business community. After all, to suggest that companies be operated in the best interests of their owners is hardly controversial."* (Rappaport, 1986).

2.2.3 Rappaport states that shareholder value is created when a company generates free cash flow in excess of the shareholders' investment in the business. Value is extracted as shareholders receive their economic returns: dividends and increases in share price. The process of value distribution among shareholders, customers and employees is not taken into account (Rappaport, 1986).

2.2.4 Marketing literature normally assumes customer value to be the key objective of the company. Other objectives, such as employee value and investor value, are however both a consequence as well as a cause of customer value (Reichheld, 1996; Heskett, Sasser and Schlesinger, 1997).

2.2.5 Heskett, Sasser and Schlesinger's approach is fundamentally different, in that it takes customer value as the point of departure. They state that good customer value leads to customer satisfaction and consequently to customer loyalty. This in turn leads to higher revenues and profitability. This outcome has a feedback effect on employee satisfaction, loyalty, capability and productivity, thereby reinforcing the creation of customer value. In the authors' own words:

> *"The strongest relationships suggested by the data collected in early tests of the service profit chain were those between: (1) profit and customer*

> *loyalty, (2) employee loyalty and customer loyalty, and (3) employee satisfaction and customer satisfaction".*

They suggested that in service settings, the relationships were self-reinforcing (Heskett, Sasser and Schlesinger, 1997).

2.2.6 As part of the value created goes to the customer in the form of lower product prices or higher perceived benefits, this reflects a second 'community': that between the company and its customers. What is good for the company is good for them. In Heskett, Sasser and Schlesinger's view the market structures are free, but they are much more governed than in the Anglo-American model (e.g. influence of labour unions, industry regulations, government regulations and programmes). This leads to higher switching costs for all stakeholders and to a more long-term attitude when it comes to profit gain and value creation (Albert, 1992).

2.2.7 Apart from the models mentioned above, there is also the Marxist/communist model. It is very dichotic, as it considers only workers and capitalists. Whereas Marx describes workers ownership as a result of an inevitable evolution, resulting in the crisis of capitalism, his ideological successors have attempted to install the model through revolution. In this model, it is the workers that should govern the company (and the society as a whole) and receive the full benefits of their work. Capital providers are exploiters by definition, making money of the added value created by the workers, but creating no added value themselves. In the Marxist view they are therefore not entitled to any compensation. After the successful proletarian revolution the workers will become the owners of the company and all added value will therefore automatically flows to them (Goddijn, Thoenes, De Valk, Verhoogt, 1980).

2.2.8 Mathur and Kenyon (1997) take a stand right between shareholder value and customer value. In their opinion the fundamental goal of the company is to earn more than the cost of capital, taking into account the investor's opportunity cost of placing his money in the company. This means that financial value (the shareholder value part) has to be optimised. The authors state however that the source of financial returns is commercial success:

> *"Thus the ultimate reality of business is the need to satisfy financial markets by success in winning profitable customers in commercial markets."*

2.2.9 Reichheld (1996) notes that, in spite of the almost exclusive focus on shareholder value, companies do not succeed in ensuring shareholder loyalty over longer periods. The disruptive consequences of this lack of loyalty are often underestimated.

2.2.10 According to Reichheld business performance is directly linked to the loyalty of customers, shareholders and employees. Disloyalty on the part of these groups results in a 25-50% lower business profit. The figures per group are not very comforting: 50% of the customers disappear within five years, 50% of the employees in four years, and 50% of shareholders in less than one year.

2.2.11 Reichheld states that by bringing together the right customers, employees and investors and carefully managing the loyalty of each of these groups, long-term value is created for the whole of the stakeholders. The starting point, however, is the creation of customer value. By putting employee productivity and investor capital to work, the company is able to create value for the customer. Consequently, sales and profits go up, leaving value available to employees and investors. In this view customer value, employee value and investor (shareholder) value are closely intertwined (Reichheld, 1996).

2.2.12 Another view held by Reichheld is that business is not a zero-sum game. In other words, value creation which benefits each of the company's stakeholders will result in an upward spiral, since the total value created is larger than when a one-sided ‘profiteering’ approach is followed. Reichheld also claims that value can be created through value sharing. In this view, the most important objective of the company will be to bring together and maintain a loyal well-matched set of customers, employees and investors, in order to create and consume value to their mutual benefit (Reichheld, 1996).

2.2.13 Previous views by various authors are heavily biased by their professional angle of view. Finance professionals are biased towards the shareholder, marketers towards the customer, and Marxists towards the employee as the dominant stakeholder. It now transpires from research by Collins and Porras, De Geus, and Reichheld that a one-sided definition of stakeholders provides too narrow a framework to understand success and continuity in the longer term. We subscribe to the view that in advanced economies companies should increasingly be considered as value creating coalitions between free stakeholders. It is this view which is not only supported by the research mentioned in this paragraph. As will be described it is the only view that enables networked companies to develop into effective, adaptive, wealth creating systems in advanced markets.

2.3 Utility as perceived value

Each individual stakeholder will seek his own (sometimes moment-specific) particular mix of utility aspects, accumulating into his personal definition of perceived value. Perceived value is the whole of the utility as seen by the individual stakeholder.

2.3.1 Throughout history, value has been defined in very different ways. St. Thomas Aquinas believed value to be divinely determined. Since humans set prices, it was possible for the price of a commodity to differ form its value. A person accused of charging a price in excess of a good’s value was guilty of charging an ‘unjust’ price. Controversies over the just price for a commodity dominated the economic discussions of the Middle Ages (Nicholson 1989).

2.3.2 In classical economic theory the value of a commodity is set equal to the price (Nicholson, 1989). The early scientific economists, such as Adam Smith and David Ricardo, continued to distinguish between value and price. To Smith, the value of a commodity meant its ‘value in use’, whereas the price represented its ‘value in exchange’. The distinction between these two concepts was illustrated by the famous water-diamond paradox. Water, which obviously has great value in use, has little value in exchange; diamonds are of little practical use but have great value in exchange. Ricardo tried to solve this paradox by stating that the relative price of two commodities is determined by the direct and indirect labour inputs used in each good. Ricardo’s theory is a pure labour theory of value, in that cost of capital is ultimately reducible to labour, a point that was taken further by Marx.

2.3.3 In the second half of the 19th century, the ‘marginalists’ stated that it is not the total usefulness of a commodity that determines exchange value, but rather the usefulness of the last unit consumed. Finally, Alfred Marshall set value equal to price, explaining price from the interaction of supply and demand. This resolves the water-diamond paradox. Water is low in price because it has both a low marginal value and low marginal cost of production. Diamonds are high in price because they have both a high marginal value and a high marginal cost of production.

2.3.4 Besides the concept of value, which in the classic view can be objectively determined as being equal to the market price, there is also the concept of utility [i]. The utility approach can be considered as a model for human behaviour. E.g. Kotler (1988) states that:

> *"Consumers strive for the satisfaction of their needs. These needs are subjective by default. The guiding concept is utility, or how well a product satisfies the consumer's needs. Utility per unit of money is defined as value."*

2.3.5 The utility theory has had severe criticisms over time. While we are aware of these criticisms, as put forward among others in Fishburn (1988), and in a number of articles by Tversky and Kahneman (1986; 1991), in this dissertation we assume individuals (or agents) to behave according to the general expected utility theory (see also Quiggin, 1993).

2.3.6 According to Pieters (1988) and Rusbult (1980, 1983)[ii], the outcome of an exchange transaction, i.e. the difference between rewards and costs can be seen as an attitude over this exchange transaction. This attitude consists of the weighted average of the different costs and rewards, or:

$$A = \sum w_I * s_i \qquad (I = 1 \Rightarrow n)$$

(A = attitude, w = weight, s = score, I = attribute)

This means, in fact, that value is not uni-dimensional, but consists of the appreciation of different attributes.

2.3.7 Following the multi-dimensional approach of value, Heskett, Sasser en Schlesinger (1997) in their book 'The Service Profit Chain' develop a concept of customer value. In their view the following items are determinants of customer value:

- Process quality of the service;
- The result the customer obtains (the solution to his problem) *("Customers don't buy products or services. They buy results.");*
- The price the customer has to pay;
- The access costs the customer has to make.

2.3.8 Customer value is calculated as follows:

Customer Value =
(results + process quality) / (price + customer access costs)

In this view, customer satisfaction is not solely dependent on the process quality of the service, but also - and perhaps even more - on the results the customer obtains (solution to his problem). Customer needs are so different that customers are willing to pay highly different prices for the same service, depending on preferences of time and place. Thus also the access costs for the customer play an important role. (Heskett, Sasser and Schlesinger, 1997)

2.3.9 What can be considered as value for employees depends greatly on the theory underlying what motivates employees. In the 1960's, Maslow (1970) formulated his famous theory of human motivation. This theory basically states that there are basic needs upon which higher needs are built. This leads to his concept of the pyramid of needs. Basic are the physiological needs (e.g. food and drink). Only when these are satisfied, the individual will start to value higher needs. The first in row is the need for safety. Once satisfied, needs for love, esteem, and self-actualisation follow respectively. This theory implies that there is no ‘rational’ or balanced decision on what motivates man. It depends to a large part on the ‘advance’ of the situation: only when the previous need is present, there is room for higher needs.

2.3.10 McGregor (1960) puts forward Theory X and Theory Y. In Theory X, assumptions are that people inherently dislike work, that they are lazy, and that they are motivated primarily by material and safety values (the basic values in Maslow’s pyramid). Theory Y, by contrast, assumes people to be motivated by the esteem they receive and by the possibilities they have to exert control over their own work (the higher values in Maslow’s pyramid).

2.3.11 Herzberg (1968) takes this even further, in stating that the basic values, once not present in the working environment, act mainly as dissatisfiers or ‘hygiene factors’. I.e., they do not motivate people when present, but they dissatisfy people if not present. These are the ‘taken for granted’ factors. Examples are financial reward, administrative practices, and supervision. Satisfiers or ‘motivating factors’, on the other hand, when present satisfy the higher needs as self-actualisation and esteem. When they are not present, however, they do not generate dissatisfaction. Examples of these are achievements, recognition for achievements, and opportunities for self-development in the job.

2.3.12 The determinants for shareholder behaviour, too, are by no means always completely rational and predictable. They decide on low risk-low return vs. high risk-high return policies, on long term investment vs. short-term speculation. Their behaviour is blurred by a significantly bounded rationality, especially as more and more private people with less financial knowledge enter the financial markets. Shareholder behaviour hence becomes less and less predictable, as small issues reinforced by positive feedback can induce large numbers of investors to change preferences, causing large price corrections in the financial markets. Hence shareholder-value is not uni-dimensional. Their utility might include balancing risk versus opportunity, long term versus short term, cash versus capital gain, as well as geographic, cultural and emotional aspects.

2.3.13 This also touches on the problem of corporate governance, or the question whether free cash flows should be reinvested in the firm or should be returned to the shareholders. Both law and economics tend to view corporate governance as simply a completely rational principal-agent relationship in which shareholders are the principals, and managers are the agents. The conventional neo-classical theory states that creditors and stockholders reach an equilibrium position, with management retaining some flexibility and creditors being compensated therefor through higher interest. In practice, however, this relationship is blurred by bounded rationality of both parties, situations unaccounted for in the principal-agent contracts, and shortcomings in the securities markets. These issues, however, are outside the scope of this dissertation. It suffices to conclude that shareholder value, also, is not uni-dimensional.

2.3.14 Peelen formulates the social exchange theory: Exchange objects in this theory represent values. These values are based on the expected utility of the object. Two notes: (1) value is subjective: the same exchange object can be valued differently by different people, (2) utility of an exchange object is experienced during use. Two kinds of value are recognised: received values (=rewards) and sacrificed values (=costs). Exchange is assumed to take place only if rewards > costs, i.e. the outcomes or profits are positive (Peelen, 1989).

2.3.15 Expectancy theory holds that people are motivated by two dynamics: how much they want certain rewards (or avoid negative sanctions) and the expectancy (probability) that their actions will generate those rewards. Expectancy theory claims that people are motivated by calculating, thus making a conscious choice, how much they want something, how much of it they think they will get, how likely it is that their actions will cause the to get it, and how much others in similar circumstances have received.

2.3.16 Foa and Foa's Resource Theory makes a distinction among values along two dimensions: tangibility and personal latency. In this structure, six possible resources (values) can be distinguished: love, status, information, services, goods, money. (Foa and Foa, 1976)[iii] Value is therefore not (in the perception of the stakeholder) exclusively financial value, but also functional value (the perceived value from the use of products and services), emotional value (status, self-expression), security value (risk-reduction), social value (e.g. environment), perspective value (development opportunities).

2.3.17 In conclusion, the concepts of the utility theory, the resource theory and the exchange applied to the interests of the three dominant stakeholders in modern companies describe their behaviour in a free market relation as a complex of value-carriers, which mix will be highly individual and time specific. Value is therefor not (in the perception of the stakeholder) exclusively financial value, but also functional value (the perceived value from the use of products and services), emotional value (status, self-expression), security value (risk-reduction), social value (e.g. environment), perspective value (development opportunities).

2.4 Utility as financial value

Although perceived value that is ('flow') or has been ('stock') created is not just financial value, in general value can be translated into money as calculation unit and unit-of-measure. Investment risk can be expressed in premiums on stock-price, speed, convenience, self-expression etc. in product-price premiums and employee benefits in cost-of-employment .

2.4.1 Van Hulst and Willems (1989) state on value:

> "*Characteristic for the Austrian school was the subjective, or rather subjectivist, value theory, in which a distinction is being made between these subjective user value, which is amongst others dependent on the utility of a good for the subject concerned, the objective exchange value, the value as expressed in the price and in exchange transaction, and the subjective change value, which expresses the importance of the good for the wealth of the subject at the time of the exchange […].*"

In this reasoning the quantities of the respective values are driven by, amongst other things, objective factors, as scarcity and income, but also uncertainty plays a role. This way of reasoning offers possibilities to formulate behaviour of subjects and companies in terms of Game Theory, putting the emphasis not so much on the equilibrium solution, but on the strategies to follow. Competition is not a state, but a process! In addition the valuations change continuously during such a process as a result of technological development and changing preferences at the consumer end; these could lead towards change in strategy with one, some or all subjects, etc.'

2.4.2 Guneysu [iv] (1964) states that:

> *(1) "Value is fundamentally a subjective quality, since it depends on the capacity and the ability of a good or service to satisfy human wants and desires. For this reason, a good or service has a value only with reference to human beings and only from their point of view. [...]"*
>
> *(2) "Since we cannot measure psychological value, a practical measure of the value of a product is its value relative to other goods and services, as expressed by the quantity of a given product which exchanges in the market place for different quantities of other products."*
>
> *(3) "In practice, value may be measured by the money price of a product in the market, using money as a common denominator of value."*

2.4.3 Or, as Vilen (1991) states:

> *"[...] we are using the prevailing consumer price on the market place as an approximation of the value created in the whole value system, i.e. from raw material to consumer. Theoretically this would assume conditions of perfect competition. In protected industries [...] price as an indication of value as perceived by final users must be seen as a somewhat rough approximation of the theoretically pure situation because, by definition, market forces are not allowed to operate freely. However, when established products are compared to each other and there are alternatives on the market, price as an indication of value as perceived by the final users must be seen as a close enough estimate."*

2.4.4 Therefore, the price of a product represents its value in the market [v], which fluctuates in connection with supply and demand plus all services and costs entering into the value of that product. This is a result of the process of economic theory of production, which is defined as the creation of economic value by addition of utilities to goods. Whereas the authors mentioned refer tp product prices reflecting utility in the company/market-interface, this reasoning could be applied to any stakeholder relation.

2.4.5 Utility theory states that each stakeholder will look at a particular mix of requirements to be achieved through his co-operation with or in the company. Some of these aspects will be predominantly financial e.g. 'financial return for shareholders', and some will be functional or emotional. In other words, the utility derived from the relationship, as seen by the stakeholder, is not necessarily financial value. Yet the creation of these utilities in the business processes of the company will be reflected in the cost structure of the company. Better products and services for clients will, in general, be more costly to produce. Salary increases, training, and motivational programmes for employees will be reflected in the cost structure of the company, as will the returns made to the shareholders. It is worth noting that those costs might, or might not, show up in the on-going cost structure of the company, but might only accumulate over a long period of time. The image of a company as an attractive employer may be built over decades, just as brand image may represent long years of substantial investments. The trust a company developed on the stock markets will equally reflect the track record and history of reliability built up over years and sometimes decades. Therefore, the relationship of the utility within the cost structure of the company contains elements of flow 'the actual momentary reflection of the utility', as well as elements of stock, many of those not being reflected in the balance sheet of the company.

2.4.6 As the internal expression of utility can be expressed in terms of financial value, although is not identical to financial value, so can the external appearance of utility be defined in terms of financial value. Financial value in this respect only represents a unit of measure, enabling the trading of various utility mixes against each other and also the comparison of various mixes of utilities. Provided there exists a sufficiently free choice for the stakeholder concerned, he will have the option to compare the utility presented to him by one company, versus that presented by another. The higher the price the company can command for the utility he puts forward to the respective stakeholder, the higher the perception of the value of the utility will be. In the consumer relationship this will be reflected in the relative price premium the company can command from its clients compared with its suppliers of the same or similar goods and services. For shareholders different utility is reflected in the price/earnings differential, created by some companies over their competitors in similar businesses. The company's attractiveness as an employer will be expressed in the average level of employment cost compared with other companies competing for the same employees. Attractive employers, in terms of non-financial utility will, in general, be capable of generating employment cost advantages over less attractive employers. Hence, although the perceived value by the stakeholders is not identical to financial value, and calculation of the conversion rates from utility to financial value might be difficult in operational terms (especially at the individual level), it seems fair to assume that, in principle, the perceived value can be expressed in financial terms. Therefore the creation of financial value for all its stakeholders can be considered a central goal of the company.

2.4.7 In free market relations, through the respective (capital-, clients- and employment-) market-mechanisms, these stakeholder values are expressed in the financial value creation of the company in terms of per unit- cost-of-capital, -product-price level and -cost-of-employment. The financial value creation mechanism of the company expresses therefor the quality and the quantity of the ability to create and distribute value to its stakeholders. In considering the mechanisms, which are underlying the creation of this value, it is necessary to separate the value creation process from the value distribution process. The primary issue is the value creation process, as distribution of value can only be applied to value which is or has been created.

2.4.8 We envisage a company as a coalition of stakeholders. In a free market, these stakeholders can decide at any time whether or not they wish to continue or participate in the coalition. Hence, the continuity of this coalition will be governed by the ability of the company to generate and distribute the utilities in a way that satisfies its stakeholders. If the total value generated for all stakeholders would be zero, then achieving better utility for one would automatically be at the expense of one or more of the remaining stakeholders. It is difficult to see how continuity of the coalition could be maintained in the longer term, if this would be the underlining structure of the value creation process. It is mandatory that companies are capable of primarily generating more value and that process is therefore the central strategic issue.

2.4.9 Yet, even to understand value creation as an interacting coalition of stakeholders, distribution of the value generated cannot be ignored completely. Nolan and Croson (1995) formulate the antagonism between the stakeholder in five conjectures about surplus distribution:

- The more competitive the output market is, the larger the customers' portion of surplus and the more managerial effort will be expended to minimise employees' and suppliers' portions;
- The more regulated the environment, the larger employees' and suppliers' portions will be. In such environments, e.g. public utilities, surplus is likely to be consumed internally rather than rebated to customers or paid to shareholders;
- The more competitive the supplier markets are, the larger the shareholders' portion;
- The more closely distribution of surplus parallels the bargaining power of the various stakeholder factions, the larger the aggregate long-term gains for all: *"Because conflict among stakeholder factions can destroy surplus, some amount of co-operation is warranted, whether motivated by mutual trust [...] or the sure knowledge that Machiavellian tactics will be amply repaid in future encounters. The surest method of getting ahead is to get along [...]";*
- The smaller the shareholders' portion, the less capital will be available to create future surplus: *"Because capital markets are highly competitive in relation to output markets, doling out today's cash favours employees or customers at the risk of forgoing capital and the opportunities for innovation that it might find."*

2.4.10 Distribution of the value generated is only secondary, although not insignificant in a number of respects. Firstly, if the distribution is seen to be unjust by respective shareholders, either because they believe their interest is insufficiently taken care of, or the returns in terms of utility do not weigh up against the investment of money, energy, and trust they have put into the coalition, they might turn away from the company, even though conditions of positive total value have been created. Secondly, as will be explained in Chapter 7 when we discuss Axelrod's Prisoner's Dilemmas, under initial conditions where trust and confidence need to be established, the way in which financial value is distributed amongst the shareholders governs the momentum of the decision whether or not to have a relationship with the company.

2.4.11 Axelrod (1984) formulates four simple suggestions for doing well with respect to creation/distribution of value in a durable iterated prisoner's dilemma:

- Don't be envious;
- Don't be the first to defect;
- Reciprocate both co-operation and defection;
- Don't be too clever.

and stresses in this way the dominant flavour of trust as a requirement to embark and sustain co-operation. Distribution of value, seen by the stakeholders as unjust or unfair (under conditions of free alternative choices) will hence prevent the necessary co-operation to occur (see also Chapter 7).

2.4.12 Therefore, although the value creation process is of primary strategic interest, and most of this thesis will be devoted to the creation of such value, it should not be disconnected from the value distribution question. In practice, policy and strategic decisions governing the creation of value will be closely inter-connected with the interests of respective stakeholders and therefore with the distribution process.

[i] **Utility theory** (from: Nicholson, 1989)
Utility theory begins with the axiom of rational choice. This leads to three basic properties for preference relations:

1) Completeness:
if A and B are any two situations, the individual can always specify exactly one of the following three possibilities:
* 'A is preferred to B'
* 'B is preferred to A', or
* 'A and B are equally attractive'

Individuals are assumed not to be paralysed by indecision: they completely understand and can always make up their minds about the desirability of any two alternatives. Also, this rules out the possibility of 'A preferred to B' and 'B preferred to A'.

2) Transitivity:
if an individual reports that 'A is preferred to B' and 'B is preferred to C', then he or she must also report that 'A is preferred to C'. This assumption states that the individual's choices are internally consistent.

3) Continuity:
if an individual reports 'A is preferred to B', then situations suitably 'close to' A must also be preferred to B. This assumption is generally deemed necessary to analyse individuals' responses to relatively small changes in income and prices. It rules out certain kinds of unusual preferences that pose problems for the theory of choice. Assuming continuity is generally not considered to run the risk of missing types of economic behaviour that are important in the real world.

The ranking of the available alternatives, from the least desirable to the most, is in economic theory equal to ranking utility. More desirable situations offer more utility than do less desirable ones. There are a number of other assumptions underlying utility measures:
Utility measures are not unique, i.e. we may attach numbers to utilities (e.g. U(A) = 5 and U(B)=4), but this does not make it possible to determined how much A is preferred to B, or to compary the utilities of different individuals. The consequence is that utility measures can be transformed, as long as this transformation is order-preserving (i.e. if U(A) > U(B), then the transformation of F(U) → F'(U) must lead to U'(A) > U'(B))
The ceteris paribus assumption; that is, utility is assumed to be multi-dimensional U(good 1; good 2; good 3; ... good n; other things). If we want to study the effects of changes in good 1 to n on U, then other things must remain constant.
The utility derived form a good is assumed to be marginally decreasing, or, when represented in an indifference curve between two goods, the marginal rate of substitution is decreasing, i.e. the indifference curve is convex in its entire reach.
Individuals are assumed to maximise utility, constrained by their budget. When this is restated for an indirect utility function, considering income as a means to acquire goods, the utility function would be U (optimum quantity good 1; optimum quantity good 2; ...; optimum quantity good n) = U[good 1 (price of good 1; price of good 2; ...; price of good n; income); good 2 (price of good 1; price of good 2; ...; price of good n; income); ...; good n (price of good 1; price of good 2; ...; price of good n; income)] = V[price of good 1; price of good 2; ...; price of good n; income].

The following assumptions are underlying the utility theory (Van Duijn, 1981):
* the economic agent can rank goods and combinations of goods to their contribution in satisfaction of needs
* this ranking is consistent and transitive
* the economic agent prefers more over less given prices and income,
* the economic agent strives for the combination of goods and services that maximises utility
* marginal utility derived from a good is positive and declining with larger quantities

[ii] Quoted in Peelen, 1989.

[iii] Quoted in Peelen, 1989.

[iv] Guneysu (1964) distinguishes four different concepts of utility:
* place utility: the goods should be in a certain place to satisfy human wants
* time utility
* possession utility: goods must be sold/bought to satisfy human wants
* form utility: through extracting, manufacturing, packaging, etc

[v] Blattberg and Deighton (1996) discuss the concept of customer value in the sense of the value the customer brings to the company. To calculate this customer value, they introduce the concept of customer equity, as depending on the company's capacity for customer attraction and retention. The optimal balance of customer attraction and retention strategies is, according to Blattberg and Deighton, reflected in the maximum amount of customer equity.
To measure customer equity, they first measure each customer's expected contribution margin over the expected duration of the relation. These are then discounted at the company's target rate of return for marketing investments. Finally, these discounted, expected contributions are added together. Ultimately, they state, the appropriate question for judging new products, new programmes, and new service initiatives is neither 'will it attract new customers?', nor 'will it increase our retention rates?', but rather 'will it increase customer equity?'.