Firm value creation and levels of strategy

Cliff Bowman and Véronique Ambrosini
Cranfield School of Management, Cranfield University, Cranfield, UK

Abstract

Purpose – The paper aims to address the following questions: "How is value created within a firm?" and "Is the distinction between competitive and corporate strategy helpful in considering the processes of value creation?"

Design/methodology/approach – The paper distinguishes five value-creating activities within the firm. Three are involved in the process of current value creation, one is directed at the maintenance of the firm and the other activity is concerned with the creation of future value. These processes of value creation are then explored from the perspective of corporate and business levels of strategy by considering whether these activities can be tightly or loosely coupled.

Findings – The paper argues that decisions regarding loosely or tightly coupled value-creating activities should belong to the realm of corporate strategy and that this "corporatising" choice involves trade-offs in terms of responsiveness and cost.

Practical implications – The arguments in this paper can be used by managers to help them think through the consequences of any corporate level strategy decisions they may envisage taking.

Originality/value – This paper addresses traditional strategic management questions by building on a range of literatures, and proposes an original and meaningful way of examining the role of corporate and competitive strategy.

Keywords Competitive strategy, Corporate strategy, Market value

Paper type Conceptual paper

Our premise in this paper is that distinctions between corporate and business levels of strategy can usefully be explored from a value capture perspective. Given that firms exist to create value, we should be able to interrogate the utility of distinguishing between corporate level and competitive level strategy from this value perspective. The paper is structured around the following questions:

- How is value created within a firm?
- Is the distinction between competitive and corporate strategy helpful in considering the processes of value creation?

To address these questions we first, explain what value means for the firm, and second, we examine the activities that create value within the firm. We consider the firm itself in the role of customer and supplier, and distinguish five activities inside the firm that reflect its motivations when these separate roles are performed. Three types of activities are involved with the process of current value creation: one is concerned with the creation of products/services, one with realising revenues from customers, and a third with minimising cost flows to suppliers. In addition there is activity directed at the maintenance of the firm, and another activity directed at the creation of future value. The core of the paper is dedicated to exploring what corporate and business (competitive) level strategy would mean when we take this value perspective. We consider the processes of value creation from the perspective of corporate and business

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levels of strategy by considering whether these activities can be tightly or loosely coupled. We argue that decisions regarding how loosely or tightly coupled value creating activities should be belong to the realm of corporate strategy and that this "corporatising" choice involves trade-offs in term of responsiveness and cost.

In essence we address traditional strategic management questions but we build on a range of literatures, and propose an original and meaningful way of examining the roles of corporate and competitive strategy. Specifically, in building the argument we draw on both the resource-based view (RBV) and on Porter's (1980, 1985, 1987) industrial organisation economics-based (IO) contributions. Both the RBV and Porter address the issues of firm value creation. The RBV helps us to understand the unique resources that create value (Barney, 1991), and an IO perspective on bargaining power provides insights into who captures value. So the RBV provides insights into value creation, and insights into the power relationships between the firm and suppliers and customers can enable us to understand who captures value and why they are able to capture it. Hence we view the RBV and Porter as complementary rather than conflicting perspectives and we draw on them both in building our argument (Bowman and Ambrosini, 2000; Coff, 1999; Peteraf, 1993).

We take the view that the firm is established to serve the interests of its equity owners, so production is undertaken in the pursuit of profit (Barney, 1986; Makadok, 2001). However, we recognise that firms do not "maximise" profits, they do not assume entirely opportunistic behaviour, rather they seek to optimise profits. Hence in what follows we reflect the broad aim of the pursuit of profit by using the term "optimise". By using optimise we are acknowledging the problems of value creation in the real world.

Value-creating activities

The firm as an economic actor and a legal entity is both a customer for inputs from suppliers and a supplier of products or services to its customers. In acting as a customer the firm would seek to optimise its consumer surplus (or colloquially get "value for money"), and as a supplier, the firm would aim to optimise the revenues obtained from customers for a supplied product/service. If firms differentiate their product/service offerings in ways that are valued by the customer, they may be able to charge a premium price, or they could offer superior product/service utility at equivalent prices to competitors, and hence increase their market share (Porter, 1980). The availability of equivalent products/services or close substitutes will reduce the price that the firm can charge, thereby increasing consumer surplus, and reducing the firm's ability to capture revenues from customers.

The firm strives to reduce input costs, and seeks to generate revenue from sales to customers. To optimise the amount of revenue gained from customers the firm has to balance the prices charged with the volume of sales achieved. Price rises will normally reduce the total amount of consumer surplus, and hence result in lower sales volume, and vice versa. So the firm performs the roles of both customer and supplier for a purpose: to return an expanding stream of profits to investors. We can identify within the firm, activities that are involved in revenue appropriation from customers, and activities directed at reducing the cost of the inputs obtained from suppliers.

We suggest that there are five main types of firm activity: type 1 activities create products and services; type 2 activities seek to generate revenues from marketing and selling these outputs; and type 3 activities are involved in procuring inputs into the firm. These three types of activity are involved in the creation of current profit flows. Type 4 activities are directed at the creation of future value, and would include R&D activity. Finally type 5 activities are support activities; they effect transactions between the firm and other parties. They are the necessary legal, tax and other activities required for the firm to continue to operate. Thus both type 4 and type 5 activities reduce current profit flows as they incur costs without any compensating revenue generation. These five types of activity have been distilled, *inter alia*, from Porter's (1985) value chain. By distinguishing between the value-creating roles of these different activities we will be better able to subsequently debate the usefulness of distinctions between corporate level and business level activity.

Product creation activities (type 1)

These activities are involved in the production of products and services, and would include some primary activities of a value chain (Porter, 1985), e.g. production or outbound logistics. The worth or value of these activities can only be identified in retrospect, because unless the activity leads to a sale i.e. it ultimately results in the appropriation of revenues from customers, the activity cannot be judged to be productive.

Value realisation activities (type 2)

These activities are directed at realising revenues from the product outputs from type 1 activities. They would include marketing activity, customer relationship management, and direct sales activity.

Input procurement activities (type 3)

These activities are directed at reducing the amount paid to the input suppliers i.e. the aim of these activities is to obtain "value for money" for the firm. These activities reflect the firm's motives as a customer, a customer of productive inputs like raw materials, electricity, and labour. This does not imply that the firm only seeks to procure the cheapest inputs. High quality inputs might be greatly valued by the firm's procurement specialists, and even where a premium price was charged by the supplier, the consumer surplus perceived could be greater than with "cheaper" alternative inputs. These type 3 activities would include procurement, and line supervision activity, as well as activities designed to increase production efficiencies. The effect of these activities is therefore to moderate the cost flows incurred by all other activities. For instance artful procurement can result in a cost advantage where the firm pays less than rivals for equivalent inputs; one form of this activity could be "resource picking" (Makadok, 2001).

Capital stock- vcreating activities (type 4)

These activities such as market research, R&D, and training have to be funded either out of current streams of profits or directly by cash injections from investors. They can be understood as dynamic capabilities (Eisenhardt and Martin, 2000; Teece *et al.*, 1997). They help to preserve the capital stock of the firm by, for example, ensuring that it adapts to changes in the market environment, and attempting to extend the capital stock through the creation of new resources.

These activities are intended to generate future streams of firm value. The dilemma is that these activities incur costs today for unknowable future benefits. Hence in the short term these activities reduce the current value retained by the firm, and as a result these activities are vulnerable to short-term pressures to cut costs as the value created by them can only be assessed *ex post*. Where these budgets are trimmed, the proportion of revenues used to fund these essentially speculative investments may be returned to investors in the form of increased dividends. However these activities potentially help to preserve and expand the stock of human and organisational capital by ensuring that activities are updated and refreshed in line with changes in the firm's environment, and they can expand the firm's capital with the introduction of new value creating activities. These may be discrete and deliberately managed support activities like R&D (Porter, 1985) or they could be co-produced with ongoing value creating activities. Co-produced activities would include learning from reflection or from interactions with clients (Argyris, 1990). Some capital creation activities may be undertaken without official sanction from management as individuals experiment with new ideas and approaches to their tasks.

Firm maintenance activities (type 5)

These activities are those necessary for the maintenance of the firm in a particular social context, and would include "infrastructure activities" (Porter, 1985) like accounts preparation, legal work, tax management, etc. They are necessary to conduct business, but they do not contribute to profit streams. Efforts will be made to perform these necessary activities at the lowest cost. Associated with this are related expenditures, which are not activities, but that have a similar impact, for example paying company taxes, training levies, etc. Some stakeholder models of the firm include a catch-all "society" stakeholder category (Clarkson, 1995), and these maintenance expenses could be viewed as payments to "society". So it could be argued that maintenance activities and maintenance expenses are a response to societal pressures, but profit-seeking firms will act to reduce the impact of these expenses.

Value creation and levels of strategy

One of the questions that this special issue of *Management Decision* seeks to address is that of hierarchical strategies or strategy levels. Traditionally competitive strategy relates to how a strategic business unit (SBU), be it a stand alone firm or a division of a larger corporation, competes within a particular market, and corporate strategy relates to how a corporation manages a set of businesses (Grant, 2005). SBUs are directly engaged in the production of goods and services; the corporate centre typically is not. Its role is to oversee, support or augment the primary activities of the SBUs, and to facilitate the creation of value throughout the corporation via organic growth or external development (Goold *et al.*, 1998).

If we return to our five value activities and take the case of a firm engaged in supplying a single product to a clearly defined market, then all of these five activity types will be performed within the same integrated structure. The question of any distinction between corporate or competitive levels simply does not arise. Managers and employees will be engaged in all aspects of value creation, indeed the same individuals may well perform two or more activity types (e.g. in the small entrepreneurial firm).

Corporate strategy emerges as a construct when we move away from this ideal-type single product/market firm, towards a firm with, for instance, two product lines, or that serves two distinct markets with the same product type. Then the managers of the firm are faced with an essentially structural question about how to organise the firm's value creating activities. One simple solution to the development of an additional product line would be to re-create an entirely self-sufficient business unit, leaving the firm with two SBUs. However, this is likely to be an unattractive and expensive option, leading to duplication and under-utilised resources. A more typical response would be to utilise common resources wherever possible, to reap cost advantages, e.g. use one sales team to sell two lines, have a common accounts department, etc.

If we consider that the "corporatising" problem originates where any diversion from the ideal-type single product business is undertaken, then the issue of corporate versus business level strategy is likely to be present in just about every firm and hence corporate decisions are likely to be made or at least considered by most managers, whatever the size of their firm. This means that it is critical to develop an understanding of what such decisions involve and what their consequences can practically be. In order to address this issue we propose that that different corporate value creating configurations should be considered from the perspective of the value creation activities we have explained and that we need to consider two questions regarding the five activity types we set out earlier. First, is the activity feasibly separable from other activities? Second, will separation confer any firm advantage i.e. will it generate more revenue for the investor? There will likely be both costs and benefits where activities are separated: net firm value may be created, but we expect that trade-offs will need to be negotiated. Moreover, these trade-offs will probably involve all types of activity. For example, we might choose to separate some type 1 activities in order to reap some benefits of task specialisation, but the longer-term effect may be a constraint on type 4 activities like R&D, due to the lack of interaction between the employees engaged in the separated type 1 processes.

In what follows we develop our argument and examine levels of strategy from this value creation perspective. To do so we first introduce into our discussion the concept of loose or tight coupling of activities (Thompson, 1967; Weick, 1976).

Loose and tight coupling of activities

Weick (1976) defined loose coupling as a situation in which elements are responsive, but they retain evidence of separateness and identity. He later explained (Weick, 1982) that loose coupling occurs when elements affect each other suddenly rather than continuously, occasionally rather than constantly, negligibly rather than significantly, and eventually rather than immediately. If we apply this concept to activities involved in value creation we may be able to interrogate the entire value system of a firm with a view to identifying the relationships between activities. This would enable us to then identify the extent to which activities are loosely coupled, and which activities are tightly coupled together. Coupling could be construed as a necessary interdependence between activities.

Generally, it is argued that the tight coupling of activities produces stability in the firm, whereas loose coupling enables it to be more flexible and therefore better able to adapt to a changing environment. However in line with Orton and Weick (1990, p. 205) we take the view that it is not helpful to simplistically categorise firms into being either loosely coupled systems or tightly coupled systems, as all firms have activities that are distinct, and they may be required to interact or respond to varying degrees with other parts of the system:

> If there is neither responsiveness nor distinctiveness, the system is not really a system, and it can be defined as a non-coupled system. If there is responsiveness without distinctiveness, the system is tightly coupled. If there is distinctiveness without responsiveness, the system is de-coupled. If there is both distinctiveness and responsiveness, the system is loosely coupled. This general image is described . . . as the dialectical interpretation of loose coupling.

The value activities we have identified are distinct in relation to value creation. We would argue that although they are distinctive, the degree to which these activities need to be responsive will vary between firm contexts. Firm contexts will vary according to broad contingency variables like environmental dynamism and diversity, and task complexity (Emery and Trist, 1965; Mintzberg, 1979), and according to the nature of the particular products or services they produce, the competitive strategies they are pursuing (e.g. product differentiation, low cost), and the production technologies they employ, etc.

"Corporatising" decisions and processes

We suggest that decisions concerned with increasing or decreasing the distinctiveness of activities are corporate level issues. We could label these as "corporatising" decisions. Increasing distinctiveness can result from increasing specialisation, narrowing the scope of activity, fragmenting activities, and relocating activities. If we ignore agency issues, the motivations for increasing distinctiveness should be to increase firm value, and there are two generic ways that these value enhancements can be realised: improving efficiency, and/or improving effectiveness. Increasing distinctiveness implies an increased separation of value activities and increased task specialisation. This can be achieved by further fragmenting an existing value system, or by combining two or more related value systems within one hierarchy. The further separation of an existing value system may allow for specialisation, a sub-set of the overall task that may either enhance efficiencies or improve effectiveness (or both).

The consolidation of activities across value systems may produce benefits from economies of scale or scope. With consolidation distinctiveness does not increase: the extent of differentiation across the activities in the system remains the same. What has changed is the degree of coupling: the benefit of activity consolidation is derived from a tighter coupling of activities. Where previously distinct activities have been consolidated, then distinctiveness or differentiation of activities is actually reduced. However, following Orton and Weick's (1990) dialectic approach to loose coupling, we cannot consider the corporatising decision processes that increase or decrease distinctiveness without addressing the corresponding issue of responsiveness between activities. Generally, we would expect that decisions that increase the distinctiveness of value activities will call for, in turn, corporatising processes that address the demands for coordination between these activities i.e. addressing the responsiveness issue. Unless attention is paid to the issue of responsiveness it may be that the benefits of enhanced corporate distinctiveness and activity differentiation will be counteracted by the downside effects of inadequate activity coordination. Similarly, where distinctiveness has been reduced by, e.g. the consolidation of activities, this results in tighter coupling within these activities, but there may be a corresponding reduction in responsiveness between these consolidated processes and other value activities.

In general we would expect that activity consolidation would increase the responsiveness of the consolidated activities. Thus consolidation enhances internal responsiveness between value activities, but, it is likely that internal responsiveness brought about by tighter coupling would also lead to a reduced ability of the corporation to respond to external changes. In contrast, we would expect that generally increasing fragmentation or distinctiveness of activities would increase the external responsiveness of the corporation i.e. it would be better able to sense and react appropriately to environmental changes. However, fragmentation and increased activity differentiation is also likely to reduce internal responsiveness.

The early studies of differentiated organisations (e.g. Burns and Stalker, 1966; Lawrence and Lorsch, 1967) addressed similar issues posed by the requirements of increasing task specialisation, the need for adaptation to external changes, and the role of liaison and coordination devices. Here we are suggesting that corporatising decisions raise these same questions and that wherever activity and knowledge specialisation is encouraged by corporate decisions, this sets up a corresponding coordination or responsiveness requirement in the structure.

Consolidation, fragmentation and the five activity types

To summarise, activity types 1, 2, and 3 are involved in the procurement of inputs, the creation of products or services and the realisation of value through sales to customers. Type 4 activity is directed at the creation of future value and includes learning, training, and R&D activity, and type 5 activity is required for the maintenance of the firm. Types 1, 2, and 3 create current profit streams, and types 4 and 5 typically reduce current profit streams (we are not considering here the investor valuation of the company, but rather the creation of current profit).

Based on our earlier argument we would expect that corporatising decisions to increase separation and distinctiveness of type 1, 2, and 3 activities would need to be compensated for by developing effective coordination/responsiveness processes to reduce the downsides of fragmentation, and that where consolidation reduces distinctiveness there may be consequent problems with internal or external responsiveness. For example, it might be decided that to achieve cost savings a sales force which was previously selling distinct product lines to more or less the same customer base should be consolidated, resulting in a reduced number of sales staff responsible for selling the whole product range. In effect here we have a corporatising decision to consolidate, with expected reductions in sales costs. A possible downside of this move would be a loss of sales effectiveness, as sales staff would have to master a greatly enlarged product range, need to form relationships with new customers, and become familiar with different industry contexts. To mitigate these reductions in effectiveness additional effort and resources would need to be committed.

Similarly, if, for instance, procurement is consolidated across three related SBUs to increase leverage over key input suppliers, i.e. procurement is now more tightly coordinated or coupled across the three value systems, the expected outcome would be probable reductions in input costs. This action could once again have a downside, as a potential consequence of this consolidation would be a lack of responsiveness of the procurement function to the particular requirements of an SBU, possibly leading to reduced effectiveness. Moreover where a type 1 production activity is consolidated to achieve the benefits of scale, there may be consequent reductions in the effectiveness of particular product lines that have been inappropriately standardised. Thus the consolidation has reduced external responsiveness.

Where corporatising decisions lead to an increase in activity differentiation through enhancing specialisation we should expect the corporation to be better able to deal with changes in the external environment, thanks to the increased distinctiveness. However the increasing internal fragmentation can then create problems of internal coordination. If efforts are not made to address the internal coordination issues this presents, there may be reductions in overall corporate effectiveness. For example, a corporatising decision may lead to the establishment of dedicated sales teams to serve specific geographic regions. This should enhance the corporation's ability to sense and respond to external changes in these different regional markets. The downside of such a decision might be a reduction in internal responsiveness, as these dispersed sales teams loose touch with staff and processes in type 1 and 2 activities, and indeed may find it difficult to liaise with each other.

Where type 4 (e.g. R&D) activities are separated from types 1 and 2 there may be benefits of task specialisation enabling more effective innovation. Again the downside might be an increasing disconnection and lack of responsiveness to those enacting type 1 and 2 processes, leading to problems in "productionising" innovations (lack of responsiveness between types 1 and 4), or innovations that don't seem to meet a market requirement (lack of responsiveness between types 2 and 4). Also it may be too costly, or unfeasible to attempt to detach capital stock creation activity from type 1 and 2 activities. For example, in knowledge intensive contexts future resources may be developed through experience, learning, and sharing ideas and insights. In these situations type 4 activity would be co-produced alongside the production of current products or services. Where it is technically feasible to detach developmental activity from the value delivery systems of the corporation there may be benefits not only of the development of a "critical mass" in R&D activity, it might be beneficial for the corporate centre to manage, and crucially fund these activities to ensure they take place. In this sense the separation of R&D has the effect of protecting these future orientated activities from short term performance pressures that might be felt by the SBUs.

This then leaves type 5 firm maintenance or support activity. We would argue that in most firms these activities can feasibly be separated from the other four types of activity. These activities can be almost de-coupled from the operating core (types 1, 2, 3) with probably little impact on effectiveness of these type 1, 2 and 3 activities. Thus there is unlikely to be a problem in increasing the separation of these activities, and there may be positive cost and effectiveness benefits in uncoupling them from SBU value systems. These advantages might be scale and scope economies from better utilisation of specialised resources and capabilities, and the ability to appoint specialists to these roles. This means that the increasing distinctiveness of these maintenance or support activities may not need to be extensively compensated for by efforts to increase responsiveness between these type 5 activities and the SBU value systems. Unsurprisingly, therefore, type 5 maintenance activities seem to be the most corporatised activities in multi-SBU firms.

In Figure 1 we have summarised part of the argument. The vertical axis refers to the need for the firm to be responsive to external product markets, and the horizontal axis refers to the need for activities to be internally responsive to other activities. The location of each activity type reflects the arguments we have put forward. Thus there is a requirement for type 2 sales/marketing activities to be responsive externally, and they also have to be closely connected to other activities internally.

In order to create value type 1 "operations" activities must be responsive to the external environment and to avoid internal inefficiencies they need to be internally responsive as well. Type 3 procurement activities need to be responsive to type 1 operations activities particularly, but we would suggest that procurement activities need not be so directly responsive externally, as they are not as customer oriented as type 2. If type 3 activities are responsive to type 1 and 2 activities, which in turn are in tune with the marketplace then this should help ensure that procurement activities are ultimately aligned externally. The oval incorporating types 1, 2 and 3 signifies the need for these core value-creating activities to be closely coordinated.

Type 4 R&D activities need to be moderately internally and externally responsive and external responsiveness is likely to be mediated by activity types 1, 2 and 3. Hence, the type 4 oval should ideally overlap with activity types 1, 2 and 3. Figure 1 indicates that type 5 "maintenance" activity, relative to the other four types, need not be strongly internally or externally responsive. Thus with respect to "corporatising" decisions, we would expect firm maintenance activities to be readily de-coupled from other SBU activities, and if there were effectiveness or efficiency improvements from managing these centrally then there are unlikely to be extensive coordination or liaison cost penalties due to their relative loose coupling with other value activities.

As we move away from the origin in Figure 1, the case for uncoupling activities becomes less straightforward. The costs involved in both the setting up and operating of liaison and coordination processes involved in effecting coordination between these activities, and the negative impacts of poor coordination become more significant the further we move northeast in the figure.

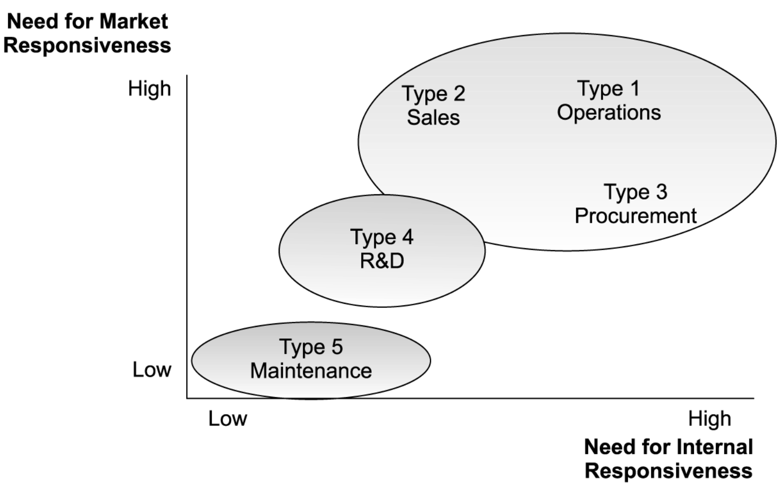

Figure 1.
Value activities and responsiveness

Concluding remarks

Firm value creation should be the determining criterion in debating the utility of corporate "levels" of strategy. Strategy for profit-seeking firms should be directed at the creation of value. Here we have defined what "value" means for the firm, and have identified five different types of activity that are involved in value creation. We have argued that when firms extend their scope beyond the single product situation "corporatising" issues arise. These concern the integration or separation of value activities. Some activities, by their very nature can be readily separated from the other activities we have identified, e.g. maintenance activity. Other activities are tightly coupled and would resist separation, or, even if separation was feasible, the costs of doing this would outweigh the benefits.

As there are both costs and benefits in separating activities, corporate level strategic activity should be directed at enhancing firm value from astute decisions regarding separation and integration, and reducing the costs of separation. Effective coordination of value activities would be one obvious way to reduce costs and therefore help to optimise firm value creation. Hence we could view corporate level strategy as having two essential roles with respect to value creation:

(1) to enhance value creation through astute decision making with respect to the separation and integration of value activities; and

(2) to establish appropriate processes to effect the required degree of coordination between value activities.

If we follow the working assumption developed in the resource-based view (Barney, 1991, 2001) the core sources of sustained value generation are valuable, rare, difficult to imitate and non-substitutable (VRIN) resources that are embedded within firm activities. These resources do not necessarily sit neatly within specific functions or stages in the value chain (Porter, 1985). They are often complex, and are embedded throughout the SBUs, and may span various components of the value chain. Some VRIN resources may not be directly managed by those at the top of the SBUs, and hence:

> [. . .] the responsibility for creating, nurturing, and exploiting . . . [VRIN] resources . . . falls on every employee in a firm. To do this employees should go beyond defining their jobs in functional terms and instead define their jobs in competitive and economic terms (Barney and Hesterly, 2006, p. 103).

Hence functional distinctions are not overly relevant where the goal is to generate firm value. Some of the implications of this, and of considering SBUs as bundles of resources, are that it may not be relevant to consider businesses as hierarchies, as having different strategy levels, i.e. value creation permeates throughout the firm.

Our argument suggests that it might be more useful to interrogate the firm's operations using our five categories of value creating activities. Not only might these activities not align to traditional functional distinctions, embedded resources may span across departments and functional divisions. Indeed, some resources may exist in the form of interconnections between functions. Thus effective coordination processes to mitigate the effects of separating activities may themselves be a VRIN resource for the firm. Clarity about the role of an activity in the process of value creation must be helpful in determining how this activity needs to be developed strategically, and how the activity needs to coordinate with other value activities. So rather than concerning ourselves with strategy levels and the purpose of corporate centres, maybe the strategy conversation should focus on the five value creating activities in the system, and whether more value can be created by rearranging these five types of activity.

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Further reading

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Corresponding author
Véronique Ambrosini can be contacted at: v.ambrosini@cranfield.ac.uk