Firm Performance is About ... Customer Willingness to Pay

by **Dr Claude Diderich** | innovate.d, *Switzerland*

As an old saying goes, "If you can measure it, you can manage it." Firm (or business) performance is no exception. But what does *firm performance* mean? According to Milton Friedman's shareholder theory[1], firm performance is about maximizing return on capital invested. This definition has been in vogue for quite some time, particularly because it aligns with Wall Street's view of economic growth. Unfortunately, this definition of performance falls short of the real challenge faced, as evidenced by the recent demise of General Electric[2] and others.

Before examining how to measure business performance, it's important to understand what performance is all about. This requires answering four generic questions:

1. *For whom* is business performance measured?
2. What is the *purpose* of measuring business performance?
3. *Whose performance* is measured?
4. How is business performance *defined*, *quantified*, and *measured*?

Successfully approaching performance measurement requires putting it in the context of someone (answering question 1) wanting to solve a problem (answering question 2) within the constraints of a well-understood definition (answering questions 3 and 4).

THE SHAREHOLDER-FIRST ERA

The most common definition of performance is based on firms' financial metrics such as earnings per share, net profits, or return on capital invested. It primarily serves the shareholders to measure to what extent the CEO's managerial decisions are in the investors' best interests. The ultimate goal is to maximize shareholder wealth regardless of how this is accomplished.

As managers know by now, the one-dimensional shareholder-first approach to performance is short-sighted. It is easily gamed, for example, through buying growth. Another of its flaws is that it considers employees to be a cost rather than a value. More importantly, it ignores the customer. Without a customer, there is no business; without a business, there is no profit to measure.

OVERCOMING THE ONE-DIMENSIONALITY

The *balanced scorecard*, made famous by Kaplan and Norton[3], addresses the shortcomings of measuring performance solely through financials by considering the four dimensions financials, customers, processes, and growth. The balanced scorecard provides a more holistic picture of a firm's overall performance by considering customers and employees (though the processes dimension) and long-term growth, in addition to financials (which focus on short-term profits). However, it

© 2023 innovate.d llc

still falls short because it takes a firm-centric approach to performance measurement rather than concentrating on the customer and their demand.

CHANGING THE PERSPECTIVE

Peter F. Drucker advocated putting customer-centricity at the core of measuring and managing business success. He wrote, "Results depend not on anybody within the business nor anything within the control of the business. They depend on somebody outside—the customer in a market economy, the political authorities in a controlled economy[4]." Although his call for action was heard, managers still struggled to translate customer-centricity into actions beyond marketing. Even today, proponents of customer-centricity are regarded as marketing scholars rather than strategists.

Too often, strategy foresight focuses on the firm, its distinct resources and capabilities, and its competitive positioning. The customer-centric mindset only entered the corporate world with the introduction of Fred Reichheld's *Net Promoter Score*[5] (NPS) framework. Performance measurement began focusing on measuring customers' happiness based on the causal assumption that happiness leads to higher profitability.

Furthermore, the NPS provides managers with feedback and offers employees insights on how to improve. As a one-dimensional performance measurement, the NPS suffers from the easy-to-game syndrome. More importantly, it fails to link customer happiness to actual customer purchasing decisions. The causality between happiness and future profitability underlying the NPS framework is easily challenged.

UNDERSTANDING WHAT CUSTOMERS WANT

Taking a customer-centric approach to business performance measurement follows the right track. However, there is still a steep hill to climb to the top. As Christensen and Ulwick[6] independently suggested, successful firms understand which jobs their customers want to get done. They address them in a compelling and differentiating way. The demand generated by the jobs they seek to get done is the cornerstone between the customer and profitability. As such, performance measurement should prioritize measuring customer demand by answering three complementary questions:

1. How much is a customer willing to pay to satisfy their demand? How much is getting their job done worth to the customer?

2. How many customers exhibit the identified job to be done and are willing to seek help from the firm to satisfy the associated demand?

3. What does it cost a firm to satisfy a specific demand in a way that customers prefer over alternatives?

Successful performance measurement requires understanding and quantifying the causalities that relate a customer to a purchase.

KEY INSIGHTS

Performance measurement supports management in making superior decisions. It must first and foremost focus on the customer and their needs. Helping customers complete their jobs makes them happy and willing to spend more money, and they refer their solutions to friends and acquaintances. While processes and costs must not be overlooked, performance measurement should be designed around how value is created for the customer and, consequently, how the firm can capture value.

Notes

1. The doctrine was introduced in a 1970 New York Times essay titled "A Friedman Doctrine: The Social Responsibility of Business is to Increase Its Profits."Called *shareholder theory*, it is a normative theory of business that holds that the business's responsibility is to increase its profits. Shareholders are the economic engine of a firm and the only group to which a firm is responsible.

© 2023 innovate.d llc

2. See *The Man Who Broke Capitalism*, by David Gelles (2022) for an in-depth illustration of why shareholder theory failed.
3. See *The Balanced Scorecard: Translating Strategy in Action*, by Robert S. Kaplan and David P. Norton (1996). The roots of the balanced scorecard can be traced back to Art Schneiderman in 1987.
4. See p. 108 in *Peter F. Drucker on Management Essentials*.
5. The *Net Promoter Score* framework was introduced by Fred Reichheld from the consulting firm Bain in 2001. See his latest book *Winning on Purpose* (2021) for more details.
6. See *Marketing Malpractice: The Cause and the Cure*, by Clayton M. Christensen, Scott Cook, & Taddy Hall (2005) and *What Customers Want: Using Outcome-Driven Innovation to Create Breakthrough Products and Services*, by Anthony Ulwick (2005).

×

Dr Claude Diderich (`claude.diderich@innovate-d.com`) is the founder and managing director of the innovation and strategy consulting boutique `innovate.d` in Switzerland. Claude holds a doctor ès sciences and a masters in computer science engineering from the Swiss Federal Institute of Technology in Lausanne and a certificate of advanced studies in strategy from the University of St. Gallen. His areas of expertise include business model innovation, customer-centric strategy development, digital transformation, and problem-solving using design thinking. His most recent book titled *Design Thinking for Strategy: Innovating towards Competitive Advantage* has been published by Springer Nature.

×

Download as PDF | Subscribe to our newsletter

© 2023 innovate.d llc