

Drucker’s Theory of the Business and Organisations: Challenging Business Assumptions

ABSTRACT

This paper considers Drucker’s ‘Theory of the Business’ (1994) as a management concept to challenge firm performance. The paper seeks to do this by using the theoretical framework developed by Drucker as a tool to apply to organisation planning. In addition the review demonstrates the often ‘silent’ but influential role assumptions have on organisations. Thus, the paper invites a reassessment of the role assumptions play in organisations and presents a new and topical perspective on Drucker’s Theory of the Business.

1. Introduction

Peter Drucker (Drucker, 1994) proposed a universal ‘Theory of the Business’. It suggested a new business paradigm built around organisation assumptions. It sought to be a blueprint for management and a template for executive action and business development.

Organisations, Drucker suggested, exist, because someone made assumptions about what they do, how they perform, how they are structured, how they operate, how they create value and how they get paid for what they do. (Drucker, 1994)

In proposing his ‘theory of the Business’, Drucker positioned assumptions as central constructs in modern management and business practice and argued that assumptions were the philosophical base of the business, the fundamental hypothesis of the enterprise and therefore demand careful attention from practicing managers.

The Theory of the Business thus gives us a unique perspective on business and provides a grounded view of the role played by assumptions in business and organisations as the fundamental building blocks
of the business.

When viewed from this perspective it allows any organisation to recognise and engage with the assumptions that underpin the business. The ability to do this, while also managing the existing enterprise and the existing assumptions lies at the heart of the papers debate.

The method by which the activity of engagement with the assumptions can be facilitated and validated by the organisation, is the key to enabling the ‘assumption function’ to become the platform for continuous development and renewal as the Theory of the Business is presented in this paper which is constructed in four parts.

First, the theory of the business is introduced as a conceptual framework. Second, assumptions are explored as constructs in recent business and management literature. The third section considers the two business case studies that led to development of theory of business, while part four attempts to synthesize and conclude the chapter.

2. The Theory of the Business


Drucker contended that every organisation operates to a ‘theory’ of its business built upon an assumptive framework which guides and nurtures the organisations activities and that it can be a powerful catalyst for business sustainability and growth. Drucker defines his Theory of the Business’ as:

“..the assumptions that shape any organisation’s behavior, dictate its decisions about

what to do and what not to do, and define what the organisation considers meaningful results. These assumptions are about markets. They are about identifying customers and competitors, their values
and behavior. They are about technology and its dynamics, about a company’s strengths and weaknesses. These assumptions are about what a company gets paid for. They are what I call a company’s *theory of the business*.” (1994:95-96).

The theory Drucker proposed was elegant in its simplicity. It was based on the architecture of the organisations primary business assumptions regarding its market choice/position, its stated mission and its competency framework. Drucker’s Theory of the Business set out the fundamental hypothesis of enterprise built around assumptions. It had three parts.

“First, there are assumptions about the environment of the organization: society and its structure, the market, the customer and technology… second, there are assumptions about the specific mission of the organization… third, there are assumptions about the core competencies needed to accomplish the organization’s mission.” (1994:99-100)

Drucker outlined that while assumptions about the environment define what an organization is paid for, the assumptions about core competences define where an organization must excel, while, the assumptions about the specific mission define what an organization considers to be meaningful results; in other words they point to how it visions itself making a difference in the economy and society at large.

He made clear that when these base organisation assumptions were acting in harmony with one another they created ‘valid’ theories of business. “Indeed, a valid theory that is clear, consistent and focused is extraordinarily powerful” (1994: 96)

Drucker detailed the specifications of a valid ‘Theory of the Business’: The assumptions about environment, mission, and core competencies must fit reality; they have to fit one another; they must be known and understood throughout the organization; and the ‘Theory of the Business’ has to be tested constantly.

Valid Theories of the Business can be taken for granted by the organisation and Drucker warned that a valid ‘Theory of the Business’ lasting for many years can just as easily lead the firm to collapse overnight, thus requiring constant reflection. “Eventually every theory of the business becomes
Drucker indicated that Theories of the Business that were no longer valid could be identified in four ways: when the organisational goals were met; when rapid growth was experienced; when unexpected success or failure was experienced; and when a competitor experienced unexpected success or failure.

“When a theory shows the first signs of becoming obsolete, it is time to start thinking again, to ask again which assumptions about the environment, mission, and core competencies reflect reality most accurately—with the clear premise that our historically transmitted assumptions, those with which all of us grew up, no longer suffice.” (1994: 101)

Once these conditions emerged Drucker argued the firm’s ‘Theory of the Business’ had become obsolete and management had to take corrective action. The deeper these combinations acted on the organisation, the more urgent and comprehensive the management action needed to be and only those managers responsive enough to these signals could restore the organisation’s Theory of the Business.

The most common reaction to an obsolete Theory of the Business was organisation defence and managerial denial that eventually led to ‘patching’, or superficial treatment of the real deep rooted problems in the enterprise. Drucker argued that the ultimate protection for the organisation against theoretical obsolescence was preventative care built around systematic monitoring of the Theory of the Business. This care system was built around designing into the organisation ‘purposeful abandonment’

“Every three years, an organisation should challenge every product, every service, every policy, every distribution channel with the question, if we were not in it already, would we be going into it now?” (94: 102)

Abandonment forces the organisation to stress test its working assumptions as a business process and to build this into its planning and screening programmes. It is too late to do this in a crisis. In fact purposeful abandonment when designed into the organisation, especially mature organisations can be liberating and can unlock significant potential.
Perhaps the best example of this is seen in the transformation of GE. Jack Welsh its legendary former CEO accredited with leading this transformation enacted purposeful abandonment at the prompting of Drucker. His new strategy for GE was to be No. 1 or 2 in all its markets and if not then to fix, sell or close those underperforming units and this drove GE to become the most successful organisation in the world.

“The clarity of No.1 or No.2 came from a pair of very tough questions Drucker posed: “if you weren’t already in the business, would enter it today?” And if the answer is no, “what are you going to do about it?” (Welch, 2001, p.108)

The other preventative cure Drucker talked about was to understand what was going on with the organisation’s ‘non customers’ as it is in this area that fundamental signs of change take place, not normally with the organisations customers.

Observing and analysing non customers was as important as researching one’s own customers as they normally represented the greater share of the market and more importantly where future customers and markets trends would emerge from. The organisation therefore had to consider balancing existing customer and ‘non customer’ needs at the same time.

The outcomes of conducting diagnosis and preventative care around the firm’s Theory of the Business is to ensure that it remains fit for purpose and that re-calibration is an easier proposition than a major overhauled. Once testing and care was built in to the system, redefining the firm’s theory of business would happen systematically as part of the organisation’s defence and growth routines.

Drucker places assumptions and the Theory of the Business at the centre of the organisation, from which all other systems and activities stem. The ‘Theory’ thus becomes the birthplace of the business, the spiritual home of the organisation and the place from which its philosophy flows. It is clear he sees the Theory of the Business as the precursor of a firm’s strategy and planning as it is the source of the firm’s primary intellectual capital.

Drucker in the Theory of the Business was suggesting that business assumptions could be skillfully used as a management process to co-ordinate signals from the environment and use them to control the
organisation. Although he was the first to use weave them into a business theory, their value had been recognised in related management literature.

3. Assumptions in recent business and management literature

Assumptions in recent business and management literature are more easily recognisable in the study of the cognitive factors that influence management especially evident in organisational culture (Schein, 1984, Pettigrew 1979), and commitment (Kegan & Lehay, 2001) creating a psychological dynamic for assumptions.

This placement has tended to focus on the individual and collective mindset as part of the firm’s memory bank and the impact that this has upon the organisation. Subsequent studies have expanded the research into organisation development as organisation learning (Arygris & Schon, 1974, Arygris, 1999, Senge et al, 1990).

Assumptions are less obvious when we move away from these fields but the organisation and systems research suggested an integrative role for assumptions which was a theme embraced by strategists and planners who seemed to appreciate the possibilities suggested by the OD studies.


3.1 Assumptions and Strategy Design

Ohmae (1982) paid particular attention to assumptions in the strategy process observing them shaping
foresight which he described as the ability to understand the reality of possible futures.

His work within the strategy (particularly the Japanese strategy process) paired assumptions with business foresight. He sat down five processes that inspired foresight that he considered critical to business success.

These processes were defining the business domain, future proofing environmental forces on the company, selecting key strategic options, pacing strategy delivery and adhering to the basic assumptions underlying the strategy choice as long as they hold true.

Conversely undermining these processes would have the opposite effect if companies denied them, eroding the key success factors and unbalancing the assumptions underpinning the original business objective.

Using a range of examples from fast food chains to shipbuilding Ohmae demonstrated that assumptions drove the business models and strategies that sustained what he called ‘foresighted companies’. Any deviation from the assumptions would begin the process of invalidating the business model and strategy.

In proposing this view of assumptions he clearly regarded them as deeply embed within the strategy process as key components of foresight and central to the business and strategy process.

Ohmae introduced and interpreted the eastern (and essentially Japanese) strategy philosophy that emphasised a strategy thought process that embraced a cultural and holistic dimension unique to west management thinking. In so doing he reserved a key role for assumptions.

Whittington (1993) recognised this centrality and contended that assumptions formed the basis of the theories that sustain a business and therefore give context to our business actions “Theories are important. They contain our basic assumptions about key relationships in business life”. Whittington, R. (1993), Pp10-1.
Whittington’s observations indicated that assumptions acted deeply within the strategy process helping to form the theoretical pathways for the business that guided the organisation actions. In this regard they were almost starting points for business or ‘short cuts to action’.

This viewpoint suggests that assumptions underpinned the business theory that shapes the business model. Magretta (2004) acknowledged this and observed the business model as a set of assumptions working together as a theory that continues to be tested in the marketplace.

Johnson and Scholes (1993) echoed Ohmae, Whittington and Magretta. They suggested that “All plans are based on assumptions. They maybe assumptions about resource availability, or the capacity of the organisation to adapt existing resources or co-ordinate the resource requirements of a new strategy. Assumptions may also be to do with the environment – that a market will grow, that funds can be raised or that suppliers will deliver on time.” (Johnson and Scholes, 1993, p.332).

Such a perspective embedded assumptions within the business and strategy making process and suggested a key placement for them. The authors felt it was important to analyse business assumptions as they represented possibly the deepest level of the organisation.

“However it is the core beliefs and assumptions which are more important to analyse since they represent what is taken for granted within the organisation and therefore are a powerful force in shaping the organisations actual strategies on the ground” (Johnson and Scholes, 1993, p.164).

According to Johnson and Scholes the role of assumptions in strategy was so fundamental they described it as the ‘taken for grantedness’ of an organisation.

“This taken for grantedness can be very difficult to surface. Nonetheless, unless these beliefs and assumptions are surfaced and challenged very little will change in the organisation. The assumptions are likely to override the logical explicit statements of the organisation’s preferred strategies” (Johnson
Using assumptions in this way within the business and strategy process was according to the authors critical to a firm's continued success. Surfacing and challenging the company's assumptions was a key business process that needed to take place at the strategy level, evident in subsequent literature on strategy regeneration.

3.2 Assumptions and Regeneration

Hammer and Champy (1993) used assumptions to drive their hypothesis of business reengineering and discontinuous thinking that became a change management model of choice for so many organisations and managers in the early nineties.

“At the heart of business reengineering lies the notion of discontinuous thinking – identifying and abandoning the outdated rules and fundamental assumptions that underlie current business operations. Every company is replete with implicit rules left over from earlier decades: “Customers don’t repair their own equipment.” “Local warehouses are necessary for good service.” “Merchandising decisions are made at headquarters.” These rules are based on assumptions about technology, people, and organisational goals that no longer hold.” (Hammer and Champy, 1993, p3)

The twin objectives of discontinuous thinking and business process re-engineering had obviously struck a chord with managers and organisations. Re-engineering championed ‘discontinuous thinking’ a theme recurring in management literature as ‘abandonment’ (Drucker, 1994), and ‘Creative destruction’ (Abrahamson, 2004) that called for the questioning of all business processes beginning with assumptions in order to drive competition.

Hamel and Prahalad (1994) used this concept of abandonment and the challenge of assumptions to reconfigure the paradigm of competition at the heart of the organisation. The authors regarded assumptions as ‘genetic codes’ of the organisation and the key to unlocking mindsets.

“Every manager carries around in his or her head a set of biases, assumptions, and presuppositions
about the structure of the relevant “industry,” about how one makes money in that industry, about who
the competition is and isn’t, about who the customers are and aren’t, about what the customers want
or don’t want, about which technologies are viable and which aren’t, and so on” (Hamel and Prahald,
1994, p 53)

The authors contended that assumptions, biases and presuppositions set the managerial frame for the
individual and corporation alike and these ‘frames’ gave the context to what the organisation did, how it
acted, how it developed. They contended that for a company to compete into the future practically
everything about the past had to be forgotten or reset beginning with the managerial frames and outlook
which management preserved.

In doing this they set assumptions at the heart of their management challenge. “The foundations of
past success were shaken and fractured when, in all too many cases, the industry terrain changes
shape faster than top management could refashion its basic beliefs and assumptions about which
markets to serve, which technologies to master, which customers to serve and how to get the best out
of employees.” (Hamel and Prahald, 1994, p6)

Consistently the authors return to the fundamental use of assumptions in driving new business
patterns and constructing an advanced future for the organisation. Unlocking the future could only
come about by delivering industry foresight. “The goal of competition for industry foresight is at one
level, simple: to build the best possible assumptions base about the future and thereby
develop the prescience needed to proactively shape industry evolution” (Hamel and Prahald,
1994, p79)

Christensen (1997) linked this theme to deficits in the strategic capability of modern managers.
Managers he contended had moved away from engaging with strategy in their daily routines and
had lost the skills to reset strategy themselves. They had become strategically ‘out of condition’.

Christensen suggested an intervention model ‘Driving Force Analysis ‘that began with assumptions. By
identifying the key assumptions that drove the company and allowing management to engage with
them, the manager’s strategic capability could be reset.
Grouping these forces and the assumptions into business statements that could be held up to inspection was critical to the model. “These summary statements constitute the group’s initial hypothesis of what the driving forces are – they make explicit the assumptions that key employees have about the problems and opportunities your company faces” (Christensen, 1997, p144)

Christensen saw the unearthing of assumptions and the mapping of them as critical to the success or failure of his intervention model. The assumptions needed to be mapped and tested for consensus. “Mapping requires managers to make their assumptions and the implications of those assumptions explicit through the diagrams, which, in turn, enable the team members to achieve consensus more easily. The words and numbers that make up many strategy documents often mask serious misunderstandings about assumptions” (Christensen, 1997, p146)

The intervention model could only work if the foundation stage of unearthing and debating the business assumptions could be completed honestly and transparently. Only then could the strategy be set up for interrogation.

More recently Kaplan and Norton (1999) in their work on the Balanced Scorecard contended that assumptions allowed a company to re-calibrate itself. “Organisations need the capacity for double-loop learning, the learning that occurs when managers question their assumptions and reflect on whether the theory under which they were operating is still consistent with current evidence, observation and experience” Kaplan and Norton, 1999, p251)

It is clear from this brief review of some of the recent literature related to the role assumptions play in organisations that they exert a silent but dynamic role in organisations.

Paradoxically the pervasive role played by assumptions in business and management is perhaps the reason why they have remained outside of investigation for so long. They are so deeply embedded in business architecture that apart from certain cultural and psychological studies, their impact on business and management practice has remained under-investigated.

Drucker’s theory of the business therefore gives us a unique pathway to follow to widen the study of assumptions in business. Remarkably his original research on IBM and GM in support of the theory of
business remains as the only developed case studies of the Theory of the Business.

4. The Case for the theory of business – IBM & GM

IBM in the 1970s had clear assumptions about the computer and backed by rigorous research could prove the future of computing lay in mainframes. It was not alone in its assertions, all the major players at the time held the same assumptions. Xerox, Univac, Siemens, Nixdorf, Hitachi, all subscribed to the same view and the same assumption.

IBM had built its operations around these assumptions, as had its competitor colleagues. With the arrival of the PC in the form of the Apple and the Macintosh, and when consumer began to buy the PC in spite of IBM’s assumptions about it, IBM, overnight accepted the PC as the new reality, moved into PC R&D, re-engineered itself to take account of the arrival of the PC, and with in a few years, was the PC’s industry largest manufacturer.

However, this was not the first time IBM had completely overhauled its business and strategy in the light of new realities. In the 1950’s, it did exactly the same thing. IBM held that large computing machines, based on its research and assumptions, would be powerful single use systems. IBM saw its market in the defence sector and was building air defence systems with the sole purpose of early identification of enemy aircraft.

Univac, then the world’s largest computer company, proved with its prototype multi purpose computer, that single systems had limited use. IBM, once again, overnight, scrapped its single purpose computer strategy, deployed engineers to R&D a multi purpose computer that could be manufactured and serviced. Within three years IBM was the industry’s dominant computer manufacturer.

These IBM examples demonstrate the power of a ‘positive’ theory of the business, but equally the theory of the business can act as a destructive or ‘negative’ force. Drucker also demonstrated in his 1994 paper that IBM got it wrong, because it got its theory of its business wrong.

In the late 1970s and 1980s IBM ‘assumed’ that computers in the form of mainframe systems and PCs could co-exist as a product offer. Drucker argued they were in fact competitor products, contradictory in
design, application and market. They both were information products, but differed in application. For Mainframes information was memory and hardware driven, for PCs information was software. IBM using the assumptions it had now generated about the PC and mainframe business, now combined the two. It assumed it could do so. But, the PC market was out stripping the mainframe business, the traditional cash cow of IBM. IBM simply could not subordinate one to the other.

As a result both businesses floundered and its assumption that a computer was a computer paralysed it. The theory of business that propelled IBM in the 1950s and 1970s about both its mainframe and PC business almost destroyed it in the late 1970s and 1980s.

General Motors provided another example of how the theory of the business acts as a positive and negative force. Since the 1920’s GM had fashioned one of the most successful theories of the business which protected the company for over 70 years from having a single corporate setback.

GM's theory of their business assumed that the US automobile market was homogeneous in its values and segmented by relatively stable income groups. Resale values of used cars and good trade in values allowed its clients trade up to the next car category. The Theory suggested only frequent trade-ins or radical consumer changes could depress trade in values, the key to the theory.

These market assumptions then formed symmetry with GM's production process, which focused on semi-autonomous divisions, built around particular income segments, connected to one another by product overlaps. For over 70 years this theory held true and not until the late 1970s did it become invalid.

In the late 1970s income no longer defined the purchase of cars, but 'lifestyle' choices and changes in manufacturing (introduction of lean manufacture) led to new product offers. GM knowing this was happening did not believe it. It continued its theory, maintained its divisions and their product offer, but also attempted to vary the product range by manufacturing division and at the same time have these divisions produce both long and short runs to compete with lean manufacture.

In Drucker's terms it 'patched' a solution. This simply had the effect of confusing the market and the company itself and masked the reality of the business. While it 'patched', it missed the fact that it was out
pacing its competitors in a key automobile segment, the minivan and light trucks sector, where it had clear leadership in their design and quality.

Having classified these automobiles as commercial vehicles, it never assumed them to be passenger based, classless, and little influenced by trade-ins. While GM assumed these things about minivans and light trucks, Chrysler, GM’s competitor assumed the opposite, and recorded totally unexpected success in this segment of the automobile market. GM's Theory of the Business which for so long protected it from failure, was now causing it.

The IBM and GM case studies clearly detail the manner in which Theories of the Business can both sustain and endanger organisations. They also indicate the centrality of the Theory of Business and how it exists as distinct and unifying process in organisations. The fact these case histories remain the only developed research on the Theory of the Business provides ample incentive to conduct further research into this concept.

4. Conclusions: Theory Matters

This paper offered a re-introduction to Drucker’s Theory of the Business and outlined its value as a distinct business and management concept. In so doing it also highlighted the role assumptions play in organisations and how they need to factored into business planning in a more meaningful manner. The paper also argues that more research needs to be conducted into the Theory of the Business concept.

The Theory of the Business endeavored to make sense of an increasingly chaotic business environment and had its origins in the fundamental challenges of the management world.

Drucker argues that the skills and competencies that managers required in modern management are rapidly changing and now operating at a much more fundamental, intellectual and theoretical levels than previously understood.

Increasingly, according to Drucker, it will be in this space that a firm’s future competitive advantage will come from and that this must begin the assumption design of the firm. He therefore postulated that
organisations and managers who can master adaptive and flexible processes that operate at this level will be positioned to gain significant advantages.

In response to his own proposal he constructed his ‘Theory of the Business’ as a development of this thinking and outlined with two prominent case studies how it exists, is constructed, operates and can be tested. He wanted it to be a practical workable theory. It was to be a praxeological theory. “It is a hypothesis. And it is hypothesis about things that are in constant flux – society, markets, customers, technology.” (Drucker, 1994, p101)

He acknowledges that motivation and commitment can also come from having a clear strategy, from the excitement of achievement, from the honour of being the best and the thrill of winning. But strategy alone is not enough he argues. It needs to be nested in a clear sense of mission and, in Drucker’s terms, a viable and compelling theory of the firm.
References


