Predictors of organizational performance in small and medium-sized professional service firms

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Abstract: The paper sets out our theoretical and empirical approach to delineating predictors of stakeholder performance in medium-sized computer service firms. It combines a resource-based approach with recent insights from the literature on small and medium-sized firms, professional service, and computer-service firms. Top managerial capital (in terms of inspiration, competence, and communication) and organizational capital (in terms of external, professional, and employee orientation as well as networking, financial management, and market focus) are assumed to be major predictors of organizational performance.

Keywords: Organizational performance; stakeholder approach; performance predictors; resource-based approach; small and medium-sized firms; professional service firms; computer service firms.


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1 Introduction

Despite the lack of rigorous empirical research, the literature on factors related to success
of professional service firms is continuously growing. This paper is preliminary to our empirical study. It sets out our theoretical and empirical approach delineating factors that contribute to organizational performance of small and medium-sized computer service firms. The most important question to be addressed in this paper is which internal organizational factors can be expected to contribute to organizational performance in professional service firms such as computer services.

The paper first explores the possibilities for valid assessments of organizational performance. It critically evaluates the predominant financial/economic approach and provides a more promising alternative, based on recent conceptual developments in organizational effectiveness and performance research. The paper then discusses major streams of research dealing with the predictors of firm performance. Special attention will be paid to the resource-based perspective which seems most promising for the case of professional service firms in one particular industry. On the basis of recent research in organization theory as well as the literature in the fields of knowledge-intensive professional service firms, small and medium-sized firms, and computer-service firms, we develop the conceptual framework of our study. This framework specifies predictors of organizational performance in small and medium-sized computer service firms. The paper ends with a short description of our empirical approach followed by concluding remarks.

2 How to best measure organizational performance?

It does not make sense to try to identify predictors of success without being explicit about what is meant by success. Without question, the notion of organizational success plays a key role in organization science. So far, however, there is little consensus on how to best define and measure this important variable. Studies on organizational success can be found under a variety of labels, including organizational performance, effectiveness, health, or excellence. Differences in background and terminology combined with a lack of theoretical and operational definitions are major obstacles to consensus and cumulative knowledge build-up in this important field.

Empirical studies of success in for-profit firms typically focus on financial/economic success criteria. These studies are usually associated with ‘corporate performance’ and are rooted in strategy research. Their – mostly unmentioned – conceptual basis is the rational goal approach. This approach concerns the degree to which organizations realize output goals (such as profitability and growth). In spite of its widespread use, this approach has been extensively criticized. The prime conceptual limitation relates to the comparability of the content of various organizational goals. Given the multifunctional nature of organizations (see, e.g., Ghorpade [1]), multiple and even incompatible goals exist within organizations. Such goal constellations vary greatly – not only over time, but also in the degree to which they are taken seriously by key members of the organization [2,3]. Another limitation is the typical measurement approach of corporate performance research. Financial/economic performance is usually assessed with accounting-based measures (e.g., profitability measures such as return on assets, return on investment, return on sales, and return on equity). These measures have met with a considerable amount of criticism (see, e.g., Brown & Laverick [4]; Doyle [5]; Eccles [6]; Habel [7];
Kaplan & Norton [8]; McGuire et al. [9]). Accounting-based figures can be misleading because they may have been manipulated to look good. A lack of consistency in corporate accounting methods (e.g., with regard to the treatment of inflation, inventory valuation, depreciation, or intangible assets) and a lack of standardization in international accounting conventions (see, e.g., Gray [10]) makes interpretations as well as comparisons between organizations difficult. A further shortcoming of all accounting-based performance measures is their backward-looking focus [7,8]. Data from past years reveal little about the future potential of a firm. The ‘short-termism’ of the accounting-based measures (see, e.g., Doyle [5]; Eccles [6]) is related to another point of criticism. Profit can easily be raised in the short term by cutting expenditures (e.g., for advertising or R&D), but this practice might be harmful in the long run. Thus, the question is whether ‘firm performance’ is truly assessed when only accounting-based measures are relied on. The fact that this approach is so common, in spite of its well-known shortcomings, is easily explained. Adhering to ingrained conventions and guided by considerations of convenience or practicability, researchers tend to measure what is easy to measure. New, more comprehensive approaches, although promising, are in a difficult position vis-à-vis these forces.

The stakeholder or multiple constituency approach of firm performance is an advancement which could become a promising alternative or addition to the narrow, short-term oriented financial/economic performance approach. It is based on recent conceptual developments in both organizational effectiveness and corporate performance research (see Glunk & Wilderom [11]). The stakeholder approach reflects the success of a firm in meeting the expectations of its major constituencies and includes not only criteria for short-term but also criteria for longer-term success. It seems especially appropriate for performance measurement in professional service firms where longer-term criteria were shown to be most relevant (see Brignall & Ballatine [12]; Fitzgerald [13]; Whitt, Whitt & Culpepper [14]).

Currently, the importance of broadening the construct of corporate performance beyond financial/economic measures is generally acknowledged. However, any broader notion of corporate performance is rarely found in the empirical literature [15,16]. At this time, we know of no substantial empirical study in the professional service sector with various performance indicators based on the evaluations of both internal and external stakeholders.

2.1 Application of the stakeholder approach

Below we will show how to apply the stakeholder approach for defining and measuring organizational performance in small and medium-sized computer service firms. The first step in this process is the identification of relevant constituencies. The literature on professional service firms as well as the results of interviews with 10 experts in the computers-service industry (both in the Netherlands and in Germany) show employees and clients to be the major stakeholders in computer service firms. Success in meeting their expectations, is, therefore, important in assessing organizational performance in the present study. Financial/economic performance is often considered as being mainly in the interest of the management. It is, however, also a general precondition for firm survival.
and thus of importance to all organizational stakeholders. This means that the conceptualization of organizational performance needs to include economic criteria as well as non-economic criteria that are related to the most important stakeholders in computer service firms. Hence, we consider financial criteria, client-related criteria and employee-related criteria. These three types of criteria are assumed to have a positive effect on organizational survival in the longer run – the ultimate criterion for organizational effectiveness/performance. Reiman [17] empirically tested this essential – yet rarely studied – issue. He found the subjective evaluation of an organization’s effectiveness (with regard to economic, personnel, and customer performance) to be an excellent predictor of the organization’s subsequent survival and growth.

3 How to delineate predictors?

Three academic schools of thought can be distinguished in predicting organizational performance: first, industrial organization economics traditionally emphasizing external market forces such as market or industry structure (see, e.g., Scherer [18]); second, contingency theorists typically focusing on the fit between external conditions and structural characteristics of the organization as major predictor of firm performance (see, e.g., Lawrence & Lorsch [19]); and third, resource-based theorists, focusing on intra-organizational variables as sources of competitive advantage (see, e.g., Barney [20]; Koch & McGrath [21]; SubbaNarasimha [22]). Our single-industry study aims to contribute to the third stream of research. In other words, our study will focus on a set of internal organizational characteristics that are hypothesized to be critical for the management of high performance in knowledge-intensive professional service firms like computer services.

3.1 The resource-based approach

The resource-based model of sustained competitive advantage (or performance) assumes that firms within one industry are heterogeneous with regard to the strategic resources they control [20]. According to this model, the disposition of valuable resources that are rare and imperfectly imitable provides firms with a competitive advantage leading to increased performance. Three categories of performance-related resources are usually distinguished (see Barney [20]; Koch & McGrath [21]): physical resources (such as technology, plant equipment, or geographic location), organizational resources (such as reporting structures or coordinating systems) and human resources (such as knowledge and the experience of managers and employees). We focus on the latter two types of resources because of the importance of intangible, non-physical assets within knowledge-based professional service firms (see, e.g., Schmenner [23]).

Our delineation of relevant types of human and organizational resources or capital is based on the literature about knowledge-intensive professional service firms and of small and medium-sized firms. Theoretical considerations and empirical evidence from major streams of organizational behaviour and organization theory will enrich our elaborations. We will present those general types of human and organizational capital that are assumed
to be strategic assets and, hence, sources of competitive advantage for small and medium-sized computer service firms.

3.2 Managerial and organizational capital

The resource-based approach, focusing on the relation between internal firm characteristics and performance, has important links with organization theory and organizational behaviour research (see, e.g., Fiol [24]). Two links are most important for the type of firms we are studying. The first link relates to research on top managerial or entrepreneurial qualities as an imperfectly imitable human capital-type variable. The second prominent link for our purpose relates to the concept of organizational culture as an imperfectly imitable strategic organizational resource (see, e.g., Barney [25]).

The literature on small and medium-sized firms strongly emphasizes top managerial or entrepreneurial qualities as a source of sustained competitive advantage [26,27]. Empirical studies on success versus failure in small and medium-sized firms repeatedly show managerial qualities to be a major predictor of success [28,29]. Organizational behaviour research has elaborated extensively on supervisory qualities. Entrepreneurial or top managerial qualities have been rather neglected. Our aim is to specify crucial qualities for top managers or entrepreneurs in knowledge-intensive professional service firms.

Organizational culture is considered a particularly important source of competitive advantage for professional service-type firms (see, e.g., Bharadwaj et al. [30]; Chatman & Jehn [31]; Wetzels et al. [32]). An effective informal coordination system is of special importance in this type of firms, while formal structures play a relatively minor role. Unfortunately, however, there is little consensus among researchers about which particular components constitute an effective organizational culture in this type of firms. Although we agree with other researchers that organizational culture is an important predictor of firm performance in professional service firms, we tend to avoid this obscuring umbrella term. In comparative research, it seems more sensible to focus on the components of organizational culture as expressed in perceived organizational practices (see Hofstede et al. [33]). Our intention, therefore, is to specify the particular performance-related organizational practices that will lead to sustained competitive advantage in computer service firms.

Figure 1 General types of variables in the study
4 Specification of predictors

The resource-based view with its links to top managerial or entrepreneurial capital and organizational capital provides a general frame for the identification of performance-related human and organizational resources. However, the specification of these general types of resources is not further elaborated within this view. Given the lack of a theory for the specification of particular managerial and organizational resources in the type of firms we are studying, we now have to follow an inductive approach.

4.1 Managerial capital

To specify performance-related managerial capital, we reviewed the literature in the fields of knowledge-intensive professional service firms, small and medium-sized firms, and computer-service firms. While we could find no information on important managerial qualities in the literature on computer service firms, the literature on the management of knowledge-intensive professional service firms and small and medium-sized firms provided useful insights.

4.1.1 Inspiration

Bahrami ([34], p.38) specifies top managerial tasks in knowledge intensive firms as follows: "to orchestrate the broad strategic vision, develop the shared organizational and administrative infra-structure, and create the cultural glue which can create synergies, and ensure unity of mission and purpose." This statement emphasizes the visionary and unifying tasks of top management and relates closely to the so-called new leadership approach (Bryman [35]) relating to the concept of inspirational or charismatic leadership [36]. This approach focuses on the personal impact of a leader on the motivational value base of his/her followers. A recent study by Koene [37] showed inspirational leadership to be an important predictor of firm performance (see also Pillai, [38]). The conceptualization of inspirational leadership is normally related to supervisory relationships. For small and medium-sized firms, it seems, however, of greater importance
to relate it to top management or entrepreneurial style. At this time, we do not know of any empirical study that focuses on the relation between inspirational management style and organizational performance on this level. In this respect, this study will require us to do some pioneering work.

4.1.2 Competence

There is in the literature on small and medium-sized firms a strong emphasis on top managerial or entrepreneurial competence as a predictor of organizational performance. Competence in terms of professional as well as managerial knowledge and experience has been shown to be closely related to firm success in small and medium-sized firms [39,40]. In addition to top management/entrepreneurial style, we will thus also include competence.

4.1.3 Communication

A third important component of top managerial capital in knowledge-intensive professional service firms relates to the concept of open communication. Providing information about important firm developments (top-down communication) as well as being open to employee suggestions (bottom-up communication) have been shown to be important predictors of performance [37,41]. One might argue that open communication is not an issue in small and medium-sized firms because of the ease of informal contacts. However, we assume that particularly in small and medium-sized firms, the smoothness of information flows can vary greatly between firms, depending on the communication style of the top manager or entrepreneur.

4.2 Organizational capital

To specify performance-related organizational capital, we started with a review of the literature on success factors in computer-service firms. This literature is mostly anecdotal in nature and consists of prescriptions or recommendations. Nevertheless, it can provide a first clue as to which variables might be worth studying. To enrich our knowledge, a pilot study was conducted in July 1995 to gain first-hand information on practitioners’ ideas about predictors of performance in the computer service sector (both in the Netherlands and in Germany). This exploratory study involved qualitative, semi-structured interviews with 10 directors of computer service firms. Table 1 summarizes the three clusters of organizational practices that were mentioned repeatedly as predictors of performance in the computer service literature and in our pilot study. Support for their importance could also be found in the academic literature as will be shown below.

<table>
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<th>Table 1</th>
<th>Organizational capital in small and medium-sized computer service firms</th>
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<td>External orientation</td>
<td>Christensen, [42]; Hofman, [43]; Nicolai &amp; Geuzinge, [44]; Raffa &amp; Zollo, [45]; Ritserma, [46]; Ritterrath, [47]; Sanders &amp; Curran, [48]; Winnenbrock, [49]; our pilot</td>
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</table>
4.2.1 External orientation

The most recent management and organization literature stresses the importance of a strong external orientation in today’s competitive environment. The importance of a strong external orientation (towards clients, competitors, and the market) as a predictor of firm performance is also supported by the literature on small and medium-sized firms [27] and the literature on professional service firms [32]. Moreover, empirical results in various types of firms and industries revealed a consistent relation with organizational performance [51,52,53,54]. The question is whether external orientation can still be considered a scarce organizational resource. The popularity of this concept and its generally acknowledged importance might have brought about a general adoption of this orientation. The development of a cohesive and systematic external orientation, however, is a complex process. Despite a general trend in the business world towards adopting a strong external orientation, we assume that small and medium-sized computer service firms still vary in the degree to which they have realized this goal.

4.2.2 Professional orientation

A capability-based professional orientation relates to organizational practices that help the firm to continuously update the existing knowledge base and to cultivate extraordinary talent. Professional orientation in terms of continuous knowledge development, stimulating cooperativeness, challenging tasks, and high-ambition orientation is generally acknowledged as an important condition for performance in knowledge-intensive professional service firms (see, e.g., Quinn, Anderson & Finkelstein [55]; Thom [56]; Wetzels et al. [32]). At this time, we do not know of any empirical research that has tested the assumed relationship with organizational performance.

4.2.3 Employee orientation

Employee orientation points to a range of organizational activities that take employee needs into serious consideration. Knowledge-intensive professional services firms largely depend on their personnel as an important asset [32,34,56]. In times of scarcity of highly knowledgeable employees, a favourable employee orientation is for them a matter of survival. Various empirical studies even support the general importance of employee orientation for organizational performance [37,51,57,58]. We assume this variable can provide small and medium-sized computer service firms with a sustained competitive advantage.
4.2.4 Remaining organizational practices

In our study, we will consider an additional cluster of variables. We find sufficient support in the literature for considering these variables as valuable and scarce resources for computer service firms. Compared to the aforementioned types of organizational capital, they are, however, rather easily imitable. Yet, for the time being, we assume that small and medium-sized computer service firms still differentiate in this respect. For professional service firms and especially computer service firms, the literature emphasizes the importance of external relationships in terms of networking [45,46]. Recent strategic management literature generally emphasizes the growing importance of such collaborative activities for small and medium-sized firms [59,60,61]. Moreover, a number of studies in strategic management research found a specialization or focus strategy to be an important predictor of performance [62,63]. The literature on small and medium-sized firms, finally, emphasizes the crucial and often neglected role of a sensible financial management for firm performance [40,64]. Given also their generally supported importance, we decided to include these three types of variables in our study.

5 Testing predictors of organizational performance

Our conceptual framework combines

(1) a human resource-type variable cluster, namely managerial capital in terms of inspiration, competence, and communication;

(2) an organizational resource-type variable cluster, namely, organizational capital in terms of external orientation, professional orientation and employee orientation, networking, specialization, and financial management;

(3) an organizational performance cluster, that will be defined in terms of financial, client-related, and employee-related criteria. Managerial capital is assumed to influence these performance variables directly as well as indirectly (via organizational capital).

Figure 2 Specification of variables in the study
5.1 Empirical approach

When investigating organizational capital in relation to performance, many studies have focused exclusively on managerial viewpoints. However, it is known that managers are considerably more positive about their companies than people at lower hierarchical levels [65]. Therefore, we will collect data from multiple informants (directors, managerial and non-managerial employees) in more than 60 small and mediumsized computer service firms. The sample of employees will be stratified in order to be representative for different hierarchical levels and functional/professional work groupings within each firm.

Data on the participating firms will be gathered through structured interviews with one person from the directorate and questionnaires for a stratified sample of the firm’s employees. The structured interview with the director will include questions regarding

1. background characteristics of the firms being investigated,
2. organizational capital, and
3. objective and perceptual financial performance data.

Employee questionnaires will include closed questions regarding

1. managerial capital,
(2) organizational capital in terms of external orientation, professional orientation and employee orientation, and

(3) employee- and client-related performance evaluations.

6 Summary and conclusions

Empirical organizational performance research usually focuses on large manufacturing-type firms. Little is known about predictors of organizational performance in small and medium-sized professional service firms. Theoretical developments and empirical research in this field of study are needed. Our study aims to take a first step in this direction.

Following a resource-based approach, it can be stated that individual managerial capabilities and an informal system of coordination are of crucial importance in small and medium-sized professional service firms, while physical resources and formal structures play a relatively minor role. Our study, therefore, considers managerial and organizational resources of sustained competitive advantage as predictors of performance (see Figure 2). The specification of predictors grounds on research in organization and management and the literature on small and medium-sized firms, professional service, and computer-service firms.

In addition to general insights on predictors of organizational performance in small and medium-sized professional service firms, our study can provide answers to a number of interesting research questions on organizational performance: How do the components of firm performance relate to each other? To what extent do perceptions of organizational performance correlate with objective performance data? Which sets of predictors are positively related to which types of performance criteria? To what degree do the perceptions of organizational performance of various stakeholders such as directors and employees differ?

The aim of our study, as described above, is to contribute to the development of knowledge on predictors of organizational performance in three ways:

1. by providing an empirical example that uses a – rarely applied – comprehensive approach to assess organizational performance,

2. by focusing on a rarely studied, yet increasingly important, population of firms, namely, small and medium-sized knowledge-intensive professional service firms, and

3. by specifying the resource-based approach of competitive advantage for this type of firm and linking it to the dependent variable of organizational research par excellence, organizational performance.
References

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