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## Governance and growth of professional service firms

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We argue that partnerships are the optimal governance structure for professional service firms (PSFs) based on our analysis of their need for collegial controls, the use of tacit knowledge, and an investigation of agency costs. However, these factors and the resulting choice of partnership as a governance structure constrain the ability of PSFs to successfully pursue growth strategies. In addition, their growth potential is further circumscribed by diversification limitations, as well as reputational and resource constraints.

**Keywords:** professional service firm; governance; growth

### Introduction

Employment in the service sector outnumbers manufacturing employment by an 8 to 1 margin in the USA today (Monthly Labor Review, 2009). The same trend is evident in most other developed countries as well. Despite this overwhelming importance of service organizations in our post-industrial economy, research on the specific characteristics of service businesses and approaches to their optimal governance is still at a nascent stage (Ethiraj, Kale, Krishnan, & Singh, 2005; Greenwood, Li, Prakash, & Deephouse, 2005; Morris & Empson, 1998). One of the least understood aspects of service businesses seems to be the considerable variance that they show in their ability to grow in size.

Some service businesses such as medical practices appear highly constrained in their ability to grow (Bradford & Martin, 2000), whereas the fast food industry has become huge in scale and global in scope. Some segments of the legal service industry have seen considerable growth, but such change has been accompanied by a change in their fundamental relationships with clients (Heinz, Nelson, & Laumann, 2001). What accounts for such wide variations in the patterns of growth in size of service businesses? An answer to this question is of equal importance for management theorists as well as practicing managers given the increasing share of the economic output that is produced by service businesses in most developed economies. Do service businesses experience constraints to growth that manufacturing businesses do not encounter? Do these constraints apply to all service businesses or only to certain types of service businesses? What characteristics of a service industry would place limits on its ability to grow? An exploration of these questions constitutes the subject matter of this article.

Our research suggests that service organizations that provide highly customized and complex services, in which the customer is intimately involved in the service process,

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have natural barriers to growth. Such businesses typically employ partnerships as their most common governance mechanism. We argue that this governance form arises out of the specific characteristics of some, but not all, types of service businesses. However, this governance form places constraints on the ability of service firms to grow. Let us begin by considering a few specific examples.

When Joel Hyatt developed Hyatt Legal Services in 1977, he broke new ground establishing a national legal services organization supported by national brand advertising. By 1989, Hyatt Legal Services was one of the largest law firms in the USA with 171 offices and nearly 450 attorneys in 19 states, as well as the District of Columbia, and they provided legal counseling to approximately 225,000 clients nationwide. Ultimately, however, Mr. Hyatt's firm did not succeed, individual offices were sold to local attorneys during the 1990s, and the company's charter was finally cancelled in 1999. No multistate chain of law offices comparable to Hyatt Legal Services has since emerged, and the American Bar Association's Commission on Multidisciplinary Practice (2000) acknowledged the apparent difficulties in maintaining such a chain from both a management and professional perspective. However, since that time Forrest Mosten has achieved success with a standardized service product that specializes in a particular type of legal service. His Mosten Mediation Centers launched in 1999, focusing on dispute mediation and arbitration, was sold to CLC, Inc., in 2002, and has grown to include over 2000 mediators in all 50 states.

The Southeast Permanente Medical Group in Atlanta was foundering badly in 1999, with high debt and perceived service problems. That year a new leadership team led by physician Dr Bruce Perry achieved a remarkable turnaround by wresting control of that organization from non-practitioner management. After establishing a culture of physician ownership and empowerment, in 2000 TSPMG achieved a 20% increase in appointment capacity, merited first in the nation on three National Committee for Quality Assurance (NCQA) quality measures, in addition to best in class in 10 areas, and they became Atlanta's first health plan with an 'excellent' NCQA accreditation for both its commercial and Medicare products.

In yet another service industry, management consulting, BearingPoint was spun off from its parent company KPMG with great optimism, and a very successful \$2 billion IPO was completed in February 2001, followed by an ambitious series of international acquisitions. However, revenues continued to decline, and beginning in 2005 they experienced annual turnover rates at levels approximating 25%. In 2009, BearingPoint filed Chapter 11, terminated its business, and sold segments of its operations to competitors.

These seemingly disparate situations might offer valuable insights regarding the governance and growth potential of service industries. It appears that those firms that offer standardized services are able to attain unconstrained growth in volume, while those firms that offer customized, complex services seem to be successful when they forego the option to grow.

This paper will attempt to bridge some of the gap in our knowledge of service firms by analyzing an important class of service firms, namely, professional service firms (PSFs). Based on a number of theoretical considerations, we argue that PSFs are best governed as partnerships. We also identify a number of constraints that limit a PSF's ability to grow in size.

## **Characteristics of services and their optimal governance**

### ***How are services unique?***

Services are different from products along a number of dimensions, such as intangibility, heterogeneity, perishability, the simultaneity of production and consumption, consumer

participation in the service creation process, and high fixed cost structure (Sarathy, 1994). The intangible nature of services makes it difficult to measure service quality, thus making assessment of service quality substantially subjective on the part of the customer. Further, unlike a physical product, which retains partial value after initial use, service consumption dissipates the entire value of the service. Because services are processes that are difficult to duplicate precisely on a repetitive basis, there is considerable potential for variation or heterogeneity in the quality and experience that the consumer will have with the service. This lack of precise standardization further clouds the consumer's ability to perceive quality before making a purchase and adds to the consumer's uncertainty when selecting service providers.

These characteristics of intangibility, simultaneity of production and consumption, and heterogeneity of products combine to form what might be called a 'hazard of unknown product quality' for the consumer. That is, clients have a greater need for reassurance about the probable quality of services prior to purchase. These characteristics also combine to generally form a class of products that is distinctly more ambiguous in nature than manufacturing products. Further, the tangibility, consistency, and methods of production depend, to a greater or lesser extent, on the service provider's interaction with customers.

Performance ambiguity is much higher in services than in the case of physical goods because of their intangibility, credence properties, and their heterogeneity (Bendapudi & Berry, 1997). Further, even within services, there is clearly considerable variation in performance ambiguity from one industry to another. While all service products retain some level of ambiguity, firms in many service businesses try to reduce it through standardization. In more standardized services, expectations for both the consumer and the provider are more stable, there is less reliance upon the consumer for involvement in the service delivery process, and thus it becomes easier to clarify prospects for mutual satisfaction.

McDonald's restaurants, for example, provide a standardized product that has almost worldwide uniformity. Such standardization is difficult to achieve in a physician's work or a lawyer's practice. Abbott (1988) emphasized that the primary distinguishing feature of professions is their immersion in abstract bodies of knowledge, and the application of abstract knowledge to particular cases (Sharma, 1997). Friedson (1983, p. 41) suggests, 'recipients of expert services are not themselves adequately knowledgeable to solve the problem or to assess the service received'. Therefore, due to this knowledge asymmetry, the client relies on his involvement with and trust in the service provider. As Mills and Morris (1986, pp. 726–727) point out, 'Clients or customers of service organizations are indispensable to the production activities of the [professional] organizations . . . output emerges from the coordinated efforts of both service employee and customer' (Sharma, 1997, p. 772).

### ***Professional services***

Our focus in this paper is on *professional service* businesses. In assessing the nature of these businesses we draw from two complimentary service industry classification models offered by Shostack (1987) and Schmenner (2004). Professional service firms differ from other service businesses mainly because they are characterized by high levels of *product complexity* and *product customization*. Product complexity refers to the number and intricacy of steps needed to generate the service. Product customization refers to the degree of service that is tailored to the individual customer and is a function of the level of involvement of the customer in the service delivery process. High levels of *product ambiguity* are present in products with high complexity and high customization,

especially when a firm offers a product that is highly customized and tailored to the individual client, and when that product has a high degree of complexity in the number of steps required to complete the service. The professional service segment of the service sector includes attorneys, accountants, some management consultants, architects, and physicians.

The service providers in the professional service segment work closely with clients to deliver unique solutions tailored specifically to individual clients. These professionals also offer complex solutions that the service provider must take time to sort through, to obtain the right solution or combination of solutions to satisfy the client. A physician, for example, faces uniquely individual challenges in making daily diagnosis. Though treatments are often similar they are not uniformly applied as ultimately each malady is distinctive, and each person treated requires personalized attention to his or her unique needs with the application of a variety of techniques.

In the case of professional services, unique solutions are devised by professionals that require high levels of client involvement to insure successful craftsmanship, application, and client satisfaction for successful product delivery. For instance, a client visiting an attorney for a legal matter must work closely with that attorney for a successful solution to the client's problem. Irrespective of whether a profession is formally accredited (e.g. attorneys and physicians) or not (e.g. management consultants and software designers), the service development processes follow a similar path involving highly skilled knowledge, applied creativity, experiencing client problems, and management of client interface skills, all often under the guidance of more senior professionals (Morris & Empson, 1998). Our discussion of optimal governance structures and constraints to growth will focus on PSFs, contrasting them with other types of service businesses, especially businesses which are low in product complexity and product customization. Such businesses may be seen as 'service factories' because they provide 'one size fits all' products with little customization on a mass, repetitive basis. Examples of service factories include fast food restaurants and airlines.

### **Governance of PSFs and constraints to their growth**

Possible governance structures include proprietorships, partnerships, private corporations, public corporations, public sector organizations, and the more recent *managerial professional business* (MPB) (Cooper, Hinings, Greenwood, & Brown, 1996). The creation of the public corporation in the nineteenth century drove out the partnership as the predominant form of organizational governance (Greenwood & Empson, 2003). However, the public corporation, which is the dominant form for organizations in other industries, is not a common form in professional services. In a public corporation and sometimes even in private corporations, shareholders are not actively involved in the running of the corporation. Instead, they are represented by a board of directors. In proprietorships and partnerships, on the other hand, ownership, management, and operations are merged. A partner is, therefore, an owner involved in managerial decisions and also a production worker at the same time (Greenwood, Hinings, & Brown, 1990).

We suggest that partnership governance is a necessary structure to support highly ambiguous service products, which contain both high levels of product complexity and high levels of product customization. However, partnership governance, although optimal for the governance of PSFs, might constrain their ability to grow in size. Successful PSFs have traditionally remained relatively small compared to those that offer standardized services. For instance, Bradford and Martin (2000), in their study of over 4000 physicians from around the country, found that the number of office visits to a physician

is positively related to the size of the firm. They found that the addition of more physicians to a firm enables the existing physicians to produce greater number of visits. However, as the number of physicians increases, the average time per visit (a proxy for provider quality) falls. The authors concluded that there is a natural boundary for the size of the physician firm, because patient demand for services is a function of the time per visit, therefore, continuing to increase the number of physicians in a practice yields reductions in quality, which decreases the overall demand for the firm's services.

We argue that a number of characteristics of professional services cause them to adopt professional partnerships and proprietorship forms of governance. However, these very characteristics also constrain their ability to grow in size. These include: (1) clan control, (2) knowledge type, and (3) agency issues. Further, we discuss three additional contributory factors, namely, diversification, reputational constraints, and resource constraints that might limit the ability of PSFs to grow beyond a point.

## **Clan control**

### *Clan control and governance*

Partnerships have a decided preference for professional control of tasks, limited hierarchy, and relatively loose forms of coordination (Hall, 1968; Morris & Empson, 1998; Smigel, 1963). Formally, all partners share the same and equal status within the firm, though some managing partners may have more responsibility for strategic direction. In his study of 'Big Eight' accounting firms, Montagna (1968) showed that informality of work groups is the norm and work groups are selected on the basis of their ability to work together and with clients (Hinings, Brown, & Greenwood, 1991).

Ouchi (1980) describes the nature of the basic relationship of the employee to the organization and the contrast between contractual and clan relationships. He suggests the factors delineating this fundamental relationship within an organization have to do with (1) the ambiguity of the measurement of individual performance and (2) the congruence of employer's and employee goals. He suggests that where individual performance ambiguity is high and where there is a great deal of congruence between individual and organizational goals, clan relationships exist and are exemplified by high levels of interpersonal trust, low levels of opportunism and low transaction costs. Thus Hinings et al. (1991, p. 377) define clan control as a state, '[Where] behavior [is] controlled through common values, traditions, and commitment to the organization is the norm, and where power rests with professionals in the production core'. They argue that partnerships are mostly governed through a system of 'clan control'.

Marcson (1962) described the partnership control system as one in which all members of the working group share authority, and power is deemed to reside in the group rather than in the individual. In such partnership organizations, the number of hierarchical levels is reduced because coordination and control is left more to the professional rather than to support administrators. Maister (1982) suggested that typical PSFs have only three general levels: owner partners, client managers, and junior staff (Hinings et al., 1991). It seems that the basis for control of professionals is ideally more normative than bureaucratic (Greenwood et al., 2005; Scott, 1998).

Collegial oversight is an important element of clan control, because only another professional with similar competencies, perspectives, and values can understand, appreciate, and fully judge the actions of the highly creative professional organizational member who is acting in a relatively autonomous fashion. The partnership distribution of authority has long been identified as unique in a professional services organization, because of its

emphasis on collegiality, peer evaluation and autonomy, informality, and flexibility of structure (Bucher & Stelling, 1969; Hinings et al., 1991; Montagna, 1968; Ritzer & Walczak, 1986). In most professional service organizations, work responsibility is indivisible and cannot be decomposed into discrete sets of activities through the implementation of hierarchical division of labor and bureaucratic rules (Greenwood et al., 1990).

Fama and Jensen (1983) argue that service quality is particularly important in professional partnerships, where variation in creatively crafted products can easily occur. The partnership arrangement of mutual joint ownership increases the incentives for the partners to consult with each other to improve quality. Thus collegiality makes a critical difference in areas where the value of professional human capital is most sensitive to performance variation.

Professional service organizations have found that the partnership arrangement, with its inherent clan control mechanisms, has produced superior retention effects through enhanced opportunity for professional advancement to the highest levels of the organization. With only a few levels of hierarchy, and the common 'up or out' process of culling top performers, the prospect of 'making partner' speaks to the achievement needs of the creative professional, as well as the commitment and skill requirements of the professional service organization. Motivation also comes from the opportunity to work on continually more interesting projects and with greater autonomy, while quality for the organization is assured with the tournament promotion policy (Morris & Empson, 1998). It appears that, for professionals, organizational commitment is enhanced by the realistic opportunity for advancement combined with creative freedom and oversight by like-minded and similar professionals.

Clan control in the partnership governance arrangement also relies on trust among organizational members as a consequence of the high degree of latitude given to professionals to perform independently and creatively. The alternative to trust is formal rules and control, which is incompatible with the delivery of highly ambiguous professional services, because collegial oversight, peer evaluation and autonomy, informality, and flexibility of structure all work toward creating a culture of trust in the organization. This culture of trust extends not just between professionals in the PSF but outward toward clients as well, because of the presence of the 'hazard of unknown product quality' experienced by the client.

With limited hierarchy and loose forms of coordination, service providers who offer highly ambiguous products have the structural freedom to allow the professional sufficient autonomy to offer customized, creative knowledge services. For instance, in their study of software development firms, Choudhury and Sabherwal (2003) found that organizational clan control was associated with high levels of client and vendor interaction with shared goals and values between them. Incremental increases in bureaucratic controls move the organization toward forms such as MPBs, and further to private and public corporations.

Ouchi (1980) argues that compliance with internalized norms and the resulting self-control of the clan form of organizing is closely associated with trust. By definition, clans rely on trust; therefore, proprietorship and partnership governance is most closely associated with trust. Trust can be said to conserve cognitive resources and simplify the acquisition and interpretation of information (McEvily, Perrone, & Zaheer, 2003; Uzzi, 1997).

### ***Clan control as a growth constraint***

The ability of PSFs to grow depends very much on their ability to standardize their offerings. As standardization of product becomes more predominant in an organization, control typically changes from clan to formal rules and authority. Standardization brings the

deployment of products that are more widely applied in similar fashion to the population of clients, therefore rules and regulations are used with greater regularity. Creativity is marginalized in order to ensure consistency. McDonald's, for example, is a 'service factory' that engages in extreme service product standardization, where individual judgment is almost completely eliminated, and standardized procedures for cooking time and temperature are enforced to ensure consistency.

Hinings et al. (1991) argue that the authority system in partnerships becomes problematic for dealing with long range, strategic change because of the lack of an organizationally prescribed, hierarchical system of decision making. To address shortcomings in the ability of PSFs to engineer change, some firms have turned to a different form of governance, the 'managerial professional business'. In contrast to the professional partnership, where clan control, democracy, and autonomy prevail, the MPB incorporates higher levels of bureaucratic rules, a reliance on stable rather than rotated leadership, and a separation of the controlling partners from clients, as well as higher levels of centralization and specialization within the ranks (Cooper et al., 1996).

Cooper et al. (1996) suggest that MPBs have taken root in previously pure partnership operations. This new archetype is somewhat similar to Mintzberg's (1979) professional bureaucracies, and emphasizes efficiency over autonomy and democracy, as well as a shift in authority control to non-production management. As the MPB emphasizes the importance of efficiency and effectiveness, it also features increased hierarchical layers, and bureaucratic implementation of rules for the purpose of heightened accountability of professionals as management takes on a more assertive and powerful role. Importantly, specialization of skills within the professions is also part and parcel to the MPB organization, as increased controls necessitate division of labor. There is a shift of values, and a 'different way of conceptualizing the relationship of the firm to its clients' (Cooper et al., 1996, p. 634) and commensurately less opportunity to build personal roles and a more bureaucratic definition of them (Cooper et al., 1996). The adoption of this governance type is commensurate with a move toward product standardization with less customization and reduced levels of product complexity.

We argue that with these additional bureaucratic controls, professional service providers might not have the latitude to offer highly customized solutions to the client. Likewise the specialized professional is limited in knowledge and experience to restricted product processes, thus reducing the complexity and intricacy of service delivery steps to process as the professional considers solutions for clients. Consequently, services offered by the successful MPB organization might be both more routine and more rudimentary in nature, therefore, of necessity more standardized.

## **Knowledge type**

### ***Tacitness of knowledge and governance***

The application of tacit knowledge to unique situations is an important trait of the PSF offering highly ambiguous products. Many service firms, in recent years, have been trying to embrace codification of their knowledge base by attempting to uniformly apply common knowledge. This allows them to leverage their knowledge assets and satisfy large numbers of customers in a consistent way. This codification effectively standardizes their knowledge product by moving it away from customization and from complexity. However, such standardization inevitably leads to a reduction of the amount of customer participation in the service process. Morris and Empson (1998), in their case studies of accounting and consulting industries, write:

... extensive process standardization is difficult, particularly when the client is actively involved in a production process, such as merger and acquisition work in corporate law firms. This client involvement adds to task uncertainty, requiring professionals to create their roles to some extent in the course of a client assignment. (p. 614)

In addition to reducing product ambiguity, codification also necessitates standardization of behaviors and hence, has implications for organizational structure and governance. The standardization of behaviors and skills requires implementation of bureaucratic methods of division of labor and oversight control, which leads to additional hierarchical levels within the organization (Morris & Empson, 1998). However, codifications and standardization necessitating the resultant formal hierarchies and bureaucratic control are hardly suited to and unlikely to succeed in knowledge intensive industries (Abernethy & Stoelwinder, 1995; Mueller, Boyer, Price, & Iverson, 1994; Raelin, 1991; Tolbert & Stern, 1991; Wallace, 1995).

A variety of knowledge management strategies have been found within the professional service sector (Morris & Empson, 1998) with varying levels of dependence on hierarchies. Research by Hansen, Nohria, and Tierney (1999) on management consulting firms found fundamental differences between firms who used a codified knowledge approach, such as Andersen Consulting and Ernst & Young, and firms using a personalized knowledge approach, such as McKinsey & Co., Boston Consulting Group and Bain & Co. The services that Andersen and Ernst & Young offered were much more standardized and less ambiguous, and relied on codified knowledge that was stored, disseminated, and reused again and again. Management consulting firms of this variety might be called 'best practice' providers. On the other hand, Bain, Boston Consulting, and McKinsey relied on their ability to develop networks that linked people so that tacit, unique knowledge could be shared. Management consulting firms of this nature might be referred to as 'customized solution' practices. Organizationally, Andersen and Ernst & Young appeared to be more bureaucratized than McKinsey, Boston Consulting, and Bain.

### ***Tacitness of knowledge as a growth constraint***

In their study of management consulting firms, Hansen et al. (1999) found that firms employing personalization strategies in selling highly ambiguous products are offering their clients advice that is rich in tacit knowledge. This process of sharing deep knowledge is slow and methodical, because tacit knowledge cannot be codified or stored and it is mostly applied uniquely to unique situations. Codified knowledge, on the other hand, saves work, reduces communication costs and allows a company to take on more projects, thus allowing the firm an enhanced opportunity for growth. Hansen et al. (1999) note that Andersen Consulting and Ernst & Young had grown at a rate of 20% or more in recent years, were much larger and had much higher growth rates than the firms using personalization strategies, such as McKinsey, Boston Consulting Group and Bain & Co.

Hansen et al. (1999) also found similar results in the health care industry, contrasting Access Health's strategy of codification of knowledge with Memorial Sloan Kettering Cancer Center's personalization model that features tacit knowledge application. Access Health had developed a software algorithm that helps insurance companies and provider groups diagnose patients over the phone, saving on unnecessary emergency room and doctor's office visits. The first 300 algorithms that Access Health developed were each used over 8000 times per year. Memorial Sloan Kettering Cancer Center, in New York City, offers highly customized advice and treatment to cancer patients utilizing a variety of experts giving individual attention to each case and managing the experts'

collaboration process. Memorial Sloan Kettering coordinates 'intensive face to face communication in order to insure that knowledge is transferred between researchers and clinicians and between different types of clinicians' (Hansen et al., 1999, p. 111). Hansen's researchers found that Access Health was growing at over 40% per year, while Memorial Sloan Kettering was consistently ranked as the top cancer research and treatment institution in the country. These represent two very different paths to success, associated with two very different service product classifications.

In their comparative case studies of UK accounting and consulting firms, Morris and Empson (1998) explain, 'codification (of knowledge) is a necessary condition for the growth of the firm and the maintenance of a coherent service offering and effective control systems across the organization' (p. 618). They found that larger, faster growing firms consistently and successfully reused knowledge, standardized work tasks, then delegated the tasks to junior staff enroute to leveraging that knowledge. Coff, Coff, and Eastvold (2006) could not find support for their hypothesis that telecommunication technology can be used to leverage tacit knowledge without codification. The success of most professional service enterprise is based on tacit knowledge. However, the problem with tacit knowledge is that it is not easily scalable as scalability requires codification and ease of replication. Thus, the reliance of professional services on tacit knowledge limits their ability to grow in size.

## **Professional service organizations and agency**

### ***Agency problems and governance***

Agency theory has been widely used in recent years as a powerful lens for organizational analysis, especially for studying governance issues. An agency perspective analysis of PSFs reveals the relationship between the high cost of supervising non-routine behavior and the appropriateness of partnerships as a governance structure (Fama & Jensen, 1983). The problem of finding and motivating an agent to act in the best interests of the principal is at the heart of the agency problem. The relationship between the principal and the agent is complicated when there is knowledge asymmetry between the two parties, thus creating the potential for opportunism on the part of the agent. The principal can neither be sure that the agent has the competence for the task (the problem of adverse selection) nor that the agent will put forth maximum effort and act in the best interest of the principal (the problem of moral hazard). As a result, the principal incurs costs related to gathering information, monitoring the agent, and enforcing the contracts.

A solution that Fama and Jensen (1983) propose for agency problems is decision control of agents by principals. They suggest that an effective system for limiting agency costs is the separation of ratification and monitoring of decisions from management of decisions. The public corporation epitomizes this system of separation where principals exercise control through representation in the boards of directors, which monitor management. Fama and Jensen (1983) suggest that another feasible solution to the agency problem is to combine the roles of the principal and the agent, and this is exactly what is done in partnerships and proprietorships prevalent in professional service industries.

The separation of decision control and management varies significantly based on the type of the organization and varies from none in small partnerships and proprietorships, to incrementally greater extent in large partnerships, the somewhat more hierarchical MPB (Hinings et al., 1991), private corporations and finally, to public corporations, as the separation of ownership and control increases. Closely held firms that feature

mutual risk of joint ownership, such as partnerships, rely on clan control, which allows for mutual reliance and non-specialization of decision functions. This seems to be further evidence that a solution to agency problems in firms offering highly ambiguous service products lies in combining the roles of the principal and the agent.

Agency costs can be divided into two broad groups: external and internal (Greenwood & Empson, 2003). All public corporations face external agency problems due to the separation of ownership and management. This agency problem is resolved through both monitoring (board of directors) and incentive alignment. In a partnership or proprietorship, because the roles of the principal and the agent are combined, external agency costs are effectively eliminated. However, partnerships and proprietorships do face *internal* agency costs. In larger, more complex partnerships, responsibility for managing the business is delegated to a small group of partner/owners who become the 'managing partners'. More often than not this responsibility is given to older partner/owners who may not have the same interests as younger partners. For example, investments or business upgrades that may have long-term payouts or returns might be shunned by older partners who might not plan to be involved in the business long enough to obtain benefit from these investments. Restraint of the risk of opportunism for internal agency is manifested by partners who are (1) knowledgeable about the businesses, (2) proximate to those they supervise, and (3) reliant upon collegial scrutiny (Greenwood & Empson, 2003). Any increase in the number of hierarchical levels in a partnership organization only serves to increase internal agency costs. As hierarchical levels increase, at some point, internal agency costs will begin to exceed external agency costs, forcing a separation between ownership and management. This, in turn, will lead to a change in the governance form to more hierarchical types, which inevitably will reduce the reliance on clan control.

Importantly, a transition to more hierarchical forms of governance would compromise the firm's ability to offer ambiguous products. Sharma (1997) views the client-PSF relationship itself as one of agency, wherein the client is extensively involved in the service delivery process yet experiences high levels of knowledge asymmetry. He argues that this extra-firm agency problem is as important to the organization as internal agency issues. He writes:

... principal (client)-professional exchanges are inherently those in which professionals have power over lay principals by virtue of their expertise, functional indispensability, and intrinsic ambiguity associated with the services they provide. Such agency exchanges involve information asymmetry that is particularly severe, since principals do not possess the technical knowledge to evaluate the effort invested in or the outcome accomplished by professional agents. (p. 768)

Sharma (1997) also suggests that this knowledge asymmetry is more acute under circumstances, where the client must rely on the professional's tacit knowledge as opposed to more codified knowledge. This implies that standardized products would incur lower levels of client/professional agency costs on the part of the client.

Sharma (1997) explains that the restraints on the professional as agent in the relationship with the client include (1) the professional's altruism and self-restraint, (2) reputation in the community, (3) the format of collegial supervision and evaluation, and (4) utilization of specialists for separate portions of the service product. Also, while utilization of specialists might allow the client to break the service product down into more understandable parts and spread the risk of agency costs over more professionals, highly ambiguous products may not be readily broken down into components. The governance solution of the agency problem in professional service organizations thus lies in the choice of partnerships as the form of organization and extensive reliance on clan control. Greenwood

and Empson (2003) suggest that both the creative professional's expectations of autonomy and freedom from constraint and the high cost of supervising non-routine behavior combine to keep partnerships a viable governance structure for professional services organizations.

### *Agency problems as a growth constraint*

Although an agency analysis leads to the identification of partnerships as the optimal governance form for service organizations, ultimately agency issues conspire to constrain their ability to grow. Combining the roles of the principal and the agent limits the organization to only those individuals who can bear the financial risk of ownership yet still provide managerial expertise (Fama & Jensen, 1983). First, the number of individuals who possess both of these qualities tend to be limited. Second, those individuals might be less willing to shoulder a high level of financial risk for the furtherance of the firm than if the organization could rely on unrestricted risk sharing as a public corporation. This invariably leads to less investment in risky projects on the part of the closely held firm and thus forms an obstacle to growth.

Third, internal agency costs begin to rise as the partnership grows and management is increasingly delegated to a small group of partner/owners (Greenwood & Empson, 2003). Internal agency costs are minimized as long as the other partners remain proximate and knowledgeable about the organization, but this becomes increasingly difficult as the firm grows. With growth in the partnership, internal agency costs commensurately grow until at some point it becomes more efficient to separate decision control and management and incur external agency costs. However, as we argued earlier, ambiguous products do not lend themselves to other forms of governance in which external agency costs prevail, because the tacit knowledge, involvement of the customer in the production process, and the ambiguity of the product make formal hierarchies and bureaucratic control structures unlikely to succeed (Abernethy & Stoelwinder, 1995; Greenwood & Empson, 2003; Mueller et al., 1994; Raelin, 1991; Tolbert & Stern, 1991; Wallace, 1995). Thus, these characteristics deter movement toward externalization of agency relationships. Consequently the service firm providing ambiguous products incurs increased internal agency costs as it grows with no available remedy of externalization, and these internal agency costs become a natural growth inhibitor for the partnership form of governance.

Professional service firms incur higher internal agency costs than other types of firms because the employee (agent) role is hard to precisely evaluate. Under conditions of clan control, peers can more readily ascertain whether the agent is shirking or providing valuable services, but as the firm moves toward more bureaucratic governance, assessment becomes increasingly difficult as managers become further removed from the service delivery process. This increases the risk that the agents will behave opportunistically either by shirking or by overstating their contribution, knowing that detection is difficult (Morris & Pinnington, 1998).

The alternative is to standardize the delivery of services so that agents can be evaluated more readily; however, this action detracts from the ability to offer ambiguous products. For the PSF with a growth strategy, the decision therefore must be whether to incur increasingly high agency costs or to reduce them through standardization.

The traditional approach to motivate professionals in PSFs has been to offer them ownership in part of the equity of the firm, which becomes, in effect, a system of deferred payment (Fama & Jensen, 1983). This opportunity is more significant to the agent than stock options to employees in a public corporation because it is at the same time an

occasion for significant financial reward, as well as achievement, prestige, and meaningful power of control in the future direction of the firm. As Morris and Pinnington (1998) point out, creating a competition for a limited number of partnership positions provides a solution to the shirking problem by offering a large reward to those deemed to have performed well and heavily punishing those deemed unsatisfactory. Because partners are selected based upon their aptitude to create knowledge work for the firm rather than for their financial wherewithal, lack of funding from owners constrains the firm's ability to undertake growth. Further, owners are less likely to engage in business decisions that involve risk for the firm (Fama & Jensen, 1983). Unlike publicly held corporations with their large numbers of potential investors, the limitation of restricted ownership available in partnerships, and to a lesser extent in private corporations and MPBs, also restricts the ability of the firm to grow.

The growth of the PSF increases pressure for division of labor, rules, and control to limit agency costs. However, these same bureaucratic remedies also impose limitations of freedom for creative professionals, along with the abandonment of clan control, and these are conditions which are incompatible and unsatisfactory for the delivery of highly ambiguous products.

### **Product diversification as a constraint to growth**

Chandler's (1962) classic study of the growth patterns of industrial corporations clearly shows that diversification is one of the most favored paths to growth. As Greenwood and Empson (2003) point out, growth in any firm will invariably create heterogeneous groups that suffer diluted and contested values. Hansen et al. (1999) argue that the diversification of any organization creates a need for diverse professionals who no longer closely share perspectives and values. This would detract from a firm's ability to engage in effective clan control, because peer review and collegiality mechanisms break down, when disparate professionals no longer share values and perspectives. Thus, the PSF in particular faces pressures to limit diversification, and therefore, opportunities for growth, to products that are closely related to their current offerings.

Diversification in the PSF also appears to have a bearing on internal agency opportunism increasing the costs of monitoring and metering (Greenwood & Empson, 2003). Collegial supervision and evaluation, which are an integral part of clan control, are the only mechanisms that can prevent agent opportunism in professional service organizations. Given the difficulty involved in establishing clan control in a diversified organization, it seems clear that professional service organizations do not have the luxury of turning to diversification as a means for growth.

### **Reputational constraints on growth**

Another important constraint on agent/provider opportunism is the firm's reputation, which is scrutinized by a community of professional peers and lay individuals outside the firm (Sharma, 1997). Insensitive actions on the part of the agent/provider can have an effect that extends beyond a single agent (provider)–principal (client) exchange. According to Greenwood et al. (2005) PSFs have 'exoteric expertise that clients believe is beyond their own competence' (p. 663). Consequently, the client '... cannot judge the expert's advice or reports on substance' (Starbuck, 1992, p. 731). Nor can the client evaluate a firm's claim that it has a better competence than other suppliers. Instead

consumers are obliged to use 'social proofs', such as reputation or status (Rao, Greve, & Davis, 2001).

Podolny (1993) also suggests that reputation affects transaction costs for the client, noting that where interpersonal and inter-organizational networks are critical to doing business the costs of obtaining information about the provider are reduced when provider's reputation is strong. Podolny (1993), in his bank underwriting study involving high quality securities, found that higher status banks realized that their reputation with investors, position in the market, and cost structure, were contingent on their ability to preserve their ties with high quality clients. He concluded that providers would halt production before reaching a level that threatens identity. His conclusion is that reputation assuages client uncertainty and the inability to bear the informational cost of search, offering an advantage to providers with high reputations. This research suggests that providers with higher status and reputation have lower administrative costs because they do not have to spend as much to attract and keep clients. Podolny (1993) also contends that a provider risks its reputation and status if it approaches low-status markets, so high-status providers are limited in their ability to grow and take over entire markets. As high-quality clients are limited in number and size, the PSF's ability to grow is constrained.

In their case study of management consulting firms, Hansen et al. (1999) found that reputation and status are more significant for the PSF than for the SF firm. They associate highly ambiguous products to firms that invest heavily in building networks of people. Reliance upon networks and resulting embedded relationships to deliver ambiguous products describes a process of sharing deep knowledge between the client and the provider. This process is time consuming, expensive, and slow. It cannot be truly systematized, and so it cannot be made efficient. Further, it is difficult to hire many new consultants in a short period, because every new person needs so much one-on-one training. These researchers suggest that for these two reasons, PSFs find it difficult to grow rapidly without sacrificing their customized approach.

Greenwood et al. (2005), in their study of the 100 largest accounting firms, theorized that stronger reputation gave the organization strategic advantages by enhancing the ability to hire the best professionals, by lowering the firm's marketing costs, because clients actively seek high-status firms (Podolny, 1993, 1994), and by allowing them to charge premiums for their services relative to other firms. They point out that 'reputation stickiness', or the difficulty of transferring reputation from one product or service to another, was particularly pronounced in PSFs. This implies that longevity and success for the PSF are not dependent upon growth, but rather the firm's ability to tap slow developing embedded relationships and the patient deployment of timely related services; all again associated with products of an ambiguous nature.

### **Resource constraints to growth**

In professional service governance control and management are unified, and so risk is borne directly by those that manage. However, this system also sacrifices the benefits of unrestricted risk sharing and the specialization of decision functions, which are traits of more bureaucratic organizations. 'The decision process suffers efficiency losses, because decision agents must be chosen on the basis of wealth and willingness to bear risk, as well as for decision skills' (Fama & Jensen, 1983, p. 306). Thus, the ability to gather resources to grow a firm is limited to the owner/manager with limited opportunity to seek growth funds from outside the firm.

### Conclusions and managerial implications

Our arguments in this paper suggest that there is a clear correspondence between the type of service offered by a firm and the type of governance form it chooses. Our basic argument is that in professional service organizations, clan control, knowledge type, and agency are inter-related factors that inter-dependently relate professional partnership governance to ambiguous products. Standardization of products requires a concomitant governance shift to more bureaucratic forms of governance. We further argue that while partnership governance might be optimal for professional service organizations, this form of governance has implications for the firm's ability to grow.

Any attempt to retain high levels of product ambiguity in the face of organizational shifts to alternate governance forms such as the MPB may lead to transitional failure or performance reductions. Hinings et al. (1991), for instance, show how the introduction of a MPB transition failed in an accounting firm, because the changes were seen to challenge existing interpretations of governance and professionalism (Cooper et al., 1996). Additional support for this perspective comes from Greenwood, Li, Prakash, and Deephouse (2005) who, in their study of the largest 100 accounting firms, found a 'U' shaped relationship between leverage ratio and performance. Leverage ratio is the number of professionals in the organization to the number of partners, which is a proxy for the hierarchical density and bureaucratization of the organization. For professional services, increasingly higher ratios (more bureaucratization) were associated with lower performance, up to a point. Thereafter, the benefits of optimized knowledge transfer begin to bring performance up. We suggest that these performance increases are a result of professional services becoming more standardized. On the far side of the 'U' organizational use of codified, explicit knowledge typical of more standardized products, which is readily transferable, begins to occur rather than tacit knowledge, which is not readily transferable. Additional empirical support for our argument that standardization of a service leads to more bureaucratized forms of governance comes from Martinez-Tur, Peiro, and Ramos (2001), who found in their study of sports facility services that more hierarchical forms of governance (government) performed similarly to private organizations when service products were simple, but that private organizations performed significantly better when service products were complex, and therefore, more ambiguous.

As PSFs pursue growth, they face a classic efficiency versus effectiveness trade off. Volume growth requires increasing standardization, which inevitably leads to a diminishing ability to produce ambiguous products using tacit knowledge and creativity. A recent in-depth qualitative study of three law firms in the UK, as they moved from partnership governance to a managed professional business form of governance by Lawrence, Malhotra, and Morris (2012), provides several interesting insights. To begin with, these three firms were similar in terms of their histories and sizes. As they transitioned from partnership to MPB governance, all three firms found it necessary to standardize their product offerings, focusing on a narrower range of limited service offerings. Significantly, the firm with the highest growth level also was rated as the firm with the most thorough and complete transition to MPB governance by the researchers. This suggests that as separation of ownership and control occurs in PSFs, internal mechanisms that supported the creation of ambiguous products are no longer robust. As formal control mechanisms become established, individual autonomy is sacrificed for approved processes, rules, and bureaucratic oversight. With collegial oversight no longer in place, managing professionals become less aware of the unique circumstances of functional professional service delivery. Thus, a drive toward less ambiguous, standardized products seems

likely. Eventually, this fosters less creativity to offer unique solutions, more routinization, and leads to a greater reliance on explicit rather than tacit knowledge, which is more easily standardized and shared. The emphasis slowly shifts to high-volume, low-margin products instead of ambiguous products with higher margins. Ultimately the trade-off for professional service managers might be whether to efficiently produce standardized products and achieve higher levels of growth, or to effectively produce highly customized ambiguous products with an attendant limitation of growth.

In recent years there has been a growing trend toward public ownership in certain professional service industries, such as advertising and management consulting. How does this pattern of external ownership fit in with our arguments that partnership form of ownership is ideal for PSFs and that attempts at growth would affect their ability to provide ambiguous services and maintain clan control? Recent research by von Nordenflycht (2007, 2010) offers some valuable insights regarding the trend observed in advertising and consulting industries. Based on the three characteristics of knowledge intensity, low capital intensity, and professionalization of work force, he proposed a taxonomy of PSFs. These are technology developers, neo-PSFs, professional campuses, and classic PSFs. While law, accounting, and architecture firms are classic PSFs, he includes consulting and advertising firms as neo-PSFs. While both PSFs and neo-PSFs have high knowledge intensity and low capital intensity, they differ in one important respect. Classic PSFs are staffed by professionalized work forces, whereas advertising and consulting firms do not have a professionalized work force. It is the presence of a professionalized work force with its set of professional norms and ideologies, self-regulation, and professional associations with relatively strict rules to qualify as a member that leads to resistance of outside ownership and reliance on clan control. The arguments we presented in this paper are more applicable to classic PSFs and professional campuses and perhaps only to a lesser extent to neo-PSFs who offer products with less ambiguity. An important area for future research is the governance of neo-PSFs, such as advertising and 'best practice/standardized solution' management consulting firms. We believe that as these types of firms pursue growth and switch their governance structure to public corporations with considerable outside ownership, product standardization, and less customization would inevitably become the norm. This is already evident in the case of firms such as Booze, Allen, and Hamilton which has increasingly focused on standardized, best practice solutions, such as 'Right-T' for right-sizing IT departments and 'Balanced Sourcing' for purchasing goods and services. Additionally, Greenwood, Deephouse, and Li (2007) found empirical evidence in the management consulting industry supporting their hypothesis that partnerships and private corporations would outperform public corporations.

It is also important to point out that growth is not a goal that all firms seek. Thousands of small family owned businesses make a conscious choice to remain small, because growth often necessitates hiring outside managers or accessing external sources of capital. Both these actions have the potential to reduce control by current owners. In the case of many professional services, such as attorneys and architects, it is entirely possible that the fear of loss of control may be a factor inhibiting partners from pursuing the growth option.

The present paper's arguments based on clan control, knowledge type, and agency, as well as constraints on diversification, reputational and resource constraints suggest that ambiguous service products are optimally offered by service firms organized mostly as professional partnerships and employing a strategy of slow growth. Although we did not undertake a detailed elaboration of the governance implications of the three constraints mentioned above, it is clear that they also have similar implications for the governance

structure of PSFs. As standardization of product increases, optimal growth strategy can shift incrementally to more rapid growth.

Importantly, from a practitioner perspective, the limitations to growth in the professional service sector should not be considered a limitation to long-term success. To the contrary, prior research suggests that PSFs offering ambiguous products can be very successful without growing, when they use closely held forms of governance such as partnerships. Prior research also suggests that growth, scale, economy, and higher profits are possible with standardized products, but that higher margins are more likely with ambiguous products (e.g. Hansen et al., 1999; Levitt, 1976; Morris & Empson, 1998; Schmenner, 1986). As Granovetter (1984) points out, small firms in a market setting may persist against large corporations, because a dense network of social relations is overlaid on the business relations connecting such firms, thus reducing pressure to grow.

The development of theoretical insights and their empirical testing with regard to the governance of PSFs and the conditions under which they can successfully pursue growth are still in their early stages. One interesting direction for future research involves the relationship between PSF growth and their ability to retain professionals. For professional service organizations offering highly ambiguous products, satisfactory service delivery and the development of professional expertise reside in the experiences and creative skills of its professional staff. Due to the high mobility of professional providers (Von Glinow, 1983), and the potentially detrimental loss of knowledge and expertise to the firm, retention can be a significant challenge for the PSF. Arthur Anderson purchased the French law firm of S.G. Archibald in 1992 and lost almost 80% of the acquired firm's lawyers in the next six years. Loss of professionals is costly to a PSF because it depletes the organization's ability to deliver customized services and it severs relationships with clients, which is often followed by client defections (Baker, Faulkner, & Fisher, 1998; Greenwood et al., 2005; Levinthal & Fichman, 1988).

In order to advance empirical investigation of PSFs, it is important that we develop valid and reliable measures of service product ambiguity or opaqueness of quality. As von Nordenfytcht (2007) points out, there is considerable heterogeneity among PSFs and this has important implications for both their governance and growth. The examination of the implications of this heterogeneity among PSFs for their choice of governance structures and growth strategies represents a promising direction for future research.

Professional service firms considering high-growth strategies should also consider the importance of customer relationships, which are often nurtured due to the professional's freedom in the system of clan control that prevails in partnership governance. For instance, Bendapudi and Berry (1997) identify performance ambiguity as an important element of a customer's rationale for establishing and maintaining a relationship with a service firm. When performance cannot be easily evaluated, as in products that are ambiguous, the customer is more likely to favor maintaining a long-term relationship with the provider. Some services are clearly more ambiguous than others (e.g. mental therapy is more ambiguous than carpet cleaning) and higher ambiguity generally leads to a greater dependence on the relationship partner. Granovetter (1984) suggests that embedded relationships within dense social networks can overcome deficiencies of trust between people. Embedded relationships take time to build and are based on prior experiences and expected future relationships. Being longitudinal in nature they are much less subject to the opportunism presented by one-time encounters between individuals. In a long-term relationship the professional's incentive is to minimize opportunism to encourage repeat business, and the client has a much greater opportunity to assess and observe the provider's behavior (e.g. Axelrod, 1984; Lambert, 1983).

Why has the partnership form of governance prevailed in professional services, while being supplanted by public corporations in other service industries? Handy's (1989) prediction that with the continued rise of the service sector and the creative knowledge worker organizations would come to integrate employees as partners in an organization run by persuasion and consent seems most appropriate for professional service organizations. He predicted that as organizations offering highly creative and ambiguous products continue to become more important in the world economy, partnership governance will also become more important, but their expansion in terms of scale and scope, as well as their governance are likely to be very different from the patterns observed in the manufacturing industries of the past. Managers of PSFs should, therefore, be cautious in their desire to grow in size or embrace governance structures such as public ownership because both rapid growth and resulting changes in governance structures are more likely to lead to failure than success.

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