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Paper Title: Implications of Competence and Governance Strategies for Entrepreneurial Growth

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Implications of Competence and Governance Strategies for Entrepreneurial Growth

Abstract

In this study, we examine the implications of the pursuit of two of strategic management's major theories, governance and competence, by small businesses, for entrepreneurial growth. While the performance implications for large enterprises, of these two theory areas, are well documented in the strategy literature, far less is known about their applicability and effectiveness in the small business context, or their implications for growth versus performance. Our results indicate that while both governance and competence strategies are positively associated with growth, attempting to be flexible and doing both, is not. We conclude with a discussion of our results and their implications for future research.

Keywords: Strategic Entrepreneurship; Value-Price-Cost; Competitive Intensity; Growth Expectations

Introduction

To engineer strategic growth through entrepreneurial activity, firms must continually explore and exploit opportunities that arise in their marketplaces. This identification and capitalization process derives from the skills and orientation of the firm's management team and founders (Fern, Cardinal, & O'Neill, 2012) in addition to the creation of firm capabilities and competencies (Hitt, Ireland, Sirmon, & Trahms, 2011). The adoption of a strategic approach to this process of opportunity exploitation is likely to yield positive returns for the firm. This involves a concentration of effort over time on activities that yield a consistent approach to the market. While we have an understanding that competencies, capabilities, and strategic decision-making influence overall performance in large firms, this is not currently the case in small business.

Research in the economics and strategic management fields highlights the existence of a basic suite of explanations for the emergence of extraordinary profits (Makadok, 2010; 2011). We focus on two of the major ones in this paper: governance-based theories and competence-based theories. In the case of governance, the firm seeks to reduce the cost of doing business. In this pursuit, it increases the efficiency of exchange mechanisms through improvements in governance and cooperation between exchange partners. In the case of competence-based theories, firms maximize the value delivered to a customer through superior resources and knowledge. While evidence exists that these approaches do indeed have an impact on performance, few studies consider small businesses (Bozec, Dia, & Bozec, 2010; Williamson, 1999). Moreover, there is also a need to consider interaction effects between these profit maximization approaches (Makadok, 2010; 2011).

In this paper, we address two crucial questions for strategic entrepreneurship. Firstly, we ask do governance and competence-based explanations of extraordinary performance apply equally to small business cases. In asking this question, we consider the impacts of these two approaches to achieving strategic outcomes in a little understood area. Secondly, we investigate whether a third approach, one that derives from strategic flexibility also achieves extraordinary growth. In taking this step, we partially address Makadok's (2010; 2011) call for further exploration of the interaction effects between rival explanations.

To achieve these outcomes, we expand the conceptualization of strategic outcomes. Rather than considering overall performance indicators, we focus on the elements of the value proposition the firm presents to the market. We build on the emergent 'Value-Price-Cost' (VPC) framework from the strategic management literature to achieve this (Adner & Kapoor, 2010; Bensanko, Dranove, & Shanley, 2000; Brandenburger & Stuart, 1996; Coff, 1999; Makadok, 2010). The advantage of the VPC framework is that it considers the key elements of a market exchange. This allows an attribution of outcomes at this level while reducing the impact of unrelated factors that affect overall performance indicators.

The paper begins with a review of the two primary explanations of profitability and the VPC framework before developing a series of hypotheses and describing a conceptual model that underpins the study. Following the model and hypothesis development, we present and discuss the methodology and our results. We conclude with a general discussion of our findings and their implications for and contributions to future research.

Theoretical Background

Theories and perspectives of the sources of sustained profitability are central to strategy, and provide potential ways to understand why/how firms make and sustain profit in the face of competition. Strategy is essentially a decision regarding how to balance the firm's tradeoffs of being efficient (reducing costs to improve profitability) or being effective (increasing value and price to improve profitability), based upon the requirements of its competitive environment. A host of factors, not the least of which is the environment in which the firm operates, complicates management's ability to strike the optimal balance between these two orientations. Depending upon the firm's current environmental conditions, it may be more advantageous to be effective than efficient (i.e. flexibility to respond to a rapidly changing environment), or it may be more advantageous to be efficient than effective (i.e. economies of scale to operate at the lowest cost in more stable environments). Williamson (1991) adopts this approach by clustering management strategies under two general headings of Strategizing and Economizing. In this view, strategizing, represents the more recent view of management strategy and consists of approaches to effectively selecting the best industries and markets, attaining competitive positions in them, and exercising power within these industries and markets (Williamson, 1991). With a strategizing approach, competitive advantage may results from "first mover" type advantages attained through correctly identifying new opportunities and markets, and having the strategic flexibility to pursue such opportunities before they stabilize and become highly competitive. Alternatively, Williamson's (1991) second category of management strategy, economizing, is a more classic management perspective and is concerned with notions of efficiency in "governing" the firm. With this strategy, firms achieve competitive advantage through efficiently governing the firm's resources, operations, and transactions. Collectively, management's orientation between strategizing and economizing receives great influence from the environmental conditions in which the firm operates.

Governance perspectives focusing on efficiency and cost reduction, while fundamental, were most likely overwhelmed by the emergent and sustained popularity of competence perspectives such as the resource-based view (Barney, 1991) and flexibility perspectives such as dynamic capabilities (Teece, Pisano & Shuen, 1997; Eisenhardt & Martin, 2000). These types of perspectives focused more on increasing the top line (i.e., enhancing value, enabling increased demand, price, and volume) over decreasing costs (although some arguments could likewise be made for employing flexibility to do either or both). Thus, for much of the past decade, scholars have examined, refined, and generally struggled to make sense out of these competing theories. Some more recent work, by Makadok, provides a categorization approach to frame and organize strategic management's major theories into one of the four following categories: *governance, competence, flexibility, and collusion* (Makadok, 2010; 2011):

- ***Governance-based theories*** - profit persists because superior alignment of interests and motivations between transaction partners (either within firms or between firms) allows superior teamwork, thereby creating superior economic value.
- ***Competence-based theories*** - profit persists because weaker firms cannot fully compete away the superior economic value created by stronger firms.
- ***Flexibility-based theories*** - profit persists because more flexible firms respond faster to the changing demands of their environment, and so get temporary protection from competition by slower-moving rivals.
- ***Collusion-based theories*** - profit persists because competition is tacitly restrained.

Our interest in this study, as framed by the VPC framework, is primarily on the first two categories, governance and competence, with some consideration of flexibility as a grounding for the agility to pursue both. Given this focus, we intentionally exclude the monopolist category of collusion, due to its lack of applicability to the context.

The VPC Framework

In the VPC framework, a buyer and supplier bargain over the price (P) for a good that contributes a value (V) or benefit to the buyer and costs the supplier some amount (C) to produce. In the VPC framework, a buyer and supplier bargain over the price (P) for a good that contributes a value (V) or benefit to the buyer and costs the supplier some amount (C) to produce. Value is the price a buyer is willing to pay for a good absent competing products or services yet within budget constraints and considering other purchasing opportunities. The good's market price lies between value and cost. Therefore, the buyer receives a surplus of value minus the price (V − P), and the supplier receives a profit of price minus cost (P − C). The supplier's resources and capabilities, in turn, influence the value of the good to the buyer and/or the cost of producing it. In this framework, the firm that produces the largest difference between value and cost (total economic surplus) has a competitive advantage over rivals. It can either attract buyers due to the better buyer surplus its product offers (V − P), make a higher profit (P − C), or both.

Hypothesis Development

Governance-based Theories and Growth

Governance-based theories, involves the concept of efficiency, which focuses on issues of market versus hierarchy structures for coordinating a firm's activities. The perspective evolved from the work of Coase (1937), and were built upon later by Alchian and Demsetz (1972), Williamson (1975), and Jensen and Meckling (1976) and is perhaps best known through the Transaction Cost Economics (Williamson 1975), and Agency Theory (Jensen & Meckling 1976). The economic profit mechanisms for the firm in this perspective can include "Coaseian" transactional efficiency rents (Coase 1937) and "Ricardian" operational efficiency rents (Ricardo 1817). Governance perspectives are historically one of the most utilized and cited in traditional strategy research.

Firms pursuing a governance-based strategy will choose to lessen costs incurred through producing the product (i.e., minimizing "C" to maximize the P-C profitability spread). Under this circumstance, the firm reduces total cost of ownership and, consequently focuses on the minimization of governance costs. This approach results in competitive differences due to the development of lower cost bases. This approach results in growth through the capture of both expanded current market as well as new market opportunities. Stated formally:

H1: Governance-based value propositions will be positively associated with growth

Competence-based Theories and Growth

Competence-based theories, evolved fairly recently, but can trace their roots back to the work of Ricardo (1817), Penrose (1959), and Demsetz (1973) (Makadok, 2010; 2011). This perspective was developed in the 1980's as the Resource-based View of the firm (Lippman & Rumelt 1982; Wernerfelt 1984; Barney 1986), and popularized in the 1990's (Barney 1991; Peteraf 1993). RBV has become one of the dominant strategy theories and is one of the most popular, and heavily cited. The economic profit mechanisms for the firm in this perspective can include "Ricardian" operational efficiency rents (Ricardo 1817), "Coaseian" transactional efficiency rents (Coase 1937), and "Banian" monopoly power rents (Bain 1956).

In the situation where a firm seeks to maximize the value derivable to customers, it will sustain a higher price (i.e., increasing "V" and "P" to maximize the P-C profitability spread). Under this option, we argue that the firm adopts an approach to maximize perceived value and is related to the development of superior competencies (competency-based strategy). These competencies are valued by consumers and thus yield higher prices and increased demand, supporting higher growth. Stated formally:

H2: Competence-based value propositions will be positively associated with growth

Flexibility-based Theories and Growth

Flexibility-based theories evolved in part from notions of dynamic capabilities (Teece et al. 1997; Eisenhardt & Martin, 2000) approaches to responding to environmental change. This flexibility perspective is based on Schumpeter's (1934) notions of creative destruction where the "old" must be destroyed to facilitate the "new." This perspective includes evolutionary views of firm behavior and routines (Nelson & Winter 1982) as well as capabilities. In this perspective, the economic profit mechanism for the firm is "Schumpeterian" flexibility rents (Schumpeter 1934), and the causal mechanism for superior profitability is the effective allocation of firm resources to market opportunities on an ongoing basis to create temporary competitive advantages and superior profitability (Makadok, 2010; 2011; Teece et al. 1997).

Generally, most scholars accept that changes in the environment can substantially affect the firm and its strategy (Schumpeter, 1934; Nelson & Winter, 1982; Teece et al. 1997). Thus, while we do not directly hypothesize such a moderation effect for the numerous environmental constructs of which one may conceive, we include several as control variables in our model. We do however, directly theorize that the firm must be flexible to respond dynamically to changes in its environment and thus at times strategize as well as economize to either greater or lesser extents. As such, a firm may employ both competence and governance perspectives together in the pursuit of growth. These approaches constitute two broad strategic thrusts that firms use to build and maintain entrepreneurial growth. As such, their interaction effects may be either additive or sub additive. Unfortunately, the combined implications of such interactions remain relatively under theorized (see Makadok 2011 for one exception) particularly for growth and largely unexamined in general. Thus, we propose speculatively that the combined pursuit of competence and governance strategies will be negatively related to growth. Stated formally:

H3: The combined pursuit of Competence and Governance-based value propositions will be negatively associated with growth.

Research Methodology

In this study, we utilize data from the National Small Business Poll conducted by the United States' National Foundation of Independent Business (NFIB). The executive interviewing group of The Gallup Organization collected the data for this survey report for the NFIB Research Foundation. The interviews for this edition of the Poll were conducted between November 20 - December 16, 2003 from a sample of small employers. Gallup defined "small employer" as a business owner employing no less than one individual in addition to the owner(s) and no more than 249. The sampling frame used for the survey was drawn at the Foundation's direction from the files of the Dun & Bradstreet Corporation, an imperfect file but the best currently available for public use. A random stratified sample design was employed to compensate for the highly skewed distribution of small business owners by employee size of firm. Almost 60 percent of employers in the United States employ just one to four people meaning that a random sample would yield comparatively few larger small employers to interview. Since size within the small business population is often an important differentiating variable, it is important that an adequate number of interviews be conducted among those employing more than 10 people. The interview quotas established to achieve these added interviews from larger, small-business owners were arbitrary but adequate to allow independent examination of the 10-19 and 20-249 employee size classes as well as the 1-9 employee size group.

Total responses numbered 754. Of these, about 83% were the owner/ manager of their business, 11% were owners but not managers and 6% were managers but not owners. Most respondents were aged between 35 and 64 (80%) and most were male (80%). The number of employees per firm ranged from 1-9 (47%), to 10-19 (27%) to 20-249 (27%) due to the sampling approach employed. Most industry groupings in the United States are represented in the sample, with retail trade (18%), professional/ scientific/ technical services (16%), other services including repair and personal care (11%), and, construction (9%) accounting for the major sectors in the sample.

We analyzed this data using hierarchal linear regression. We performed both exploratory factor analysis (EFA) to examine the factor make up of the sample data, and confirmatory factor analysis (CFA) to confirm the three-factor model structure derived from our theory development. The results of the EFA indicate that the items/questions load to their respective latent construct. We also used Variance Inflation Factor (VIF) analysis to assess multicollinearity. All VIF scores were below two, which suggest multicollinearity is not a concern since the VIF scores were well below the conventional cutoff of 10.00 (Neter, Wasserman & Kutner, 1989).

Measures

Dependent Variables

We used *Growth* as our dependent variable as a measure of the ability of a firm to grow. We operationalized growth by utilizing questions from the NFIB poll on past growth, current strategy for growth, and future growth expectations. The first question asked respondent about past growth. The second asked respondents about current growth strategy. The third asked respondent about their future expectations of growth. We grouped these questions by averaging across responses across cases.

Independent Variables

We operationalized our first independent variable measure, *Governance-strategy,* by using questions related to strategies that represent the governance theories. These included the firm's use of internal controls for price fixing, overhead minimization, etc. In the NFIB poll, we utilized two questions to represent this strategy, grouping them into one variable.

We operationalized our second independent variable measure, *Competence-strategy* by using questions related to strategies that represent the competence-based theories. These strategies include a focus on internal resources and capabilities to how to acquire them. These capabilities include capabilities such as marketing, service quality and product positioning capabilities. One way to acquire resources is by cooperating with other firm in the industry. We utilized four questions from the NFIB poll to represent this approach, which we grouped into an overall measure for our competence variable.

We operationalized our third, speculative independent variable for flexibility, as the interaction effect of our governance and competence measures above. We calculated this measure by simply multiplying the standardized measures to create an interaction measure for inclusion in the model.

Controls

We controlled for a number of possible alternative or confounding effects. Consistent with previous research in this area, we control for *firm size*. We use the number of employees as a proxy. We also as controlled for *firm age* as younger firm may be affected by liability of newness. Firms in different industries face a unique set of competition, therefore, we controlled for *competitive intensity*. This measure includes an assessment of competitive climate and the number of competitors. Finally, we controlled for the area in which the business operates by introducing a dummy variables for the geographical *region.* We present an overview of our variables and their measures in Table 1 and offer their descriptive statistics and bivariate correlations in Table 2.

Insert Tables 1 and 2 about here

Results

In Table 3, we provide and overview of the results of the models for the dependent variable growth. The base model "model 1" includes only the control variables and explains a significant amount of the variance in growth ($R^2 = .023$, $p < .01$). In model 2, we included the main effect of governance strategy. Model 2 explains a significant amount of variance in growth ($R^2 = .031$, $p < .01$). The added variance explained in model 2 is over and above that explained by the base model ($\Delta R^2 = .008$, $p < .01$). In Hypothesis 1, we proposed that governance strategy is positively related to growth. The results reveal a significant, positive relationship between governance strategy and growth ($\beta = -0.096$[1]; $p< .05$) supporting hypothesis 1. In model 3, we included the main effect of competence strategy on growth. In Model 3, we explain a significant amount of additional variance in growth ($R^2 = .136$, $p < .01$), and the added variance is significant compared to that explained by the base model ($\Delta R^2 = .113$, $p < .01$). In Hypothesis 2, we proposed that competence strategy is positively related to growth. The results in model 3 indicate a significant, positive relationship between competence strategy and growth ($\beta = -.342$[2]; $p< .01$), thereby supporting hypothesis 2.

Model 4 "the full model," we included the interaction between governance and competence. In hypothesis 3 we proposed that there is a positive interaction effect from the interaction of governance strategy and competence strategy. We observe no support because the interaction term is not significant ($\beta = -.096$; $p> .01$); therefore, we conclude that hypothesis 3 is not supported.

Insert Table 3 about here

Limitations, Conclusions, and Future Research Directions

In this paper, we addressed a core issue for strategic entrepreneurship, the relationship between strategy and growth. Our approach explored the relative impacts of two basic types of

[1] Note this observation is negative, but interpreted as a positive effect because we did not reverse code the two questions for governance.

[2] Note this observation is negative, but interpreted as a positive effect because we did not reverse code the items for competence strategy.

growth strategy. Under governance-based approaches, where the focus is on reducing costs, firms seek to maximize the efficiency of transactions. We observed this through small business' attempts to minimize the price of their offerings as well as their overheads. Under competence-based methods, firms seek to maximize the deliverable value to customers in exchange for a higher price. Small businesses in our sample did this through better service, unique marketing, by targeting unrealized opportunities, and, by forming alliances. Our results show that both approaches have significant effects on growth.

Adopting flexibility-based approaches to growth, however, resulted in a non-significant growth outcome. Through the adaptation to evolving circumstances, the firm appears to risk key bases of differentiation in favor of reacting to prevailing market circumstances. At any given point, the firm may choose to minimize costs, maximize value, or both. Our results show that taking this approach yields a non-significant impact on growth. That is, there is no strong positive or negative impact. While flexibility-based approaches, by their nature, incorporate a focus on adaptation, this appears to be at the expense of significant growth. However, this adaptive stance may be necessary under certain circumstances.

An important element of our results is that, with the exception of firm size, no other control factors appear to have significant impacts on growth. This is a somewhat surprising finding. Previous research finds support for the impact of competitive intensity as a determinant of small business performance (Bierly & Daly, 2007). We theorize that our results reflect two prevailing dynamics. Firstly, it is possible that the majority of the firms in our sample have approaches that provide relative competitive buffers. In governance-based strategies, the firm must adopt measures to ensure transactional efficiency. In competence-based approaches, the firm develops points of competitive difference. The focus on one element of the VPC framework allows the firm to shield itself from competitive attacks. A second explanation is that small businesses may not be on the competitive radar of all industry participants. Recent advances on competitor analysis show that firms are only able to assess a relatively small subset of competitors in a given analysis (Bergen & Peteraf, 2002; Chen, 1996). This observation may also be the case for small businesses, particularly in situations where competitive interplay occurs more frequently between larger industry participants.

Our study has the potential to advance research in several important areas for strategic entrepreneurship. The exploration of two primary forms of growth strategy in the small business context is currently a relatively under-developed field. Our study finds support for the notion that the assumptions inherent in the prevailing strategic management theories Makadok (2010; 2011) identifies are also applicable in small business context. This finding provides added support for the incorporation of the VPC framework in strategic entrepreneurship research. Our findings also appear to support VPC based claims that a focus on value or cost dimensions have important impacts for small business growth. Moreover, the blending of the use of the VPC framework to highlight the key points of competitive difference that emerge from the adoption of one of the major growth strategies is a relatively novel addition to the strategic management and strategic entrepreneurship literatures.

Our study also has important managerial implications. The results highlight the relationship between concentrated approach to growth and the achievement of this outcome in a small business context. For owners and managers in this setting, this finding constitutes an endorsement of a concentrated and deliberate approach to securing growth. Our study highlights key dimensions of interest when examining the value proposition the firm presents to a customer. Through the demonstration of the integrated relationship between value, cost and price, managers now have an additional framework that is applicable when developing their strategic approach in a small business context.

While the study encompasses several important outcomes, it faces limitations also. The use of cross-sectional data reduces the applicability of the findings beyond the current empirical setting. Using an alternative sample such as one that defines small businesses in more narrowly may influence results.

Several research directions could enhance or complement the findings of this study. We echo Makadok's (2011) call for further research into the nature of interactions between major approaches to achieving strategic growth. A more fundamental examination of the rent creation and appropriation implications for the interaction effects between each major strategic management archetype should help to uncover the implications of flexibility-based strategy. This has important implications for the primary forms of conceptualizing strategy while also yielding an examination of the fundamental mechanisms at play in building growth. The VPC framework to model competitive differences in terms of strategic focus and rent appropriation is another area with significant potential to yield rich research outcomes. The application of this lens to specific industry contexts (e.g. high tech vs. low tech) could help uncover the fundamental essence of competitive dynamics in a suite of industries. A third research direction is the explanation between transactional dynamics and entrepreneurial growth. While our study highlights three categories of these interactions, further research could highlight the roles of specific mechanisms at a micro level.

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Table 1: Variables and Measures

Variables	Description	Measure(s)
Dependent variable		
Growth	Ability of the firm to grow. Utilizing data on past growth, current strategy for growth, and future growth expectations.	Q20 = 'EXPECTATION FOR GROWTH IN NEXT 3 YEARS'; QD4 = LAST TWO YEAR, REAL VOLUME SALES CHANGE' Q18M = GROWTH STATEGY
Independent variables		
Governance	Implementing a governance strategy.	Q18A = STRATEGY - LOWER PRICES'; Q18F = STRATEGY – MINIMUL OVERHEAD'
Competence	Implementing a competence strategy.	Q18E= STRATEGY – BETTER SERVICE '; Q18H = STRATEGY – TARGET MISSED/POORLY SERVED CUSTOMERS ' Q18G= STRATEGY – ALLIANCES ' Q18L= STRATEGY – UNIQUE MARKETING '
Governance X Competence	The interaction of governance and competence strategies	The multiplication of Governance and Competence variables
Control Variables		
Competitive Intensity	Assessment of competition.	Q1 = ' COMPETITIVE CLIMATE'; Q2 = COMPETITION CHANGE LAST 3 YEARS ' Q4 = CHANGE NUMBER OF COMPETITORS LAST 3 YEARS
Firm Size	Employee size of firm	Q2= NUMBER OF EMPLOYEES
Firm Age	Age of firm	QD6 = NUMBER OF YEARS OPERATING/OWNING THE BUSINESS
Region	Geographic Region	Dummy variables by region

Table 2. Means, standard deviations, and correlations[a]

	Variable	Mean	SD	1	2	3	4	5
1	**Growth**	2.78	0.91					
2	**Governance**	5.78	1.71	-0.35**				
3	**Competence**	5.47	2.12	-0.09**	-0.30**			
4	**Firm Size**	18.37	29.01	-0.07	0.07	-0.00		
5	**Firm Age**	20.12	20.23	0.065	-0.037	-0.02	0.14**	
6	**Competitive Intensity**	1.98	0.43	0.022	-0.147	0.10**	-0.16**	-0.015

**P< .01

a. Listwise, N=754

Table3. Results of Hypothesis Testing Using Hierarchical Regression Analysis[a]

Variables	Model 1	Model 2	Model 3	Model 4
Firm Size	-.079*	-.080*	-.059†	.060†
Firm Age	.070†	.068†	.055	.055
Competitive intensity	.012	.003	.035	.033
East	.046	-.036	.023	.025
South	-.069	-.070	-.058	.060
Midwest	.050	-.052	-.042	-.042
Central	-.016	-.021	-.023	-.023
Governance		-.091*		.072
Competence			-.342**	-.294**
Governance X Competence				-.096
R^2	0.023**	0.031**	0.136**	0.137**
ΔR^2	0.023**	0.008**	0.113**	0.117**

a Standardized regression coefficients are displayed; *n*=754.
† $p < .1$
* $p < .05$
** $p < .01$