

DYNAMIC CAPABILITIES AS ANTECEDENTS OF THE SCOPE OF RELATED DIVERSIFICATION: THE CASE OF SMALL FIRM ACCOUNTANCY PRACTICES

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We propose that differences in the scope of related diversification in firms can be accounted for by differences in their dynamic capabilities. In order to test this, we analyze 254 Norwegian small firm accountancy practices' possession of key dynamic capabilities including the heterogeneity of their human capital, their internal development routines, and their alliances with complementary service providers. We also analyze the influence of strategic choice, in terms of the positioning of the practice and its underlying strategic intent. While we observe no clear effects for these two latter factors, we find that dynamic capabilities have a distinct impact on the scope of services.

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INTRODUCTION

Diversification is a commonplace feature of business firms and the question about what determines the scope of the firm is fundamental within strategy research (Rumelt, Schendel, and Teece, 1994). In a review article spanning three decades of research beginning with the seminal work of Chandler (1962), Hoskisson and Hitt concluded that 'there is much work that remains before definitive conclusions are possible' (Hoskisson and Hitt, 1990: 492) either in regard to the antecedents or the performance implications of diversification. Arguably little has changed in the intervening years (Montgomery, 1994; Peng, Lee, and Wang, 2005; Stern and Henderson, 2004).

The distinction between related and unrelated diversification—product relatedness being defined

as the extent to which a firm's different lines of business are linked by a common skill, resource, market, or purpose (Rumelt, 1974; Luo, 2002)—is of particular significance in regard to setting the boundaries for theorizing on the antecedents of diversification. As Hoskisson and Hitt (1990) indicate, although firms have primarily diversified through mergers and acquisitions, firms may also increase the scope of their product offerings through internal development. However, unlike diversification through mergers and acquisitions, firms diversifying through internal development will be primarily doing so in highly related product markets.

Hoskisson and Hitt (1990) contend that deployment of surplus resources is one of the prime motives of diversification. They distinguish tangible resources—such as financial, plant, and equipment—from intangible resources—such as skills and know-how. They argue that whereas tangible resources are relatively inflexible, intangible resources are potentially more flexible for diversification through internal development. However, they further argue that the deployment of intangible

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resources for diversification is subject to managers perceiving incentives, thereby acknowledging the role of strategic choice. It is noteworthy though that their theorizing fails to take into account differential capabilities as antecedents of resource deployment for purposes of diversification.

In this article, our focus is on related diversification through internal development. While we accept Hoskisson and Hitt's (1990) notion that related diversification is primarily a consequence of the deployment of surplus intangible resources—a theory supported by Chatterjee and Wernerfelt's (1991) research—the aim of this article is to extend this research significantly by delineating the antecedents of resource development. In order to realize this ambition, we draw on the dynamic capabilities approach that enables us to identify core underlying dynamics of diversification. We do this by directing our attention to variations in the scope of related products provided by accountancy practices serving small firms in Norway. The key reason for this choice is that small firm accountancy practices in Norway are characterized by a well-defined, unvarying, and narrow scope of core products where even modest levels of diversification are readily observable and easily measured—an advantage not enjoyed by many previous studies of diversification (Markides and Williamson, 1996). Although these practices share a set of characteristics—they are small firms offering mandatory standard accountancy services to other small firms—they do however vary with the degree to which they provide additional services beyond, but related to, accountancy. On the basis of data obtained from 254 Norwegian authorized accountancy practices, we investigate the antecedents underlying variations in the scope of their services.

The need for a dynamic capabilities approach

The primary product offered by small firm accountancy practices is the provision of standard accountancy services to their clients. One of the most important, if not the most important, source of business advice for small firms is these practices (Mole, 2002). Moreover, there is evidence that those practices that have broadened their scope beyond that of standard accountancy services enjoy substantially higher profits as well as higher revenue per partner than those whose scope is limited

to accountancy services (Bagchi-Sen and Kuechler, 2000). However, despite this apparent incentive for small firm accountancy practices to seek a broadening of the scope of their service provision, previous research indicates substantial differences in terms of the scope of advisory services they provide (Gooderham and Nordhaug, 2000).

Given that the intangible resources in terms of know-how and skills required for the delivery of mandatory accountancy practices are largely common across the industry, and inasmuch as the incentives to deliver advisory services also pertain across the industry, neither standard intangible resources nor industry-wide incentives can provide a sufficient explanation of variations in the scope of advisory services provided by small firm accountancy practices. The intangible resources that support related business advisory services have to be developed. Thus although we acknowledge the perspective on the value of resources as contained in Hoskisson and Hitt's (1990) review, we advocate that the related dynamic capabilities perspective of the firm is a more fruitful approach for accounting for variations in the scope of internal diversification within an industry. We therefore seek to account for differences in the scope of the business advisory services small firm accountancy practices supply (i.e., services over and above standard accountancy services) by primarily employing a dynamic capabilities view of the firm.

In the first part of this article we present the most salient features of small firm accountancy practices as business advisors. We then delineate the context of our study, Norway. Thereafter we present and deploy a dynamic capabilities view in order to account for variations in the scope of accountancy practices as providers of business advisory services. This view is supplemented by taking into account the influence of strategic choice. On the basis of data obtained from Norwegian authorized accountancy practices, hypotheses are tested and the results discussed. In our supplementary analysis we examine the degree to which advisory services supplement traditional accounting services as sources of revenue. Finally, we draw a number of conclusions regarding those capabilities that appear to be most pertinent for small firm accountancy practices in their development as business advisors.

SMALL FIRM ACCOUNTANTS AS BUSINESS ADVISORS

The European business scene is dominated by the SME (small to medium-sized enterprises) sector, i.e., by firms with 250 employees or less. The sector represents 66 percent of all jobs and 65 percent of the total business turnover in the European Union (EFAA, 2004). One important characteristic of the smaller firms in the SME category is that they rarely have the resources to allow accounting duties to be conducted in-house. Consequently, small firms often seek external assistance from accountants. For example, in Norway about two-thirds of firms with fewer than 100 employees use the services of an external authorized accountant in the production of financial accounts (*Dagens Næringsliv*, 2003).

Because of the long-term, regular cooperation small firm accountancy practices have with their clients through the provision of basic accounting services, there is a potential for the development of the trust required to act as business advisors (Bennett and Robson, 1999; Gooderham and Nordhaug, 2000; Marriott and Marriott, 2000; Mole, 2002; Ram and Carter, 2004). Moreover, by purchasing multiple services from the same source, clients are able to economize on information costs (Bennett and Smith, 2004; Bryson and Daniels, 1998; Nayyar, 1990, 1993). For their part, accountancy practices may achieve synergies (economies of scope) in the production of, for instance, a number of management accounting services in conjunction with producing statutory financial accounts (Marriott and Marriott, 2000). Accountancy practices are thus in a potentially favorable position in regard to offering related advisory services—services that small firms would otherwise be reluctant to seek out, let alone purchase. Moreover, there is a clear incentive for small firm accountancy practices to develop business advisory services because their clients are generally willing to pay more for these than standard accountancy services (Gooderham and Nordhaug, 2000).

Although it is important not to exaggerate the current size of this market for business advice—few of the large, established consultancies regard the small firm business advice market as attractive (Jevnaker, 1996)—it is clear that small firm accountancy practices are increasingly becoming a significant source of such advice. For example in the United Kingdom, Kirby and King (1997)

and Deakins, Logan, and Steele (2001) found that accountants are among the most frequently used external sources of business advice. Indeed Bennett and Robson's (1999) survey shows that accountants are in fact the dominant source of such advice in the United Kingdom, ahead of both banks and solicitors. Moreover, Mole's (2002) research suggests that it is unlikely that publicly funded small business advisors will ever achieve the same impact on SMEs as accountants, a finding borne out by Norwegian research (Kvitastein, 1997). Given this expanded role beyond standard accounting services, small firm accountancy practices have been depicted as 'multidisciplinary practices, one-stop shops for an extensive array of services, including financial advisory, management consulting, and legal services' (Greenwood, Sudaby, and Hinings, 2002: 58).

The Norwegian context

In order to meet statutory requirements regulated by Norwegian law, firms are obliged to produce annual financial accounts. Because of their complexity, rather than doing this in-house, as we noted above the majority of small firms in Norway employ the services of an external authorized accountancy practice (*autorisert regnskapsbyrå*) for this purpose. In all there are some 2,000 authorized accountancy practices in Norway of which over 90 percent are members of *Norges Autoriserte Regnskapsføreres Forening* (NARF), a professional association for accountants with a small firm focus. In addition to support staff, a practice will typically contain five front-line staff one of who must, in accordance with Norwegian law, be authorized.

Since 1993, a prerequisite for authorization has been the successful completion of a two-year diploma program of higher education within economics and business administration, as well as two years of relevant practice. In other words, authorized accountants are not required to have a three-year bachelor's degree level of education.

In the Norwegian context, the distinction between the two-year accounting diploma and a bachelor's degree is one not only of length, but, more importantly, also one of kind. The purpose of authorization is to ensure that the work of the accountant is executed in an adequate manner

in accordance with prevailing laws and regulations. Thus the diploma is characterized by a narrow, technical focus aimed at ensuring that annual financial accounts adhere to an explicit, regulatory framework. In contrast, the focus of a bachelor's degree goes significantly beyond purely procedural concerns. As a consequence, the composition of front-line staffs of small firm accountancy practices is both potentially and, as our data will indicate, in practice highly variable. Disregarding the element of in-house trained accountancy staff common to most practices, at one end of the spectrum there are practices entirely composed of authorized accountants, and at the other practices that contain individuals with bachelor's level degrees and individuals who have both the two-year accounting diploma and a bachelor's degree. Whereas the former constitute a homogeneous competencies base, the latter is considerably more heterogeneous.

As we have indicated, in regard to the production of annual financial accounts, Norwegian authorized accountancy practices operate within an explicit, regulatory framework that results in standardized services. However, it should be noted that these practices are free of statutory restrictions in regard to providing their clients with additional, advisory services. Obviously, though, clients are under no obligation to purchase these additional services. On the contrary, advisory services, in contrast to standard accountancy practices, must meet their client firms' idiosyncratic and ever evolving needs. As such, authorized accountants face two very different environments, one is standardized and therefore relatively predictable, the other nonstandardized and unstable.

A DYNAMIC CAPABILITIES VIEW OF SMALL FIRM ACCOUNTANCY PRACTICES AS BUSINESS ADVISORS

The resource-based view of the firm (RBV) views the ability of a firm to extend the scope of its products or services enabling it to enter new markets as being dependent on its possession of superior resources (Miller, 2004). According to RBV, a firm's possession of valuable, rare, inimitable, and difficult-to-imitate resources such as competencies or know-how is the fundamental determinant of a firm's ability to pursue economies of scope (Barney, 1986; Penrose, 1959; Rumelt, 1984; Wernerfelt, 1984).

However, the emphasis in RBV is on the deployment and *protection* of unique knowledge rather than on the need for resources or competencies to actually change over time (McEvily, Eisenhardt, and Prescott, 2004). Early explanations of why firms had differential stocks of resources featured luck and/or superior information (Zott, 2003). More recently though, the need to specify the dynamics of the processes underlying resource development and differentiation has resulted in the dynamic capability construct, which refers to 'the firm's ability to integrate, build, and reconfigure internal and external competencies to address rapidly changing environments' (Teece, Pisano, and Shuen, 1997: 516). In his discussion of the concept of dynamic capabilities, Winter (2003) provides an example that is particularly pertinent to small firm accountancy practices:

Consider a hypothetical firm 'in equilibrium,' an organization that keeps earning its living by producing and selling the same product, on the same scale and to the same customer population over time. The capabilities exercised in that stationary process are the zero-level capabilities, the 'how we earn a living now' capabilities. Without them, the firm could not collect the revenue from its customers that allows it to buy more inputs and do the whole thing over again. By contrast, capabilities that would change the product, the production process, the scale, or the customers (markets) served are not at the zero level. New product development, as practiced in many firms, is a prototypical example of a first-order 'dynamic capability' (Winter, 2003: 992).

As we have indicated, the focus of this article is on small firm accountancy practices that have diversified beyond selling standard accountancy services to their clients by developing new products in the form of business advisory services. Given standardized competencies for the production and delivery of the former, together with uniform incentives to diversify, we argue that change in product scope derives from the possession of dynamic capabilities.

Iansiti and Clark (1994) define dynamic capability as an organization's general capacity for the regeneration of its knowledge base. More recent conceptions refer to dynamic capabilities in the sense that firms may possess several, discrete but complementary capabilities. Thus Eisenhardt and

Martin (2000) refer to dynamic capabilities as consisting of specific strategic and organizational processes that manipulate resources into new competencies and that renew old ones. However, these include not only internal processes, but also collaboration with other organizations as a means of extending each firm's competencies (McEvily *et al.*, 2004). The value of dynamic capabilities lies in the resource configurations that they create or enhance, which in turn enable the firm to pursue opportunities in new, unpredictable markets. Specifically, Eisenhardt and Martin define dynamic capabilities as 'the organizational and strategic routines by which firms achieve new resource configurations as markets emerge, collide, split, evolve and die' (Eisenhardt and Martin, 2000: 1107). Winter (2000) similarly argues that dynamic capabilities are systematic and persistent features of an organization, but he takes issue with the notion that they are routines. He argues that unlike routines, which are sometimes entirely invisible and unknown to the management, the control levers and intended effects of dynamic capabilities are known. In other words, dynamic capabilities must be built with the manager's role analogous to an architect (Makadok, 2001). Winter (2003) has further argued that dynamic capabilities involve long-term commitments to specialized resources. Our view is that dynamic capabilities are best conceived as enduring routines, systems, and processes that are visible, known, and managerially intended as a means to achieving new resource configurations.

The dynamic capabilities view of the firm has three implications for authorized accountancy practices in terms of their ability to generate a broad scope of business advisory services. The first concerns the configuration of the practice's human capital resources. For business advisory services these will be significantly more complex than the configurations required for the production and delivery of standard accountancy services. While the latter are principally defined by the regulatory environment and are therefore both relatively narrow and homogeneous, those configurations that are required for business advisory services entail the ability to respond to a variety of client needs and situations that call for novel responses. Such responses are dependent on the possession of heterogeneous human capital and the internal synergies they confer. In short, accountancy practices

whose human resources are predominantly homogeneous and that are first and foremost configured for the delivery of standard accounting practices will be considerably less likely to produce the synergies that generate a wide range of business advisory services.

The second implication of the dynamic capabilities view of the firm for business advisory services is the criticality of possessing internal development routines and systems that ensure that the practice's human capital configuration is not static, but is subject to continuous development. Finally, the third implication of the dynamic capabilities view is that accountancy practices lacking in strong alliancing processes for accessing outside knowledge will be more confined to standardized accountancy services than those practices that interact with an array of complementary service providers.

In summary, a dynamic capabilities view of authorized accountancy practices emphasizes the possession of strategically derived organizational routines, systems, and processes that enable practices to acquire, integrate, recombine, and broker knowledge from heterogeneous internal and external sources. In the next section we further develop the dynamic capabilities view applied to authorized accountancy practices in order to generate testable hypotheses.

THE DEVELOPMENT OF DYNAMIC CAPABILITIES

As we have indicated, authorized accountancy practices in Norway face two environments. One involves the delivery of standardized accountancy practices and is, for the most part, predictable in the sense that the services are defined by statutory regulations. The other environment involves responding to small firms' needs for advisory services and is relatively unpredictable in that firms' needs represent a response to changing environments. Only practices that are capable of generating timely responses will be able to adapt to this latter environment. A limitation to RBV is that it does not set out to address how and why certain firms exhibit timely responsiveness in unpredictable situations (Eisenhardt and Martin, 2000). In these markets, differences in competitive ability are best explained by variations in dynamic capabilities, not the least of which is the ability to develop knowledge resources through skills

acquisition and learning. In unpredictable markets the dynamic capabilities by which firms 'integrate, build, and reconcile internal and external competencies' (Teece *et al.*, 1997: 516) become a critical source of competitive advantage. Thus the development of the dynamic capability to meet the requirements of a changing environment is a challenge involving the ability to exploit both internal and external competencies. These two sources of competencies are not to be regarded as substitutes for one another, but as complementary (Powell, Koput, Smith-Doerr, 1996).

Internal competencies

Because of uniform statutory requirements for authorization throughout the Norwegian accountancy industry, there are standard human resources common to virtually all practices. These resources may be an example of what Winter (2003: 992) denotes 'zero-level capabilities.' The production of a specific advisory service in addition to basic accounting would require additional knowledge and skills resources. However, the capabilities exercised in the process of altering the service portfolio, as well as developing the specific services and selecting, developing, and deploying human resources required to produce those services (Hatch and Dyer, 2004) would be dynamic capabilities. Accordingly, variations in terms of the capabilities required for services beyond standard accountancy services must be primarily sought by examining the development and accumulation of those types of competencies that create a potential for diversification. Systems, processes, and routines for developing firm-level competencies are therefore key dynamic capabilities in regard to diversification (Kor and Leblebici, 2005). We argue that there are two main internal sources of the dynamic capabilities relevant for delivering business advisory services. The first of these involves the heterogeneity of the accountancy practice's competencies assets base.

The issue of heterogeneity of internal competencies can be approached from two distinct angles, one concerning the professional training of front-line staff and the other the level or type of their formal education. In terms of professional training, at one extreme there are authorized accountancy practices whose front-line staff consists entirely of authorized accountants or accountants who have been trained in-house by authorized accountants.

Such a degree of homogeneity of human capital, with its focus on standard accountancy services, will narrow the scope of the practice to develop business advisory services. More heterogeneous human resources can, we argue, augment the capability for developing the practice's service portfolio.

As did Hatch and Dyer (2004) in their study of human capital as a source of competitive advantage, we acknowledge that formal education is an imperfect measure of cognitive skills such as absorptive capacity. Nevertheless, in terms of formal education, a bachelor's degree in the specific industry we are examining may be regarded as a source of heterogeneity in that it is indicative of an ability to handle complex information, engage in boundary-spanning activities, and be more receptive to the adoption of innovations (Hadjimanolis, 2000; Kimberly and Evanisko, 1981; Young, Charns, and Shortell, 2001). In the context of small auditing firms, previous research shows that survival is positively related to founders', managers', and employees' higher education (Bröcheler, Maijoor, and van Witteloostuijn, 2004). It is not the number of years of education as such that is critical, but rather the broader set of knowledge and skills that has been acquired. A bachelor's degree is an indicator that the individual employee and employees possess the wider and more general knowledge and skills needed to develop and produce nonstandard services (cf. Nordhaug, 1994). This would, for instance, include general knowledge and skills that underpin the strategic management of business portfolios and that are not generally learned in basic accounting training. In other words, front-line staff who possess a bachelor's degree will be more predisposed to engage in the development of a variety of business advisory services.

Hypothesis 1 (H1): The scope of business advisory services delivered by an accountancy practice will be broadened by the heterogeneity of its human capital.

The second significant internal source of dynamic capabilities for the delivery of a broad scope of business advisory services is located in specific systems that enable the practice to develop and thereby regularly reconfigure its competency base in a firm-specific and therefore inimitable manner (Hatch and Dyer, 2004). Eisenhardt and

Martin argue that: 'Dynamic capabilities are the antecedent organizational and strategic routines by which managers alter their resource base—acquire and shed resources, integrate them together, and recombine them—to generate new value-creating strategies' (Eisenhardt and Martin, 2000: 1107). Important features of these critical and readily identifiable systems for the management of the reconfiguration of the competency asset structure of the practice will at the very least involve the clearly defined policies and plans for the development of its human resources. Thus Collins and Smith (2006) find that systems of this type impact on the conditions that facilitate knowledge interactions that in turn lead to knowledge reconfiguration.

Hypothesis 2 (H2): The scope of business advisory services delivered by an accountancy practice will be broadened by its having established specific, identifiable routines and systems aimed at reconfiguring the competency base of the practice.

External competencies

Although many core dynamic capabilities have their focus on the reconfiguration of resources within firms, other dynamic capabilities are related to the development and exploitation of inimitable collaborative interfirm relationships that confer access to resources and capabilities from differentially endowed firms (Eisenhardt and Martin, 2000; Gulati, 1999; Iansiti and Clark, 1994; Koka and Prescott, 2002; Lane and Lubatkin, 1998; Powell *et al.*, 1996). The critical value of superior network positions for a firm's innovativeness has been well documented (for overviews see, e.g., Afuah, 2000; Zaheer and Bell, 2005). Indeed, 'A common feature across successful knowledge creation processes is explicit linkage between the focal firm and knowledge sources outside the firm' (Eisenhardt and Martin, 2000: 1109). It is unlikely that any one single collaborative relationship with an external partner will suffice in unstable environments. Thus the diversity or range of a firm's interorganizational ties can function as a proxy for a dynamic capability that enables a firm to acquire and maintain a heterogeneous network of positions that confer access to a variety of capabilities and resources as well the opportunity to gather and

screen relevant information from diverse sources (McEvily and Zaheer, 1999).

In regard to the provision of business advisory services, the facility to nurture alliances for joint problem solving and service development with different but complementary business service providers constitutes an essential dynamic capability (Jones *et al.*, 1998; McEvily and Marcus, 2005). Given the size of authorized accountancy practices, there is clearly a limit to the number of competencies they are able to develop internally. Like any small firm, the quality and range of the practice's external network will therefore be critical for obtaining those resources it lacks. This means that small firm accountancy practices that seek to develop services over and above standard accountancy services are highly dependent on being able to leverage off the competencies of third parties (Birley and Westhead, 1992; Storey, 1994). There are many potential sources of external partnerships or alliances for the development of business advisory services, such as lawyers, external auditors, consultants, software suppliers, IT firms, banks, and insurance companies. Small firm accountancy practices that develop extensive, long-term alliances for the purpose of developing business advisory services with a broad range of such external actors acquire access to diverse but complementary competencies that enable them to develop and offer a broader range of services than those practices that lack such alliances (Bagchi-Sen and Kuechler, 2000). Thus we hypothesize that:

Hypothesis 3 (H3): The scope of business advisory services delivered by an accountancy practice will be broadened by the range of its alliances with external complementary service providers.

STRATEGIC CHOICE

While dynamic capabilities create the necessary potential for evolving business advisory services, these must be accompanied by some form of strategic decision making that reflects an acknowledgment of the desirability of pursuing opportunities for the development of business advisory services (Grant, 1996). This may in part be conceived of as involving strategic positioning, and in part as involving strategic intent.

The publication of Porter's (1980) book, *Competitive Strategy*, placed the emphasis for competitive advantage on external, industry-based competitive issues. One important aspect of strategy according to Porter's 1990 book, *The Competitive Advantage of Nations*, is that of positioning the firm. In short: 'Some positions are more profitable than others. . .' (Porter, 1990: 34). In terms of accountancy practices, those that provide standard accountancy services to clients who are relatively more disposed to the purchasing of different types of specialized business services are also in a favorable position to offer such services to the same clients. In other words, by achieving this positioning a small firm accountancy practice is more able to diversify into business advisory services. Previous research on professional service firms supports this notion that the type of clients an accountancy practice targets is indeed likely to influence the range of services the practice develops and offers (Løwendahl, Revang, and Fosstenløykken, 2001).

Client size is one crucial parameter for the positioning of an accountancy practice. Although it may be the case that the smaller the firm the greater the need for business advisory services (due to their limited internal competencies), the smallest firms are also the most reluctant to purchase these from a professional service firm (Bennett and Robson, 1999; Bennett, Robson, and Bratton, 2001; Greene, Kirby, and Najak, 1998; Marriott and Marriott, 2000). Larger client firms tend to be more organizationally complex—they have a wider range of specialized functions—and will therefore have a greater capacity to demand, purchase, and utilize specialized business services (Cohen and Levinthal, 1990; Schwartz and Bar-El, 2004). In smaller client firms, the owner-manager frequently takes care of most administrative tasks, and critical resources such as time and attention may not be available for nonroutine issues (Gooderham *et al.*, 2004). Moreover, it is reasonable to assume that there is a substantial fixed cost in the provision of business advice and the variable component may not be proportional to the size of the firm. This implies that the cost of purchasing advisory services is relatively higher for the smallest firms. Costs of services and capacity of client accordingly implies that the propensity to procure business advisory services varies positively with size, and we will hypothesize that:

Hypothesis 4 (H4): The scope of business advisory services delivered by an accountancy practice is broadened by the proportion of relatively large client firms served by the practice.

With the diffusion of the RBV during the 1980s, emphasis shifted to internal aspects of strategic decision making. Hamel and Prahalad (1989, 1994) employ the concept of 'strategic intent,' that is a consistent ambition to set targets that imply 'a sizable stretch for an organization' (Hamel and Prahalad, 1989: 67). Thus we will argue that the concomitant possession of some degree of strategic intent that involves the deliberate choice to seek out new markets or to develop new services will be a significant determinant in regard to business advisory services performance. Strategic intent should not be confused with unfettered ambition: it is the quest for new opportunities and thereby a means of identifying a misfit between current resources and aspirations. The development of any significant degree of strategic intent for small firm accountancy practices may be assumed to be particularly problematic (Hadjimanolis, 2000) because like any small firm there is a strong focus on preserving autonomy and independence rather than aspiring to growth (Choi and Shepherd, 2004; Low and Macmillan, 1988). Thus although there may be potential benefits from an expanded scope of service offerings, owner-managers may not have the motivation to perceive let alone realize these. This lack of strategic intent may be particularly prevalent in the small firm accountancy industry given the strong regulatory standardizing pressures they are subject to in relation to accountancy services.

In the context of small firm accountancy practices, strategic intent would imply a well articulated aspiration to search for new opportunities and new markets through the broadening of the scope of related services (Bagchi-Sen and Kuechler, 2000). Conversely those practices lacking in strategic intent are practices that have no articulated intention of seeking out new markets or developing new services unless they are compelled to do so. Our final hypothesis is therefore:

Hypothesis 5 (H5): Those accountancy practices that intend to seek out new markets or launch new services will provide a broader scope of business advisory services than other practices.

DATA

Our data set is derived from a questionnaire that was mailed electronically in November 2003 to heads of the 1,380 authorized accountancy practices for which NARF had e-mail addresses. Of the 1,380, 130 addresses proved to be defunct. Of the 1,250 practices who received the questionnaire, 254 replies were received. This constituted a response rate of 21 percent, a rate that is comparable to similar surveys (Mole, 2002). Using NARF's overview of its member practices, we were able to compare our sample with the population from which it was derived in terms of size of practice. We observed that our sample is slightly skewed toward larger practices, so that in our analysis we specifically control for the effect of size and assume our results to be robust with regard to size (Berk, 1983; Gelman *et al.*, 1995).

Independent variables

Heterogeneity of human capital

We have operationalized the heterogeneity of the human capital held by authorized accountancy practices in two distinct ways. The first of these is the degree to which front-line staff are authorized accountants. We have reasoned that the greater the degree to which a practice comprises authorized accountants the narrower the scope of business advisory services. Our second approach to operationalizing heterogeneity concerns the proportion of front-line staff who have a bachelor's degree level of education. We have reasoned that the greater the degree to which a practice contains degree-level front-line members of staff, the broader the scope of business advisory services. Thus, in order to represent the heterogeneity of the practice's human capital, we employ two separate variables: the percentage of front-line staff with an accounting diploma and the percentage of front-line staff with a bachelor's degree.

Specific and identifiable routines and systems aimed at reconfiguring the competency base of the practice

We asked respondents to the questionnaire to indicate if their practice had devised a skills development plan. Responses to this question were coded

as 0 for 'no' and 1 for 'yes' in order to form a dummy variable. Forty-five percent of the practices confirmed that they had implemented such a plan.

Range of alliances with external complementary service providers

In order to capture the range of strategic alliances, respondents were asked to indicate the degree to which their practices cooperate with external service providers within seven specified industries: lawyers, external auditors, consultancies, software providers, IT-firms, banks, and insurance companies. This list of providers closely corresponds to the one employed by Bagchi-Sen and Kuechler (2000), except that their list additionally included advertising and financial planning consultancies, both of which their study indicated were of marginal relevance. Based on responses to our seven-fold list of external service providers, we counted the number of industries in which the practice had alliance partners to create a measure for the range of external alliances. This variable ranges from zero (14% of the practices do not have any alliances at all) to seven (6% have alliances in all of the seven industries). On average, the practices in our dataset have alliances in 2.8 of these industries.

Proportion of relatively large client firms served by the practice

From previous research it is known that the use of external advice tends to increase with size up to about 50 employees, where it tends to level off (Bennett and Robson, 1999; Bennett *et al.*, 2001). In the present sample, 35 percent of the practices report that they serve clients with more than 20 employees, and for these practices the largest clients generally constitute about 10 percent of gross income. Only a fraction of the practices obtain substantial revenues from clients with more than 50 employees. In the context of small firm accountancy practices, we accordingly define large clients as those having more than 20 employees. On average, practices obtain 20 percent of gross income from clients with more than 20 employees, only 10 percent of the practices obtain more than half of gross income from relatively large clients.

Intention of seeking out new markets or launching new services

Because the absence of strategic intent is in some respects easier to specify than its presence (cf. Bagchi-Sen and Kuechler, 2000), we measured this factor in part by using an item that maps this. In terms of a four-point scale, practices were asked to respond to the following statement: 'We will not seek out new markets or launch new services unless forced to do so.' In addition, practices were asked to respond to another four-point scale item that measured the presence, rather than the absence, of strategic intent: 'We want to strengthen our market position and search for new market opportunities through the continuous development of our services.' Scores for the first item were subtracted from the second to form an index (Cronbach's alpha = 0.68).

Control variable*Number of staff in practice*

It may be assumed that practices with larger numbers of front-line staff have more surplus resources and therefore more latitude for specialization over and above standard accountancy services. That is the larger the practice, the greater the scope of business advisory services.

Dependent variable

Together with a group of seven experienced authorized accountants, we developed a list of 15 business advisory services that Norwegian authorized accountants may offer. It was observed that the list was broadly similar to the one developed by Bagchi-Sen and Kuechler (2000), except that it was somewhat more exhaustive. In Table 1 we list these services.

In the left-hand column of the table we provide an overview of the percentage of accountancy practices that had been billed for each of the advisory services on at least four occasions over the last two years. The table indicates, for example, that 90 percent of our sample had billed for the provision of *remuneration schemes/salary administration*, but that only eight percent had billed for *pension schemes*. In the right-hand column we display the degree to which each of these services accounted for at least 10 percent of gross revenue. At one extreme, 37 percent of practices derived at least 10 percent of their gross revenue from *remuneration schemes/salary administration*, whereas at the other extreme no practices reported this for the delivery of *pension schemes*. All in all the table indicates that few single services make a significant contribution to the overall

Table 1. Percentage of authorized accountancy practices that have billed for an advisory service on at least four occasions over the last two years, and percentage of practices that derived at least 10% of their gross revenue from these services

Type of advisory service	Percentage of practices	
	...providing service	...deriving at least 10% of gross revenues from advisory service
Taxation/tax planning	76	21
Inheritance issues/generation transfer	27	3
Choice of type of company entity	77	3
Debt administration/closure of firms	41	3
Financial management/budgeting	88	21
Pension schemes	8	0
Transference of ownership	45	2
Marketing/sales/strategic planning	16	1
Secretary to company boards	58	9
Administrative routines/IT	50	7
Management/organization/HRM	23	2
Training and skills development	23	3
Outsourcing of the financial officer function	41	15
Remuneration schemes/salary administration	90	37
Valuation of firms/mergers/demergers	26	1

N = 254

Table 2. Percentage distribution of authorized accountancy practices according to the number of advisory services provided

Number of services	Percentage of practices
0–4	24
5–9	55
10–15	21
Total	100

N = 254

revenues of the practices. In addition to *remuneration schemes/salary administration*, the main exceptions are *taxation/tax planning* and *financial management/budgeting*. Further analysis indicated, not reported here, that only a negligible proportion of the practices derived more than 25 percent of their gross revenues from any one of these services. For about half of the practices, no single service exceeded 10 percent of gross revenues.

We obtained the dependent variable, *number of services*, by counting the number of different services provided by each firm. As can be seen in Tables 1 and 2, this variable ranges from 0 to 15. Table 2 shows that the range of advisory services provided varies considerably from practice to practice with most practices (55%) supplying 5–9 services, but with a substantial proportion (24%) supplying fewer than this.

A more detailed analysis we undertook indicated that only four practices did not provide any business advisory services at all, and that only three practices provided all 15 services.

RESULTS

Table 3 shows means, standard deviations, and correlations for all the variables featured in the hypotheses.

In addition, the matrix includes the variable *proportion of gross revenue*, which will be discussed in our supplementary analysis. We asked the respondent to indicate the proportion of gross revenue derived from each service in terms of the following intervals: no revenue, less than 10 percent, 10–25 percent, 26–40 percent, 41–55 percent, 56–70 percent, 71–85 percent, and 85–100 percent. In order to create an overall measure of the *proportion of gross revenue* from advisory services, we assigned values 0–7 to each of these

intervals and created an index by summarizing values across all the indicated services. This index varies around a mean at 8.7 (median 8), with a minimum at 0 (four practices) and a maximum at 21. One outlier at 79 was omitted from the analysis.

With one exception the bivariate correlations between number of services and the hypothesized variables are all in accordance with the hypotheses. The exception is that of the percentage of staff with a bachelor's degree for which the correlation with number of services is apparently negligible. As our linear regression analysis below shows, this lack of significant correlation is an artifact of the positive correlation between the percentage of staff with an accounting diploma and the percentage with a bachelor's degree (0.46). This correlation is ascribable to some front-line staff having both the accountancy diploma and a bachelor's degree. A regression analysis allows us to control for this qualifications overlap.

Our final table, Table 4, is a hierarchical regression analysis that enables us to test our hypotheses.

The results in Table 4 address variations in the number of services offered by accountancy practices. The first analysis includes the control variable, the *number of professional staff in practice* and the constant only. We may note that the size of the practice captures about 15 percent of the variation in the scope of business advisory services. The larger practices do indeed tend to offer a greater scope of business advisory services. In the second analysis, variables related to strategic choice are included in the model (Hypotheses 4 and 5). The analysis indicates a small but significant increase in the proportion of variation accounted for, and coefficients for both variables are significant at the five-percent level. That is, the more strategic intention the practice displays in regard to developing products or markets, the more services the firm has actually billed for during the last years (Hypothesis 5). Equally, the second analysis indicates that the larger the percentage of relatively large clients, the greater the scope of advisory services (Hypothesis 4).

When variables derived from the dynamic capabilities view of the firm are included, explained variance increases substantially. The model as a whole explains 34 percent of the variation in the number of services, which is relatively high for this type of study. The highest variance inflation factor (VIF) observed in the regression analysis is 1.4; this indicates a low level of multicollinearity.

Table 3. Descriptives and correlations

Variable	Mean	SD	1	2	3	4	5	6	7	8
1. Number of services	6.8	3.2								
2. Proportion of gross revenue	8.7	6.4	0.72***							
3. Intention of seeking out new markets or launching new services	0.4	2.0	0.22***	0.05						
4. Proportion of relatively large client firms served by the practice	21.6	21.5	0.17**	0.16*	0.05					
5. Percentage of staff with an accounting diploma	48.6	27.0	-0.29***	-0.15*	-0.13*	-0.20**				
6. Percentage of staff with a bachelor's degree	48.2	32.8	-0.05	0.02	-0.15*	-0.09	0.46***			
7. Specific and identifiable routines and systems aimed at reconfiguring the competency base of the practice	0.4	0.5	0.28***	0.25***	0.15*	0.04	0.01	-0.04		
8. Range of alliances with external complementary service providers	2.8	2.1	0.45***	0.37***	0.25***	0.15*	-0.12	-0.05	0.14*	
9. Number of staff in practice	4.4	3.8	0.41***	0.23***	0.18**	0.15*	-0.37***	-0.24***	0.18	0.33***

* $p < 0.05$ ** $p < 0.01$ *** $p < 0.001$ (two-tailed)
 N = 234

Table 4. Determinants of the number of services, linear regression^a

Variable (hypothesis)	Control only		Control + Strategy		All variables	
	beta	b	beta	b	beta	b
Heterogeneity of human capital (H1):						
percentage of staff with an accounting diploma					-0.23	-0.03** (0.01)
percentage of staff with a bachelor's degree					0.14	0.01** (0.01)
Specific and identifiable routines and systems aimed at reconfiguring the competency base of the practice (H2)					0.20	1.26*** (0.35)
Range of alliances with external complementary service providers (H3)					0.32	0.48*** (0.09)
Proportion of relatively large client firms served by the practice (H4)			0.11	0.02* (0.01)	0.05	0.01 (0.01)
Intention of seeking out new markets or launching new services (H5)			0.15	0.23** (0.10)	0.06	0.10 (0.09)
Number of staff in practice (control)	0.41	0.34*** (0.05)	0.37	0.31*** (0.05)	0.20	0.17*** (0.05)
Intercept		5.34 (0.29)		5.05 (0.33)		4.62 (0.57)
Adjusted R ²		0.16***		0.19***		0.34***
R ² change				0.03**		0.16***

^a Ordinary least square estimates
 b = unstandardized coefficients, beta = standardized coefficients, standard errors in parentheses
 * $p < 0.05$ ** $p < 0.01$ *** $p < 0.001$ (one-tailed tests)
 N = 234

This third analysis indicates that Hypothesis 1 is supported in terms of both operationalizations of heterogeneity in that there is both a significant positive effect of having a larger proportion of staff with a first degree on the scope of business advisory services, and a significant negative effect in having an increased proportion of staff qualified as authorized accountants. Despite the positive correlation between the two operationalizations of heterogeneity, they have opposite effects on the scope of business advisory services. As can be seen from the coefficients for the dummy representing internal development routines, practices having these routines have a significantly greater propensity for offering a greater scope of services (Hypothesis 2). Our findings finally indicate that the greater the range of strategic alliances, the greater the scope of services offered (Hypothesis 3).

In the third analysis in Table 4 we can also observe that the two coefficients related to strategic choice are no longer statistically significant. We conclude therefore that while the hierarchical regression results support Hypotheses 1, 2, and 3, the support for Hypotheses 4 and 5 is no more than marginal. Finally, we can also observe that

our control variable, number of staff in practice, is significant at all stages of our analysis, indicating that larger practices are able to offer a broader scope of business advisory services. Although both strategic intent and client portfolio correlate with scope of services, the results reported in the third analysis in Table 4 indicate that the apparent effect of strategic choice is spurious and should in fact be attributed to dynamic capabilities.

Because our sample is slightly skewed toward larger practices, we constructed weights to obtain the same distribution with regard to size as in the population. The results of the weighted analyses are virtually identical to those presented in Table 4, and we conclude that the results are robust.

Supplementary analysis

Although the focus of this article is on the antecedents of variations in the scope of diversification in relation to small firm accountancy practices, it is also of importance to substantiate one of our underlying premises, that is that when these services are developed they constitute important sources of revenue for the individual accountancy practice. As we have noted, previous research

indicates that small firms are generally willing to pay more for business advisory services than standard accountancy services so that we should expect to observe that as advisory services are developed they will increasingly supplement or displace traditional accounting services as sources of revenue and profit (Bagchi-Sen and Kuechler, 2000; Gooderham and Nordhaug, 2000). As Table 3 indicates, *proportion of gross revenue* is indeed highly correlated with *number of services* (0.88). Thus we can conclude that the range of services offered is strongly correlated with the proportion of revenue related to advisory services. This indicates that practices with a relatively large portfolio of services tend to derive a greater proportion of their revenue from advisory services. Equally, it is not unreasonable to expect that as this occurs and the relative profitability of these services is experienced, such profitability will act as a stimulus for the practice to deliver yet more business advisory services. As such, this finding constitutes some further, tentative support for the performance benefits to be derived from related diversification (Hill, Hitt, and Hoskisson, 1992; Markides and Williamson, 1994; Miller, 2006).

CONCLUSION

Our findings confirm previous research that has indicated that advisory services are more remunerative than traditional accounting services in that we demonstrate a pronounced association between the range of services a small firm accountancy practice provides and the proportion of overall revenue derived from these services. However, our article is first and foremost concerned with attempting to account for differences in the propensity or ability of small firm accountancy practices to provide a broad scope of these services. We have done this by primarily drawing on the dynamic capabilities view of the firm, and our findings underscore the importance of routines, systems, and processes that promote the heterogeneity and continuous development of human capital and external alliances.

While our findings do not entirely dismiss the role of strategic choice in developing a broad scope of business advisory services, our findings emphasize the importance of small firm accountancy practices developing relevant dynamic capabilities. In purely pragmatic terms, achieving heterogeneity of human capital involves recruiting front-line staff

that have a bachelor's degree level of education and avoiding an overconcentration of authorized accountants. The implication is that practices that are seeking to develop their scope of business advisory services should seek to recruit and incorporate staff with education types that are less narrowly geared to the technical specifics of accountancy. At the same time, small firm accountancy practices must also have routines and systems in place that ensure the regular development of their human capital. Finally, our analysis emphasizes the importance of having processes for developing alliances with a range of other service providers. All of these developments clearly involve purposeful investment in routines, systems, and processes not only in the financial sense, but also in terms of time. In other words, the routines, systems, and processes involved in transforming a small firm accounting practice with a narrow scope of business advisory services into an extensive provider of business advisory services is a long-term endeavor. Our analysis suggests that one possible shortcut to developing a capacity for providing a broad scope of business advisory services may be through the expansion of the practice in terms of numbers of front-line staff with broad-based types of higher education. However, while this may, if properly managed, enhance heterogeneity, it does not represent a response to the need for strategically anchored internal development routines and systems, or the need to develop external alliances with complementary service providers.

Our findings also suggest that the small firm accountancy industry is currently somewhat bifurcated in the sense that there is a substantial minority of small firm accountancy practices that deliver only a limited range of services. On the other hand, there are those practices that have succeeded in developing the resources that enable them to extensively focus on the more lucrative market for business advisory services. Whether this will remain the case is difficult to ascertain on the basis of this study, but clearly the strong association we find between the range of services delivered and the proportion of overall revenue derived from these services suggests a 'virtuous circle.' However, initial entry to this circle is dependent on a range of investments, not least in terms of internal human capital, that may be too daunting for the more traditional small firm accountancy practice.

While diversification remains a key topic within strategic management, research tends to focus on

performance outcomes of types and degrees of diversification rather than what determines diversification in the first place (Hoskisson and Hitt, 1990; Miller, 2006; Ramanujam and Varadarajan, 1989). We further observed that the distinction between related and unrelated diversification is generally regarded as crucial and as such is a distinction that underlies this article. We have also noted that in the case of related diversification through internal development, Hoskisson and Hitt (1990) contended that this is an effect of the deployment of surplus intangible resources. However, while we too subscribe to this view, it is deficient in one significant respect; that is, it fails to account for the antecedents of resource development. In this article, our primary aim has been to address this deficiency in our understanding of related diversification by specifying key underlying antecedents. We have done so by drawing on insights from the dynamic capabilities approach in the context of small firm accountancy practices. In particular, we hypothesized that dynamic capabilities would enable firms to expand their scope of services. Given standardized competencies for the production and delivery of core products, together with uniform incentives to diversify, change in product scope, we argued, derives from the possession of dynamic capabilities. We conclude that the findings reported here support this basic hypothesis, although specific findings may not be readily generalized to other industries and to larger firms. Some measurements used in the present research were adapted to industry idiosyncrasies, and may not be readily applied to other research contexts. Although these measurements were adequate for this research, future research in this area may need to develop more general measures or possibly develop measures tailored to other research settings.

On the other hand, the industry studied in this article is characterized by a well-defined, unvarying, and narrow scope of core products where even modest levels of diversification are readily observable and easily measured. Given standardization of core products and associated competencies, measurements of other variables are also straightforward. In sum, the small firm accountancy industry provides a homogenous setting where the expansion of scope and the role of dynamic capabilities in the process can be sharply focused. In addition we believe that the present research on small service firms contributes to a field dominated by data

obtained from large, divisionalized firms. Future research might extend our approach to other professional service industries, and possibly to other sectors and larger firms as well.

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