STRATEGY AND STRATEGIC ALIGNMENT IN PROFESSIONAL SERVICE FIRMS

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Abstract
This chapter reviews the strategic management choices that are central to professional service firms (PSFs), which in turn undergird their competitive advantage and long run performance. In the first part of the chapter we focus on human capital as a critical resource for PSFs, and explore different ways in which firm value is created by attracting, developing, configuring and leveraging human capital. Further, it is critical that PSFs’ human capital be aligned with and harnessed to the firm’s objectives, which naturally raises issues related to motivating professionals, the sharing of economic rents with (and among) them, and the overall governance of the firm. We then draw on these building blocks of strategy in PSFs in the second half of the chapter to explain the corporate strategy decisions (such as service and geographic diversification) that PSFs must make, and discuss the value creating role of client relationships.

Keywords: knowledge hierarchy, leverage, firm-specific human capital, professional expertise, rent division, firm governance, client relationships, employee mobility, service and geographic diversification
INTRODUCTION

Professional Service Firms (PSFs) that provide services in such areas as law, accounting, management consulting, and advertising have become a vital sector in modern developed economies, and continue to increase in economic importance. In 2011, according to the US Bureau of Economic Analysis, the professional and business services (PBS) sector contributed approximately 9% more to US Gross Domestic Product (GDP) than the entire manufacturing sector, and these estimates are likely quite conservative because they exclude PSFs in industries like real estate, financial services and medical services. Moreover, GDP value added by the US PBS sector – as defined above – grew by 260% in the two decades between 1991 and 2011, compared to only a 77% growth for US manufacturing. Similarly, US employment in the PBS sector was 49% more than manufacturing in 2011, and grew by 49% between 1991 and 2011 whereas employment in manufacturing actually fell by 31% during this time period.

Despite the significant and growing importance of PSFs in the economy at large, academic research on the strategic management of PSFs has been somewhat sparse. For this review, we undertook a comprehensive search of academic databases to identify research pertaining to the strategic management of PSFs and found fewer than 100 relevant articles, many of which were published in specialized journals or profession-specific journals such as law reviews. In searching for relevant research, we followed von Nordenflycht (2010) in defining PFSs as firms that have high knowledge intensity, low capital intensity, and comprising a professionalized workforce. Despite the limited research conducted so far, PSFs have piqued the interest of strategy scholars because, unlike other types of firms, PSFs are built almost entirely from knowledge-intensive assets that are highly mobile and not amenable to secure property rights (Coff 1997, 1999; Teece 2003), conditions which run counter to those that the strategy literature has identified as necessary for sustaining competitive advantage (Barney 1991; Peteraf 1993).

Systematic thinking about the strategic management of PSFs goes back at least to Maister who noted that “Management of a professional firm requires a delicate balancing act between
the demands of the client marketplace, the realities of the people marketplace,...and the firm’s economic ambitions” (1993:3). In our extensive review of strategy research on PSFs, we identified several core themes in the literature, namely; how PSFs create value from human capital, the alignment of the professional workforce with the firm’s goals, and how value is created from client relationships. The remaining theme builds on these foundations to examine research explaining various corporate-level strategies on PSFs. We conclude our review by identifying potential directions for future strategy research on PSFs.

**STRATEGIC MANAGEMENT AND VALUE CREATION FROM THE PROFESSIONAL WORKFORCE**

Perhaps the most salient characteristic of PSFs related to strategic management is the extent to which their critical knowledge assets and core drivers of competitive advantage come from human capital. Therefore, as a starting point for our review we examine the core mechanisms through which PSFs create and capture value from their human assets. *Inter alia*, we review the role of knowledge management in PSFs, which is intimately connected to the organization and management (including training, development, and deployment) of human assets. Elsewhere in this Handbook knowledge management in PSFs is examined in the context of variation in PSF characteristics across firms and professional service industries. Our review focuses on how PSFs strategically organize and align their professional workforce, and examines the competitive impacts. Seriatim, we review the roles played by the organizational infrastructure for human capital, knowledge hierarchies and leverage, “star” and expert talent, and mechanisms adopted by PSFs to ensure the goals of the professional workforce align with those of the firm.

**Infrastructure for Organizing Human Capital**

One stream of strategic management research - the knowledge-based view - describes firms as repositories and organizers of multiple strands of knowledge that underlie a firm’s capabilities and performance (Grant 1996; Kogut & Zander 1992). A knowledge-based view of
PSFs considers how PSFs can create value from their organizational infrastructure for managing knowledge and by using various mechanisms to organize, transfer, integrate and protect knowledge across different individuals and groups within the firm (Jensen, Poulfelt, & Kraus 2010; Morris 2001).

PSFs may organize by codifying their knowledge and deploying technology to enable fast and reliable access to this codified knowledge repository. Here, value can be created from economies of scale generated by the re-use and dissemination of knowledge as an organizationally owned asset, while direct access to codified core information can reduce internal costs to communication and enable consistency in delivering client services (Hansen, Nohria, & Tierney 1999). However, critical knowledge within PSFs may be largely tacit and difficult to codify. For example, the experience and skills of expert professionals may only be effectively communicated through personal interactions with others. However, tacit knowledge forms part of an employees’ human capital and thus is not an organizationally owned asset, though organizations may seek to employ and appropriate some of this knowledge. Moreover, in some PSF industries, client needs may be highly complex and non-standard, limiting the benefits of codified knowledge.

A central challenge for PSFs in deriving value from human capital is therefore devising ways to encourage professionals to share their tacit knowledge that can also give those professionals a personal competitive advantage (Empson 2001; Morris 2001). At the same time, knowledge that is well understood or codified is at greater risk of replication by competitors or clients, while mobile professionals are also more likely to transfer codified knowledge when they migrate between firms (Phillips, 2002; Wezel, Cattani & Pennings). Thus, one strategic concern for PSFs is to balance value creation from codifying the tacit knowledge held by their human capital on the one hand against potential value erosion from the easier expropriation of codified knowledge on the other.

Extant research literature provides numerous examples of how PSFs generate value through codified knowledge management. For example, bureaucratic procedures developed to
organize the PSF’s knowledge may create value by transferring externally sourced knowledge, such as that gained from clients, across the firm’s internal stakeholders (Briscoe 2007). Indeed, in modern-day PSFs that increasingly follow a more “corporate-style” organizational model (Cooper et al. 1996), systems that codify best-practice solutions to recurring client problems and monitor the productivity and fee income generated from these solutions often support value-creating strategies (Brivot 2011; Forstenlechner, Lettice, & Bourne 2009). Finally, Morris (2001) shows in a case study of a large UK management consulting firm that the firm’s codified knowledge largely consisted of a “knowledge architecture” that supported a technically consistent methodological approach across projects, which effectively gave the consultancy a “brand”.

At the other end, PSFs may adopt strategies that draw primarily on individual and collective tacit expertise – developed through repeated internal and client interactions – to provide solutions for very complex and high-level strategic problems (Hansen et al. 1999). Thus, while this feature varies in degree across professional services, value is created through the ability of expert professionals to address unique problems by using tacit knowledge, where codified knowledge resources are largely used to support the delivery of professionals’ tacit expertise (Hansen et al. 1999). Even in Morris’ (2001) case study, the codified knowledge architecture described above provided a consistent process template but left individual consultants with sufficient autonomy to deliver value from their tacit professional expertise, which was instrumental in identifying client problems and constructing complex solutions for them.

In sum, we see that PSFs may adopt an internal infrastructure that harnesses, deploys and in some cases stores the critical knowledge that drives PSF performance. We turn next to specific ways in which value created and captured by PSFs is driven by how they manage knowledge and develop the expertise of employees.
Knowledge Hierarchies and Leverage

The dominant PSF model, particularly in legal, consulting and accounting services, is the vertical differentiation of human capital, which lends itself to a top-down knowledge management structure that has been labeled as a “knowledge hierarchy” (Garicano & Hubbard 2007). In the typical PSF partnership model, the largely tacit human capital of senior PSF members (experts) is “leveraged” by junior members (novices) through a hierarchical structure that generates economies of scale to the experts’ experience and expertise while simultaneously building the knowledge, skills, and experience of novices through learning-by-doing (Garicano & Hubbard 2007; Gilson & Mnookin 1989). Through this knowledge-management process, novices gain industry (and firm-specific) knowledge under the supervision of experienced and often high caliber professionals in their field.

Leverage is typically operationalized in research as the PSF’s “leverage ratio”, which is the number of novices per expert (partner) in a firm. A higher leverage ratio allows experts to delegate higher volumes of routine work to novices, enabling PSFs to take on more new business as the productive time of experts is reserved for higher value-added client services and strategic management of the firm (Kor & Leblebici 2005; Kordana 1995). Accordingly, a key knowledge management strategy for many PSFs is the dynamic adjustment of their leverage ratio according the scale of demand for services (Garicano & Hubbard 2007, 2009). For example, research has shown that as market demand for PSF services increases, PSFs may capitalize on this demand by employing more novices and intensively leveraging expert human capital (Garicano & Hubbard 2007; Sherer 1995). Building on this logic, studies have generally found a positive relationship between a PSF’s leverage ratio and PSF profitability (Greenwood et al. 2005; Hitt et al. 2001; Kor & Leblebici 2005; Sherer 1995), while corroborating anecdotal evidence states that when demand for PSF services is high, increasing the firm’s leverage ratio is akin to “printing money” (Heinz 2009).

Implicitly, knowledge management and the corresponding management of human assets for value creation reflect both the nature of underlying professional knowledge and the type of
client service (Malhotra & Morris 2009). As such, not all PSFs are organized as partnerships; rather many PSFs are private or public corporates, and some start as private or partnership firms before going public through IPO (for example, investment banking giant Goldman Sachs and global business advisory and consulting firms KPMG and Accenture). Moreover, extant research reveals that ownership and governance form may be related to the particular professional service industry; legal services, accounting and management consultancy dominate the partnership form of ownership, while advertising and architecture are most notable as being corporations (Greenwood & Empson 2003; von Nordenflycht 2007). However, despite these important differences between PSFs, very little research has been conducted on knowledge management in non-partnership PSFs (i.e., public or private corporations). There are, therefore, research opportunities available to gain a deeper understanding of knowledge management within PSF corporations, such as uncovering the particular knowledge management mechanisms and their impacts on PSF performance. Another line of inquiry may be to compare knowledge hierarchies between PSFs in the same industry that are governed differently. von Nordenflycht (2007) finds differences in financial performance and productivity between public and privately owned advertising agencies and future studies could build on these findings to understand if systematic knowledge-based differences occur as a result of different ownership and governance form. However, it may be that, rather than in knowledge management per se, the impacts of differences between partnerships and private and public corporations manifest most strongly in the strategic concerns of appropriation, and incentives and motivation of the professional workforce, which we turn to next.

**Strategic Alignment of the Professional Workforce**

As noted above, for PSFs, human assets are *the* critical resource for generating firm performance. However, professional workers are highly mobile and can often quit their employer at will or withhold effort (Coff 1997, 1999). Arguably, employee exit or reductions in employee productivity are most likely when the goals of the firm and goals of employees
divege. Incentives for behavior and motivation have a significant bearing on both the ability of
PSFs to retain professionals and to enhance their productivity (Castanias & Helfat 1991, 2001;
Coff 1999, 2010), and indeed, economic rents generated from human assets will be diminished if
effort and motivation are misdirected (Coff 1999; Coff & Krascynski 2011). Thus, an important
strategic concern for PSFs is aligning the personal interests and goals of professionals with
those of the firm (Coff 1997, 1999; Coff & Krascynski 2011; Teece, 2003).

Prior research shows that PSF ownership and governance form can have a significant
bearing on PSF performance (Greenwood & Empson 2003; Greenwood, Deephouse, & Li 2007;
Von Nordenflycht 2007). Differences in PSF performance across ownership and governance
form have been associated with differences in the incentives and motivation of professionals, and
the level of “agency costs” for PSFs. In PSFs, agency costs occur when conduct of a professional
employee deviates from that which is best for firm. Agency costs are particularly high when
there is a clear separation of ownership and control, or where the behavior of professionals may
be largely undetected without the PSFs incurring significant costs for monitoring the behavior of
its professional employees (for an overview of agency theory and its contributions to
organizational theory see: Alchian & Demsetz 1972; Eisenhardt 1989; Fama & Jensen 1983;
Jensen & Meckling 1979). However, agency theory maintains that firms can circumvent high
monitoring costs by ensuring appropriate incentives are in place to motivate and align
employees. For example, research suggests that the partnership form of ownership is particularly
effective at aligning managers because shared firm ownership (and thus profits), and personal
liability for firm debt and misconduct of other managers both provides incentives for acting in
the interests of the firm and increases peer monitoring (Greenwood & Empson 2003). However
as partnerships become very large, with hundreds or even thousands of partners, significant
principal-principal agency problems may surface and pose a novel set of challenges that has not
yet been systematically studied.

In aligning the professional workforce to the goals of the firm, PSFs need to devise
mechanisms to motivate and reward employees at both expert and novice levels. While
incentives in PSFs are closely linked to rent division and appropriation there are also important non-pecuniary motivators of professional workers, and as such, the core motivators include money, power, status, autonomy, learning opportunities, and alignment to professional norms (Gottschlag & Zollo 2007). This section reviews how the strategy literature has discussed the challenges for PSFs in devising systems and processes that guide, integrate and make more productive the autonomous but interconnected work of highly skilled workers, who may also have divergent interests (Teece 2003).

Appropriation of Economic Rents

The production of value in PSFs is often socially complex and as such PSFs may not hold clear property rights over many critical value-generating assets; therefore numerous stakeholders can arguably claim a share of the economic rents (profits) of the firm (Coff 1997, 1999; Teece 2003). Drawing on Coff’s insightful comment that “Organizations don’t appropriate rent, people do” (1999: 120), we note that division of rents in PSFs is largely within and between the ranks of senior managers (who are also typically the shareholders) and junior members (or associates).

Research on PSFs has equated rent appropriation to the relative bargaining power of employees vis-a-vis the firm (Campbell et al. 2012; Coff 1999). Employees are often in an advantageous bargaining power position due to the portability of human capital that enables them to capture a larger share of value generated from their knowledge and expertise (Coff 1999). Moreover, professional workers are more than ever aware of their own brand and value (Teece 2003) and in turn, expert professionals can exploit low barriers to mobility to maximize their personal compensation (Henderson 2006; Henderson & Bierman 2009). In PSFs organized as partnerships, and where professionals hold a higher degree of autonomy (such as legal services), the compensation structure of the firm may be highly dispersed in order to retain the most value-creating talent (Campbell et al. 2012; Carnahan, Agarwal, & Campbell 2012); in effect, PSFs contain extreme earners who may be compensated several times more than a peer employee.
The degree to which firm value is generated from human capital alone has been shown to have a significant bearing on employee rent appropriation (Bowman & Swart 2007). Indeed, when firm value is derived from the combination or embedding of human capital with complementary firm assets (such as firm brand or reputation), combinations of human capital (such as teams) professionals, or from firm-specific knowledge of the firms routines and processes, professionals may have less legitimate claims that their human capital is the critical value-generating asset (Bowman & Swart 2007; Coff 1999; Malos & Campion 2000). Research dating back to the origin of human capital theory (e.g., Becker 1964) posits that the higher the proportion of firm-specific human capital an employee holds, then the lower his (or her) bargaining power over the rents created, in part, because the threat of exit is less credible. In order to maximize bargaining power (and mobility), professionals may resist making substantial investments in firm-specific human capital, and therefore PSFs may still be at risk of unproductive workers if professionals feel that their personal contributions to firm value are not being rewarded. In these instances, PSFs may need to build effective non-pecuniary reward structures to ensure the ongoing satisfaction of employees, maintain higher levels of productivity, and drive firm performance (Coff & Kryscynski 2011), which we turn to in the next section.

Finally, as is explored in more detail in other chapters this Handbook, there is variation in the ownership and governance form of PSFs which has implications for rent appropriation, and in turn for employee incentives and motivation. In non-partnership PSFs (i.e. corporations), firm profits are not distributed exclusively to manager-owners (partners), but instead are concentrated in a smaller group of firm owners (private corporation) or widely dispersed among external shareholders (public corporation). The key implication that is highlighted in the literature for non-partnership PSFs is a weakening of the link between human capital and financial reward, which can delink incentives of the firm’s human capital from the overall performance of the firm (Greenwood & Empson 2003; Greenwood et al. 2007). We explore these incentive and motivation issues next.
**Incentives and Motivation of the Professional Workforce**

**Partnership model**

When organized as a hierarchy (typically the “partnership model”), the vertical division of labor creates different incentive mechanisms between the levels – or tiers – of professional talent. Until recently, the dominant incentive mechanism adopted by these PSFs was a profit-sharing model. In this model, the level of compensation and strategic authority is allocated according to seniority in the firm (Gilson & Mnookin 1985), where the strategic emphasis is on collective (i.e., firm) rather than individualistic performance. In this model, managers (partners) typically remained at the same firm for most of their career and thus had incentives to invest deeply in the development and long-term success of the firm. However, the modern-day focus on production and profit-maximization targets, allied to increased mobility of professional workers, has increased the relative bargaining power of key talent. In turn, PSFs began to incentivize partners by directing the distribution of profits and authority to individuals who contributed most significantly to firm performance (Campbell et al. 2012; Carnahan et al. 2012). Moreover, because these PSFs are driven primarily by the individualistic motivations of financial reward and personal reputations, partners in these PSFs face an ongoing incentive to maximize billing hours (and achieve high reward) or see their compensation drop due to under-performance, and potentially being forced out the firm.

In the partnership model, PSFs incentivize and motivate novice workers using different mechanisms than those used for partners. Primarily, PSFs use expert mentoring from partners and the chance of partnership which confers participation in profit sharing (thus creating a “tournament model”) to drive associates to align with the goals of the firm (Galanter & Palay 1990; Gilson & Mnookin 1989; Malos & Campion 1995; 2000). However, PSFs who derive competitive advantages from firm-specific human capital may find it more challenging to motivate novices to invest in accumulating less transferable skills as this can constrain alternative employment opportunities and reduce employee bargaining power vis-à-vis the firm (Becker 1964; Coff 1999). Research has shown that when PSFs rely on greater levels of firm-
specific human capital, the use of non-pecuniary mechanisms to motivate novice employees may increase (Malos & Campion 1995, 2000). For example, these PSFs may have a lower leverage ratio which enables closer mentoring from experts and reduced competition between novices for promotion to partner. In addition, the length of time required before becoming eligible for promotion to partner may be shorter, which may also be a spillover effect from closer mentoring and broader work experiences during novice training (Malos & Campion 2000).

In sum, while partners and associates are incentivized using different mechanisms, at a fundamental level the levers are similar. One set of motivating mechanisms is based on firm-specificity and collegiality, whereas the other is based on incentivizing individual performance through higher levels of compensation and transferable skills. However, this discussion is in the context of PSFs organized as partnerships. We discuss next the incentive and motivation implications in PSFs not organized as partnerships.

*Non-partnership PSF model: public and private corporation*

Although the research literature that pertains to strategy in PSFs is largely in the context of the partnership model and in specific industries (notably the legal industry), our review would not be complete without discussing how research in the non-partnership model context explains incentives and motivation of professionals as drivers of firm performance.

As noted above, important differences in the incentives and motivation of the professional workforce may result from the type of ownership and governance form, and these differences may be reflected in the overall performance of the PSF (Greenwood & Empson 2003; Greenwood et al. 2007; von Nordenflycht 2007). For example, while publicly owned PSFs may benefit from market discipline such as a more formal strategic direction and clearer accountability (Greenwood et al. 2007), the separation of ownership and control increases internal agency costs. Moreover, while public ownership gives greater access to capital, often this capital is not required as the investment needs of PSFs (for such things as physical assets and R&D) are generally low (von Nordenflycht 2010). Thus, the benefits of public ownership may
be minimal, while the incentive and motivation costs can be substantial. Indeed, research in management consulting has found that, on average, publicly owned PSFs have the lowest financial performance when compared to partnerships and private PSF corporations. On the other hand, von Nordenflycht (2007) shows that when PSFs (in this case advertising agencies) are publicly listed companies, the expected negative impact on performance due to lower financial incentives for professional workers does not automatically materialize. Rather, the size of the PSF is an important moderator of the relationship between ownership form and PSF performance. The key finding of von Nordenflycht (2007) is that for smaller advertising agencies, public ownership was associated with inferior performance, but not for larger advertising agencies. One explanation put forward is that as PSFs grow larger, fixed capital expenditures are greater and this increases the need for access to capital, while employee incentives may be less important considerations (von Nordenflycht 2007).

Nevertheless, in non-partnership PSFs, the weakening of the link between ownership and control, and distribution of firm profits away from managers can reduce the incentives of professionals to align with the strategic goals of the firm. The dilemma for PSFs is how to motivate these individuals to work in the interests of the firm, especially as extant research in both legal services and advertising has found clients to have often stronger bonds with PSF employees than the firm itself (Broschak 2004; Somaya, Williamson, & Lorinkova 2008). One possible motivator for employees to align with the firm may stem not from any firm-specific mechanism but from the internal motivations of the professional herself. Consistent with Gottschlag and Zollo (2007), professional workers may be motivated by an intrinsic desire to produce high quality client services within the institutional norms of their profession, regardless of their employer. Thus, while professionals in non-partnership PSFs may not share in the profits of the firm or have ownership control, professionals in general pay a significant amount of attention to developing their personal brand and building social capital Teece (2003). Such intrinsic motivation may substitute, to some extent (and more so in professional service
industries than others) pure financial reward. In terms of developing and reaping advantages from their own brand, we turn next to a particular type of professional – star or expert talent.

Stars and Expert Talent

A notable characteristic of the professional service industries and knowledge intensive work generally is the presence of “star” or “expert” human capital. Stars are individuals who are disproportionately productive relative to average performers in their profession due to the superior education, skills, motivation and/or experience they hold as human capital. Allied to being expert service providers, they may also have superior strategic and general management abilities (Teece 2003). Furthermore, as stars represent a small fraction of the labor market and their human capital is only imperfectly imitable (Barney, 1991), they typically also have a high replacement cost to the firm (Coff 1999). PSFs with star talent should, holding everything else equal, be able to generate competitive advantages over PSFs lacking such talent. In addition to their human capital, stars typically also hold valuable social capital embedded in their extensive professional networks, client relationships and perceived high status (Teece 2003). The value can manifest itself through access to additional competencies through professional contacts, while the personal reputation of expert human capital can attract high caliber clients and other professional talent. Human capital and social capital are thus two important complementary, yet distinct, mechanisms through which stars generate value for the PSF.

While PSFs are naturally drawn to star individuals to provide a strong foundation for the firm, it is important to underscore that there may be important firm-specific contributions to the value that stars produce. Stars do not work in a vacuum; rather the organizational contexts of PSFs may make firm-specific contributions to value creation that “enhance the star’s brightness” (Groysberg, Lee, & Nanda 2008). Examples of firm-specific contributions to value creation include administrative or structural processes that support and mobilize stars’ human and social capital, routines shared with team members, and firm-level resources such as superior financial or reputational strength. Indeed, research from the mutual fund industry shows expert fund
managers who are responsible for investment decisions may only contribute between 10-50% to fund performance (Baks 2003), while Groysberg et al. (2008) show that stars can suffer a deep and prolonged performance decline if removed from their work environment to a new firm. Moreover, Groysberg, Polzer, and Elfenbein (2011) find that while building project teams with multiple experts can initially increase team performance, there are decreasing marginal returns after a certain point (especially if the individuals have similar expertise) as clashes of status and ego coupled with the lack of functional hierarchical arrangements impede team effectiveness. Taken together, the research literature suggests that while expert talent can deliver substantial value to PSFs, it is important for PSFs to understand that stars require significant organizational supports (Teece 2003) and that having too many stars working together may not be an effective use of human resources.

**STRATEGIC OPPORTUNITY**

Strategic concerns in PSFs extend beyond the purely human capital and human resource related aspects discussed thus far. Indeed, a key central concern of PSFs is the creation of “opportunity space”. In this section on strategic opportunity we examine a set of distinct, but inter-related, strategic factors that PSFs implement at the corporate level – i.e., corporate strategy. We also examine how PSFs strategize in terms of client relationships and how value is derived from these relationships.

Corporate strategy is fundamentally about the ways in which firms create value and derive competitive advantages from the configuration of multi-market activities (Porter 1985). Thus, it is essentially concerned with strategies related to the scope of the firm. For PSFs, this entails a set of issues pertaining to the range of client services (including multi-profession PSFs) and geographic footprint, and also the degree of integration across these different operations. Relatedly, an important dimension of corporate strategy is the extent to which PSFs use mechanisms such as mergers & acquisitions (M&A) and network alliances to implement choices related to corporate scope. Critically, the viability and performance of specific corporate
strategies may depend on the quality of human capital and degree to which human capital is leveraged (Hitt et al. 2001; Kor & Leblebici 2005), expertise in particular specializations (Garicano & Hubbard 2007, 2009; Sherer 1995), and relational assets with clients (Chatain & Zemsky 2007; McKee & Garner 1992; Rose & Hinings 1999). Thus, corporate strategy in PSFs cannot be considered in isolation of the professional workforce.

**Service Scope of PSFs**

Professional service industries are characterized by PSFs of varying size and scope of services. The service scope of PSFs pertains to the array of services it offers clients, either within the same industry (e.g., law or advertising) or across industries, such as the “Big 4” global business advisory PSFs who dominate across the fields of accounting services and management consulting.

PSFs may undertake a specialist “boutique” strategy, operating in a narrow range of closely related areas underpinned by tightly aligned organizational structures, processes and human capital that enables them to provide of best-of-market services (Garicano & Hubbard 2007). In contrast, other PSFs prefer to function as multi-service providers that create value from operating in numerous client markets, offering clients “one-stop shopping” (Siggelkow 2002) and at the same time strengthening client ties and building relational benefits (Chatain & Zemsky 2007). Other PSFs implement “hybrid” strategies (Greenwood et al., 2005) that provide multiple client services but are more dominant in a single service or profession. However, hybrid multi-service PSFs (in accounting) have been shown to not perform as well as specialist or broader-based PSFs, ostensibly because the “lesser” services are not deemed “creditworthy” (Greenwood et al. 2005). However although Greenwood et al. (2005) find a balanced, broad service portfolio is associated with better performance, von Nordenflycht (2010) suggests PSFs may remain specialized to signal the quality of their expertise in a narrow area.

The corporate strategy of PSFs is likely to be intimately linked to prevailing market conditions. For instance, research has found that with greater market demand, PSFs may become more narrowly specialized in order to differentiate from the market based on quality, where, in
turn, deep expert knowledge is often more highly leveraged (Garicano & Hubbard 2007; Sherer 1995). Greater market demand is presumed to give PSFs greater confidence in making sunk-cost investments in highly specialized expert knowledge; and markets with higher demand also have deeper labor markets that enable firms to find higher quality professional talent. Further, as market demand increases, so too does the number of PSFs looking to capture a share of this demand, which encourages firms to differentiate their services based on quality and specialization (thereby attracting high caliber talent, and clients who want best-of-market services). The consequences of specialization for human capital leverage stem from a smaller set of highly coordinated organizational processes that allow some knowledge to be codified into common repositories that novice workers can access directly, while managers themselves may find it easier to train novices within a narrower and more tightly aligned knowledge domain (Garicano & Hubbard 2007, 2009; Sherer 1995).

Other studies have noted the influence of the relational dimension of client and industry ties for PSFs corporate strategy. Indeed, when opportunities to cross-sell services to clients exist, a multi-service as opposed to specialized strategy may become increasingly valuable (Chatain & Zemsky 2007). For example, Rose and Hinings (1999) and McKee and Garner (1992) suggest that the overall design of global accounting and business advisory PSFs is in direct response to the specific service needs of their clients, whereby these PSFs have extended both geographically and in services (beyond audit) to leverage client relationships by meeting new (e.g., business advisory) needs of their clients. Similarly, in a study of the Canadian investment banking industry, Shipilov (2006) found clients place high value on the superior sector expertise of specialist banks but also on accessing the broader-based investor networks of multi-service banks. Indeed, broad-based banks in large networks that provide significant opportunities to connect clients to investor groups outperformed specialists in this context (Shipilov 2006). While these studies have made some initial forays into assessing the relative tradeoffs between service specialization and diversification in PSFs, in the concluding section we outline additional research opportunities in this area.
Geographic Scope of PSFs

While many large PSFs compete in multiple distinct geographic markets, the geographic scope strategy of PSFs (which is arguably quite unique when compared with the corporate strategies of manufacturing firms) has been relatively understudied; with one exception – global expansion. Global commerce requires PSFs to be able to facilitate transactions and solve disputes that span national borders and institutions, and global multinational clients may desire to deal with PSFs that can provide seamless and reliable services across multiple jurisdictions. Indeed, in 2012, the top five global law firms by gross revenue operated in a total of 127 overseas countries that accounted for almost 54% of attorney headcount\textsuperscript{vi}, while the behemoth “Big 4” business advisory PSFs have grown into global entities. Yet, the drivers of international corporate scope in PSFs mirror service scope in many ways. Research in the accounting industry informs us that accounting and business advisory firms went global to leverage and maintain relationships with clients who themselves were internationalizing (Rose & Hinings 1999). Thus, client relational assets and client pressures can be an important driver of global expansion in PSFs. From a human capital perspective, Hitt et al. (2006) found that US legal firms, whose expert talent held higher levels of firm and occupation-specific human capital, were more likely to expand overseas; however, after a certain level of overseas expansion these firms faced diminishing economic returns to further expansion. For UK law firms, the opposite relationship has been found, whereby international expansion is loss making until a certain threshold level of expansion is reached (Brock, Yaffe, & Dembovsky 2006), again highlighting the potential for further research to understand the tradeoffs inherent in the geographic and international expansion of PSFs.

Moreover, Hitt et al. (2006) indicate the importance of human capital, not only as a key resource whose development might be affected by corporate scope choices, but also as a critical enabling resource for changes in PSF scope. In PSFs, senior managerial human capital is a critical resource for both running the day-to-day service operations of the firm, as well as
managing the expansion into new service and geographical areas (Hitt et al. 2001, 2006; Kor & Leblebici 2005). Drawing on the Penrosean theory of firm growth (Penrose 1959), Kor and Leblebici (2005) note the limited capacity of managers to simultaneously manage a significant strategic move, while also mentoring large numbers of junior colleagues and responding to client needs. Indeed, Hitt et al. (2001) find that PSFs with superior expert talent can increase profits when undertaking either higher levels of service or geographic expansion, but not both at the same time. Kor and Leblebici (2005) extend Hitt et al. (2001) by also investigating the effect of human capital leverage on the diversification-performance relationship, and show highly leveraged PSFs suffer a drop in performance when undertaking either high levels of service or geographic diversification, or when recruiting higher numbers of expert talent. Taken together, these results show that when embarking on strategies to expand the scope of their organization, PSFs need to pay careful attention to the strains placed on their managerial human capital and understand the competing demands faced by them. In addition, expansions of firm scope inherently implies a need for human capital in new areas – e.g. a new location, or a new service – and raises questions about how such human capital can be efficaciously acquired or developed, to which we now turn.

**Mergers & Acquisitions, Alliance Networks and Global Expansion**

PSFs typically do not begin life as multi-service firms. For example, in the accounting and business advisory industry, the firms who globally dominate both the accounting and management consulting industries operated initially as more focused accounting, audit, and tax PSFs. While PSFs can grow organically by hiring and training new talent, accessing and acquiring competencies of other PSFs (through M&A or alliance) is generally the preferred mechanism for PSFs to quickly and substantially alter their corporate scope.

M&A is a pervasive corporate strategy across professional services, as exemplified by legal services where top 200 law firms alone have been involved in over 350 M&A transactions between 2000 and 2012. The potential benefits of M&A are well documented in the broader
strategy literature (but empirical studies are lacking in PSFs), which include scale and scope economies, acquiring new competencies, and access to new markets and clients. However, while achieving synergies between strategic and operational elements are fundamental to any M&A, the human aspects of integration – particularly, the fusing of disparate human capital and organizational infrastructures – are also critical for acquisition success, especially when human capital is the key asset. Extant strategy literature (e.g., Greenwood, Hinings, & Brown 1994; Larson & Finkelstein 1999) highlights differences in management styles (such as differences in managerial problem solving, risk preferences, formal governance and communications) as key integration challenges, which may not be apparent ex ante and only be realized during the integration process (Greenwood et al. 1994). Pertinent to PSFs, clashes about professional ethics, performance measures, rewards and compensation, and paths to promotion can all contribute to undermining successful integration (Greenwood et al. 1994) or even result in a deal collapsing (Wooten, Wolk, & Normand 2003), while other significant issues may be related to newly acquired individuals resisting their new employers’ attempts to impose “property rights” over their knowledge and client relationships (Empson 2001). At the same time, the non-integration of incoming talent, for example due to path-dependency of existing relationships, distrust of new people, or the initial unwillingness to share resources (e.g. clients) may result in the preservation of separate cultures and management styles, which can also be value destroying (Briscoe & Tsai 2011).

Research also investigates the influence of client relationships as important antecedents to M&A, which can also have a significant impact on the efficacy of M&A (Rogan 2014b; Rogan & Sorenson 2014). Clients can serve as bridging ties between PSFs, leading to more interactions between firms. Research shows that an M&A event is more likely to occur between those PSFs who have a common client (Rogan & Sorenson 2014) as PSFs can use that client as a source of reliable information on potential acquisition targets. However PSFs who use common clients as part of the M&A search process may suffer post-acquisition loss of clients, and of those clients it retains, the PSF may receive less new business (Rogan & Sorenson 2014).
This research highlights the risk that a PSF incurs when increasing the “competitive overlap” of its portfolio of clients by acquiring another. An important concern for PSFs in general is that “competitive frictions” can materialize when serving multiple clients. Typically, clients prefer to not use a PSF that also represents key market competitors due to the risks of knowledge leakage, while conflicts of interest often prevent the same PSF from representing clients who may be engaged in aggressive competition (e.g. litigation) against each other. Following an M&A between PSFs, the merging of the respective client portfolios can result in the competitive frictions described above, and thus result in the dissolution of client relationships (Rogan, 2014b; Rogan & Sorenson, 2014). Moreover, Rogan shows in a study of M&A’s between advertising agencies that the decision of the advertising agency to merge with a firm that serves the competitor of a long standing client can increase the likelihood that the long standing client relationship will terminate due to “a violation of norms governing behavior in embedded exchange” (2014b: 6).

In general, however, corporate strategy research on PSFs would benefit from more systematic investigation into the drivers and performance effects of M&A; despite the high volume of M&A undertaken by PSFs and recent work examining client-based impacts of M&A, our understanding of this phenomenon is lacking compared to other industrial contexts.

As an alternative to M&A (or greenfield expansion), specifically for global expansion, a significant proportion PSFs operate as members of global alliance networks (Koza & Lewin 1999; Lenz & James 2007), which may in turn differ in their strategic objectives. In accounting and business advisory services, the largest networks are operated (and branded) by the “Big 4” (e.g. “KPMG International”). Member firms operate independently but are required to adhere to standardized processes in return for access to common resources, knowledge, expertise and the use of the brand name of the host firm (Lenz & James 2007). Value is generated for the host firm (e.g., KPMG) by having a truly global reach, while smaller member firms reap the membership and spillover advantages of alliancing with global leaders (Baskerville & Hay 2010). A second form of alliance network is structured for referral purposes only, where each
member is a separate firm in the truest sense and no costs or profits are shared for accounting purposes; e.g., Nexia International in accounting and business advisory services, and Lex Mundi in legal services. Value for PSFs following this alliance network strategy is generated through cross-referrals between members. However, tensions can often occur due to strict restrictions on one network member serving clients in another member’s territory (Koza & Lewin 1999). In the case of Nexia International, asymmetries in the volume of referrals ultimately resulted in a Middle Eastern member exiting the network and opening a New York office (Koza & Lewin 1999). Other network risks include damage to reputations from the behavior of other member firms, or opportunistic behavior arising from members who follow their own interests rather than that of the network (Jones et al. 1998; Lenz & James 2007). Strategy research on the drivers and impacts of PSFs’ network memberships has also been quite limited, and presents a unique opportunity for future studies.

**Client Value & Client Relationships**

In our final review section we discuss the importance of client relationships as a source of value for PSFs. As noted above, one way client relationships impact value creation in PSFs is in the efficacy of corporate strategy, specifically, the negative impact of M&A on client relationships. However, the discussion of client relationships within extant research literature is wider reaching. Notably, research considers that *relational assets* between PSFs and their clients can be a source of *strategic advantage* for PSFs, particularly in the capture of new business (Chatain 2011; Levinthal & Fichman 1988; Mayer, Somaya, & Williamson 2012; Moeen, Somaya, & Mahoney 2013). Accordingly, PSFs may dedicate substantial firm resources towards identifying and meeting the emerging needs of *existing* clients, leading some scholars to describe PSFs as often having a more relational or more transactional strategic orientation (e.g., Baker, 1990; Baker, Faulkner, & Fisher 1998). Although client relationships are addressed in more depth in a separate chapter in this volume, we focus here on the strategic implications of the different types of value added in these relationships (Chatain 2011).
In his seminal text on managing PSFs, Maister (1993) stated a critical strategic concern for PSFs is balancing the firm’s economic ambitions with the client marketplace. PSFs often leverage client relationships in formulating new strategies, in particular because existing clients represent a profitable source of new business. For example, the entry into management consulting of the “big 4” accounting and business advisory PSFs has been noted to be a result, at least in part, of value-adding strategies of firms who recognized the opportunities to serve more needs of their clients by increasing their portfolio of business services. Similarly, the globalization of the “big 4” has also been described in the context of these firms paralleling their clients’ international expansion. By following the expansion of clients, those PSFs can provide a seamless global service to international clients, strengthening the bond with clients and increasing the likelihood of future new business. Drawing on these palpable implications of client relationships for PSF corporate scope choices, recent academic research has found that PSFs may diversify in response to demand from clients and are more likely to do so when they share valuable relational assets with their clients (Mawdsley & Somaya 2014).

Separately, building on ideas regarding the specificity or specialization of knowledge held by PSFs’ human capital, research has shown that clients may outsource work to PSFs in order to access their superior (industry) domain-specific and/or occupational (professional) knowledge (Mayer et al. 2012). Thus, the PSF’s expertise in a specific professional area or industry domain may be important sources of value in its relationship with clients. In the current environment where clients shift their work more frequently between PSFs (Heinz 2009) and have become more sophisticated in assessing PSF capabilities, the ability of PSFs to develop unique expertise and adapt their expertise to changing market conditions is central to value-addition in servicing clients (Chatain 2011). Thus, evolving client needs and the resulting divergence in client-supplier fit may be associated with supplier switching (Baker, et al. 1998), and thus poses a counter-balance to the value of relational assets embedded in client relationships.

Nonetheless, the stock of client-specific knowledge that a PSF may acquire through past outsourced projects is a relationship-sustaining source of value, which can give the PSF a
privileged position in obtaining subsequent related business from the client (Mayer et al. 2012). Additionally, client relationships may also embed other relational assets – such as inter-firm coordination routines and informal trust and governance – that can help the transacting firms overcome market frictions and work more effectively across organizational boundaries (Dyer & Singh 1998). PSFs that develop client-specific knowledge and other relational assets are therefore likely to cement PSF-client relationships and break away from a more transactional model of service provision. Prior research on U.S. patent legal services has attributed increased PSF business from clients to the strengthening of such client relational assets through employee mobility (Somaya et al. 2008; Carnahan & Somaya 2013), and suggested that clients may increase the “concentration” of their outsourced business to PSFs with whom they share such relational assets (Moeen et al. 2013). Similarly, in the UK legal services industry, law firms holding higher levels of client-specific knowledge were more likely to be chosen to fulfill the emerging needs of existing clients (Chatain 2011). Furthermore, research in advertising also shows that clients respond favorably to suppliers that actively nurture client relationships (Labahn & Kohli 1997).

An important tension regarding client relationships, and one that is yet to be fully investigated in the literature, concerns the locus of control over the relationship – in other words, who effectively “owns” the relational value: the firm or key “boundary spanning” professionals? Several research papers in the literature indicate that clients’ ties to professionals may be stronger than to the firm. In the advertising industry, clients have been found to dissolve ties when key relationship managers exit the PSF (Baker, et al. 1998; Biong & Ulvnes 2011; Broschak 2004), while Seabright, Levinthal, and Fichman (1992) shows in accounting that the likelihood of client tie dissolution is attenuated by longer tenure of senior human capital. On the other hand, Rogan (2014a) finds in the advertising industry that PSFs can in some cases mitigate the effects of employee departure when the firm has multiple ties to the same client. Moreover, research in (patent) law has also shown that professionals can port client relationships when they switch firms (Somaya, et al. 2008). It is interesting to note, however, that Biong and Ulvnes
(2011) also find that clients are less likely to follow the professional (even when she has valuable human capital) when the PSF has a greater level of structural (relational) capital with the client. Therefore, there do appear to be important firm-level contributions to the client relationship even when the client derives significant value from individual-level talent. Future research should further elucidate where the locus of client-relationships resides, and how PSFs may strategically influence its location.

CONCLUSION AND FUTURE DIRECTIONS

In this chapter we have reviewed the extant literature on the strategic management of PSFs. Given the importance of human capital for PSFs, it is only natural that the strategy literature on PSFs is built significantly on a human capital foundation. In particular, we have reviewed the different ways in which PSFs seek to create value from human capital, which includes the vertical differentiation of talent (e.g. within knowledge hierarchies) as well as the organizational infrastructures to support, develop, combine and co-specialize human capital. In turn, PSFs seek to align their talent with the firms’ overall objectives through a delicate balance of motivational tools, rent division with professionals, and governance structures for the firm. Another important resource for virtually all PSFs is their relationship with clients, although ownership over these relationships may be shared with professionals and thus raises similar concerns regarding rent division and motivation as human capital. Lastly, we reviewed the literature on corporate strategies pursued by PSFs, which include both decisions about firm (service and geographic scope) as well as specific strategic actions such as M&A and alliances that can be used to support these corporate scope choices.

Within each of the reviewed streams of research, we have described a number of fruitful avenues for future research in the strategic management of PSFs. For instance, we note the need to develop a deeper understanding of the limits of leveraging, tradeoffs between different types of human capital specialization, performance implications of PSF governance, the ownership locus of client relationships, geographic scope choices, and the use of M&A and alliance
networks. Additionally, research on strategy in professional services may benefit from exploring additional measures of firm performance besides profitability. While most research on PSF performance focuses on profits per partner as the dependent variable, many industry sources (e.g., published law firm rankings) base their rankings on gross revenue or number of professionals, rather than average partner profits. Performance measures such as growth, revenues, billing rates, and survival may also have theoretical appeal in the context of PSFs, in addition to their practical real world significance. Indeed, in recent times we have witnessed the dissolution of large and seemingly financially strong PSFs, but we are yet to fully understand the reasons or triggers for collapse. While each of these areas (and others besides) are certainly promising areas for research, we are particularly struck by the need for integration and reconciliation between the different research streams within our review.

Consider for example the interactions between human capital building through leveraged knowledge hierarchies, its specificity to firm-, industry- or occupation, and the organizational infrastructures within which it is built and deployed. While prior research has explored each of these aspects in significant detail, significant gaps remain in our understanding of the connections and tradeoffs between them. Similarly, the relationships between different human capital building strategies (Chauradia 2014) and the motivation and governance of human capital are quite underdeveloped, although recent work on compensation dispersion has begun to fill this lacuna (Campbell et al. 2012, Carnahan et al. 2012). Another significant research opportunity lies in connecting client relationships with the development and maintenance of important human capital-based expertise within both PSF and client organizations (e.g. Mayer et al. 2012). Last but not least, while research on corporate strategy has incorporated considerations of human capital (Hitt et al. 2001, 2006; Kor & Leblebici 2005) corporate strategies related to firm governance and client relationships remain under-research areas (for an exception, see Mawdsley & Somaya 2014).

Furthermore, the strategic landscape of professional services has been undergoing significant changes. A globalized economy created by advances in telecommunications and
transportation has led to the significant growth and consolidation of national and multi-national corporate clients for professional services. PSFs have in turn become more “corporate orientated” and moved away from traditional, collegial partnerships towards target-driven Managed Professional Businesses (Cooper et al. 1996). This shift has brought with it increasing levels of employee mobility as PSFs seek to attract the highest caliber talent and dispose of under-performers, while professionals have been able to develop highly specialist domain capital which they can leverage as bargaining power when negotiating for economic returns to their human capital. However, as global growth has tapered and this model of professional services has matured, PSFs are poised for yet another strategic shift. Their clients have become increasingly more sophisticated, demanding, cost sensitive and capable of handling more work internally. The next generation of research on strategy in professional services will also need to reflect these important shifts in PSFs’ strategic environment.

Naturally, this review makes no claim to being comprehensive in covering all pertinent issues related to strategic management of PSFs. One area that deserves mention, and is lacking within strategy research in PSFs, is the wider institutional framework within which PSFs operate. Our review has presented strategic management concerns based on PSFs being in a position to make important choices. However, institutional theorists often challenge the assumption that firms can freely make choices, arguing instead that firms are constrained by institutional pressures, such as being required to operate in a certain way in order to conform and maintain legitimacy (DiMaggio & Powell 1991). Future research should investigate the different institutional pressures that PSFs face and how these may impact important strategic decisions (such as the scope of the firm). Another avenue for future research in this area could be to contrast the performance of PSFs who maintain conformity to institutional expectations with those who diverge. We also know little about how PSFs themselves influence and shape the institutional environment, such as public policy. For instance, to what extent can PSFs navigate or influence government regulation that defines the competitive environment? What role can PSFs play in the aftermath of a crisis, such as the most recent recession, and how would this
impact the strategic issues described throughout this chapter? This a nascent area of PSF research where many opportunities lie. Given the increasing economic importance of professional services and professional work more generally, we expect research in these areas (and in the study of PSFs’ strategies generally) to grow rapidly in the near future.
REFERENCES


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i [http://www.bea.gov/industry/index.htm](http://www.bea.gov/industry/index.htm) [last accessed April 7, 2013]. Statistics are taken from the industry tables compiled and published by the Bureau of Economic Analysis (U.S. Department of Commerce). Industries such as Real Estate, Financial and Insurance Services, and Healthcare, which are also significantly comprised of PSFs, were excluded from our computations because the statistics on PSFs within these industries are not separately reported. By the same token, the Professional and Business Services sector also includes some industry segments – Management of Companies and Enterprises and Administrative and Waste Management Services – that may not fit the PSF mold. Excluding these segments, the residual “Professional, Scientific, and Technical Services” segment is still about 67% the size of manufacturing in GDP value added, and grew by 260% in the two decades to 2011.

ii Specifically, we searched the Proquest, ABI-Inform Complete, EBSCO and Econ-Lit databases using a number of search algorithms that combined the search terms “strategy” or “compete” or “competitive advantage” or “performance” or “competition” AND “professional service” or “PSF” or “law firm” or “accounting” or “advertising” or “investment bank” or “consulting” or “human capital”. We complemented this search with relevant articles and reports from focused
professional services journals, and finally we also incorporated research from the reference sections of articles we found in this manner and from the authors’ personal knowledge.

iii We adopt the language of “experts” and “novices” to distinguish between senior and junior employees. These terms may be used inter-changeably with, respectively, “partners” and “associates”. However, because many PSFs are not organized as partnerships (especially those outside of law, accounting, and consulting) for consistency we use “experts” and “novices” to reflect a generalizable difference in human capital expertise across all professional service sectors.

iv The “Big 4” consists of KPMG, Ernst & Young, Pricewaterhouse Coopers, and Deloitte.

v The authors cite the example of accounting firm Arthur Anderson being unable to merge with elite law firms in the UK, and the separation of its consulting arm to form Accenture because its managers grew tired of their secondary status.
