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Service diversification and growth of professional service firms

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ABSTRACT

This study investigates the impact of service diversification on the rate and mode of firm growth in professional service firms (PSFs). Drawing on the extant PSF literature, we identify differing views regarding the growth impact of service diversification. Specifically, some scholars suggest that the external client benefits associated with service diversification should allow PSFs to expand revenues at a rapid pace and pursue less merger and acquisition activity, whereas others imply that increased diversification can cause internal challenges with respect to learning costs, coordination and innovation that can limit the rate of revenue growth and encourage more mergers and acquisitions. We test these competing views using longitudinal data on 137 accounting firms and cross-sectional data on 125 law firms and find that service diversification is negatively associated with the rate of firm revenue growth and positively associated with the use of mergers and acquisitions.

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The last several decades have seen a significant expansion in the scope-of-services offered by professional service firms (PSFs). Much of this increased diversification[1] has been associated with a transition from single-to multi-disciplinary PSFs (Greenwood et al., 2005). While this transition originally occurred in the 1980s and 1990s among the Big Five accounting firms (Greenwood et al., 2002), this practice has since become more widespread, gaining traction in other PSF industries (Harlacher and Reihlen, 2014). For example, advertising firms have diversified into several marketing service areas (Silk and Berndt, 2004); consulting firms have diversified into a number of new areas, such as information technology management (DeLong and Nanda, 2003) and sustainability services (Toffel et al., 2012); and law firms have expanded their service offerings to meet the growing needs of their clients (Baker and Parkin, 2006).

While it is clear that many PSFs have diversified to provide a larger array of services, the firm-level growth implications of such diversification are less clear. On the one hand, research (e.g., Greenwood et al., 2002; Greenwood and Suddaby, 2006; Kor and Leblebici, 2005; Hitt et al., 2001; Morris and Empson, 1998) suggests that increased service diversification provides externally-oriented benefits (e.g., a larger potential client pool and greater ability to cross-sell services to existing clients), and that these could lead to higher rates of growth. On the other hand, there is the potential that increased diversification could introduce internally-oriented challenges that could constrain the rate of growth of PSFs. Specifically, the argument is that increased service diversification requires a vast amount of diverse knowledge, and such knowledge can make it difficult to manage client services across service areas (Hitt et al., 2001; Kor and Leblebici, 2005), limiting the degree to which a PSF can refine, augment, and leverage its stock of knowledge (cf., Anderson, 1983; Bower and Hilgard, 1981; Morris and Empson, 1998;

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Winter, 1987). These challenges, it is suggested, can have a negative impact on the quality of services provided, thus affecting the retention and attraction of new and existing clients (i.e., revenue growth).

Though these positive and negative viewpoints on the growth implications of PSF service diversification are present in the literature, to date the evidence is anecdotal; that is, we are aware of no systematic empirical examinations of this relationship. As a result, it is unclear whether service diversification has positive or negative effects on the rate of PSF growth. The intent of this study is to address this gap in our understanding. Using revenue as an important growth outcome, we develop and test competing hypotheses regarding the impact of service diversification on firm-level revenue growth in PSFs. We also explore how service diversification influences the mode of firm growth, as theoretical extensions of these alternative views of service diversification can lead to different conclusions regarding the use of inorganic growth modes (i.e., mergers and acquisitions). To examine these competing hypotheses, we use samples from two different professional service industries. The first sample is longitudinal and consists of data on large domestic accounting firms located in the United States between 2004 and 2010. The second sample is cross-sectional and is composed of large domestic law firms located in the United States in 2009/2010. By examining the hypotheses in two different samples (with different designs, data sources and timeframes), we increase the robustness of our analyses and lend considerable credence to the findings noted below.

This study makes important contributions to the PSF and corporate diversification literatures. First and foremost, we contribute to the PSF literature by clarifying the service diversification-firm growth link. As mentioned above, there is ambiguity in the extant literature regarding the directional impact of service diversification on firm growth in PSFs. We help to address this ambiguity by: 1) synthesizing extant thoughts on the service diversification-growth link into theoretical arguments linking external- and internal-oriented considerations with firm growth and highlighting the contrasting views associated with these arguments; 2) providing the first empirical tests of this association in two large-scale quantitative studies of PSFs in different industries; and 3) finding consistent results across the two studies in support of one of the theoretical perspectives. In doing so, our paper extends the arguments of Hitt et al. (2001) and Kor and Leblebici (2005) by increasing our understanding of service diversification's impact on revenue growth. These studies advanced several ideas regarding the benefits and challenges associated with service diversification in PSFs, focusing on the implications of these for firm profitability. Our paper integrates these various perspectives into external and internal-oriented factors and extends them to the realm of revenue growth. Collectively, these help to improve our understanding of the nature of the association between service diversification and PSF growth, and allow us to make important steps toward providing a parsimonious framework to think about the performance impact of service diversification in PSFs.

We also contribute to the broader strategic management literature on the diversification-performance association by examining the potential for boundary conditions regarding firm-level implications of related diversification. Much of the extant work on the diversification performance link has focused on the differential performance benefits of related and unrelated diversification. While there remains some ambiguity regarding the relative benefits of these types of diversification, the bulk of empirical findings suggest that related diversification is superior from a performance standpoint (Palich et al., 2000). However, relatively less research has focused on the potential for contextual factors to influence the performance impact of related diversification. In this paper, we assess the possibility that related diversification in PSFs could negatively influence a particular dimension of firm-performance: revenue growth. We therefore make a contribution to the broader literature on strategic management by shedding light on how the unique characteristics associated with PSFs (e.g., reliance on human action and tacit knowledge in production) could impact the performance consequences associated with related diversification.

This paper begins with a brief overview of the extant research on service diversification in PSFs. We then describe the different viewpoints in the PSF literature regarding the directional impact of service diversification on the rate and mode of firm growth, and note the competing hypotheses associated with these differing perspectives. The methods and analyses that were used to test the competing hypotheses are then described and we conclude by discussing the results and providing a number of future research implications and suggestions.

Theory and hypotheses

Service diversification in PSFs

The general expansion of the scope-of-services offered by PSFs has attracted scholarly attention in two broad areas. The first of these areas is associated with the institutional and field-level factors that surround increased service diversification in PSFs. Researchers have examined, for example, the role of professional associations in legitimizing these changes (Greenwood et al., 2002). Additionally, scholars have explored the broader context in which knowledge is produced in business advisory services and argued that the diversification of PSFs represent efforts to corner and control the market for the production and dissemination of “management knowledge” (Suddaby and Greenwood, 2001). Researchers have also suggested that increased PSF service diversification is tied to the international expansion of their clients (Brock, 2006). Specifically, scholars contend that PSFs were pushed towards offering all-encompassing services so that they could provide one-stop shopping for clients’ business advisory needs in new international locations.

The second broad area is on the organizational consequences associated with increased diversification. In this area, researchers have found that service diversification is negatively associated with the leverage ratio in PSFs (Sherer, 1995), and that it also interacts with the leverage ratio to influence firm performance (Kor and Leblebici, 2005). Greenwood et al. (2005)

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