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DIALOGUE


Asghar Zardkoohi
Texas A&M University

Leonard Bierman
Texas A&M University

Daria Panina
Texas A&M University

Subrata Chakrabarty
University of Nebraska-Lincoln, chakrabarty@unl.edu

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DIALOGUE

Revisiting a Proposed Definition of Professional Service Firms

In a recent *Academy of Management Review* article, Professor Andrew von Nordenflycht (2010) focused on defining professional service firms (PSFs). In the article von Nordenflycht argues that past research leaves the term *professional service firms* either undefined or at best provides only examples, such as law firms, accounting firms, "etc." In addition, he argues that while most scholars agree that law firms and accounting firms fit the "definition" of PSFs, there is "little consensus on what the 'etc.' refers to. Does it include ad agencies? Physician practices? Software firms? Why or why not?" (2010: 155). The author's contributions include (1) identifying three distinctive characteristics associated with PSFs (i.e., knowledge intensity, low capital intensity, and a professionalized workforce), (2) arguing that while all PSFs share knowledge intensity, they may vary based on the degree of intensity of the other two characteristics (i.e., capital intensity and professionalized workforce), and (3) describing managerial challenges facing each structural form and providing solutions. In this dialogue we discuss the limitations of the proposed definition, question the managerial challenges von Nordenflycht associates with PSFs, and critique the corresponding solutions he offers.

THE PROPOSED DEFINITION

Based on a review of the PSF literature for a definition, von Nordenflycht "landed on three characteristics—knowledge intensity, low capital intensity, and a professionalized workforce—as the central ones" (2010: 159). These three distinctive characteristics were chosen "because (1) they can be well defined, (2) they are commonly noted as distinctive characteristics . . . , and (3) they have been linked in the literature . . . to distinctive managerial challenges or organizational outcomes" (2010: 159). Focusing on the three characteristics, von Nordenflycht (2010) suggests developing "a taxonomy of knowledge-intensive firms" that vary in the degree of capital intensity and workforce professionalization (2010: 157).

Knowledge Intensity and Professionalized Workforce

Knowledge intensity is touted as "perhaps the most fundamental distinctive characteristic of PSFs," which is said to permeate throughout the organization, including "frontline workers" (von Nordenflycht, 2010: 159). However, knowledge intensity creates two problems for PSFs: cat herding and opaque quality (von Nordenflycht, 2010). We discuss each in turn.

Cat herding. Cat herding refers to the challenges of "retaining and directing" skilled and professionalized employees with "substantial human capital (such as complex knowledge)" who have "a strong bargaining position relative to the firm, since their skills are scarce and, in many instances, transferable across firms" (von Nordenflycht, 2010: 160). Regulation by organized professions through their codes provides for "strong preferences for autonomy" (2010: 160) and "a responsibility to protect the interests of clients and/or society . . . against a 'commercial' or 'economic' ethos that allows unfettered pursuit of self-interest" (2010: 163). An implication of such regulation is "muted competition," both against potential entrants into the profession through licensing requirements and among professionals. Thus, "in the name of preserving the profession's trustworthiness, professional codes tend to prohibit a range of commercially competitive behavior, including soliciting competitors' clients, advertising in any way . . . , and even competing on price" (2010: 164). The organizational slack resulting from such muted competition provides

an opportunity to address the challenges of cat herding in ways that would not be possible in more competitive environments. For example, firms may be better able to satisfy employee preferences for autonomy by adopting highly autonomous and informal structures, whose consequent lack of internal coordination might be too inefficient in more competitive environments (2010: 164).

Von Nordenflycht provides two organizational solutions to help with the problem of cat herding: (1) alternative incentive mechanisms, "such as contingent and/or deferred compensation,"

and (2) allowing "autonomy and informality in organizational structure" (2010: 161).

We argue that whether professionals (with substantial and complex human capital) appear to behave like cats or like well-mannered employees depends on (1) how easily they can be replaced by the employer (i.e., how competitive the labor market is for their expertise) and/or (2) whether the task and its contexts require an autonomous or decentralized decision-making structure. On the first issue, the more competitive the market for their expertise, the more likely professionals will lose their job if they behave like cats. Given market competition and the transferability of human capital in many professional organizations, such employees are replaceable and, thus, easily salvageable. Although transferability of human capital may allow an employee catlike behavior, since he or she may threaten to move to a competitor (were it not for a noncompete clause), transferability also affords the firm the ability to hire from competitors. Thus, cat herding problems do not arise because knowledge is complex; they may arise because of lack of competition in the market for a given professional. However, even in this case there is a limit to catlike behaviors. Consider, for example, one of the most canonical examples of PSFs: law firms. In this case a cursory examination would reveal a high degree of competition among a group of highly touted professionals: lawyers. Besides the online legal service advertisements, one cannot avoid repeated commercials by law firms inviting injured workers or patients suffering from side effects of medication to patronize their services. In addition, a significant increase in lateral movements by associates and partners across firms strongly suggests competition in the labor market for such professionalized talent (Henderson & Bierman, 2009).

We argue that an alternative explanation for the appearance of catlike behavior (i.e., autonomy at work) is a context that requires decentralized decision making for efficiency reasons. Think of professors in classrooms, surgeons in operating rooms, or lawyers in courtrooms—all three groups are led by their own initiative in performing their tasks, with relatively little day-to-day regard for administrative superiors. Such catlike behavior is organizationally efficient, given the idiosyncratic nature of the tasks, requiring decentralized decision rights. Unanticip-

ated events may occur that provide time-dependent information at the "local" level, to which professionals react autonomously. In these contexts the professional has the relevant information to behave independently and autonomously, not the supervisor. Thus, allowing autonomy is *not* a concession to professionals in service organizations but, rather, an efficient organizational response to the decentralized nature of information held by professionals.

Opaque quality. Opaque quality means that complex knowledge of the expert "is hard for nonexperts (i.e., customers) to evaluate, even after the output is produced and delivered" (von Nordenflycht, 2010: 161). Von Nordenflycht argues that opaque quality gives rise to at least four types of measures PSFs undertake in response to the challenge of opaqueness: bonding, reputation, appearance, and ethical codes. An example he invokes for bonding is the "unlimited liability partnership" structure to induce "partners to monitor and pressure each other to provide quality service since each is at risk for any actions of the others that expose the firm to financial or legal liability" (2010: 161).

Is the opaque quality of services provided by PSFs an explanation for unlimited liability? Our observations indicate that most traditional PSFs are organized as *limited liability* partnerships (i.e., LLPs). For example, virtually all of the largest 200 law firms in the United States have the LLP postfix after their name. In addition, the U.S. and European subsidiaries of the major accounting firms have similar structures—for example, KPMG Europe LLP and KPMG America LLP. All the KPMG operations in different areas of the world are set up independently as LLPs so as to prevent cross-liabilities and cap liability exposure (Greenwood & Empson, 2003). There are a few reasons for adoption of limited liability. First, given the large size of many PSFs, assumption of liability by each partner for the entire organization is too costly and, thus, economically infeasible. Second, cross-monitoring of partners by partners is impractical when the PSFs are geographically diversified, with many national and multinational branches. Assumption of unlimited liability in these situations would expose each partner to high risks if he or she were not in a position to monitor the behavior of other partners. Finally, as the size of PSFs increases, the free-rider problem by each partner can prevent effective monitoring. For exam-

ple, while the cost of monitoring other partners would be absorbed by a given partner, its benefits would be spread across all partners, thus arguably creating a free-rider problem. Given the impracticality of cross-monitoring in large and geographically diversified PSFs, unlimited liability has been replaced by limited liability in many cases.

We believe high monitoring costs have another organizational implication: contingent compensation systems. Contrary to von Nordenflycht's claim that "contingent and/or deferred compensation" (2010: 161) systems are a response to the cat herding challenge, we believe instead that the high monitoring costs are the main explanation for the adoption of such compensation systems, where each partner's compensation is contingent on his or her performance only. In general, when monitoring costs are high, organizations use contingent pay systems as a substitute for monitoring and control—in such systems employees become their own monitors since shirking at work will directly cost them part of their compensation (Brickley, Smith, & Zimmerman, 2008; Milgrom & Roberts, 1992).

Low Capital Intensity

While von Nordenflycht's paper allows for flexibility in capital intensity, low capital intensity has a special place in his framework. In particular, low capital intensity is said to have two implications. First, PSFs requiring low capital intensity will further increase "employee bargaining power" because (1) relatively speaking, if capital intensity is low, human capital intensity becomes even more important; (2) with the low cost of capital, employees may "easily start up their own firms"; and (3) "without non-human capital to specialize to, there is less likelihood of generating firm-specific human capital, which would reduce employee mobility" (2010: 162). Thus, "if knowledge intensity creates the cat herding problem, adding low capital intensity turns it into a situation where the assets go down the elevator each night . . . and the firm can't control whether they come back" (2010: 162). Second, low capital intensity creates the opportunity to lower "the need for raising investment funds and thereby reduces the need to organize in ways that protect outside investors" (2010: 162). The author states that, not

having outside investors as monitors, the firm may resort to alternative compensation measures and to employee autonomy and informality as two measures of managing cat herding problems.

With all due respect, we disagree with both implications. First, as discussed above, whether cat mentalities dominate PSFs hinges on the competitiveness of the labor market for the profession in question. Competition and, thus, transferability in such markets afford the firm the ability to replace those "who choose not to ride up the elevator." Second, in spite of whether ownership is internal or external, alternative compensation measures and greater employee autonomy may or may not be efficient organizational characteristics on their own. Given the nature of tasks in PSFs, such as law firms, hospitals, universities, and the like, jobs are designed to afford professionals decision rights and, hence, autonomy. We stress that such autonomy in decision rights does not signify a compromise or a concession to professionals who would otherwise behave like cats but represents an organizational approach to efficient utilization of local information held by professionals (Brickley et al., 2008; Milgrom & Roberts, 1992).

Ownership Structure

Regarding ownership structure of PSFs, von Nordenflycht argues that there "is a resistance to having nonprofessionals, especially commercially oriented nonprofessionals (such as investors), involved in the ownership and governance of professional firms," because PSFs have a "core of professional codes of ethics," whereas commercially oriented investors would encourage "unfettered pursuit of self-interest" (2010: 163). This argument also appears open to question. We believe that the alternative ownership structures that PSFs assume will ultimately represent the most efficient organizational approaches to risk sharing. A casual examination of the most touted and canonical PSFs (e.g., law firms) indicates that some PSFs have even embraced the corporate form. For example, law firms in Australia are now permitted to sell shares of stock on the open market. This kind of ownership allows for considerable risk spreading in large class action and contingent fee cases (Regan, 2009).

TABLE 1
Summary of Some Key Arguments

Concept	von Nordenflycht's (2010) Argument	Our Argument
<p><i>Knowledge intensity:</i> Direction difficulties</p>	<ul style="list-style-type: none"> ● Not being able to direct or supervise employees is a problem (pp. 160–161). ● The solution is to give the employee autonomy—by not trying to direct or supervise (pp. 160–161). 	<p>Independence in behavior is not the same thing as “cat herding” behavior. The former arises because of the nature of tasks and information asymmetry between professionals and their supervisors. Consider professors in classrooms, surgeons in operating rooms, and lawyers in courtrooms: all three groups are led by their own initiative as they perform their respective jobs, with no regard for administrative superiors. When the relevant information of the context is held by the professional and the task is idiosyncratic, efficient organizational structure requires a decentralized decision rights system. While professionals in these contexts appear to behave like independent cats, such behaviors are efficient in these contexts.</p>
<p><i>Professionalized workforce:</i> Autonomy</p>	<p>“Firms may be better able to satisfy employee preferences for autonomy by adopting highly autonomous and informal structures, whose consequent lack of internal coordination might be too inefficient in more competitive environments” (p. 164).</p>	<p>The need for (or lack of) employee autonomy (i.e., decentralization of decision rights) within an organization has less to do with its employees’ personal preferences and more to do with deciding on a structure that is efficient given the context of the task and the location of the relevant information in the hierarchy.</p>
<p><i>Knowledge intensity:</i> Retaining difficulties</p>	<p>There are difficulties in retaining skilled employees with “substantial human capital (such as complex knowledge)” who have “a strong bargaining position relative to the firm, since their skills are scarce and, in many instances, transferable across firms” (p. 160).</p>	<ul style="list-style-type: none"> ● Transferability/mobility also affords the firm the ability to hire from competitors. ● There is a limit to job switching, because a professional will face difficulty in moving if known to have such catlike behavior. ● Hence, in a free market, catlike behavior of excessively switching jobs will be solved on its own over time.
<p><i>Opaque quality</i> (customers are nonexperts; cannot evaluate quality of service)</p>	<p>PSFs resolve opaqueness via <i>unlimited liability partnership</i> structures to induce “partners to monitor and pressure each other to provide quality service since each is at risk for any actions of the others that expose the firm to financial or legal liability” (p. 161).</p>	<p>Most traditional PSFs and their subsidiaries are organized as <i>limited liability partnerships</i> (i.e., LLPs). In other words, personal wealth is not exposed to liability when such PSFs or subsidiaries are sued. The goal is to prevent cross-liabilities when faced with lawsuits; opaqueness is the least of their concerns here.</p>
<p><i>Low capital intensity:</i> Employee mobility</p>	<p>Low capital intensity increases “employee bargaining power. . . if knowledge intensity creates the cat herding problem, adding low capital intensity turns it into a situation where the assets go down the elevator each night . . . and the firm can’t control whether they come back” (p. 162).</p>	<p>Competition and transferability in markets afford the firm the ability to replace those who choose not to ride up the elevator in the morning.</p>
<p><i>Ownership structure:</i> No outside ownership</p>	<ul style="list-style-type: none"> ● Low capital intensity gives the firm the opportunity to avoid outside investors as monitors so that the firm has the freedom to adopt efficient measures of alternative compensation, employee autonomy, and informality (p. 162). ● There “is a resistance to having nonprofessionals, especially commercially oriented nonprofessionals (such as investors), involved in the ownership and governance,” because PSFs have a “core of professional codes of ethics,” whereas commercially oriented investors encourage “unfettered pursuit of self-interest” (p. 163). 	<ul style="list-style-type: none"> ● These arguments are questionable and contrary to the corporate governance literature. Why would an outside investor object to organizational measures if they are efficient? Outside investors support measures that are perceived to improve efficiency and performance because their wealth is at stake. ● In a number of countries, law firms have embraced the “corporate form,” with stocks traded on the open market. Further, outside investors in the United States (such as hedge funds) invest in plaintiffs’ cases as a substitute for direct investment in law firms.

Finally, while law firms in the United States are not currently permitted to share risks with outside equity investors in this manner, outside investments have nevertheless crept into the U.S. legal system through the back door. Instead

of directly investing in law firms, outside investors in the United States (in this case, hedge funds) have recently started investing in plaintiffs’ cases—cases that would probably not otherwise be brought by plaintiffs for the risk of

losing. Investment in a portfolio of such cases lowers the cost associated with risk and works as a substitute for investment in law firms by outside investors (Glater, 2009).

DISCUSSION AND CONCLUDING REMARKS

We believe the proper question is not how to define a PSF but how a given service becomes optimally organized. The difference in these two approaches is significant. In this dialogue we have attempted to explain why PSFs, even in some of the most "canonical" examples (e.g., law firms), fail to follow the "traditional" definition. Growth in the size and geographic diversification of law firms have transformed their organizational structures and in some cases even allowed outside investment. Moreover, most large law firms in the United States, at least, are organizationally structured as LLPs and are increasingly active in marketing and advertising their services.

In sum, we believe an attempt at defining organizational structure and ownership for any distinct group of firms, including PSFs, is exposed to creating too many exceptions that may fall outside the confines of the definition. In particular, the problem of defining PSFs is that while a given definition may in one context neatly correspond to the existing organizational structure and ownership, changes in the context can render the definition irrelevant over time. As an alternative to defining a distinct group of firms, it might be more productive to examine how a distinct group of firms becomes optimally organized as contexts change. Indeed, this appears to represent a key opportunity for future research in this area. We provide a summary of our primary critiques of von Nordenflycht's arguments in Table 1.

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Asghar Zardkoohi
Leonard Bierman
Daria Panina
Texas A&M University

Subrata Chakrabarty
University of Nebraska–Lincoln

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