

Business Strategy and Corporate Performance in Small Firms

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Abstract

This paper contributes to the strategic human resource management and performance literature by examining these relationships using a sample of small firms in the UK and US. We examine firstly, whether the effectiveness of HRM is contingent upon business strategy, secondly, whether there is universal relevancy of HRM, and thirdly, whether firms that introduce HRM techniques within an institutionally supported, coherent package outperform those that introduce similar HRM practices in an *ad hoc* fashion. Using data collected from a sample of small firms in matched manufacturing and service sectors in the UK and US, we find firstly, that the relationship between the use of HRM and performance *is* dependent upon business strategy; secondly, that there is a *positive relationship* between the use of high levels of HRM combined with an innovator/quality-enhancer approach to business strategy, on the one hand and performance on the other; and thirdly, that firms that introduce HRM practices as part of an institutionally supported, mutually reinforcing package ('strategic HRM') perform best. These findings are consistent with our previous research into the links between HR practices and performance in large organizations.

Keywords: strategic human resource management, small firms, strategy and corporate performance.

1. Introduction

There is a large and growing literature on the relationship between the use of human resource management practices on the one hand, and corporate performance on the other (Becker and Gerhart, 1996; Ichniowski *et al.*, 1997; Osterman, 1999). This literature, which is largely US-based but which also now includes several studies analyzing UK data, has mostly found some degree of positive association between the use of such human resource practices on the one hand, and organizational outcomes and corporate performance on the other. However, the strength and significance of the associations found varies across studies. Thus the general claim from the HR literature – of a positive association between what might be termed 'progressive' human resource practices on the one hand, and organizational outcomes and corporate performance on the other – is precisely that: a *general* claim that may not apply to any given firm, since that firm may not exhibit the specific characteristics – such as pursuing a quality-enhancing rather than cost-cutting strategy – that are found to be particularly associated with these positive outcomes.

The recognition of these sorts of patterns has contributed to a consensus in the HR literature that a better understanding of the interaction between business strategy and HRM – strategic human resource management (SHRM) - will be key to gaining a better understanding of why the relationship between HRM and corporate performance varies across firms. Indeed, some papers have found explicitly that the associations between HR and performance do vary according to specified characteristics, such as the corporate strategies pursued by the firms in question (Michie & Sheehan, 2005a; Khatri, 2000).

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We would therefore argue that to make further advance, studies must analyze firms according to particular characteristics, to determine whether the general results from the literature hold equally in these more specific investigations, and if not, why not; and there needs to be a better understanding of how effective strategy is actually implemented, with a particular focus on the idiosyncratic dimension of HR's strategic fit. The current paper contributes to both these avenues, by analyzing the relationship between business strategy, HRM, and performance specifically within small firms.

This paper builds upon our previous work on the links between business strategy, human resources and competitive advantage in large UK companies by examining these relationships in small firms (employing 10-100 employees). Our previous work for large firms found, firstly, positive correlations between the use of HR practices and corporate performance ('internal fit'), secondly, that the relationship between HR and performance is dependent upon business strategy and that companies pursuing an integrated approach to HR coupled with an innovator/quality enhancer focus within their business perform best ('external fit'); and that these relationships were strengthened further when HR practices were 'strategic' – that is where both internal and external fit occurred (Michie & Sheehan, 2005a). In particular, the paper examines: firstly, the types of business strategies found in UK and US small firms; secondly, the relationship between business strategy, HRM and firms' performance; and thirdly, the similarities and differences between these relationships across small and large firms.¹

2. Theoretical background

Three theoretical perspectives dominate the SHRM literature: contingency, universalistic, and configurational. The contingency approach argues that to be effective, an organization's HR policies must be consistent with other aspects of the organization. The organization's strategy is generally considered to be the primary contingency factor. Human resource policies and practices must be consistent with the organization's strategy (Miles and Snow, 1984; Guthrie *et al.*, 2002). Business performance will be improved when there is consistency (often referred to in the literature as 'fit') between business strategy and HR policies.

The best practice, or universalistic approach, considers employees as one of the most important resource of the firm, and that investment in this resource – use of HR practices – will improve the performance of the firm (Becker and Huselid, 1998; Kochan and Osterman, 1994; Pfeffer, 1998). Our previous research - which used a modified version of Delery and Doty's and Pfeffer's 'best practice' policies - found support for this hypothesis in large firms (Michie & Sheehan, 2005a) and using the same database used in this paper, we found evidence supporting the 'best practice' or universalistic hypothesis in relation to small firms in the UK and US (Michie & Sheehan, 2005b).

The traditional universalistic perspective suggests there is a 'best practice' approach to SHRM, with a set of HR policies to be identified which will improve performance (Osterman, 1999; Pfeffer, 1998; Delery and Doty, 1996). These 'best practice' policies may be embodied in a variety of concrete and detailed HR techniques or practices; for example, there may be many techniques that will encourage the sharing of information within an organization (Richardson and Thompson, 1999). This traditional approach to universalism has been modified and broadened by authors such as Hoque (1999) and Wood (1999). Hoque, for example, argues: 'When testing universalism, it is important to acknowledge the difference between the *universal effects* that HRM might have, and the *universal relevance* of HRM as an approach. Where universal effects are concerned, the implication is that contrary to external fit arguments, HRM has performance effects irrespective of circumstances, or irrespective of the business strategy adopted. Most tests of universalism have focused on this issue' (Hoque, 1999: 422). Given that we have already found evidence of the *universal effects* of HRM for this set of firms (that is, that there is a positive relationship between HR policies and performance), in this paper we test for the *universal relevance* of HRM - which can be regarded as a test for internal consistency, placed in an overall context of external fit. We therefore examine specifically if, and how, the relationship between HRM and performance is related to the business strategy that the firm is pursuing.

The configurational approach differs from the contingency and universal relevancy theories by being guided by a holistic approach to inquiry and adopting the systems assumption of 'equifinality': 'In general, configurational theories are concerned with how the pattern of multiple independent variables is related to a dependent variable rather than with how individual independent variables are related to the dependent variable' (Delery and Doty, 1996:

804). Configurational SHRM is concerned with ‘the pattern of planned human resource deployments and activities intended to enable an organization to achieve its goals’ (Wright and McMahan, 1992: 298). The configurational approach suggests that an organization must develop HR as a *system* so that both horizontal and vertical fit can be achieved.

Horizontal fit implies there must be internal consistency of the organization’s HR practices – as HR ‘bundles’ or ‘systems’. Internal fit emphasises the interdependency between individual HR practices, with the use of one HR practice enhancing the effectiveness of others - a synergy between practices. Our previous work on this database found statistically significant evidence of horizontal/internal fit (see Michie & Sheehan, 2005b). Vertical fit refers to the consistency of the organization’s HR system with other organizational characteristics such as the firm’s strategy. External fit suggests that HR practices must ‘fit’, or be congruent with, the firm’s policy choices outside the area of HR. The presence of these two fits implies that specific combinations of HR practices can be identified which improve performance, but these combinations will vary by organizational context – such as firm strategy. Different notions of ‘fit’ underlie the three theoretical perspectives in the literature. The traditional universalistic approach suggests that only internal fit matters, so that ‘best practice’ policies work in all contexts albeit with variation in terms of the actual HR techniques used. The contingency perspective suggests that to be effective an organisation’s HR practices must be consistent with other organisational factors primarily its strategy – there needs to be external fit. The configurational perspective suggests that improved performance will only occur when ‘vertical’ or external fit *and* ‘horizontal’ or internal fit are achieved. We use a modified approach toward ‘horizontal’ or internal fit that does not exclude key aspects of the firm’s behaviour – its competitive strategy.

3. Hypotheses Tested

Following Hoque (1999), three business strategy typologies are used to test the contingency hypothesis: ‘innovators/quality-enhancers’, ‘cost-reducers’, and ‘others’. The contingency (‘external fit’) hypothesis tested is as follows:

Hypothesis 1: Any correlation found between the use of HR on the one hand and performance on the other will be contingent upon business strategy; in other words, if we find such a correlation, we would expect any such correlation to vary between firms as a result of firms pursuing different strategies.

The universal relevance hypothesis is tested by categorizing the firm’s business strategy and the number of HR practices it uses. The following hypothesis is tested:

Hypothesis 2: The level of performance is dependent on the approach taken to HR and to business strategy; ‘high-HR innovators/quality-enhancers’ outperform the other categories within the sample.

The final hypothesis concerns the introduction of HR as a synergistic package of mutually supporting practices. According to bundling theory, companies that adopt their HR practices as a coherent, institutionally supported synergistic package – strategic HRM - should outperform establishments within which HR has been introduced in an *ad hoc* manner.

Hypothesis 3: Firms that introduce HR practices within an institutionally supported, coherent package outperform those that introduce similar numbers of HR practices in an ad hoc manner rather than as part of an overall strategy.

If the coupling of internal and external fit is important (the configurational hypothesis), the ‘strategic HR’ companies (see below for discussion) should outperform the other establishments within the sample.

4. Methods

The data used in the analysis were derived from a stratified sample of firms from the Dun and Bradstreet databases in the UK and US respectively. Two dimensions were used to stratify the sample: organizational size and the primary sector of business activity. In relation to size, the selection criterion was that the firms employ between 10 and 100 employees. Nine sectors were identified - five in manufacturing and four in services - using the 1992 UK and US Standard Industrial Classification (SIC) codes. The matched SIC codes are as follows: Manufacturing – medical:

2833 – Medicinal Chemicals and Botanical Products; 2834 – Pharmaceutical Preparations; 3827 – Optimal Instruments and Lenses; 3841 – Surgical and Medical Instruments and Apparatus; 3644 – Radiology/Electrical Medical Equipment; Services – medical & health related: 8071 – Medical and Scientific Laboratories; 8072 – Dental Laboratories; 8051 – Skilled Nursing Facilities; Services – other: 5411 – Grocery Stores/Super Markets.

Dun & Bradstreet supplied a total of 1281 firms with the above characteristics in the UK and 1470 in the US (see Appendix for sample details). The medical and health-related SIC codes were selected because these represent industries of significant growth - both current and expected - in the UK and US. Grocery stores were selected to serve as a comparative industry. This is a large industry with high expected rates of growth, although not known for high skill or training levels.² We conducted a telephone survey of the selected companies, as follows:

- i. The main contact person identified from the Dunn and Bradstreet databases was sent a one-page briefing on the objectives of the survey and the expected length of the interview (around 40 minutes). Confidentiality was emphasized.
- ii. The person was then contacted to see if they would agree to the telephone interview and if agreeable, a date and time was set. They were then faxed a 'glossary' of HR terminology and definitions of the financial variables that would be asked about. It was found, however, that this fax seemed to have a negative effect on people actually completing the telephone survey. This was a particular problem in the US. It is likely that small business owners did not wish to reveal financial information, despite the assurances of confidentiality. Once this problem was identified, the financial variable information was dropped.

Interviews were conducted by telephone with the company's CEO/Owner/Director in 87% of cases in the UK and 83% of cases in the US. The remaining interviews were carried out with the Director of Human Resources/Personnel/Employee Relations. Many of the interviewees appeared extremely interested in the research and the survey questions. Thus, in around half of the interviews, quite lengthy discussions – almost 'mini case studies' - took place between the interviewee and the research team members conducting the interviews. Summaries of these discussions, comments, and feedback were entered into the final databases which were used in the analysis and which help to provide an understanding of the processes and rationales behind the quantitative data. Some of this informal feedback is reported below.

In total 1173 companies were asked (holding companies and companies where it was clear that they had been categorized in the wrong SIC were excluded) to participate in the survey in the UK. Of these, 1051 declined, 31 agreed but subsequently failed to complete the interview, and 91 interviews were completed successfully. In the US, 1221 companies were asked to participate, 1066 declined, 56 agreed but subsequently failed to complete the interview, and 98 interviews were completed successfully. Where possible, potential interviewees were asked why they declined to participate: the main reason was 'time constraints'. Many of the business owners commented that they worked long hours, often 7 day weeks, and even though many stated that the study seemed interesting and that they *did* need to learn more about 'personnel management' and how to 'manage their employees more effectively', they simply could not 'spare the time'. The other main reason for not participating in the study was 'confidentiality concerns', particularly for the US firms.

The measures

(i) Performance Variables

Three questions were asked concerning performance outcomes, with respondents asked to rate each on a scale of one (much worse) to five (much better):

- i. How well does labour productivity at your company compare with other companies in the same industry?
- ii. How does financial performance at your company compare with other companies in the same industry over the past financial year?
- iii. How does the ability to retain existing customers at your company compare with other companies in the same industry?

While there is a perception that small business owners may have difficulty gauging how well their company performs relative to other companies in the industry, this appeared not to be the case: companies seemed acutely aware – at least in relation to the relative/subjective measures used – where their company ranked compared to others in the same industry. While companies were asked for financial performance data, the majority did not answer these questions. Companies were asked to supply information on the following variables: net sales, cost of goods sold, after tax earnings, and return on capital employed. The percentage response rates in the UK and US in relation to each of these variables were respectively: 35% and 30% for net sales; 20% and 17% for cost of goods sold; 16% and 10% for after tax earnings; and 11% and 8% for return on capital employed. UK companies were slightly more likely to supply financial data compared to US companies, perhaps reflecting the fact that some companies in the sample would be required to file reports with Companies House and thus data for these companies would be publicly available.³ Where the data were available (for nine companies) we purchased the data to check for consistency between what was reported in the survey and what was submitted to Companies House. The most consistent comparisons could be made on profits: in all cases, the accuracy between what was reported on the telephone survey ('self report') and the data lodged with Companies House ('objective data') was high. This finding is consistent with our previous research that demonstrated a relatively high degree of consistency between 'subjective' performance measures and their 'objective' counterparts (Wall *et al.*, 2004).

(ii) *Control Variables*

The following standard control variables were included in the analysis (see Appendix for descriptive statistics on the variables), with the name used to identify them in the results Tables given in parentheses (for variables ii-vii):

- i. company size, with dummies for establishments with 10-25, 26-50, 51-75, and 76-100 employees (the omitted category is establishments with 10-25 employees);
- ii. the age of the company (Age);
- iii. sector dummies for 'high technology' and 'low technology'. Companies in the 2833, 2834, 3827, 3841, 3644, 8071 and 8072 SIC codes were placed in the former category and companies in the 8051 and 5411 SIC codes in the latter (Industry);
- iv. whether the company has a large firm affiliation (34% and 41% for UK and US companies respectively) (Large Firm Affiliation);
- v. the market environment (1 = declining; 2 = turbulent; 3 = stable; 4 = growing; and 5 = growing rapidly) (Market Conditions);
- vi. trade union presence (50% and 14% for UK and US companies respectively) (Trade Union Presence); and
- vii. whether the company received External Assistance from organizations such as Business Links/Small Business Advisory Service, Small firms loan guarantee scheme, or the European Union in the UK; or the Small Business Administration, Chambers of Commerce, or Business Administration Centers in the US (38% and 19% of UK and US companies respectively) (External Assistance).

(iii) *Measurement of HR Practices*

Five different HR practices were conceptualized and measured (see Table 1 for details of the individual techniques). The practices cover the areas of recruitment and selection, performance appraisals, performance-based pay, training and development, employee participation (voice) and participation.⁴ The mean number of practices used within the UK sample is 11.1 and 12.7 for the US sample.

(iv) *Measures of Business Strategies*

We build upon the business strategy typologies from Schuler and Jackson (1987) and Hoque (1999). The classifications are based on both subjective responses to questions on strategy and objective data. In terms of the

subjective responses, companies were asked to rank the importance of various business strategies for their company's competitive success (where 1 = insignificant; 2 = not very significant; 3 = moderately significant; 4 = very significant; and 5 = crucial).

Additional data used to formulate the strategy classifications were collected on how the company's remuneration rate for the overall workforce compared to its main competitors (where 5 = well above average; 4 = above the average; 3 = average; 2 = below the average; 1 = well below the average); and whether the company had introduced a new product or process innovation in the past three years; if it had a system of Total Quality Management (TQM) in place; and if it had ISO recognition (or other industry-specific certificates/awards).

Companies were classified as having a *cost*-based strategy if they ranked 'offering the best price'/'value for money' as the main source of their competitive advantage (4 or 5 on the scale described above) *and* paid low remuneration rates to their employees compared to their main competitors (1 or 2 on the scale described above) *and* if *at least one* of the following applied: no innovations were introduced in the past three years, no TQM system in place, and no ISO recognition (21% of UK companies, 25% of US companies, and 23% of all companies in the sample). Companies were classified as having an *innovator*-based strategy if they ranked 'frequently innovating their product or service' and/or 'frequently implementing process innovations' as the main source of their competitive advantage (4 or 5 on the scale described above) *and* if they had introduced either a product or process innovation over the past three years (22% of UK companies, 36% of US companies, and 29% of all companies in the sample). Companies were classified as having a *quality*-based strategy if they ranked 'offering the highest quality product or service' as the main source of their competitive advantage (4 or 5 on the scale described above) *and* if they paid high remuneration rates to their employees compared to their main competitors (4 or 5 on the scale described above) *and* if *at least one* of the following applied: at least one product or process innovation was introduced in the past three years, a TQM system was in place, and ISO recognition (40% of UK companies, 24% of US companies, and 32% of all companies in the sample). The *innovator*-based and *quality*-based (*innovator/quality-enhancer*) strategies are combined for this analysis because of the similarities in the outcomes both groups achieved. For example, all but four UK companies and all but three US companies that had introduced an innovation had either higher than average remuneration rates, a TQM system in place, or had achieved ISO recognition. Companies were classified as 'other' if they did not meet any of the criteria outlined above. These companies placed no significant emphasis on cost, quality, or innovation in terms of their competitive success (17% of UK companies, 14% of US companies, and 15% of all companies in the sample). These companies appeared to run their businesses in a rather *ad hoc* manner.

US companies were more likely to emphasize a *cost*-based strategy (26%) compared to their UK counterparts (21%); US companies were more likely to emphasize an *innovator*-based strategy (36%) compared to their UK counterparts (22%); and UK companies were more likely to emphasize a *quality*-based strategy (40%) compared to their US counterparts (24%). Comparing the strategies of UK small firms to a survey of large UK firms (employing over 100 people), the break-down of strategy categories for the large firms were as follows: 15% *cost*-based, 25% *innovator*-based, 50% *quality*-based (75% combined *innovator/quality*-based) and 10% 'other' (Michie and Sheehan, 2005a). The main difference appears to be that small firms were more likely to have a *cost*-based approach (21% compared to 15% of large firms) and also more likely to have no identifiable strategy (17% compared to 10% of large firms). These results are not surprising since strategy tends to form and evolve as companies grow and mature, and many small firms attempt to enter the market based on the price competitiveness of their product or service.

Hypothesis Testing

(i) *Testing the Contingency Theory:*

Following Hoque (1999), the measure of HR used in the analysis is cumulative, with each company being ranked according to the extent to which they adopted the 17 individual HR practices (see Table 1). The aim of this variable is to measure the extent to which HRM practices have been adopted. By splitting the sample by strategy typologies, and then regressing the aggregate HR variable on each of the performance variables, we assess the effectiveness of HR in the context of 'cost-reducer', 'innovator/quality-enhancer', and 'other' business strategies. Hypothesis 1 is therefore tested for whether HRM is most effective, in terms of performance outcomes, when there is external fit. By splitting the sample based on the type of strategy the firm is pursuing, the HRM variable is then regressed on

each of the performance variables. This enables us to assess the effectiveness of HRM in the context of the business strategy being pursued by the companies.

(ii) *Testing the Universal Relevance of HRM*

Having split the sample three ways to perform the external fit tests, discussed above, the sample is reclassified and dummy variables created, to enable comparisons between business strategy categories as follows:⁵

1. 'low-HR cost reducers', using 8 or fewer HR practices: 5 UK companies and 12 US
2. 'medium-HR cost reducers', using more than 8 but fewer than 13 HR practices: 10 UK companies, 7 US
3. 'high-HR cost-reducers', using 13 or more HR practices: 4 UK companies, 5 US
4. 'low-HR innovators/quality-enhancers', using 8 or fewer HR practices: 9 UK companies, 10 US
5. 'medium-HR innovators/quality-enhancers', more than 8 but fewer than 13 HR practices: 16 UK, 15 US
6. 'high-HR innovators/quality-enhancers', 13 or more HR practices: 32 UK companies; 34 US
7. 'low-HR others', using 8 or fewer HR practices: 4 UK companies, 7 US
8. 'medium-HR others', more than 8 but fewer than 13 HR practices: 7 UK companies, 6 US
9. 'high-HR others', 13 or more HR practices: 4 UK companies; 6 US

This series of dummy variables enables comparative analysis between the level of performance dependent on the approach taken to HR *and* business strategy. Category 6 is held constant which allows us to examine whether the 'high-HR innovator/quality-enhancer' establishments outperform the other categories.

(iii) *Testing the Configurational Hypothesis:*

The final test is for the configurational hypothesis: whether it is important to introduce HRM as a synergistic package of mutually supporting practices (in other words, are internal *and* external fit important?). Of the firms using a higher than average number of HRM practices, based on hypothesis 3, we would expect that the firms that introduce these practices strategically, should outperform the firms where HRM has been introduced in a more *ad hoc* manner. Consistent with other studies of small firms (Storey, 1994; Cassell *et al.*, 2002) it was found that a low percentage (15%) had an HR Department or Specialist (in the UK this was 13% and in the US 17%). The company's CEO/Owner/Director almost always reported that he/she felt HR and personnel issues were their 'responsibility'. Despite the absence of HR Departments or Specialists, we do find evidence of 'strategic' HR practices and use these practices to determine whether companies had strategic HRM in place. The firm is categorized as having 'strategically integrated' its HR practices if it had at least two of the following 'strategic' HR policies in place: (a) analysis of recruitment methods at least annually (33% of UK firms; 39% of US firms; and 36% of all firms in the sample); (b) a recruitment plan for the next year (31% of UK firms; 44% of US firms; and 37% of all firms in the sample); and (c) a training and development plan for the next year (53% of UK firms; 48% of US firms; and 51% of all firms in the sample). This led to the following categorization:

- (a) 'strategic HR' establishments: above-average usage of HR practices,⁶ strategically integrated with each other: 31% of UK companies; 38% of US companies and 35% of all companies in the sample.
- (b) 'non-strategic' HR establishments: above-average usage of HR practices, but not strategically integrated: 24% of UK companies; 20% of US companies; and 22% of all companies in the sample.
- (c) 'low-HR' establishments: below-average usage of HR practices: 44% of UK companies; 43% of US companies; and 43% of all companies in the sample.

5. Results

Table 3 reports strong correlations between strategy and the cumulative HR variable (Hypothesis 1). In both UK and US firms, and in the combined sample, the correlation between the HR index and all three performance measures is significant at the 5% level in each sample for labour productivity and customer retention, and at the 10% level for financial performance. The correlation between the cumulative HR variable and all three performance measures is particularly strong for the *innovator/quality-enhancer* firms (1% significance levels in each sample). However, for the *cost-reducer* firms and ‘other’ firms, the statistical significance of this relationship disappears for financial performance and customer retention, although remaining significantly positive in each sample for labour productivity (but only at the 10% level in the UK and for the combined sample, and at the 5% level for US firms). This suggests that a higher use of HR practices will be generally associated with higher labour productivity, but to be associated with relatively high values for the other performance variables requires HR practices to be combined with an innovator/quality-based strategy.

The type of strategy pursued by firms is also related to many of the control variables. In relation to cost-reducers, age is significantly negatively correlated with all of the performance variables. This may be because older firms that have acquired higher costs over-time are attempting to cut-costs to survive and/or re-gain competitiveness. The coefficient for a rapidly growing market and customer retention is significantly negative for all firms except those pursuing an *innovator/quality-enhancer* strategy, perhaps reflecting the fact that the emphasis placed by these firms on quality helps to keep customers coming back. The other case where patterns differ in relation to the *innovator/quality enhancer* firms and the ‘other’ firms is in relation to UK trade union presence where there is a significantly positive relationship (at the 10% level) between the presence of a trade unions for firms pursuing an *innovator/quality enhancer* approach to strategy and customer retention, whereas for the ‘other’ firms this relationship is not significant. A final significant difference between the two strategy types is in relation to external assistance. External assistance is more positively correlated (higher coefficient significance rates) with labour productivity and financial performance for the ‘other’ firms compared to the *innovator/quality enhancers* firms. Interestingly, for firms pursuing a cost-reducer strategy, while the correlation between external assistance and all of the performance measures are positive, none are significant.

These results give support to the external fit hypothesis, that the effectiveness of HR is strongly dependent upon the business strategy pursued. As hypothesized, there is little evidence that the adoption of HR leads to improved performance where companies emphasize cost control within their business strategies. In contrast, where HR is coupled with strategies that emphasize quality-enhancement and innovation, performance is positively affected.

The Universalistic (‘Internal Fit’) Hypothesis

The results reported in Table 4 suggest that the ‘high-HR innovators/quality-enhancers’ are the highest performing establishments in terms of all the performance variables. The negative signs on the HR-strategy coefficients show that establishments not following the ‘high-HR innovator/quality enhancer’ approach perform less well than those establishments that are following this approach. The exception to this appears in relation to labour productivity for ‘high-HR other’ (where the signs are positive but not significant): even where a firm does not have a clear strategy, HR practices do seem to enhance productivity (providing support for the traditional universalistic hypothesis). But the results suggest that the return to this HR investment for these firms would be higher if they introduced HR practices within the context of an *innovator/quality-enhancer* strategy.

Configurational (‘Internal and External Fit’) Hypothesis

Finally we examine whether establishments that introduce HR practices as a strategically integrated package of mutually supporting practices outperform establishments that introduce their practices in a more *ad hoc* manner (Hypothesis 3). The results show that ‘strategic HR’ companies outperform the ‘low-HRM’ firms across all performance measures. The ‘non-strategic HRM’ companies outperform the ‘low-HRM’ companies on only one of the performance measures – customer retention, where the fact that these practices are at least in place appears to be correlated with the delivery of service to customers. The size and statistical significance of the coefficients on the performance variables are, however, unambiguously greater across the board for those firms pursuing *strategic HRM*.

6. Conclusions

The results reported here for small firms are consistent with results we have found previously in relation to strategic HRM found for large firms (Michie & Sheehan, 2005a). Thus, investing in 'progressive' HR practices appears to pay dividends in terms of corporate performance. However, the results reported in this paper suggest that the degree to which this is true – in statistical terms, the size and significance of the effect – will vary according to a range of factors. One of these factors is the strategy that the firm adopts. Broadly, it may be pursuing a 'high road' strategy of investing in progressive HR practices that tend to be associated with a greater degree of commitment and motivation amongst the workforce, as well as to both an increased ability and greater opportunities to work more productively. Hence such HR investment will tend to be associated with higher productivity and customer retention, and thus also profitability. Alternatively, the firm may choose a 'low road', cost-cutting strategy. This appears to be especially so for 'older' small companies, who may turn to this approach as a 'strategy of last resort'. The effectiveness of HR policies and practices, therefore, will depend, in part at least, on the strategy being pursued by the company.

If a 'high road' strategy is consciously chosen, then the costs of investing in HR practices can be expected to be recouped through improved performance. However, for this to happen requires the HR practices to lead not just to higher levels of commitment and motivation amongst staff, it is also necessary for this to be matched firstly by the skills to work more productively, and also by the opportunities to put those skills and motivation to good effect. For these three factors to be present – motivation, skills and opportunities – HR practices are best introduced and implemented as a coherent 'bundle', and combined with appropriate organizational design.

It might be thought that while these results have been reported previously for firms in general, they are unlikely to apply to small firms, where there is less scope for implementing the whole range of policies and practices that such an approach involves. The results reported above suggest that such an assumption would be incorrect. The importance of introducing HR practices in appropriate combinations appears to be equally important for small firms as for larger companies. And the benefits of combining this with an appropriate company strategy is likewise confirmed by the results reported above for small firms. Finally, different legal, institutional and cultural contexts mean that we cannot generalize such results from one country to another. However, the results we got from testing the above hypotheses were remarkably consistent across the firms in both the UK and the US. It is true that the likelihood of pursuing a particular company strategy varied somewhat between the two countries, as reported above, but the way in which such strategies appeared to interact with the use of HR practices, and the correlations between these interactions on the one hand, and the company's productivity, customer retention and profitability on the other, were quite consistent between the UK and US firms.

Table 1. HR Practices Used in the Analysis

HR Practices	Mean UK	Mean US	Mean All Firms
<i>A. Recruitment and Selection</i>			
a. Use of at least one of the following selection methods: formal application form; formal interview; work sample; test of job skills; assessment of job skills	0.889	0.913	0.901
b. Written employment contract	0.934	0.615	0.768
c. Written job description	0.553	0.592	0.572
<i>B. Performance Appraisal</i>			
Formal Appraisal of majority (>50%) of managerial and non-managerial employees on a regular basis, or at least annually	0.605	0.721	0.665
<i>C. Performance Based Compensation</i>			
a. Individually based performance related pay	0.521	0.605	0.563
b. Profit sharing (or some other type of company-based reward system)	0.100	0.152	0.126
c. Employee stock options	0.022	0.053	0.037
d. Team-based performance	0.208	0.285	0.249
e. Training-education achievement linked bonus	0.199	0.152	0.175
<i>D. Training and Development</i>			
a. Formal induction programme for new employees	0.912	0.936	0.926
b. The majority (> 50%) of managerial and non-managerial employees received formal (NVQ and/or 'off-the-job') training in the past 12 months	0.612	0.489	0.550
c. The majority (> 50%) of managerial and non-managerial employees received informal ('on-the-job') training in the past 12 months	0.802	0.785	0.794
<i>E. Employee Voice and Participation</i>			
a. Employee Representation at Board/Senior Management Meetings	0.462	0.412	0.434
b. Joint Consultative Committees (JCCs)	0.203	0.221	0.211
c. Employees are surveyed on a regular basis, at least annually	0.788	0.792	0.794
d. Employees consulted about new hires	0.332	0.255	0.291
e. Where financial targets are set (59% of UK firms; 68% of US firms), employees are informed about the status of these targets (i.e., whether targets were exceeded, met, or not met)	0.205	0.153	0.180

Table 2. Business Strategies: UK and US Firms

Business Strategy	UK Firms	US Firms	All Firms
<i>A. Cost-based</i>	21%	26%	23%
<i>B. Innovator-based</i>	22%	36%	29%
<i>C. Quality-based</i>	40%	24%	32%
<i>D. 'Other'</i>	17%	14%	15%

Note: percentages may not sum to 100% due to rounding.

Table 3. Results for Hypotheses 1: All Firms (UK and US combined)Labour Productivity

Variables	All Firms	Cost-reducers	Innovators/Quality-Enhancers	Others
HRM	0.235 (0.090)**	0.117 (0.055)*	0.320 (0.090)***	0.250 (0.126)*
25-50 employees	0.118 (0.114)	-0.098 (0.049)*	0.153 (0.077)*	0.056 (0.042)
51-75 employees	0.219 (0.115)*	0.066 (0.055)	0.099 (0.039)**	0.234 (0.109)*
76 – 100 employees	0.187 (0.054)***	0.122 (0.058)*	0.188 (0.063)***	0.066 (0.030)**
Age	0.015 (0.113)	-0.033 (0.015)*	0.112 (0.057)*	0.228 (0.114)*
Industry	0.289 (0.119)**	0.106 (0.096)	0.296 (0.088)***	0.216 (0.083)**
Large Firm Affiliation	0.244 (0.107)**	0.078 (0.036)*	0.223 (0.069)***	0.147 (0.064)**
Market Conditions	0.172 (0.070)**	0.104 (0.040)	0.156 (0.064)**	0.119 (0.058)*
Trade Union Presence	0.058 (0.035)	-0.019 (0.215)	0.092 (0.078)	0.042 (0.038)
External Assistance	0.155 (0.082)*	0.091 (0.055)	0.160 (0.082)*	0.111 (0.047)**
n	186	42	115	29
Pseudo R ²	0.130	0.119	0.122	0.114

Financial Performance

Variables	All Firms	Cost-reducers	Innovators/Quality-Enhancers	Others
HRM	0.188 (0.094)*	0.072 (0.046)	0.198 (0.059)****	0.177 (0.145)
25-50 employees	0.017 (0.014)	0.079 (0.055)	0.041 (0.030)	0.028 (0.026)
51-75 employees	0.101 (0.055)*	0.099 (0.060)	0.053 (0.025)*	0.095 (0.0450)
76 – 100 employees	0.092 (0.039)**	0.126 (0.061)*	0.111 (0.034)***	0.107 (0.051)*
Age	0.099 (0.040)**	-0.112 (0.060)*	0.123 (0.048)**	0.033 (0.023)
Industry	0.130 (0.053)**	0.102 (0.052)*	0.095 (0.032)***	0.093 (0.038)**
Large Firm Affiliation	0.139 (0.043)***	0.109 (0.050)*	0.203 (0.066)***	0.140 (0.057)**
Market Conditions	0.144 (0.044)***	0.075 (0.036)*	0.199 (0.062)***	0.098 (0.039)**
Trade Union Presence	0.003 (0.009)	-0.040 (0.400)	0.026 (0.020)	-0.059 (0.044)
External Assistance	0.060 (0.025)**	0.044 (0.035)	0.143 (0.061)**	0.109 (0.033)***
n	181	41	112	28
Pseudo R ²	0.108	0.126	0.117	0.100

Customer Retention

Variables	All Firms	Cost-reducers	Innovators/Quality-Enhancers	Others
HRM	0.203 (0.085)**	0.107 (0.101)	0.246 (0.062)***	0.211 (0.171)
25-50 employees	0.111 (0.033)***	-0.060 (0.032)*	0.096 (0.031)***	0.103 (0.044)**
51-75 employees	0.108 (0.056)*	0.056 (0.030)*	0.087 (0.046)*	0.120 (0.063)*
76 – 100 employees	-0.088 (0.033)*	-0.099 (0.031)***	0.022 (0.018)	-0.112 (0.044)**
Age	0.077 (0.040)*	-0.090 (0.049)*	0.120 (0.049)**	0.096 (0.088)
Industry	0.134 (0.082)	0.097 (0.058)	0.172 (0.075)**	0.119 (0.060)*
Large Firm Affiliation	0.120 (0.049)**	0.116 (0.071)	0.203 (0.068)***	0.120 (0.048)**
Market Conditions	-0.098 (0.047)*	-0.111 (0.053)*	0.221 (0.118)*	-0.131 (0.054)**
Trade Union Presence	0.023 (0.023)	-0.005 (0.008)	0.060 (0.035)	-0.053 (0.054)
External Assistance	0.130 (0.058)**	0.082 (0.051)	0.155 (0.075)*	0.111 (0.044)**
n	185	43	114	28
Pseudo R ²	0.099	0.117	0.129	0.119

Notes: Ordered probit analysis

Coefficients given (standard errors in brackets).

***significant at 1%; ** significant at 5%; * significant at 10%.

Table 4 . Results for Hypothesis 2: All Firms (UK and US combined)

Variables	Labour Productivity	Financial Performance	Customer Retention
'Low-HRM cost reducers'	-0.407 (0.155)**	-0.372 (0.258)	-0.414 (0.129)***
'Medium-HRM cost reducers'	-0.255 (0.166)	-0.245 (0.125)*	-0.255 (0.132)*
'High-HRM cost reducers'	-0.411 (0.252)	-0.299 (0.092)***	-0.220 (0.146)
'Low-HRM innovator/quality enhancers'	-0.018 (0.015)	-0.193 (0.089)*	-0.278 (0.090)***
'Medium-HRM innovator/quality enhancers'	-0.176 (0.129)	-0.271 (0.169)	-0.226 (0.140)
'Low-HRM others'	-0.133 (0.055)**	-0.296 (0.121)**	-0.400 (0.124)***
'Medium-HR others'	-0.118 (0.073)	-0.130 (0.084)	-0.276 (0.142)*
'High-HRM others'	0.197 (0.123)	-0.166 (0.100)	-0.198 (0.119)
	0.112 (0.091)	0.161 (0.103)	0.117 (0.052)**
25-50 employees	0.130 (0.065)*	0.224 (0.093)*	0.179 (0.110)
51-75 employees	0.249 (0.107)**	0.302 (0.101)**	-0.266 (0.100)**
76 – 100 employees	0.134 (0.086)	0.119 (0.051)**	0.088 (0.076)
Age	0.306 (0.129)**	0.185 (0.058)***	0.246 (0.177)
Industry	0.349 (0.104)***	0.414 (0.127)***	0.305 (0.129)**
Large Firm Association	0.150 (0.078)*	0.276 (0.113)**	-0.119 (0.048)**
Market Conditions	0.027 (0.023)	-0.060 (0.049)	0.075 (0.061)
Trade Union Presence	0.098 (0.045)*	0.142 (0.061)**	0.212 (0.091)**
External Assistance			
n	186	181	97
Pseudo R ²	0.129	0.122	0.126

Notes: See Table 3.

Omitted Category = 'High-HR innovators/quality-enhancers'

Table 5. Results for Hypothesis 3: All Firms (UK and US combined)

Variables	Labour Productivity	Financial Performance	Customer Retention
‘Strategic HRM’	0.448 (0.115)***	0.492 (0.111)***	0.633 (0.146)***
‘Non-strategic HRM’	0.293 (0.221)	0.226 (0.145)	0.325 (0.151)*
25-50 employees	0.108 (0.091)	0.184 (0.123)	0.140 (0.065)*
51-75 employees	0.133 (0.068)*	0.176 (0.088)*	0.155 (0.127)
76 – 100 employees	0.243 (0.105)**	0.279 (0.094)***	-0.255 (0.098)**
Age	0.160 (0.149)	0.229 (0.093)**	0.102 (0.077)
Industry	0.331 (0.129)**	0.195 (0.081)**	0.104 (0.083)
Large Firm Association	0.322 (0.104)***	0.336 (0.113)***	0.176 (0.063)**
Market Conditions	0.144 (0.058)**	0.344 (0.110)***	-0.152 (0.077)*
Trade Union Presence	0.037 (0.042)	-0.113 (0.093)	0.047 (0.035)
External Assistance	0.183 (0.092)*	0.146 (0.075)*	0.134 (0.064)*
n	186	181	185
Pseudo R ²	0.112	0.122	0.124

Notes: See Table 3 for estimation techniques and Table 4 for hypothesis 3 estimation techniques

Notes

- 1 Earlier work using the same database examined: firstly the types of HR practices found in UK and US firms; secondly, how the use of these practices vary in relation to different characteristics of these firms; and thirdly, the relationship between HR practices and firm performance (see Michie and Sheehan, 2005b – available from the authors on request). We find firstly a wide *range of usage* of HR practices, including some degree of strategic HR; secondly, a *positive relationship* between HR policies and performance; and thirdly, that HR is more likely to contribute to competitive success when introduced strategically as part of an integrated and coherent package, that is, as part of a *bundle* of innovative work practices.
- 2 For details on the grocery store industry in the US and UK see: www.connexions.gov.uk/jobs4u/furtherdetails.cfm?id=605&parentID=594 (2004) and www.collegegrad.com/industries/trade03.shtml (2004).
- 3 Companies defined as ‘small’ by Companies House and thus exempt from filing an annual report have to fulfil at least two of the following conditions: annual turnover £5.6 million or less; balance sheet total £2.8 million or less; number of employees 50 or fewer.
- 4 For a discussion of how these HR practices were selected and how the use of HR practices in these samples compare to other small firm studies, see Michie and Sheehan (2005b), available from the authors on request.
5. Companies that use less than 50% of the possible HR practices (8 or less practices out of a possible 17) are placed in the ‘low HRM category’; companies that use between 9 and 12 practices are placed in the ‘medium HRM category’, and companies that use 75% or more of the possible HR practices (13 or more) are placed in the ‘high HRM category’.
- 6 The average number of HR practices used was 11.1 for UK firms, 12.7 for US firms, and 12.2 for the combined sample.

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