

Towards a Strategic Understanding of Professional Service Firms – A Knowledge and Capabilities Based Approach.

Søren H. Jensen

Assistant professor, Ph.D. sth.lpf@cbs.dk
+45 38153819

Field Code Changed

Flemming Poulfelt

Professor, Ph.D. fp.lpf@cbs.dk +45 38153638

Field Code Changed

Stig Hartmann

Associate professor, Ph.D. sth.lpf@cbs.dk +45 38152654

Field Code Changed

All from Copenhagen Business School, Department of Management, Politics & Philosophy
Porcelænshaven 18A DK-2000 Frederiksberg, Fax: +45 3815 3635

Abstract

This paper address the issue of how PSF's use knowledge and capabilities to pursue competitive strategies. The approach is rather new, as even though PSF's is still a hot topic in business and management, it has not received a lot of attention as regards the strategic implications. By adopting knowledge and capabilities as defined by Grant (1996) it is proven that analysing the PSF's using technology and organizing we get a deeper insight of the companies and learn that they use the concept of modularity to remain competitive and flexible and hence strike a balance between exploration and exploitation.

Introduction

Professional service firms (PSF's) have received increased attention over the last decades. This is due to a variety of reasons as these firms are becoming increasingly important as economic actors.

The nature of their activities – the emphasis on knowledge as both product and resource have received increased attention as we are still lacking in our understanding of this phenomena. Thus they are interesting as they deal with knowledge, and as knowledge has become increasingly important as a competitive force (Blackler, 1995, Grant, 1996). This triggers a number of questions. Why do these companies perpetually have problems managing their own knowledge – and how do they manage in general? This has been emphasized by Starbuck, (1992), Maister, (1994), Quinn, (1996) and Mintzberg, (1998).

Another question is how these companies retain the key resource knowledge over time, since most agrees that knowledge primarily resides in individuals (Simon, 1991, Nonaka, 1994). This makes for a somewhat shaky foundation for conducting long term strategies if a classical resource based perspective is applied (Penrose 1959, Barney 1991, 2001, Peteraf 1993). Therefore, the question remains: how are the knowledge resources being imbedded in the organization so it is possible for a firm to decide and act strategically? Which organizing factors play a pivotal role in this process? As such there are several interesting issues related to knowledge intensive or professional service firms, that needs to be explored further. Both to deepen our insights of this type of firm and to further develop the theories used to analyze their behavior, in particular the resource based perspective in a broad sense including the capabilities and learning perspectives.

This paper focuses on how PSF's can use knowledge strategically to gain a competitive advantage and what the challenges are. More specifically the paper will focus on:

- How do PSF's embed knowledge and capabilities in their organizational routines in order to use it to pursue competitive strategies?
- How can the resource and capability based perspective on strategy be applied to the study of competitiveness in PSF's

The concepts of knowledge and capabilities have been dealt with by several authors. While it seems obvious that there are huge overlaps and interrelatedness between the two concepts, the distinction used by Grant (1996) that capabilities are the outcome of knowledge integration will be adopted in this paper. This definition and the examples used by Grant (1996) are very close to the definition of core capabilities as mentioned by Prahalad & Hamel (1990) and Hamel & Heene (1994) but for issues of clarity this paper will adhere to the notion of capabilities.

The underlying idea is that professional service firms actively embed knowledge in the organization through using knowledge as a governing principle in the organizing of activities. This is by no means a simple procedure as it requires simultaneously pragmatism and reflection in order so secure that what they embed in the organization is indeed the knowledge they need to serve clients and develop new tools through the application of knowledge. This is to some degree inspired by Grants knowledge based theory of the firm (Grant 1996) but this paper is directed towards PSF's and the primary inspiration is previous work conducted among PSF's (Jensen et al, 2004).

The paper will be applying a resource based perspective since this perspective on strategy seems best capable of linking knowledge to competitiveness and competitive advantage. In order to get a firmer grip on this rather intangible and ambiguous concept (Penrose, 1959, Kosselleck, 1982, 1985) the capability approach (Grant 1996, Teece, Pisano & Shuen, 1997) will be used to conceptualize knowledge as it is through capabilities that knowledge finds its use. This includes concepts such as competence and core competence (Selznick, 1957, Prahalad & Hamel, 1990, Hamel & Heene, 1993) as they are to a large extent synonymous, they share the same ontological assumptions and it will not bring a clearer picture by using the different concepts.

Theoretical foundation

While PSF's have received a lot of attention it seems that most is centered on purely internal matters related to organizing, managing and creating knowledge or external relations. Consequently too little focus have been put on the external strategic use of knowledge and the challenges it poses. The issue of strategy in knowledge intensive companies in general has been dealt with previously (Sveiby, 1992) as has the management of PSF's (Maister, 1989, 1993) but a strategic approach directed towards PSF's has lacked so far.

It seems that almost all the attention they have received stems from issues related to maintaining the knowledge base (Robertson, Scarborough & Swann, 2003, Werr & Stjernbjerg, 2003), keeping the clients loyal (Frantz & McDougell, 2004), looking at human capital issues, using the proper marketing mix (Chang & Birkitt, 2004, Barr 2003), reputation management (Zabalaet al. 2005) and trust and control issues (Rogers & Tierney, 2004, Hanlon, 2004). Clearly these issues are highly relevant and indeed a lot of them are closely related to strategy. But while issues indirectly attributed to are of relevance it is necessary to look more directly at strategy. Of the few contributions looking in to strategic matters emphasis is on the effect of planning on performance (French, Kelly & Harrison, 2004), strategic groups in PSF's (Panayides, 2002) or the professional service firms ability to facilitate strategic change in their clients (Hartshorn & Wheeler 2002).

Stumpf, Doh & Clark, 2002 look into how the changing face of the market for clients as well as talent affect the performance of professional service firms. This approach is more outside-in than the one presented here but also addresses the need of PSF's to be active in keeping their competitiveness in the light of their somewhat fragile nature.

Lorsch & Tierney (2002) attacks the very issues of how to manage PSF's and this work gives us a good starting point for how to proceed looking directly into how internal strengths or stars should be harnessed and organized in order to drive competitiveness. The approach is very much management driven but it is obvious that it is the resources, the persons as embodied knowledge that are the key factor in maintaining the success of PSF's. In

the paper there will be a more elaborate review but this initial endeavor has shown that there is a need for a more strategic approach to the study of PSF's.

When looking into strategic issues in PSF's the resource based perspective seen in a broad sense encompassing capabilities and capabilities is a promising theoretical direction. It combines the nature of the PSF as a particular version of the knowledge intensive company as described in the literature (Sveiby & Lloyd, 1987, Starbuck, 1992, Maister, 1994, Lorsch & Tierny, 2002) with the focus on resources, capabilities and capabilities as the main factors determining competitive advantage (Penrose 1959, Barney 1991, 2001, Peteraf 1993). Furthermore it fits well with (Grant, 1996) who coined the phrase the "knowledge based theory of the firm" with a clear reference to Penrose (1959). As mentioned it is also Grant (1996) that lends inspiration to the choice of capabilities as a measure of knowledge in use.

Teece, Pisano & Shuen (1997) argue that within a dynamic environment companies need to be able to chance, innovate and learn and therefore they introduce the concept of dynamic capabilities –the ability to continuously develop new forms of competitive advantage that effectively and efficiently respond to challenges in a rapidly changing environment. Dynamic capabilities are based on the ongoing learning in the organisation . the approach is also included as they like this paper makes little if any practical distinction between resources, capabilities and capabilities as they all share the same basic characteristics. Indirectly Teece, Pisano & Shuen (1997) argue that in order to create competitive advantages we must look both within the organization and toward its environment. This is an important aspect as large parts of the literature both within knowledge, PSF's and strategy seem to look solely inside-out or outside-in. the present paper will act to include both views even though the resource based perspective is inside-out. The choice of capabilities (Grant, 1996, Teece, Pisano & Shuen, 1997) facilitates this choice.

The above theoretical discussion is more of a general positioning than an actual operationalization of the the knowledge and capability based approach chosen. The paper will develop a framework for analysis based on the interrelation between knowledge and capabilities as described. This operationalization will put emphasis on embracing both internal and external factors as the strategic challenge lies in matching knowledge and capabilities with market and client demands.

2. Methodology

The paper is based on a study of Scandinavian professional service firms undertaken in 2004-2005. In addition the paper draws on data and experiences from previous and current studies of professional service firms in Scandinavian as well as in other countries.

The empirical data of the most recent study consists of in-depth interviews with managers, specific case studies as well as questionnaires focusing on specific managerial issues. The interviews have all been semi-structured using the same framework in all the interviews. For secondary data annual reports, excerpts from websites, statistical data, related to the involved industries have been used. Also several companies provided us with classified documents related to the company strategy as concerns both business and knowledge strategy as documentation for their chosen strategies and to explicate some of the procedures they used as a part of their business model. This has provided a rich description of the activities of the companies and their behavior, enabling the us to conduct in-depth analysis. The idea is to target the data collection so that the data fits closely with the issues dealt with. In practical terms this means that data will be especially related to development in customer base over time, changes in profitability both overall and on different client groups, types of knowledge and capabilities possessed and documentation of both knowledge and capabilities. Also data on how the PSF's approach the market, which types of clients they approach as concerns both size and industry, shift in this approach over time as well as differentiation on the various segments. This allows us to identify how knowledge as a resource and capabilities is linked to their strategic actions.

The firms selected, have all been well fairly performing. This approach has been chosen as it guarantees that the firms dealt with in the article can be seen as examples of best practice and that the challenges and dilemmas will be to a large extent be representative for knowledge intensive firms in general as they do not relate to low performance, so the dilemmas can not simply be solved by organizing better. The chosen companies represent a wide number of firm types, which means that a broad part of the knowledge based industry has been included.

Empirical data

The sample of professional service firms, each with their own unique characteristics but all of them drawing on similarities usually found in PSFs. Consequently it is necessary to explore the industry level traits in order to gain understanding of the context in which the firms operate and the constraints they operate under. The industry part will serve as the entry to the subsequent analysis helping to understand the overall frame for the firms but equally well helping to identify the categories used in the analysis.

The empirical foundation is rather broad as the four firms that makes the empirical core in this paper is a law firm, an architect, an IT company and a management consultancy company. The reason for this being that these four companies have been interviewed over a short span of time and that they are representative of the PSF population. Also the depth in these four cases provides a solid basis for extensive analysis. Clearly the four firms are highly diverse in their structure and activities to the extent that it makes little sense going in depth with this diversity. It is interesting to see how they converge on a number of issues and how this emphasizes the relevance of treating them as examples of the same phenomena, the development of the professional service industry especially as concerns competition and concentration.

As concerns size they are all among the top three players in their respective industries. This is the result of both organic growth and mergers and acquisitions. The process that led them to their current position is not as interesting as the fact that they all emphasized that size was becoming increasingly important for a number of reasons. Professionalization and focus were at the heart of the industry. Needless to say it has always been central issues for PSF's and companies in general but with the increase in size it has become even more important to reap the potential benefits of concentration. This has been accomplished by paying extra attention to the capabilities of the professionals and actively organizing the activities accordingly. It provided them with more diversity in their assignment portfolio and gave them an increased strategic responsiveness as concerns both the speed of delivery and the speed with which new tasks can be adopted. Also it gave them visibility, a characteristic they had not previously been concerned about and a safe guard towards being engulfed in larger firms. Last but not least it helped them stabilize the market situation as their size and the concentration tendency acted as a repellent on potential market entrants both domestic and foreign. However, there was also an upper limit to size.

The scale effects were not without limits. These limits were set up by the size of the market, but equally important the organizing of work and the span of control. The capabilities were heavily embedded in the culture and even if the organizations strived to maintain a balance between autonomy for the professionals and control from the partners and managers the scale were most often on the autonomy. Capabilities were best used and developed when the professionals felt motivated.

This provides an overview of the overall PSF industry. In order to get a more detailed idea of how the capabilities in this reorganized industry with more emphasis on large players affects their strategic options, it is necessary to go more into depth with the parameters that were most central to give the capabilities direction and enhance their efficiency. This takes us through complexity as the overarching fact the companies have to deal with and more concretely how this complexity is reduced through the use of technology and through the organizing of the activities of the professionals.

The issues of complexity

This is the starting point, and possibly the conclusion or rather, the main governing factor in explaining how capabilities are dealt with by PSF's. As complexity is rather a broad and somewhat intangible concept the complexity will be operationalised through the subsequent issues.

Capabilities are more tangible and less sticky than knowledge (Szu 2003, Penrose, 1959) but are nevertheless complex in organizational settings where they are used to collect, process and sell knowledge. Since they hold a critical position in the production system as the core of the company and since the markets the PSF's operate in, are highly competitive and dynamic, the companies are in a constant dilemma. How can they simultaneously possess the capabilities that allows them to be efficient (Pfeffer & Salancik, 1978) in the day to day operations and that will not stagnate and lead to cumbersome path dependencies (Teece, Pisano & Shuen, 1997) that will hinder future competitiveness. This dilemma leads to several concrete actions, first a thorough mapping of the existing capabilities in all parts of the companies, and listing them hierarchical. Not in a strict and rigid sense but in order to gauge which capabilities were most important for the core business and as such should be given most attention. This was

followed by a monitoring of the capabilities in relation to profitability and acquisition of work to ensure that any changes in market either by costumers, competitors or general market conditions could be met by their capabilities.

It is a classical case of knowing the price of sleeping on the laurels and the cost of a major, re-active turn-around process that lead to this constant balancing between exploitation and exploration (March, 1991) of the capabilities. Going back to the starting point of knowledge vs. resources, the fact that the knowledge used in shaping and developing the capabilities are in a pure form and not embedded in machinery, as in the high-tech industries shows the vulnerability of the industry. This leads to the two areas where the organizations actively deal with the complexity and maximize the effect of the capabilities that define their business.

Organizing

Another area where the structural elements of the firm support the capabilities is the way work is being organized. As there is little capital invested in the firms and the production system made up by the professionals working in the organization it is essential to structure the activities of the firms in a manner that focuses on the central capabilities. The argument borrows from both the contingency approach (Galbraith, 1973) and Mintzbergs configurations (Mintzberg, 1983, 1991, 1999) in the sense that the specific tasks and context of the organization defines or at least helps define the organizing of the work.

This was evident in each of the firms. The work was organized around teams, projects, partners, and bodies of knowledge. In each case the firms identified the unit where the capabilities were best expressed and used that unit as an organizing concept. The capabilities were allowed to dictate or at least guide the concrete manner in which the work was being organized. Any concrete configuration, mode of organizing, was a framework for allowing the capabilities to be directed in a manner that best utilized the commercial side of the capabilities.

The law firm was organized around the different law specialities and client accounts in a matrix organization making sure that they always able to provide the clients, particularly the large and complex organizations, with the best solutions no matter the nature of the legal problem. Also this structure provided the firm with a lot of flexibility and made sure that the issues of client "ownership" among lawyers, especially partners would not be a hindrance to giving the clients the best possible advice regardless of who had the client account.

The architects were organized in a simpler or flatter structure around the five partners. However, as the work is organized in projects there was a kind of matrix structure with partners and projects as the two parameters. The partners would always be responsible for the projects making them organizational "hubs". The limits for the size of the company was given by the span of control of the partners, with five partners being able to oversee around 20 architects the limit of the company was around 100 architects. The numbers as such are not interesting. What is interesting is the fact that these teams with a partner and a number of architects working on concrete projects was central in the company's success and creativity, as the structure facilitated the capabilities of the partners and architects and kept the employees motivated.

The IT Company was organized in a divisionalised structure where each division was identified by primary work functions. This could either be the industry they worked for or a support function. There was little cross divisional cooperation, it more often happened that individuals got "borrowed" from one division to another for a particular project often such borrowing resulted in the person permanently working in the new division. There were a number of capabilities identified at the corporate level that were representable to the organization as a whole. Each of the divisions had particular emphasis on one or two of the capabilities to give them a distinct profile and to match professional and divisions. As such the divisions can be seen as concentrations of capabilities directed towards business areas. This way of organizing also allows for changes in the capabilities of the divisions over time by training or by moving individuals to divisions where there was a better fit between tasks and capabilities.

The management consulting firm was organized in a matrix structure with projects and fields of expertise called "pillars" as the parameters. The logic was somewhat different from the architects as the individual area or expertise manager was not as important a factor in determining the size of the area. Also there was much more cooperation between the areas in the different projects. It was a rare occurrence that a project was solved by only one of the teams or areas. The logic behind having the areas of expertise was very much determined by capabilities as the pillars also have a kind of hub function organized around specific tasks.

When looking at how the work is organized it becomes apparent that it is the capabilities that determine the concrete organizing mode and that the capabilities can be seen as organizing concepts (Jensen, 2003). This has two distinct implications. One is that the PSF's hinge their strategies directly on the capabilities and organize accordingly making sure that the organizational structure enhances the skills and knowledge of the professionals. The other is that the actual way of organizing depends on the particular company and sub-industry, there is a clear difference between the organizing of say a law firm and a IT company, and that even when the organizing seems identical the underlying logic is different. This highlights the need to look closely at the context when analyzing the relationship between capabilities, organizing and strategy.

Technology

The concept of technology is to be understood in the widest possible interpretation (Heidegger, 1977) and includes both IT systems, reporting systems, documentation systems and knowledge management tools.

Taking a closer look on the relationship between capabilities and technology, the primary insight is that while technology is highly efficient in enhancing the effects of the capabilities and in linking knowledge from individuals to the organization it is not in itself a competence. All of the companies were heavily reliant on technology, the IT-company in particular but technology as an independent concept never played a significant role.

Technology was used to boost the effect of the core capabilities of the firms but with a very high degree of focus on the transitory and intangible nature of capabilities. It was never the technology that defined the capabilities but vice versa. There was much emphasis on avoiding expensive en cumbersome technological lock in positions that would reduce the effect of the capabilities or prevent a free development of them over time. In this sense technology and organizing share a lot of similarities as they are both structural elements that at the same time has to enhance the effect of the capabilities and act as support in keeping the capabilities in the organization regardless of the movement of people and allow for openness and changes. The distinct difference is that while organizing refers to the overall handling of day to day activities, technology refers to the distinct tools that facilitate the commercialisation of the knowledge of the professionals made tangible and workable through capabilities (Grant, 1996). In effect this means that the observed relationship between strategy, capabilities and technology is surprisingly close to what described by Heidegger (1977) as the ideal relationship as it opens the human or rather organizational mind to the essence of technology.

It is also evident that the organizations have hitherto been reluctant to include technology in the form of IT in large scale. This is particularly true for the law firm and the architects. As a consequence of this the idea of modularity has been prominent in the design and use of technology. Again this refers to the fear of a lock-in situation and the dilemma of exploration and exploitation in regards to the capabilities (Levinthal & March, 1994). The fact that too much emphasis on exploitation would make the firms more vulnerable as capabilities might become obsolete while too much emphasis slows down the use of the current capabilities seems to be at the heart of the dilemma. From this it seems obvious that in order to use the capabilities strategically and get beyond the trivialities of noting that both exploitation and exploration are important, the nature of the capabilities and the context in which they are applied have to be taken into consideration. The pragmatic solution to this seems to be modularity and emphasis on capabilities as the governing factor, and with technology as a structural support function.

So it seems that through studying how PSF's relate to capabilities with particular emphasis on technology and organizing, the former understood in a broad sense not limited to IT and the latter as a both structural and process oriented parameter a picture emerges of how this particular type of firm use their capabilities in a strategic sense. This allows us to answer the initially posed questions, not in full but it provides us with insights and leads for further research.

Conclusion

PSF's use a reflective and a pragmatic approach to knowledge and capabilities. The fact that knowledge resides in individuals but is most efficient if used collectively by the organization makes it necessary to embed the knowledge into specific capabilities that can be kept within the organization, diffused among organizational members and used to develop and implement distinct strategies.

As concerns the issue of how PSF's embed their knowledge and capabilities in organizational routines in order to pursue competitive strategies it seems clear modularity is a central concept both when looking at organizing and technology. Modularity is usually found in classical production companies and industries, as it is primarily here the concrete benefits of having the same parts for different types of a product can be reaped. However, looking more closely at the companies in question it is clear that they organize their knowledge and competences based on a principle of modularity. The logic is the same as for traditional production companies that by arranging routines and tasks in small units that can easily fit in many different contexts, complexity is reduced and flexibility is increased. The exploration/exploitation balance can easily be adjusted.

Regarding both technology and organizing the PSF's allow the knowledge and more particularly capabilities to be the driving factor, providing a direction for the actions of the professionals. By applying a modular approach and identifying what the optimal module consists of the capabilities of individuals can be aggregated and used to actively pursue competitive strategies. Also this reduces the risk of a lock-in situation making the capabilities obsolete and reducing the competitiveness of the company. Finally it highlights the vulnerability of PSF's. Capabilities understood as the action oriented manifestation of knowledge is both the strategic core and the production system and more than that it is mainly embedded in individuals. PSF's are able to embed them in routines and use them strategically only insofar as they can create tangible linkages between individuals and organization. Organizing and technology are the primary tools and modularity is the primary method. This makes the capabilities and the knowledge on which they are built, relatively robust to changes both internally and externally as they are both well understood actively used and at the same time flexible and easy to organize and support depending on the exact context.

As concerns the pressing question of how looking at knowledge and capabilities add to the understanding of PSF's the answer is both straight forward and complex. It was obvious from the analysis that the chosen approach allows for a solid understanding of how PSF's work, what the underlying logic is what makes them able to pursue competitive strategies and what makes them vulnerable. However, even though Grants (1996) definition of capabilities brings substance to the concepts of knowledge and capabilities and provides for an understanding of the relationship it is still far from a fully coherent and unambiguous concept. This means that the explanations based on knowledge and capabilities still lack some precision in determining exactly how they manifest themselves and exactly what the causality between knowledge, capabilities and strategy is. We certainly have a better image of it, but we still need to understand the relationship on a deeper level.

Thus, by applying a resource and capabilities based approach to the study of PSF's the field is expanded in two distinct ways. It shows that Grant's notion of a knowledge based theory of the firm is highly applicable, not just on internal matters but also on the way they are being used externally, on the strategic actions of PSF's. It also illustrates how the strategic challenges faced by PSF's directly are related to their nature, which is an area that has not received sufficient attention despite the increased focus on PSF's in general.

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