THE LINK BETWEEN CORPORATE CULTURE AND FIRM PERFORMANCE

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Abstract

The existing literature on the relationship between culture strength and performance focuses on the consequences of strong cultures for performance levels but has not examined how strong cultures affect performance variability, or the reliability of firm performance. This is surprising, since the arguments relating culture strength to performance draw particular attention to the benefits of having greater internal consistency in goals and behaviors. One should therefore expect strong-culture firms to exhibit less variable performance. This expectation is complicated, however, by the fact that the variability of a firm's performance depends not only on the ability to maintain consistency in internal processes but also on the firm's ability to adapt to environmental change. The relationship between culture strength and performance reliability, therefore, should depend on how strong-culture firms learn from and respond to both their own experiences and changes in their environment.

***Keywords*:** corporate culture, firm performance, values, norms, organization, environment

Preliminary considerations

It is said that strong cultures, defined as “a set of norms and values that are widely shared and strongly held throughout the organization” (Cameron, Quinn, 1999: 16), enhance firm performance. This hypothesis is based on the powerful idea that organizations benefit from having highly motivated employees dedicated to common goals. In particular, the performance benefits from a strong corporate culture are thought to derive from three consequences of having widely shared and strongly held norms and values: enhanced coordination and control within the firm, improved goal alignment between the firm and its members, and increased employee effort. In support of this argument, quantitative analyses have shown that firms with strong cultures outperform firms with weak cultures.

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Studying the relationship between culture strength and performance variability therefore has the potential to shed light on the ability of strong-culture firms to adapt to change. Performance variability is also an important outcome in its own right, because it plays a central role in a variety of theoretical approaches to organizations. Behavioral theories of the firm suggest that risk taking by managers depends on firm performance relative to aspiration levels. Similarly, while "organizations may attempt to buffer themselves from environmental variability in order to facilitate planning and decision making and increase organizational autonomy, this may be more difficult when performance is highly variable" (Cray, Mallory, 1998: 24). Organizational ecologists have attributed causal importance to performance variability by arguing that external stakeholders typically attach value to predictable performance, giving reliable firms a survival advantage.

Firms with highly variable cash flows find themselves at a competitive disadvantage, for two reasons. First, highly variable cash flows imply that there will be periods when a firm will not invest so much in worthwhile projects. Some projects that are attractive when there is sufficient internal capital will be unattractive during periods of internal cash-flow shortfall, if external capital is more expensive than internal capital. This is one reason why firms may wish to engage in risk-management activities, such as hedging. Second, firms with more variable cash flows have higher costs of external capital than firms with more stable cash flows, which means that fewer projects will be attractive in firms with variable performance. The increased cost of capital derives in part from greater information asymmetry in the external capital market, because firms with highly variable cash flows are less likely to be followed by market analysts. For all of these reasons, corporate culture strength has implications for organizational outcomes that go beyond their effects on mean performance levels. Interest in the concept of organizational culture has exploded in the past two decades. While "some see attempts to measure organizational cultures and their effects on organizations as highly problematic, a large body of research starts from the assumption that culture is a measurable characteristic of organizations" (Cronk, 1999: 100). These studies do not seek to interpret the meaning of different organizational cultures or cultural forms but, rather, focus on their consequences for organizational behavior and processes. Studies of the effects of strong corporate cultures for firm performance fall within this tradition. I adopt Deal and Kennedy, (1999:160) definition of organizational culture as "a system of shared values and norms that define appropriate attitudes and behaviors for organizational members". Moreover, a culture can be considered strong if those norms and values are widely shared and intensely held throughout the organization. This definition of culture strength, in contrast to some others, entails no assumptions about which values and norms might enhance organizational performance.

One of the key consequences of a strong corporate culture is that it increases behavioral consistency across individuals in a firm. Organizational culture defines a normative order that serves as a source of consistent behavior within the organization. In this sense, organizational culture is a social control mechanism. At the same time, organizational cultures frame people's interpretations of organizational events and basic assumptions about organizational processes. Schein (1992: 15) emphasized that organizational cultures "provide group members with a way of giving meaning to their daily lives, setting guidelines and rules for how to behave, and, most important, reducing and containing the anxiety of dealing with an unpredictable and uncertain environment". Widespread agreement about basic assumptions and values in the firm should increase behavioral consistency and thereby enhance organizational performance, which is a function of the potential return to an organization's activities and its ability to carry out those activities.

While it is possible that strong-culture firms may be better (or worse) at choosing appropriate strategies, theories of the culture effect focus on the positive impact a strong culture has on the execution of routines. Theorists have put forward three interrelated explanations for the performance benefits of strong cultures. First, widespread consensus and endorsement of organizational values and norms facilitates social control within the firm. When there is broad agreement that certain behaviors are more appropriate than others, violations of behavioral norms may be detected and corrected faster. Corrective actions are more likely to come from other employees, regardless of their place in the formal hierarchy. Informal social control is therefore likely to be more effective and cost less than formal control structures. Second, strong corporate cultures enhance goal alignment. With clarity about corporate goals and practices, employees face less uncertainty about the proper course of action when faced with unexpected situations and can react appropriately. Goal alignment also facilitates coordination, as there is less room for debate between different parties about the firm's best interests. Finally, strong cultures can enhance employees' motivation and performance because they perceive that their actions are freely chosen.

Early studies reported mixed evidence of a positive relationship between culture strength and performance but generally defined culture strength in terms of the content of organizational values and norms. More recent studies, which defined culture strength in terms of the degree of agreement and commitment to organizational values and norms, found evidence in favor of the linkage. For example, Kotter and Heskett (1992: 55) related mean performance over a ten-year period to measures of the strength of corporate culture and found that, "across industries, firms perceived to have strong cultures generally had greater average levels of return on investment, net income growth, and change in share price". The performance of insurance companies increased to the extent that there was consensus surrounding cultural values. Consensus surrounding organizational values increases organizational effectiveness. The effect of corporate culture strength was contingent on market context, with the performance benefit of strong cultures being enhanced in highly competitive markets. When firms in an industry are highly constrained by the structure of their markets, differences in organizational performance are more likely to be due to differences in the efficiency of organizational routines.

While previous research focused on the relationship between culture strength and mean performance, strong cultures can also enhance the reliability of firm performance under the right environmental conditions. Performance reliability depends on two factors: "the consistency with which a firm performs its organizational routines and the degree to which those routines are well adapted to changing environmental conditions" (Dunbar, Knight, Power, 1999: 66). A key factor influencing performance reliability is therefore the nature of change in organizational routines in response to experience. In other words, reliability is a function of organizational learning processes. The link between the strength of corporate culture and reliability therefore lies in the consequences of strong cultures for organizational learning processes.

Culture, Learning, and Performance Variability

Organizational cultures and organizational learning are closely related. In fact, several authors have conceptualized organizational cultures as the product of histories of organizational learning. Frost (1991: 89) characterized organizational culture as "the product of attempts by the organization to impose coherence, order, and meaning on its experiences". Similarly, Schein (1992: 68) suggested that "culture ultimately reflects the group's effort to cope and learn and is the residue of learning processes". Schein further argued that organizational cultures are strongly influenced by shared experiences in the firm's early history and that, once established and taken for granted; the firm's basic assumptions are difficult to change.

While organizational cultures reflect past learning, they also define the context for future organizational learning, which, in turn, has consequences for performance reliability. Environmental change poses dual threats to reliable performance. First, environmental change can create internal problems by increasing the likelihood of failures in communication, coordination, and control. Second, environmental change can render existing organizational routines inadequate or inappropriate. Such environmental shifts demand learning and modifications in organizational routines that take the new conditions into account. Unless the organization discovers such solutions rapidly, it will perform haphazardly.

Strong-culture firms should generally be better than firms with weak cultures at avoiding internal threats to reliable performance, or breakdowns in coordination and control. Efficient and consistent firm functioning in the face of environmental change depends on both appropriateness and coordination: employees must respond to events by deploying the right routines at the right times and in the right sequence. Employees are more likely to take actions consistent with a firm's goals if they understand those goals and agree with them. If employees lack a clear understanding of the organization's goals, coordination will also be more difficult, as they are more likely to take actions that conflict with what is happening in other parts of the organization. Thus, heterogeneity in beliefs within the organization makes performance more haphazard. If employees differ in their understandings of the environment, they will either spend more time debating alternatives or behave inconsistently and, therefore, be more likely to carry out routine tasks poorly. Strong cultures minimize heterogeneity in beliefs about the state of the environment and should thereby enhance internal reliability. Organizational cultures codify the organization's understanding of itself and its environment and thus clarify the organization's beliefs and goals for members. In strong-culture firms, most members work from a shared knowledge base and common beliefs, which enhances organizational reliability. As Schneider (1994: 83) argued, “Knowledge makes performance more reliable. As work is standardized, as techniques are learned, variability, both in the time required to accomplish tasks and in the quality of task performance, is reduced”.

Culture, Environmental Volatility, and Performance

In the absence of environmental change, reliability, and performance more generally, is simply a function of internal organizational processes. Environments do change, however, both incrementally and more discontinuously. Organizational performance in changing environments depends on the ability of the firm to modify its routines in response to changes in conditions. “The nature of environmental change therefore affects the relationship between culture strength and performance, since organizational routines embody assumptions about the state of the environment and the expected path of change in external conditions” (Price, Shaw, 1998: 75). When environmental change is incremental, and therefore consistent with the basic assumptions underlying the organization's routines, organizations achieve reliable performance through corresponding incremental adjustments to routines. The consequences of strong cultures - enhanced coordination and control, goal alignment, and increased motivation - should all increase the speed and accuracy with which organizations adapt to incremental changes in their environments. In relatively stable environments, strong-culture organizations should exhibit more reliable performance than organizations with weak cultures because they are more adept at refining and improving established competencies. But excellence at exploitation comes at a cost.

Strong-culture organizations will, in general, be ill-suited to exploratory learning, for several reasons. First, strong culture organizations may have greater difficulty recognizing the need for change. Second-order learning is triggered by suboptimal experiences that the organization can no longer ignore and cannot handle within its existing interpretive frameworks. Because members of strong-culture organizations have a greater commitment to a particular understanding of the world than weak-culture organizations, they may be slower to detect fundamental changes in environmental conditions. Second, the elements of strong cultures that facilitate first-order learning may simultaneously impede second-order learning. One source of exploratory learning is the presence of individuals whose beliefs contradict the organization's dominant beliefs. For a firm to learn from such individuals, it must both allow them to maintain their deviant beliefs and be willing to incorporate potential insights into the organization's procedures. Organizations that are good at learning from their members and exhibit weak socialization pressures will have the most accurate understanding of a changing environmental reality.

Finally, strong-culture organizations may be less likely to reap the benefits of any exploration that does occur. Innovation and change in organizational routines can be fostered by viable countercultures, but countercultures may be less likely to emerge and persist in strong-culture firms. Moreover, even when countercultures can be sustained in strong-culture firms, the transfer of new ideas and knowledge to the dominant culture is fraught with difficulty. In this respect, “A coherent statement of who we are makes it harder for us to become something else" (Sentell, 1998: 124). This reasoning suggests that, other things being equal, strong-culture organizations should have greater difficulty responding to environmental volatility than weak-culture organizations. If environmental change sharply reduces the value of the organization's existing routines, strong-culture firms should have greater difficulty regaining their footing. Short of such radical environmental change, however, strong-culture firms should still maintain the internal organizational benefits identified by culture researchers: greater goal alignment, superior coordination and control, and higher motivation levels than weak-culture firms.

Conclusions

Firms with strong cultures incur a tradeoff with respect to their adaptive ability in the face of environmental change. Strong corporate cultures facilitate reliable performance in relatively stable environments, but as volatility increases, these benefits are dramatically attenuated. This pattern is consistent with the fundamental tradeoff between exploration and exploitation and suggests that strong-culture firms excel at exploiting established competencies but have difficulty exploring and discovering new competencies that better suit changing environmental conditions.

While the tradeoff between exploration and exploitation has been acknowledged for some time, there has been little empirical research linking this tradeoff to organizational characteristics. Organizations make implicit and explicit choices about the allocation of resources to each type of learning. Some of the more explicit choices are encoded in formal structures. For example, the interdependencies created by vertical integration demand a commitment to a particular technology and, hence, a shift of resources toward exploitation. This affects adaptability in rapidly changing environments. In franchising organizations, the balance between exploration and exploitation depends on the mix of company-owned and franchised units. In hotel chains the effects of operating experience depend on the structure of the chain and the nature of the operating experiences of chain members.

Corporate cultures consist of ideas about the firm's unique capabilities, frameworks for interpreting the state of the environment, and means of responding to environmental changes. Strong-culture firms have a high level of commitment to an established way of understanding the world, while weak-culture firms exhibit heterogeneity in participants' beliefs about the relationship between the organization and its environment. As long as the organization's perceptions of its environment are reasonably accurate, firms benefit from strong corporate cultures, both by achieving higher performance levels and by doing so more reliably. Strong-culture organizations do not bear the costs of disagreement surrounding organizational goals and the means to achieve them. When environments are volatile, however, exploration skills become more valuable. Success in volatile environments requires being able to learn from new and changing situations. In volatile environments, the assumptions forming the basis of the corporate culture become inaccurate at a faster rate. When the environment shifts, strong-culture organizations have no fall-back position, and the lack of internal diversity in perspectives makes it more difficult for the firm to adapt.

These findings might lead one to conclude that the optimal strategy for firms would be to develop strong cultures that explicitly encourage exploratory learning and innovation. The value of a strong culture of exploration still depends on the existence of environmental conditions that reward exploration. If the environment changes to reward efficiency and exploitation of organizational routines, firms that are strongly committed to exploration should have greater difficulty adapting than firms with weak cultures of exploration, because such an environment demands relative stability in organizational routines and the ability to make incremental improvements in efficiency. The difficulty encountered by the firm with a strong culture of exploration is, in this case, not an inability to discover new routines but greater difficulty in discovering a set of values and norms that are appropriate to the new environment.

Finally, the fact that there are tradeoffs associated with strong corporate cultures should not overshadow one of the central results of this paper, namely, that strong cultures in general lead to reductions in performance variability. Firms benefit from reduced variability in performance. Strong cultures therefore create competitive advantage not only by increasing motivation and facilitating coordination and control, but also by leaving the strong-culture firm in a stronger position to respond to investment opportunities that might solidify its competitive advantage. While the results in this paper suggest that strong-culture firms encounter difficulties during periods of fundamental change, "the advantages that accrue to them during periods of incremental change may make them better able to weather periods of upheaval"(Trice, Beyer, 1993: 43).

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