

JOURNAL OF SMALL BUSINESS
STRATEGY

**THE LINK BETWEEN LEADERSHIP, STRATEGY, AND
PERFORMANCE IN MANUFACTURING SMEs**

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ABSTRACT

Sustainable competitive performance, in today's turbulent environment, is widely thought to depend on the quality of leadership and strategy. In this paper, we empirically examine the relationship between strategy, leadership and performance within a single study. Evidence is presented from 194 firms, outlining the association between strategy characteristics and the dimensions of leadership in a ranked order according to their degree of importance. The analysis indicates that a balanced transformational and transactional leadership style is likely to lead to better performance. The study also found that firms strongly emphasizing any of the leadership styles performed better than firms with uncertain or weak leadership styles.

The findings provide practical guidelines to enable senior managers to consider leadership style in the formulation and deployment of their strategic plan. Finally, the analysis indicates the need to consider and align leadership and strategy in order to achieve sustainable competitive performance.

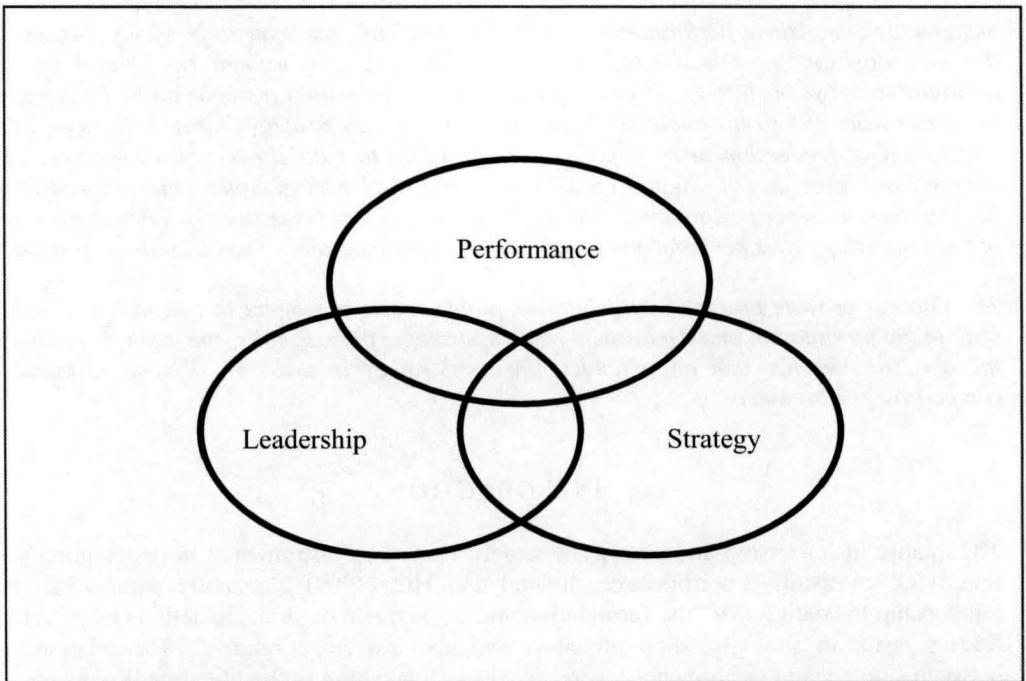
INTRODUCTION

The quality of leadership and strategy is widely viewed as instrumental in maintaining and improving competitive performance. Ireland and Hitt (1999) eloquently summarize this relationship by stating that "the formulation and deployment of strategic actions by effective leaders result in strategic competitiveness and above-average returns". The relationship between strategy and performance has received much attention in the literature. For example, Schwenk and Shrader (1993) conducted a meta-analysis of existing studies and found that strategy was positively linked to growth. But what does this mean, and what drives the effectiveness of the strategy? Arguably, success arises from approaching the strategy process in the right way, both from formulation and deployment perspectives. Accordingly, leadership has an important role to play in strategic effectiveness. It is therefore no great surprise that the literature on leadership and its impact on strategy and performance is extensive. Indeed, the

literature contends that it is difficult to formulate and deploy any type of strategy without the active involvement of the firm's leadership. Leadership can be either 'hands-on' or encompass a guiding role. Either approach depends on the impact of leadership characteristics on strategy and overall organizational performance. Interestingly, Mintzberg et al (1988), while acknowledging the role of leadership, contended that in the pursuit of strategic intent or performance, many leaders encountered significant difficulties in aligning organizational actions. In essence, this leads to one of the important questions often asked "which type of leadership is likely to lead to better strategic direction and ultimately organizational performance?" Existing studies largely point to the existence of a dynamic and circular relationship between leadership, strategy, and performance (see Figure 1). Most of the studies to date have focused on examining the bilateral relationship between two of these variables in a single study, rather than examining the relationship between the three variables simultaneously. The integrated approach pursued in this study has a number of advantages. First, it is possible to test the model presented in Figure 1 more vigorously by eliminating the contingency influences inherently present in different bilateral studies. Second, the bilateral studies can, at the very best, provide a partial view of the relationship between these three variables and any broader conclusion is necessarily based on conjecture.

The overall aim of the study is to test the relationships depicted in Figure 1.

Figure 1 - The Leadership-Strategy-Performance Relationship



AIMS OF THE RESEARCH

To date, most SME research focuses on factors that contribute to their survival such as financing, rather than a greater understanding of the growth process and the achievement of sustainable competitive advantage. The majority of the literature focuses on large firms, and there is a dearth of research on smaller organizations. Accordingly, it is important to understand the drivers of performance in manufacturing SMEs. The literature suggests that a

number of attributes are associated with performance such as strategic planning and leadership. These attributes formed the basis of a number of focus group activities held with managing directors of manufacturing SMEs prior to the development of the conceptual model depicted in Figure 1.

Despite a common operating environment, some firms perform better than others. The reason for superior performance is attributed to the various stages of the strategy process from formulation to deployment. While it is not clear what part of the strategic process triggers the increase in performance potential, we contend that a key component in the response of SMEs to the operating environment is based on their leadership style. The existing research mainly focuses on large firms and provides a useful basis for examining leadership and strategy in smaller firms. However, SMEs differ from large firms in aspects such as competencies, ideals, and resources. On the other hand, large firms tend to focus on formal strategic initiatives.

SMEs with limited opportunities for direct influence on the market structure have to be creative in launching new business concepts. However, being creative for SMEs is often made difficult by resource and cultural constraints as well as their inability to analyze their own capabilities and ascertain their shortcomings or seek support to address those shortcomings. This implies that SMEs are less likely to exert influence over their environment and must rely on their internal resources such as their people in the quest for competitive advantage.

Mintzberg (1979:306) sees SMEs as having 'little or no techno structure, few support staffers, a loose division of labor, minimal differentiation among its units, and a small managerial hierarchy. Little of its behavior is formalized, and it makes minimal use of planning, training, and liaison devices. It is above all, organic'. This implies a focus on informality and intuition, although Perry (2001) found that firms failing to engage in business planning did not perform as well as planning focused firms. The literature suggests that 'to date, researchers have not reached consensus about many of the factors that may influence performance'- Short et al (2002). Accordingly, a better understanding of the influence of leadership and strategy and their interplay can assist SMEs' growth processes. The increasing recognition that leadership and strategy are among the main drivers of success provides the ideal opportunity to re-assess the association in relation to small and medium sized manufacturing firms.

This paper is structured as follows: first, a brief description of strategy, leadership, and performance is provided that leads to the formulation of the constructs. Second, the methodology outlines the conduct of the research. Third, the analysis is depicted and interpreted. Finally, the paper presents conclusions and recommendations on the most likely alignment of leadership and strategy dimensions based on varying performance outcomes.

FORMULATION OF CONSTRUCTS

Strategy

The essence of strategy is to understand why organizations perform differently, and how performance can be directed and controlled (Ketchen, et al 1996). Indeed, the relationship between strategy and performance has concerned researchers for years – Brews and Hunt 1999. The research effort typically falls into two separate but interrelated streams: process and content. Process focuses on how strategies are formed and implemented. Content represents the substance of strategy, that is to say, the scope of the firm (product, level of integration, markets) and on what basis the firm will compete in its chosen markets. The literature on strategy is 'vast, and growing at an astonishing rate' (Mintzberg et al 1998). Yet there is no consensus on what strategy is – rather there are many definitions. Strategy is frequently described as a deliberate set of actions to achieve competitive advantage, and giving coherence and direction to the organization.

The impact of strategy on performance is well covered within the literature. Three important meta-analyses found a relationship between strategy and performance (Boyd 1991; Schwenk and Shrader 1993; Miller and Cardinal 1994). Barry and Elmes (1997, p. 430) note that strategy must 'rank as one of the most prominent, influential and costly stories told in organizations'. It is therefore vital to the organization. This led to the formulation of the following research question '*does strategy impact on the performance of manufacturing firms, and if so, to what extent?*'

Following an extensive examination of the literature we adopted the following characteristics to represent the key factors used to craft strategy: external orientation, internal orientation, departmental or functional integration, staff creativity, employee involvement, the use of analytical techniques, resources for strategy (managerial and financial), and a focus on control. Their relevance was further examined through qualitative interviews with six managing directors of SMEs.

Leadership

Aspects such as leadership are becoming increasingly important in an era of global competition and greater customer demands. Studies so far indicate that leadership and strategy are positively related (Berkeley 1988). This relationship arises from the need to make 'hard choices'. Therefore, effective leaders 'must provide the discipline to decide which industry changes and customer needs the company will respond to while avoiding organizational distractions and maintaining the company's distinctiveness' (Porter 1996). Leadership is also the main driver of organizational culture. Indeed, Kotter (2001) suggests that only through leadership can one truly develop and nurture culture that is adaptive to change. However, there is no agreement to date on the accepted styles of leadership. The more commonly accepted styles are transformational and transactional - Bass (1998). Other styles depicted in the extant literature include strategic, charismatic and human resources orientation. Many of these styles have overlapping attributes with transformational style usually seen as encompassing the charismatic style. In an empirical study of small firms, the following four main leadership styles were derived, tested and validated: transformational, transaction, human resources, and laissez faire styles. Transformational leadership style is made up of a number of attributes that relate to the ability to develop a vision for the future, the development and nurturing of competences, and the use of creativity. Transformational leaders tend to be charismatic, inspiring and stimulating. They instill trust, encourage new ideas and allow sufficient flexibility to meet what are often ambitious targets. In essence, while they have a strong external orientation, at the same time, they recognize the value of internal motivational factors. Human resources style leaders tend to have a greater employee focus and work through their employees in order to achieve their overall tasks. There is inevitably some degree of overlap between these two styles. Transactional leadership is more internally orientated with a strong emphasis on control. It offers rewards for work carried out to specified standards largely to meet the financial and other goals of the firm. While the control elements of this style are useful, it shows little or no concern for employee welfare. Laissez faire style has little to offer in today's dynamic business environment. It encompasses the avoidance of decision-making until problems are seriously detrimental to the firm's operations. Accordingly, as these constructs were already validated on SMEs, they were selected for use in this study. Their validity was further tested in qualitative interviews with six chief executives of SMEs, employers' representative bodies and in the pilot phase of the fieldwork. Accordingly, the following research questions were formulated:

What leadership styles are associated with strategy formulation and deployment?

Is there any one leadership style that is associated with enhanced performance?

Performance Measurement

Laitinen (2002) suggests that performance 'can be defined as the ability of an object to produce results in a dimension determined a priori, in relation to a target'. He also suggests that a well-organized system of performance measurement may be the single most powerful mechanism at management's disposal to enhance the probability of successful strategy implementation. An effective performance measurement system ought to cover all aspects of performance that are relevant for the existence of an organization and the means by which it achieves success and growth. This means that any performance measurement system ought to include more than just financial measures. Accordingly, we sought to include non-financial measures as a means of addressing such concerns. Laitinen (2002) states that 'when financial and non-financial measures are incorporated in the same model, managers can survey performance in several areas simultaneously in order to enable efficient strategic decision making'. However, 'to date, researchers have not reached consensus about many of the factors that may influence performance' - Short et al (2002). Our exploratory interviews with the Managing Directors of six firms confirmed that the effective evaluation of alternative strategies, avoiding problem areas, improving long and short-term performance, and innovation are also important performance dimensions. This study, therefore, uses these dimensions as well as financial measures, and provides a 'multiple assessment' of a firm's performance (Pett and Wolff 2003).

METHODOLOGY

A postal survey was carried out using constructs on strategy devised and tested on small banks in the US (Kargar and Parnell 1996), as well as constructs on leadership devised and tested on Dutch SMEs (Wilderom and v.d. Berg 1997). The validity of the constructs used and their relevance was tested through the qualitative phase of the research. This involved in-depth interviews with six managing directors of SMEs and discussions with employer representative bodies such as the Chamber of Commerce and the Confederation of British Industry. Furthermore, the survey instrument was tested and modified through the pilot phase of the fieldwork.

The sample consisted of 1,000 small and medium sized UK electronics and engineering firms. The reason for this choice was threefold. First was the contrasting product life cycles of the sectors – engineering firms, by and large, operate in a mature market, whereas electronic firms operate in a market characterized by short product life cycles. Second was the relative economic importance of the two sectors. The third reason was the presence of a large number of small and medium sized firms within these two sectors. Small and medium sized firms were defined as having fewer than 250 employees. As there are nearly 15,000 electronic/engineering SMEs in the UK, it was decided to use a random sampling methodology using a directory available from a reputable commercial firm.

Data Analysis

The procedures used to analyze the responses included the determination of the reliability of the instrument. Internal consistency was established using Cronbach's Alpha and factor analysis. Cronbach's Alpha was used to test the scale reliability. Factor analysis was used to reveal the underlying themes and also as a means of data reduction.

We examined the relationship between leadership style and both strategy and performance by calculating, for each firm, the aggregate score for each leadership dimension and dividing these into four quartiles. Then, for every firm we assigned a value of 1 (lower quartile) to 4 (upper quartile) for each dimension of leadership. We focused on the upper quartile to examine the relationship between leadership styles and the degree of emphasis placed on the strategy process and performance using descriptive statistics and correlation analysis. The upper quartile was used as it contains the strongest emphases on the characteristics used. Finally, we correlated the characteristics of strategy with a range of performance indicators.

RESPONSES

Factors such as address changes, size, and sector incompatibility reduced the effective size of the sample to 702. One hundred and ninety four valid responses were received - a response rate of 27 percent. The demographic of non-responding firms were compared with that of responding firms. No discernible differences were detected, pointing to the absence of serious response bias. Furthermore, non-respondents were contacted to ascertain the reasons for non-response. These were analyzed to determine whether or not the non-response was a source of potential bias. The reasons proffered for non-response did not reveal an underlying bias.

The Leadership-Strategy Linkage

We examined the relationship between leadership styles and the characteristics of strategy using three different approaches. First, we factor analyzed the constructs used for describing each leadership style. Second, we computed the aggregate score for each of the four leadership styles and used these scores to create a new set of variables by placing each leadership style for each firm in the upper, the two intermediate, or the lower quartile of the scores. We then examined the importance attached to each characteristic of strategy by firms at the upper quartile. Third, we correlated the new variables derived by classifying organizations' management styles into four quartiles with the strategy constructs. The relationship between the extent of emphasis placed on each of the strategy characteristics by firms at the upper quartile on each of the four leadership styles is depicted in Table 1.

Table 1 - Percentage of Firms with Strong Leadership Placing a Significant Emphasis on Strategy Characteristics

Strategy Characteristic	Transformational	Transactional	Human Resources
Staff Creativity	69.5	52.3	63.4
External Orientation	68.9	51.6	60.9
Employee involvement	77.2	38.8	72.1
Departmental co-operation	76.1	27.6	70.6
Use of analytical techniques	31.2	24.0	27.3
Internal orientation	63.9	57.4	54.4
Strategy – a control mechanism	32.1	36.5	30.3

Firms with strong transformational and human resources style leadership placed strong emphasis on all the characteristics of strategy with the exception of *strategy – a control mechanism* and the *use of analytical techniques*. Transformational style firms placed stronger emphasis on all characteristics compared with human resource style firms. In addition, both transformational and human resources style firms placed greater emphasis on all characteristics compared with transactional style firms. Arguably, greater attention is placed

on strategy characteristics when transformational style is more prominent, followed by the human resources styles. In turn, these findings suggest that the combination of two styles potentially increases the emphasis placed on each of the strategy characteristics. We next correlated each leadership style with the level of emphasis placed on the strategy characteristics (see Table 2). The results indicate significant correlation between *transformational* and *human resources* styles and all of the strategy characteristics save for *resources for strategy* and the *use of analytical techniques*. *Transactional style* was correlated with *Strategy – a control mechanism* only.

Table 2 - Correlation Between Firms with Strong Leadership Styles and Strategy Characteristics

Leadership Styles	Strategy Characteristics	
Transformational	Internal Orientation** Departmental Co-operation**	External Orientation** Staff Creativity** Employee involvement**
Human resources	Internal Orientation** Departmental Co-operation**	External Orientation** Staff Creativity** Employee involvement**
Transactional	Control mechanism*	
* Correlation significant at the 0.05 level (2-tailed)		
** Correlation significant at the 0.01 level (2-tailed)		

The results presented in Table 2 are consistent with the results of the descriptive statistics presented in Table 1. The degree of emphasis on both transformational and human resources styles, and their strong emphasis on the characteristics is not surprising. For example, Gill (2003) states that leadership requires the development of a culture of sustainable shared values that support the firm's strategic vision and should empower, motivate, and inspire employees. Clearly, such actions are crucial to any organization facing a changing market environment and seeking to retain current market share or maximize new market opportunities. One of the attributes of transformational style is flexibility. This is often seen as a critical factor in the pursuit of competitive advantage and increased profitability in an uncertain marketplace. In a highly unstable operating environment, increased flexibility could result in increased costs as the firm seeks to develop new competencies. In our exploratory interviews with SME Chief Executives, transformational leadership was seen as re-enforcing the role of leaders as change agents within their firms, as well as strategy drivers. It is logical to conclude that a balanced human resources/transformational leadership style is more conducive to strategy formulation and deployment, compared with transactional style. Indeed, we argue that a combination of both styles is essential for the deployment of corporate strategies in order to meet the needs of an ever-changing and uncertain market environment.

The Leadership-Performance Linkage

Descriptive statistics and correlation analysis were used to examine the relationship between the three main leadership styles and the eight measures. The descriptive statistics showing the percentage of firms with strong leadership indicating that their performance objectives were fulfilled/entirely fulfilled are depicted in Table 3.

An examination of the figures presented in Table 4 facilitates the identification of the impact of each leadership style on different measures of performance. Both *transformational* and *human*

resources leadership styles have the greatest impact on all measures of performance with the exception of *short-term performance*. However, the analysis depicts a wide range of performance objective fulfillment. For example, just over half the firms surveyed, indicated that their market share objective was achieved, compared with over 90 percent of firms achieving customer satisfaction.

Table 3 - Percentage of Firms with Strong Leadership Styles Indicating Fulfilled /Entirely Fulfilled Performance Objectives

Leadership Style	Transformational	Transactional	Human Resources
Financial results achieved	61.6	48.5	50.9
Customer Satisfaction	90.7	51.8	62.3
Customer Retention	74.8	57.7	63.4
Market Share	57.8	42.0	51.2
Short-term performance	69.4	59.9	52.3
Long-term performance	86.4	46.7	71.4
Innovation	65.2	47.8	70.7
Introduction of new products	68.8	43.1	65.2

The next lowest performance measures fulfilled are financial performance and innovation. Arguably, these performance measures are dependant on and influence customer satisfaction.

Firms with transactional leadership style indicate that *short-term performance* and *customer retention* performance objectives are fulfilled to a greater extent than the remaining six measures. Interestingly, both of these measures are consistent with a transactional approach, which is commonly described as involving a reward or benefit in return for actions carried out and/or performance achieved. In addition, both performance measures achieved are consistent with a strong emphasis on maintaining the status quo, rather than being change orientated. We next used correlation analysis to determine whether the observed relationship between leadership style and performance were statistically significant (see Table 4).

Table 4 - Correlation Between Strong Leadership Styles and Organizational Performance

Leadership Styles	Factors Used to Measure Performance	
Transformational	Financial results* Long-term performance* Customer satisfaction** New product introduction*	Innovation** Market share* Customer retention**
Human Resources	Innovation* Market share*	Long-term performance*
Transactional	Short term performance*	
* Correlation significant at the 0.05 level (2-tailed)		
** Correlation significant at the 0.01 level (2-tailed)		

Table 4 indicates that there is a strong correlation between firms emphasizing *transformational* leadership and all performance measures, with the exception of short-term performance. This is to be expected as *transformational* style is normally linked to a broad long-term outlook that incorporates future performance. A strong *human resources* leadership style also shows a significant correlation with innovation, market share, and long-term performance. This finding is consistent with earlier studies, suggesting that both

transformational and human resources leadership styles are likely to lead to greater performance in the longer term.

Firms with *transactional* leadership style show a significant correlation with short-term performance only. Interestingly, despite nearly 58 percent of transactional style firms indicating that their *customer retention* objectives were achieved, the correlation analysis fails to show a significant relationship between transactional leadership and customer retention. This finding indicates that firms would be unwise to rely on transactional leadership style as the driver of any performance measure other than *short-term performance*. Accordingly, we can conclude that firms emphasizing transformational leadership style will have different performance outcomes than firms emphasizing transactional style leadership.

The Strategy – Performance Linkage

The final stage of the analysis is the examination of the degree of association between strategy and performance. The results of the correlation analysis between firms with strong emphasis on the factors used to craft strategy and performance are depicted in Table 5.

Table 5 - Correlation Between Firms with a Strong Emphasis on Strategy Characteristics and Organizational Performance

Strategy	Factors used to measure performance	
External Orientation	Financial results* Long-term performance* Customer satisfaction** New product introduction*	Innovation** Market share* Customer retention**
Strategy – a Control Mechanism	Short-term performance**	Financial results*
Staff Creativity	Innovation **	
Internal Capabilities	Short term performance*	
Departmental Cooperation	Long term performance*	
Employee Involvement	Long term performance*	
Use of Analytical Techniques	None	
* Correlation significant at the 0.05 level (2-tailed)		
** Correlation significant at the 0.01 level (2-tailed)		

The analysis of Table 7 indicates that the factors used to craft strategy correlated with broadly the same performance measures as leadership style. The only exception related to the correlation between the strategy characteristic *creativity* and performance, which results in a high degree of significance for *innovation*. The findings are consistent with an earlier study by Cohen and Levinthal (1990:137) where firms that are more externally orientated ‘tend to be more proactive, exploiting opportunities present in the environment, independent of current performance’.

IMPLICATIONS FOR SMEs

This study began with a number of research questions that are of significant interest to the managing directors and chief executives of small and medium sized firms. We began by querying the impact of strategy on performance and, if there is an impact, what it is likely to be. We also sought to examine the impact of leadership on both strategy and performance and sought to ascertain the style of leadership that is most likely to lead to the achievement of performance objectives. These research questions were formulated following a thorough literature review as well as focus group interviews with Chief Executives. Not surprisingly, these research questions arise virtually every day during chief executives' conversations. Practitioners as well as academics have mixed views on these questions. In attempting to marry the three concepts together, we were mindful of the many objectives that smaller firms have from innovation, customer satisfaction, financial results, and so on. Such objectives inevitably lead to questions such as which leadership style and strategic emphasis are needed to achieve success. Unfortunately, the research findings to date have largely failed to answer such questions.

Our starting point was that a firm's leadership style should be compatible with the strategic plan proposed. If managers are serious about strategic planning formulation and deployment, they must accept that the existing leadership style may present a significant barrier as well as a potential driver of activity. We examined four distinct leadership styles: transformational, transactional, human resources, and laissez faire. As the laissez faire style has little to offer in today's dynamic business environment, it was omitted from the analysis of this study.

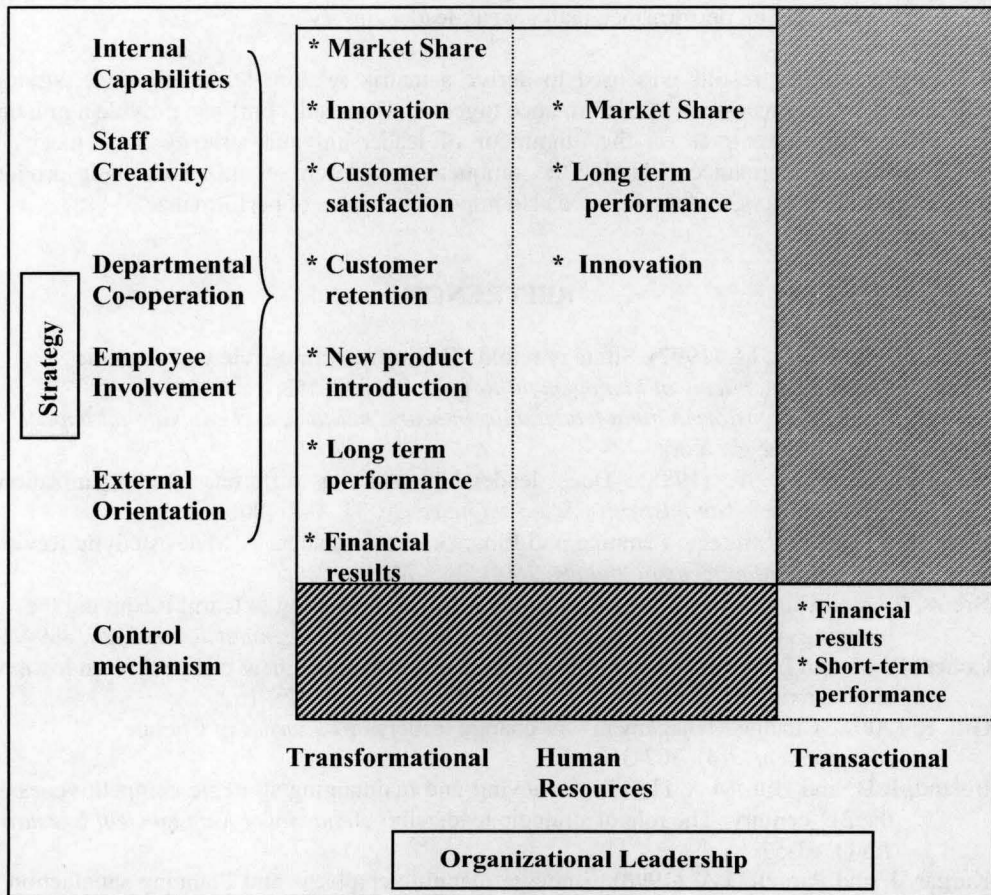
The study examined the main factors used in the crafting of strategy: external orientation, internal orientation, staff creativity, employee involvement, departmental or functional co-operation, the use of analytical techniques, and control. Both transformational and human resources leadership styles were associated, to a significant extent, with similar characteristics of strategy, whereas transactional leadership was associated with only one characteristic, internal orientation. A broadly similar picture emerges when we examine the correlations between leadership and performance. Transformational leadership is significantly associated with the majority of performance measures. Human resources style is associated with innovation, market share, and long-term performance. This indicates an overlap with transformational leadership style.

The relationship between transactional leadership and performance indicates only one significant correlation, with short-term performance. Accordingly, firms with corporate objectives other than the improvement of short-term performance should look to transformational and human resources styles of leadership. Conversely, leaders currently holding transactional style traits only should focus on short-term performance improvement.

This analysis provides a practical step-by-step guide for managers to consider in the alignment of organizational strategy, leadership, and performance as depicted in Figure 2. The findings will enable managers to give detailed consideration to the organization's leadership at the same time as adjusting or formulating a new strategy. While the analysis suggested that the *transformational and human resources styles* are best suited to overall performance, it should be noted that there can be no prescriptive leadership style as the success or otherwise of each leadership style, and its suitability to strategy depends entirely on individual organizations, their products, stakeholders, and markets. This means that the presence of any one leadership style may not always lead to the achievement of performance objectives, as there are other contingency factors that impact the achievement of competitive advantage that

are often beyond the control of the chief executive. Nevertheless, Figure 2 is a useful indicative template.

Figure 2 – Maximizing the Strategy-Leadership Relationship for Performance



It is important that a conscious effort is made by all firms, irrespective of their desire to propagate new strategic directions or not, to ensure that their leadership style is consistent with the strategic direction established. One of the key advantages of Figure 2 for managers is that it facilitates the consideration of the alignment process based on their current strategy, leadership, or indeed performance measures.

SUMMARY AND CONCLUSIONS

The growing importance of competitive advantage in the face of increasing uncertainty provides an opportune time to explore the impact of strategy and leadership in SMEs. In this study, we examined the relationship between factors deployed in crafting strategy, leadership, and performance.

The outcome provides substantial support for the interdependent model depicted in Figure 1 and indicates that there is considerable common ground between the three concepts. Nevertheless, the degree of interplay between the concepts is complex and dynamic. Our

findings show that leadership styles are correlated with strategy characteristics as well as with a range of performance measures. We further found that performance measures and most of the strategy characteristics chosen are correlated. This provides some support for the proposition that the type of leadership, strategic approach, and performance attainment are related. Interestingly, we found that a strong leadership style, irrespective of the style itself, had a greater impact on performance than a weak leadership style.

The analysis of the results was used to derive a matrix relating leadership style, strategy characteristics, and measures of performance together. The results outlined provide a practical guide for chief executives on the alignment of leadership and strategy as a means of attainment of performance. Clearly, the uniqueness of each organization, their product, processes, stakeholders, and markets are also important drivers of performance.

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