Knowledge in Professional Service Firms

Perceptions among auditors in Malta

Bachelor thesis within Business Administration

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Abstract

**Background:** In the last decade the interest in the “knowledge economy” has grown both in the popular press and in academia. Peter Drucker is arguing that today ”knowledge is the only meaningful resource…”. Professional Service Firms (PSF) is a group of heterogeneous companies more knowledge intensive than most organizations.

**Problem:** Even though all PSFs are dependent on knowledge as their main factor of production, this dependence varies with firm type. In pursuit of higher margins amid strong competition and increasing regulation many audit firms in Malta are moving away from procedure-based services towards expertise-based.

**Purpose:** The purpose of this thesis is to investigate and describe how practitioners in procedure-based professional service firms in Malta perceive knowledge. An attempt will be made to interpret how this perception may affect the firm’s ability to diversify away from procedure based offerings.

**Method:** This thesis uses a qualitative method focused on interviews to collect the empirical data. The analysis of the empirical material has been inspired by the hermeneutic school of thought.

**Conclusions:** Unsurprisingly the interviewees perceived knowledge as the tool they need to perform their job. Knowledge was said to be considered important, but the empirical results reveal a surprisingly low sophistication in the understanding of the concept. The dramatically increasing complexity in the audit firms’ operating environment, caused by rapid changes in regulation and standards, is putting pressure on the firms. Many audit firms respond by attempting to diversify into less regulated areas such as consulting. Since the importance and usage of knowledge is different between a procedure-based operation such as an audit firm and an expertise-based operation such as a consulting firm, diversification from one type to the other will prove difficult.
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Introduction

1.1 Background

In the last decade the interest in the so called knowledge economy has grown both in the popular press and in academia (Edvinsson & Bounfour, 2004; The Economist, 1999; Marr & Spender, 2004). The idea of the knowledge economy is that knowledge, rather than labour or capital, will become the main factor of production. In the last few years this trend has become more visible in the developed world since manufacturing operations are being outsourced and replaced by more knowledge intensive jobs (The Economist, 2006). The result is that services today amount for two third of worldwide GDP (The World Bank Group, 2004). Recently, even service jobs have started to be outsourced (Loxton, 2004). This transformation is by many observers viewed as a socio-political change with the same magnitude as the industrial revolution. Drucker (1993:38) is even arguing that today "knowledge is the only meaningful resource...". This would suggest that the centre of gravity is shifting from what we do to what we know.

Peter Drucker was born two years before Frederick Winslow Taylor (1911) developed the concept of scientific management to increase the productivity of manual workers. Every task and job was measured, specified and designed for optimization. This thinking was conceptualized in the assembly line and later found its way into management thinking with Porter’s (1980) popular value chain model as a prime example. However, since the time of Taylor much has changed. Drucker (1999) identifies as the key challenge for the 21st century the productivity of what he termed the “knowledge worker”. He argues that knowledge worker productivity is fundamentally different from manual worker productivity because:

1. The task that need to be made more productive is not known
2. The knowledge worker must be responsible for productivity
3. Knowledge workers must manage themselves

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1 McKinsey argues that “tacit jobs” (jobs involving complex interactions that require a high level of judgment) make up 40% of the American labour market and account for 70% of the jobs created since 1998 (The Economist, 2006).
• Knowledge workers must continuously learn and teach
• Productivity for the knowledge worker is a matter of quality not quantity
• The knowledge worker must be treated as an asset not a cost

Hence, Taylor’s (1911) principle of managing the organization by controlling and specifying individual’s task seems out of place in a world increasingly dominated by service and knowledge intensive jobs.

One group of organizations that not only is increasingly important in terms of employment, GDP contribution and management theory development (Løwendahl, 2000) but also more than any other alien to Taylor’s (1911) ideas, are the Professional Service Firms (PSF). This group of heterogeneous companies have a common denominator – they are all knowledge rather than labour intensive2 (Løwendahl, 1993).

Even though all PSFs are highly dependent on knowledge as a factor of production, theory suggests their dependency varies with firm type. Maister (1993) differentiate between three types: procedure-based, experience-based and expertise-based while Løwendahl, Revang & Fosstenlokkken (2004) categorize firms in terms of their degree of service customization. In both theories an important distinctive factor between firm types is the difference in service customization. Despite the fact that Maister’s (1993) definitions are great simplifications of reality they are good separations for research purposes and partly used in the work of Hansen, Nohria & Tierney (1999). Therefore Maister’s (1993) trichotomy will be used also for this research.

1.2 Problem discussion

Since the term professional service firm (PSF) encompass a large number of radically different organizations (Løwendahl, 1993), this research will only investigate one particular type of PSF, namely audit firms. Maister (1993) puts them into the procedure-based category.

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2 Legge (2002) defines knowledge intensive companies as organizations where the most important input is esoteric and exclusive expertise embodied in people, physical or social capital, routines or cultures.
In pursuit of higher margins amid strong competition and increasing regulation many audit firms in Malta are moving away from procedure-based services towards experience- or expertise-based. Therefore many firms operate in what Löwendahl et al. (2001) describe as “mixed modes” – a combination of both procedure-based and expertise-based service offerings.

Maister (1993) argues that this move is not simply a change in service offering. It will have implications on both firm performance and development potential since it must be followed by a fundamental change in operations. In a purely expertise-based firm the service customization is high, knowledge is not reused to a large extent and the leverage\(^3\) is low – the complete opposite to a procedure-based firm (Figure 1).

Procedure-based organizations are operating with a business model that Hansen et al. (1999) calls “reuse economics”. This refers to a firm’s ability to maximize efficient reuse of knowledge when providing a service. Since customization is low, services can be built around procedures that capture the firms knowledge and managed by junior staff, hence the leverage. Compared to non-procedure-based organizations, these firms will have different strategies for utilizing people, information technology and knowledge and thus different competitive strategies (Hansen et al., 1999).

\(^3\) Number of junior staff to senior staff
Expertise-based organizations are using a business model that Hansen et al. (1999) calls “expert economics”. This model refers to the firm’s ability to solve unique problems and deliver unique solutions. Since it is difficult to have a procedure for identifying and solving unique problems, there is relatively less reusing of knowledge compared to procedure-based organizations, the leverage is low and the service customization high.

A shift from one service type to the other is hence not just a simple change in offering, but requires a change in modus operandi. Knowledge is still central in both service types, but the way it is managed and the way it contributes to the final service offering is fundamentally different. The successful shift from one to the other will hence depend on the practitioner’s understanding of the implications on the management of the firm.

Perception – the way practitioners view, talk and think about knowledge – can reveal their readiness for this shift. Assuming that we normally act based on our perceptions, practitioner’s perception of knowledge will guide their behaviour and actions and thus their firm’s strategic choices.

The problem discussion can be summarized by visualizing the shift as an “organizational emigration”. The firms are moving to a space where languages, customs and expectations seem to be different compared to their current operational environment. Their “emigrational readiness” will be evaluated through their perception of knowledge by attempting to answer the following questions: How do practitioners in audit firm in Malta perceive knowledge? Are they ready for a shift from one service type to another? How may their perceptions and readiness influence the potential developments, successes and failures?

1.3 Purpose

The purpose of this thesis is to investigate and describe how practitioners in procedure-based professional service firms in Malta perceive knowledge. An attempt will be made to interpret how this perception may affect the firm’s ability to diversify away from procedure based offerings.

Despite the fact that scholars such as von Krogh (2005) and Nonaka (1994) do not believe that knowledge can be managed but only enabled, the term “knowledge management” will be used in the absence of better terminology.
2 Frame of reference

The following section will make an attempt to define Professional Service Firms in general and procedure based PSFs in particular. Then knowledge will be discussed and defined. The frame of reference will be finalized by looking at a definition of value creation and diversification.

2.1 What is a Professional Service Firm?

A main difference between a service firm and a professional service firms is the dominating factor of production. Most service organizations such as hotels, hair saloons or hospitals are actually not as knowledge intensive as they are labour intensive. However, not even all knowledge intensive organizations should be considered Professional Service Firms either. Universities, schools and gourmet restaurants are indeed knowledge intensive but are non-professional knowledge-intensive service organizations (Løwendahl, 2000). This study will focus only on knowledge intensive Professional Service Firms (PSFs).

The traditional meaning of the word “professional” indicates belongingness to a profession (Dictionary.com, 2006). A profession typically has a common body of knowledge, an altruistic approach to client problems and a common and strong code of ethics (Løwendahl, 2000). From this definition it follows, that a Professional Service Firm (PSF) is a service firm employing people belonging to a profession, such as accountants, lawyers or engineers.

Nowadays however the colloquial meaning of the word “professional” leans more towards what was implicit in the belongingness to a profession namely skilfulness, the competence and the ethics. This shift might be a reflection of today’s growing number of occupations that are not organized around a professional association but still contain many of the ingredients of a profession.

One of the most influential group of professionals when it comes to the practical development of strategy and management indeed have no influential professional association at all – the management consultants. Løwendahl (2000) therefore argues that professional services should refer to the service type and delivery method rather than the group of people delivering it. She therefore defines it as a service that is: highly knowledge intensive; delivered by people with higher education; highly customized; involving a high degree of personal judgment by the expert delivering it and requiring high degree of interaction with the client.
As mentioned previously, the fundamental difference between PSFs and manufacturing firms or even labour intensive service firms, is that the main factor of production is knowledge (Løwendahl, 2000). Unlike other productive assets, knowledge is not directly controlled by the firm; it appreciates the more it is used and it resides in the mind of the individual. Von Krogh (2000) therefore argues that knowledge cannot be managed in the traditional sense of control and command since control does not spark enthusiasm and you cannot command people to be creative and generate new ideas – all of which are abilities needed in most PSFs (Dawson, 2000). Therefore PSFs need to be studied on their own.

2.1.1 Classification of Professional Service Firms

Even though all PSF have knowledge as the dominant factor of production, the way in which knowledge is used is different between firms due to differences in client’s expectations (Maister, 1993). Maister argues that, depending on the task at hand, clients look for any one of three characteristics: efficiency, experience or expertise. To distinguish service types dominated by one of the three characteristics, Maister (1993) created the trichotomy: procedure-based, experience-based and expertise-based. He argues that a single firm cannot effectively offer all three types simultaneously as they require very different organizational structures and processes. Activities ranging from human resource management and information technology infrastructure to practice development and marketing will vary depending on which of the three service types the firm will want to specialize in (Hansen et al., 1999).

Hansen et al. (1999) distinguishes professional service firms in terms of their knowledge management strategy. They divide the strategies into what they term codification and personalization.

Codification centres on the idea that certain type of knowledge can be stored and made readily available. They call the economic model of companies utilizing the codification strategy “reuse economics”, similar to Maister’s (1993) procedure-based concept. The thinking is that knowledge is stored and reused as efficiently as possible. IT systems are geared towards easy codification of, and access to information, the HR policy is focused on

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5 Since knowledge can only reside in the mind of the individual, it is important to understand that knowledge is actually not stored in a database or book, but it is information that will enable the reader to generate any particular knowledge.
attracting implementers rather than inventors (Hansen et al., 1999). The audit is an example of reuse-economics since the service is based on a set of highly specific standards and procedures that are “invented” once, codified into a methodology and then implemented over and over again. Hence the need for implementers rather than inventors.

Companies utilizing the personalization strategy are working with knowledge that is difficult or perhaps impossible to codify and capture. Polanyi (1962) called this tacit knowledge and Nonaka (1994) argues that it can only be transferred through person-to-person interaction. The economic engine in companies that are pursuing the personalization strategy is called “expert economics” and is similar to Maister’s (1993) expertise-based concept. Investment in IT systems is smaller than in “reuse firms” and primarily focused on facilitating person-to-person contact, the HR policies are set to attract the best and brightest innovators.

What both Maister (1993) and Hansen et al. (1999) have in common is their idea about varying degree of customization in the service delivery. Maister’s procedure-based firms utilizing the codification strategy are primarily focused on tasks that are based on procedures and set standards and thus have low levels of service customization. Expertise-based firms utilizing the personalization strategy are, on the other hand, delivering unique solutions to unique problems and thus have high levels of service customization. Løwendahl (2001) is arguing that Hansen’s (1999) dichotomy and Maister’s (1993) trichotomy are too crude methods to classify professional service firms and is instead suggesting a continuum of low to high customization. Contrary to Maister’s (1993) idea that firms have to choose to either specialize in procedure-based, experience-based or expertise-based projects, Løwendahl (1997:922) is arguing that firms can actually operate in “mixed modes”, effectively offering all three project types. Even though anecdotal evidence suggests that many firms do operate in mixed modes, it is questionable if they do that efficiently and effectively.

### 2.1.2 Diversification

Johnson and Scholes (1999) define diversification as a move that takes a company away from its present markets and products at the same time. Diversification can be either related or unrelated where the former is when a company stays in the same industry while the latter is when the company move to a completely different industry (Johnson and Scholes, 1999). Industries are however becoming increasing more difficult to define and delineate due to convergence, consolidation and integration (Normann & Ramírez, 1994).
The audit industry in Malta will be defined as the firms offering audit services. This industry can be considered experiencing related diversification since it is often the capabilities as accountants that are being sold to different client through different products and or services.

An audit firm’s attempt to shift its offering away from traditional audit and accounting services to what is loosely termed as “consulting” is an example of diversification. Consulting will be defined as expertise-based services relying less on procedural knowledge and more on expertise in an area.

Audit firms have traditionally operated in highly formalized and regulated environments where the services were dependent on rules and regulations. This made the difference between firms small and competition tough especially during slow economic growth. Clients had little incentive to stay with any particular firm as most offerings were very similar. In recent years the pressure on the firms have increased as a result of many high level bankruptcies where audit firms where blamed for not performing their auditing duties properly and independently. New regulation such as the Sarbanes-Oxly act in the United States, the extended International Financial Reporting Standards and the International Standards on Auditing in Europe have made the audit tasks more laborious and costly for many clients who already see little value in the mandatory audits⁶ (F. Azzopardi, personal communication, 2005-06-28). Therefore many small audit firms are diversifying into related areas with far less regulation and higher margins. Based on findings by Maister (1993) and Løwendahl (1993 & 2000) it is reasonable to believe that these new areas of business are very different in terms of their impact on practice management since they move away from the procedure-based services and instead approach what Maister (1993) have termed expertise-based services. One key difference is the way knowledge is utilized.

⁶ It should be noted that the new regulation have had very positive impact on the revenue and profitability of large audit firms handling public clients that have - due to external investor pressure - a different approach towards compliance (Datamonitor, 2003). The impact is completely different among small owner managed organizations in Malta since they in general have no external investors to satisfy but still have to follow the same stringent rules imposed on large companies with external investors.
2.2 Knowledge

2.2.1 Data, information and knowledge

Knowledge is a complex and versatile concept. The word is often used interchangeably with information and data. Nonaka (1994:15) defines the difference between information and knowledge by stating that: “information is a flow of messages, while knowledge is created and organized by the very flow of information, anchored on the commitment and beliefs of its holder”. What does this really mean? Put more simply Nonaka defines information as everything we can see, hear, smell or feel while knowledge is this very information when it gets internalized and connected to what we already know. This view holds that knowledge is dependent on information but clearly different from it. Nonaka (1994) continues stating that knowledge is subjective and strongly interrelated with the individual’s beliefs. Based on thinking by Plato, and supported by scholar such as von Krogh (2000), Nonaka (1994) defines knowledge as justified true belief. This means that for something to be called knowledge it has to be true, we have to believe in it but we also have to have a justification for our belief (Figure 2). Therefore this thesis will follow the classic definition of knowledge as justified true belief.

![Figure 2](image)

In the management literature knowledge has been discussed from a number of perspectives and dimensions all trying to capture the complexity of the subject. Many authors have tried to emphasize certain aspects of knowledge or tried to categorize it. Some examples are Polanyi’s (1962) tacitness, Itami’s (1987) articulated and non-articulated knowledge, Winter’s (1987) transferable knowledge, Badaracco’s (1991) migratory knowledge and von Krogh
and Roos’ (1993) thematized and non-thematized knowledge. A clear-cut typology of knowledge does not seem to exist as knowledge often shows a multitude of characteristics. However, one of the most influential of these perspectives has been Polanyi’s idea of tacit knowledge. This notion has helped us understand and explain why there are things that we know but are not able to speak about or even things that we don’t know that we know.

### 2.2.2 Tacit knowledge

Knowledge that can be expressed in words and numbers and thus easily codified and transferred is called explicit knowledge. It is bordering to information and data. However, explicit knowledge only represents a fraction of a person’s total knowledge (Nonaka, 1994). The largest part is what Polanyi (1962) termed *tacit knowledge*. Tacit knowledge is personal and based on the individual’s values. It is difficult to express in words or numbers and deeply rooted in action, commitment and context (Nonaka, 1994). Polanyi (1966 p.4) summed up the nature of tacit knowledge by concluding that “we know more than we can tell.”

Spender (1998) elaborates on Polanyi’s (1966) concept by presenting a framework to clarify the distinction between tacit and explicit knowledge. He argues that there are at least two different kinds of knowledge at two levels. On a conscious explicit level we are aware of what we know and can speak and communicate it. On the other level knowledge is not difficult to communicate as some interpreters of Polanyi’s (1962) ideas suggest, but we are unaware of it. The knowledge is implicit. Implicit knowledge is defined as knowledge acquired “independently of conscious attempt to learn and the absence of explicit knowledge of what was learned” (Reber, 1993:5 in Spender, 1998). Spender (1998) is therefore suggesting paraphrasing Polanyi by saying that “we know more than we know we know”.

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7 As a curiosity it can be mentioned that the former U.S. Secretary of Defense Donald Rumsfeld was much ridiculed for comparing the “known unknowns” and the “unknown unknowns” in a public speech about security (Wikipedia, 2006b). However, it points to his awareness of different knowledge types.
2.2.3 Knowledge creation

In the cognitive epistemology the organization is viewed as an information processing entity whose success depends on the effectiveness and accuracy with which it can process information. Little attention is given to the area of new knowledge creation since the concept of creating knowledge does not exist in the cognitive worldview (Nonaka, 1994). In the cognitive world all knowledge already exists in the world outside the organization and the organization’s task is to collect and process that information as effectively and efficiently as possible. The critics to this view state that innovation cannot come from collecting or processing information. According to Nonaka (1994) innovation comes from creating and defining new problems and then actively developing new knowledge to solve them. This view forms part of what is called the autopoietic epistemology. Autopoietic means self creating and the concept of “self creation” is central to this view. Knowledge creation will in this thesis be defined as extending one’s justified true belief.

2.2.4 Four modes of knowledge creation

Nonaka (1994) identifies four modes of knowledge creation that occur in the conversion between tacit and explicit knowledge. There are four conversions: 1) from tacit to tacit, 2) from explicit to explicit, 3) from tacit to explicit and from 4) explicit to tacit (Figure 3).

Figure 3

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8 Epistemology comes from the Greek words episteme (ἐπιστήμη, knowledge) and logos (λόγος, word/speech) and is a branch of philosophy that study the nature and origin of knowledge (Wikipedia, 2005). See the section Epistemological assumption in the Method chapter on page 26 for further explanation.

9 See the section Epistemological assumption in the Method chapter on page 26 for a more elaborate definition.
The first mode consists of tacit knowledge created in the interaction between individuals. Tacit knowledge cannot be conveyed with language but has to be transferred through some sort of shared experience and interaction. Apprenticeship, on the job training, observation and imitation are ways to create tacit knowledge. Due to the need of some sort of social interaction this mode is called *socialization*.

In the second mode existing explicit knowledge is combined in order to create new knowledge. Through dialogues in meetings, telephone conversations, but also through manipulation of codified data new knowledge can be created. This mode is named *combination*.

The two other modes are the conversions between explicit and tacit knowledge. These modes show the complementary nature of tacit and explicit knowledge. Conversions from one to the other will create new knowledge.

The conversion of explicit to tacit knowledge is termed *internalization* and is similar to the conventional understanding of “learning”. By studying explicit knowledge codified in books the insight gained can be greater than the sum of the codified knowledge under study. This exemplifies the conversion of explicit knowledge into tacit. However, internalization often requires an element of action. One cannot learn how to ride a bike only by reading, looking or thinking, one must *do it*. Only trial-and-error or experimentations will make you internalize the knowledge of riding a bike (Nonaka, 1994).

The conversion of tacit to explicit knowledge is termed *externalization*. Nonaka (1994) argues that metaphors play an important role in this mode since they can convey complex and contradictionary knowledge through already existing concepts. This conversion can be most clearly seen in the increasing interest in story telling as a management tool.

### 2.2.5 Individual knowledge creation

The individual’s ability to contribute to knowledge creation is according to Nonaka (1994) strongly influenced by *intention*, *autonomy* and a certain level of *environmental fluctuation*.

Intention is about the individual’s sense making and approach to the world. Without intention it is impossible to judge the value of information or knowledge. Every individual has different intentions due to different personalities (Nonaka, 1994). Hence, without intention we could not create knowledge since it is in the human nature to make sense before understanding and ultimately learning something.
Autonomy refers to the individual’s independence in the organization. Allowing certain levels of autonomy increases the opportunity to create unexpected, new knowledge and hence the likelihood of innovation (Nonaka, 1994). This is a rather dramatic suggestion since it deviates from the classic rational strategy school. An organization cannot plan the activities for its employees but should rather give employees the space needed to develop autonomously. These ideas can explain Mintzberg’s et al (1998) notion of emerging strategies which postulates that companies are unable to develop strategies by planning and implementing but strategies emerge over time. It is also supported by Drucker (1999) who is arguing that the knowledge worker must be self-managed. It can be exemplified by Google that allows certain staff to spend 20% of their time on any project of their choice.

An important question for managers is how to control organizations where autonomy is needed. However, control as we know it, is losing its relevance in the post-modern world dominated by knowledge workers. Managers should instead focus on enabling knowledge creation by creating the necessary conditions to allow employees to thrive in their personal knowledge creation (von Krogh, Ichijo & Nonaka, 2000).

Environmental fluctuations can create knowledge by altering an individual’s world-view. Our world-view is based on a paradigm created by systems of knowledge to handle ambiguity, redundancy, noise and randomness produced by our organization and the environment. These systems are often stable over periods of time. However, environmental fluctuations can cause periodic breakdowns to the paradigm (Nonaka, 1994). A fluctuation can consist of a big financial loss or a sudden and unexpected change in the competitive landscape. These events often make individuals abandon their current world-view in pursuit of new sense-making of the environment they are operating in. This creates new understandings of the world and thus new knowledge. An example is when Apple computer experienced severe losses of market share in 1997 and struggled to survive. The company brought in a new CEO who has been much credited for the company’s current success with new design, new operating system, the portable music player iPod and the creation of the world’s largest online music shops. However, new leadership and the heavy loss of market share can also be seen as initia-

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10 With the risk of oversimplifying the interaction between politics, organizational structure and innovation it is still interesting to ponder on the fact that the relatively free, open and democratic societies create virtually all technological innovations.
tors of the environmental fluctuation that generated a process of new sense-making. The results have been impressive.

Intention, autonomy and environmental fluctuation all help in the individual’s knowledge creation. However, individual knowledge creation has to be extended out in the organization possibly even to facilitate organizational knowledge creation.

### 2.2.6 Organizational knowledge creation

There is a divide in the research community between those who believe that organizations can know independently of individuals and those who don’t. Nonaka (1994) suggest that knowledge is created by individuals but organizations are a critical part of the development process. Løwendahl et al. (2001: 917) defines knowledge on the collective level as the “combination of skills, routines, norms and values developed and shared by at least two individuals”. The individual is in the centre of any knowledge creating activity since knowledge in the autopoietic epistemology per definition can only be created by individuals.

Organizations can help creating the right context for knowledge creation and through different organizational set-ups, procedures and routines “save” the knowledge and make it organizational. Nelson & Winter (1982 in Spender 1998) argue that organizational routines are the organization’s memory. But an organization without people can, so far, not create knowledge since organizations do not have minds of their own. Organizational knowledge creation should therefore be understood as the organizational amplification of knowledge created by individuals (Nonaka, 1994).

The three previously discussed enabling factors for individual knowledge creation (intention, autonomy and environmental fluctuation) should be enabled in tandem with the enabling factors for organizational knowledge creation: creative chaos, redundancy of information and requisite variety (Nonaka, 1994).

Creative chaos focuses the organization’s ability to find and solve new problems, which according to Nonaka (1994) is a key activity for a company wanting to create innovation. Environmental fluctuation can generate creative chaos but creative chaos can also be put into motion intentionally be individuals within the organizations. A CEO of a large multinational company once created the biggest accounting loss in the company’s history to enable the environmental fluctuation and the following creative chaos (Kotter, 1998). The reason and need for creative chaos is the notion that the different problems facing an organization
do not present themselves clearly\textsuperscript{11}. The organization must decide what problems to identify and solve. For instance, the problem of not having 30 000 megabytes of music in your pocket was not clear before Apple introduced the iPod. The company found new problems and focused on solving them innovatively.

Information redundancy is the overlap of responsibilities, activities and company information. This is achieved when more information is available than necessary to perform a job or function. By allowing information redundancy individuals will share more information, interact more and hence develop a sense of commonness. In this environment more tacit knowledge can be converted since trust can be developed. The more tacit knowledge is shared the easier it becomes to understand what other individuals are trying to articulate. Job rotation is a practical way of creating information redundancy (Nonaka, 1994).

The principle of requisite variety states that an organization can maximize efficiency by building the same level of complexity into the organizational structure that it is trying to manage (Nonaka, 1994). This principle identifies the need of new organizational forms. The traditional functional based organization will have difficulties operating in today’s world where a customer can also be a suppliers as well as a competitor.

Creative chaos, redundancy of information and requisite variety can help a company becoming a learning organization. Prahalad and Hamel’s (1990) idea about core competencies has been become popular among managers in pursuit of competences that will separate their company from others. Since Nonaka’s (1994) notion of organizational knowledge creation is close to Senge’s (1992) idea about the learning organization, it can be argued that organizational knowledge creation is a core competence that can create sustainable competitive advantage. Below follows an introduction to the necessary structural conditions under which organizations are more likely to enable knowledge creation.

\textsuperscript{11} Clearly different from the information processing paradigm where the objective of the firm is only to process the information not to decide what information to process
2.2.7 Organizational structure and knowledge creation

When differences in access and quality of information exist, the members of an organization can no longer interact on equal terms. This hinders differences in interpretation of information, the creation of trust is limited and hence also the room for new knowledge creation (Nonaka, 1994). In a “top down” organization ambiguity is minimized since the top management is communicating to middle management who is communicating to lower level staff. Top management is creating all knowledge in this system (Nonaka, 1994). The hierarchy ensures that top management interprets the environment and set not only the direction of the firm but specifies the tasks of each employee. Due to the lack of creative chaos, autonomy and environmental fluctuations the levels of knowledge creation and innovation tends to be low. This was the optimal and typical set-up during Taylor’s time when the goal was not knowledge creation but task optimization. However, as Drucker (1999) pointed out, in a knowledge economy the task that must be optimized is no longer known. This thinking points to the need of developing new organizational forms for the knowledge creation potential to proliferate.

2.2.8 Client interaction and knowledge creation

Løwendahl et al. (2001) argue that the most important way of knowledge creation for professional service firms (PSF) is through client interaction. This interaction can most likely contain all four knowledge creation modes. However, a question should be raised whether client interaction is the most important knowledge creation situation for all three types of PSF offerings (see 2.1.1)? Expertise-based offerings centres around delivering highly customized solutions to the specific needs of a client while procedure-based firm deliver a predefined service. In the first instance a high level of interaction with clients will obviously be beneficial since the greater your knowledge about the client the better the service can be tailored to the client’s needs. In the second instance it is less obvious whether interaction with clients will give any benefit in the service delivery. Knowledge about the client would seem irrelevant for the service delivery of audit firms since the service is strictly governed by rules and regulations detached from any specific client. Furthermore, the client is not

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\(^{12}\) Løwendahl et al., 2001 uses the term learning synonymously to what Nonaka (1994) defines as knowledge creation. Therefore the term knowledge creation will be used instead.
likely to have knowledge about regulations than can be beneficial to the practitioner. It seems that only if the firm wants to deliver value through experience-based or expertise-based services that interaction can be beneficial. Since many small firms are attempting to move towards offerings that are perceived to generate more value to clients, the concept of value creation will be investigated.

2.3 Value creation

All organizations exist to create value. This paper will define it as creation of significant benefit for owners and customers. It can be both financial and non-financial. Some people argue that corporations should focus only on creating financial value, popularly known as “maximizing shareholder value”. This implies that the sole focus of management should be to take appropriate action to increase the value of the organization’s shares since this – in the long term – is considered a good proxy of the organization’s overall success. However, such a goal is theoretical since one can never know the point of maximization if there is no absolute point of reference. Furthermore, as Kay (2004-01-17) points out, “meeting global business targets are the type of goals often best achieved when pursued indirectly”. This means that a narrow focus on the blurry “shareholder value” target might not be the best way of actually achieving it. It is particularly true for Professional Service Firms. PSF create value for their clients by using the firms resource base to solve a problem or perform a task. The value creating process springs almost exclusively from intangibles such as knowledge. Løwendahl et al. (2001) argues that a PSF exists, just like any other organization, to create value for its clients and its owners. However, in contrast to most other organizations the value for the owners of PSFs comes not only in the form of earnings but also in the form of knowledge. Projects with lower earnings but higher knowledge creation might be prioritized since a better knowledge base might increase the future revenue potential (Løwendahl et al., 2001). Since knowledge can be considered as the PSF’s main asset there is a strong need for continuous knowledge creation just like machinery needs continuous investment and maintenance. If the company fails to generate new knowledge it will sooner or later face problems (Maister, 1993).

Løwendahl et al. (2001) presents a framework for analyzing value and knowledge creation in professional service firms. They stress the importance of the knowledge creating processes in the interaction between practitioner and client due to its impact on firm strategy. Different clients and projects support practitioners to a varying degree in their knowledge
creation. Clients can therefore be considered as both enablers and constrains on a firm’s knowledge base. The knowledge base on the other hand both enables and constrains what clients and projects a firm can credibly undertake in the future. Therefore the current and future service delivery is a result of the reciprocal relationship between the type of clients accepted (domain choice) and the knowledge base developed (See Figure 4).

![Figure 4. Simplification from Løwendahl et al. (2001).](image)

The thinking that client interaction is an important knowledge creation enabler would suggest that choosing your clients is one of the most important strategy decisions since it enables or constrains your knowledge creation, your service delivery and your future potential. This also suggests that PSF must have a more long-term view in mind when making decisions about clients. Profitability, cash-flow or fees cannot be the only nor the guiding star in the decision making process. However, it is worth pondering whether the importance of the client’s role in knowledge creation is as large for procedure-based organizations as Løwendahl et al. (2001) has showed that it is for expertise-based firms. If client interaction is only marginally important for procedure-based firms, than their focus should be very different from expertise-based firm that are much more clearly dependent on the client.

### 2.4 Summary

This chapter has defined a procedure based professional service firm as an organization primarily offering services that are based around predefined procedures and routines. Knowledge in these firms is created once and reused as much as possible. The level of knowledge creation seem relatively low compared to expertise based firms that sell unique solutions to unique problems. Hence would the concept of knowledge creation
seem relatively less important in procedure based firms. However, to transform an organization from one firm type to another creates a great challenge since both knowledge and firm operations need to be managed differently. This is due to the differences in structure, systems and client expectations.
3 Method

The method choice should reflect the research purpose (Carlsson, 2001; Patel & Tebelius, 1987). In social sciences the choice stands, on the most general level, between quantitative or qualitative method. The quantitative research attempts to measure observations using mathematical and statistical tools (Merriam, 1994). This type of method should be used when the purpose is to answer questions such as “how much, how many or to what degree” (Svenning, 1997). The qualitative research on the other hand tries to understand the “why and how” of a phenomenon (Wikipedia, 2006). Since this thesis is attempting to understand the perception of knowledge and how this might affect strategic choice it is considered appropriate to choose the qualitative method.

3.1 Qualitative research

The qualitative research tradition tries to understand a phenomenon by collecting opinions of a limited number of respondents. Unlike the positivistic tradition that assumes that the researcher independently and objectively can measure a phenomenon, the qualitative tradition is more relativistic. Jacobsen (2002) argues that we cannot have objective knowledge about the society since we are formed by our interest and our previous knowledge. It is hence impossible to approach a problem completely unbiased (Lantz, 1993). The qualitative approach therefore encourages the researcher to engage with the object of study but rigorously explain the sources of possible bias. This direct interaction often achieved through interviews, may provide a richer experience of the problem under study and give rise to new or different perspectives. The drawback lies in the restricted ability to generalize findings due to limitations in sample selection and size (Patel & Davidson, 1991). In this less clinical research tradition the need of a systematic and logical approach in order to achieve trustworthiness should not be underestimated (Eriksson and Wiedersheim-Paul, 1999). These issues have all been taken into account and are explained below.

Qualitative research often runs the risk of being more broad than deep (Daymond, 2002). This risk is amplified by Drucker’s (1999) argument for an interdisciplinary and practical approach when studying management. This thesis has attempted to follow the second part of his advice by intertwining real-life business examples with theory. The risk of being too broad has then been contained by formulating a stringent purpose narrowing down the empirical study area to cover a limited and specific group of companies.
3.2 Selection of empirical sources

In the qualitative method the empirical sources are selected based on their relevance vis-à-vis the research questions rather than their population representability (Lekvall & Wahlbin, 2001). The choice should however not be done haphazardly but be based on predetermined criteria (Holme & Solvang, 2001). Below follows an explanation of the criteria used for what Lekvall & Wahlbin (2001) call purposeful sampling.

The audit and assurance industry in Malta consists of the ‘big four’ (Deloitte & Touche, Ernst & Young, KPMG and PriceWaterhouseCoopers), Grant Thornton and a number of small firms\(^\text{\textsuperscript{13}}\), micro firms\(^\text{\textsuperscript{14}}\) and sole practitioners. Since audit firms are highly influenced by their professional association (Løwendahl, 1993) it will be assumed that the large firms have a disproportionately large influence over the industry’s development since they are overrepresented in the association. Therefore it falls natural to include all the big four in the sample. Since the audit methodology is similar irrespective of the size or type of client it would also be relevant to speak to a number of smaller firms. As most firms still are hierarchical it was clear that the interviewees should be with the partners since they are the ones influencing the firms’ strategic choices and future developments.

To increase the likelihood of securing interviews, the author asked someone well connected with the Maltese industry to introduce my request for interview. The “big four” where all contacted as well as Grant Thornton, one small firm Avanzia and a micro firm called Pace Galea Musu. All firms where provided with an outline of the research idea and the objective with the interview (see appendix 7.1 on page 40). All firms returned the request favourably except Ernst & Young and KPMG that did not respond.

3.3 Data collection

Since the objective of this study is to reach a certain level of understanding of the audit practitioners’ perceptions, a person to person interview was deemed as a good data collection method. It is popular in qualitative studies, but it carries its own risks. Lekvall and

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\(^{13}\) Small firm as defined by the European Commission as companies with less than 50 employees

\(^{14}\) Micro firm as defined by the European Commission as companies with less than 10 employees
Wahlbin (2001) warn of the “interviewer effect” where the interviewees are trying to project a positive self-image to the interviewer rather than giving a more unbiased answer. To decrease this effect the questions in the interview guide and during the interview have been formulated as much as possible in a neutral way. In the analysis stage it will than be important to evaluate the answers and try to determine their trustworthiness.

Another problem, partly related to the interviewer effect, is the inevitable mutual influence between the interviewer and the interviewee (Holme & Solvang, 1991). It is a balancing act to direct the interview in a direction desirable to achieve the scope of the research without adversely affecting the quality of the interview. Two tools at the disposal of the interviewer to mitigate the risks, are the standardization and structure elements of the interview. Standardization refers to the level of consistency between questions asked to different interviewees. In a high standardized interview the same questions are asked in the same order to all interviewees. Structure refers to the permitted openness in the interviewees answers. The more unstructured an interview the more space is given to the interviewee of explain and communicate his or her perceptions (Patel & Davidson, 1991). The interviews in this study where semi standardized with a number of high levels level questions asked at all interviews, but not necessary in the same order. It was also rather unstructured since the interviewees where allowed to “take the scene” when responding the questions and elaborate and interconnect questions and subjects freely (see appendix 7.2 on page 41 for interview guide).

When collecting data for investigations about complex phenomena that do not allow for an isolation of single variables, the data gathering method must allow for the complexity to shine through. Denzin & Lincoln (1994) suggest the use of interviews with open-ended questions, as long as they are clearly guided by the researcher. In this research all interviews lasted around one hour except the one with Azanzia which had to be cancelled after 30 minutes. The place of the interview was the interviewee’s office. Every interview was recorded and transcribed. Since this thesis is based on the assumption that knowledge and knowledge creation is very context specific, all interviews where conducted around a number of high level semi-structured questions. Based on Holme & Solvang (1991) who argue that data collection during an interview should be similar to a normal conversation, the interview guide was used but a high level of flexibility was allowed since it was important to quickly move into a relaxed discussion and make the interviewees freely discuss the subject.
3.4 Designing the interview guide

The interview guide was designed as a help to understand three things: what is knowledge, is it important and if yes, in what way is it important. Any one question was not designed to “test” for a particular theory or idea, nor was it a result thereof. Rather it was my distilled knowledge at that point in time. Since the interviews were semi-standardized and rather unstructured some questions in the guide were not asked and new questions were sometimes added based on the input from the interviewer.

3.5 Epistemological assumptions

Epistemology comes from the Greek words ἐπιστήμη (episteme meaning knowledge) and λόγος (logos meaning word/speech) and is a branch of philosophy that study the nature and origin of knowledge (Wikipedia, 2005). Epistemology is the science that tells us how we know what we know. In the pursuit of understanding how knowledge is perceived in audit firms, it is imperative to be clear about the epistemological assumptions influencing the outcome of the study. There are two important epistemological traditions: cognitive and autopoietic epistemology.

Cognitive epistemology views the world as an objective true reality. The organization creates knowledge by collecting as much data and information about it as possible. The organization’s key activity is to collect and disseminate knowledge. The more knowledge it accumulates, the better the understanding of the world (Järvi & Koskinen, 2004). Knowledge is defined by the accuracy and quantity of data and information collected by the organization. Clearly, little difference is made between knowledge and information.

Autopoietic epistemology on the other hand does not view the world as given but constructed in the mind of the individual. Data and information can be transferred between individuals, but the resulting knowledge will be created in the mind of the receiver. Two students listening to the same lecture will not create the same knowledge, since their experience and previous knowledge is different. Autopoietic means “self-production” which implies that knowledge is produced based on the previous knowledge (Järvi & Koskinen, 2004).

The author has to a large extent been educated in the autopoietic paradigm and is thus strongly influenced by it. It can therefore be argued that this study is based on it.
3.6 Interview interpretation

The analysis of the empirical material has been inspired by the hermeneutic school of thought. The hermeneutic researcher admits her subjectivity when analyzing findings and tries to understand the findings from her own limited subjective experience influenced by conscious or unconscious assumptions (Lundahl & Skärvad, 1999). An attempt has been made to present the conscious assumptions throughout the thesis. A potential problem in the analysis of the interviews has been definitions of terminology. The interviewer and the interviewees might have used the same words but attached different meanings to them. As far as possible those instances where identified by looking at the context in which the word was used and any possible contradictions in other parts of the interview.

3.7 Generalization and Trustworthiness

Since this thesis is using a qualitative research method with a small purposeful sample, the findings cannot be generalized with any degree of scientific certainty (Patel & Davidson, 1991). Instead it contributes to a deeper understanding of the phenomenon as it is perceived by the interviewees and interpreted by the author.

Eriksson and Wiedersheim-Paul (1999) suggest that trustworthiness in a qualitative thesis is dependent on the logic and systematic approach in the study. The reader must be able to follow how the study was made, what assumptions were taken and how conclusions were derived. In view of this, the author has attempted to clearly state the methodology and its possible shortcomings. The interviews have been conducted in a way that decreases the different risks discussed above and the material has been discussed and analyzed using previous research covered in the frame of reference. A number of quotes have been integrated in the analysis of the material to let the interviewees’ views and opinions simmer through. A possible risk to the trustworthiness has been the author’s limited experience and knowledge of the audit industry under study as well as in interview techniques. However, one year of work experience in an audit firm and continuous discussions with people in the industry about the topic has hopefully been a counterbalancing force. Another limitation is the lack of empirical research on consulting business even though much reference is made to it. It therefore has to be emphasised that the conclusions, whenever consulting is concerned, are based only on the perceptions of the interviewees.
4 Empirical results and analysis

4.1 Data, information and knowledge

All interviews started with the question of defining knowledge. Four of the five respondents described it as the tool they need to perform their job: “Knowledge is about having methodologies and tools available to perform jobs and tasks.” “Knowledge is something you learn from your studies but you continuously absorb new knowledge. In the assurance industry it is often technical but other knowledge is also needed.” “There are two types of knowledge: one that helps carry out work and one general knowledge about the environment.” “There is the technical knowledge that you have to learn and the more generic knowledge of being street wise – applying it in practice.”

The answers can be interpreted as expressions of the cognitive epistemology. This does not come as a surprise since the auditing function is centred on standards making an auditor’s working context seem objective and procedural in nature. As one interviewee put it: “You either know it or you don’t”. This kind of thinking is obviously understandable considering the legal implications if an auditor does not know of certain standards or laws. However, it is diametrically different from an expertise-based offering where value is not derived from efficiently implementing a procedure but from providing new knowledge through new perspectives or insights.

Most respondent made a distinction between knowledge and information when asked directly about the difference: “Information is all around us, available through books, internet, magazines etc. while knowledge is easily accessible in our minds.” “You create knowledge in your mind when you assimilate and absorb information.” “Knowledge and information is different but at some points it converges.” “Knowledge is information transformed into tools.” However, during the discussion the words were still used interchangeably. This may be due to a combination of both the generally low sophistication in the understanding of knowledge and the dominating cognitive epistemology that makes a less clear distinction between the two.

4.2 Tacit knowledge

When discussing knowledge most interviewees had audit methodologies and technical know-how in mind. However, the need for “experience” and “practical knowledge” was also emphasized. Even though no one explicitly talked about tacit knowledge, it was clear from the discussions that the so called “study kind of knowledge” needed complementation by a deeper more elusive knowledge – in the literature referred to as tacit knowledge. One in-
The interviewee argued that a good auditor must possess and develop a large amount of tacit knowledge in order to spot misstatements and possible fraud. Nevertheless, the person argued this was made increasingly difficulty with clients’ continuous pressure for efficiency and low cost.

4.3 Knowledge creation

The interviewees had somewhat different explanations when asked to define knowledge creation. One respondent said: “Knowledge creation is about taking information and making it into knowledge…” This clearly shows an understanding of the difference between information and knowledge, and can be see as an instance of internalization, but does not shed much light on how the process works. Others explained it as: “Knowledge creation is about creating tools, methodologies and proposals that the whole firm can reuse.” This perception about absorbing a large quantity of relatively complex information and building an audit methodology – a set of procedures, interpretations and rules –confirms the notion of the audit firms as procedure-based organizations that reuses knowledge to drive their business. “…you need to translate the IAS[International Auditing Standards] into methodologies and then spread the knowledge about them in your company.” In terms of Nonaka’s (1994) terminology it would probably be close to the concepts of externalization or combination.

One way of viewing knowledge creation, shared among some of the interviewees, is well illustrated with the quote: “Knowledge creation is about contributing to the data or information repository.” It is interesting because of two intrinsic assumptions: that knowledge can be stored in a database accessed at will and that the knowledge creating process exists outside the human mind. It is true that a properly managed database can give access to a lot of useful information and perhaps shorten time it takes to internalize that information. However, knowledge creation as defined by Nonaka (1994) is a process taking place in the human mind but facilitated through external factors such as databases, conversations etc. So in a sense you can actually say that knowledge creation is taking place while you contribute to a data repository, but the knowledge is created in your mind. Whatever is left in the database, is information and data. This was a distinction few made.

One of the interviewees complained that “We have enough to do with knowledge absorption, let alone knowledge creation”. Even though the respondent might not have been aware of it, this statement highlights the essence of knowledge creation through internalization; when you
absorb information and connect it with existing knowledge and other information you create knowledge.

The discussion about knowledge creation continued with the question of its importance for the assurance industry. Some respondents argued that it is becoming increasingly important since the number of new regulations and standards is on the rise. Two of them said: “Essential – the regulations and standards are developing so fast that it is becoming difficult to keep abreast.” “Currently we are trying to absorb the information available…” However, one respondent put it in a different perspective: “It is important but mostly when you create a methodology. When you have done that it is just about updating it.” This comment draws our attention to the fact that the industry standards and regulation currently are in a process of fundamental change15. This requires far-reaching changes in the audit methodologies. However, it is a transitory situation sparked by unusual events in the external environment. Following the logic of the respondent, the need for new knowledge creation will decrease when the process slows down. This would suggest that knowledge creation is actually not a continuous requirement pushed by clients, as some researchers argue, but dependent on temporary pressures from other elements in the external environment.

Looking at Nonaka’s (1994) argument about the intimate relationship between knowledge creation and innovation could shed more light on why knowledge creation is less important. Audit firm are likely to require less innovation to survive compared to expertise based firms due to the legal requirements that create the need for their services. The laws are in a way “umbilical cords” fuelling the demand and effectively limiting the amount of knowledge that must be created. In fact, innovative accountants are probably more associated with Enron and Worldcom than with firms providing reliable services. This also makes the enablers for individual knowledge creation – intention, autonomy and environmental fluctuation seem a little out of place. Perhaps this shows the need of trying to define the concept of knowledge creation more stringently, adapted for the needs of a procedure based organization?

Following the discussion about knowledge creation was a dialog on the differences in knowledge creation between audit and consulting firms. “It is important for assurance industry

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15 One example is the departure from valuing assets according to their historical value and instead applying what has been termed “fair value”.

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but there are more gains from it in the consulting business.” The general consensus was that the assurance industry is pretty well defined and thus knowledge creation is, as one respondent put it “more rigid in assurance…” Another respondent highlighted the regulatory aspect of knowledge creation in the assurance industry: “Assurance has become a quiet well defined business where the scope often is specified by the law. This is not the case for consulting. You need to discuss more to achieve knowledge while you can often read what you need to know for the assurance business.” One respondent brought forward an important reason for the differences: “It is important in both, but for different reasons. In consulting [the lack of knowledge creation] will decrease your bottom line while in assurance you might be sued…”

4.4 Organizational structure and knowledge creation

Nonaka (1994) argued that organizations need creative chaos, information redundancy and requisite variety in order to fully enable knowledge creation. Even though all interviewees agreed to the importance of knowledge creation, the firms interviewed only worked formally with traditional training as the means of disseminating and creating knowledge. Even though the larger firms had intranets, these seem to be simply repositories of information. None of the interviewees employed any of the organizational requirements that Nonaka (1994) argues are important to increase knowledge creation. With their traditional hierarchical structures, these firms seem to be built for task optimization rather than knowledge creation. Than again, many of the respondents pointed out, that knowledge creation is comparatively less important in the assurance industry. One reason for this could be the lack of good tools and methodologies to quantify and measure the effect of working with knowledge. According to one interviewee, it is the bottom line that dictates what activities to pursue and hence activities that cannot clearly be related to the bottom line are not pursued. “I think it would be very useful [to manage knowledge], but I’m not sure if people would see the tangible benefit. There are a lot of intangibles benefits. Persuading people of intangible benefits is not easy at all. The benefits in the knowledge area are hard to value.” However, as the previous section highlighted, knowledge creation may simply be less important due to the smaller need of new knowledge. This confirms Maister’s (1993) argument that moving from one service type to another will prove difficult since the more expertise-based the firm becomes the more innovative it will have to be. Hence the need for knowledge creation will increase.
4.5 Client interaction and knowledge creation

According to the model presented by Løwendahl et al. (2001) the client is not only important by enabling and constraining the firm’s possible future strategic choices but also due to the potential knowledge creating possibilities in the interaction between client and practitioner. However, contrary to these suggestions, the respondents argued that the client was not an important source of knowledge creation in an audit business: “You can get more knowledge from a client doing consultancy than doing assurance. This is since assurance is regulated by rules…”

The clients’ perceived value of an audit might partly explain their limited role in knowledge creation. Many respondents argued that clients, who are often owner-managers, don’t see the benefits of an audit and hence don’t have many demands other than a low price. One respondent said: “Assurance is mandatory, the client is not very knowledgeable, everyone does it and hence there is little value added seen.” Since clients are not interested and do not demand new knowledge creation, the process will be inhibited. Two of the respondents confirmed this reasoning: “…if the customer does not demand state-of-the-art, the things will not be state-of-the-art…” But this also highlights the point that knowledge creation in the assurance industry might not be driven by clients as has been the argument in the frame of reference, but by legal requirements and pressures from the professional association.

The client as a person has little or no role in the knowledge creating process since auditing is about applying regulation. However, as one respondent put it: “The most interesting learning is coming from the client since you can apply your knowledge.” The conclusion could be that even though the client per se is not important in the knowledge creating process, applying theoretical knowledge on client cases is essential to develop the explicit and tacit knowledge necessary to master the auditing task. Therefore the argument brought forward by Løwendahl et al. (2001) that the client base will have an impact on the knowledge base seems relevant. Possibly the argument could be understood in a wider sense and include not only interacting with clients but more specifically working on their cases.

4.6 Value creation

No respondent explicitly pointed out that knowledge creation is an important aspect in their firms’ value creating process. One could therefore question whether the model presented by Løwendahl et al. (2001) is applicable to the audit industry. Using the definition of value creation as “significant benefit for customers” it is doubtful if much of the audit
work done for many SME’s in Malta can be considered falling under this category. Many respondents pointed to the fact that clients often don’t see any value in an audit. In fact audit work does not fulfil three of the criteria Løwendahl et al. (2001) uses to define a professional service: it is not highly customized; it does not involve a high degree of personal judgment by the expert delivering it and it does not require high degree of interaction with the client. Much audit work can be seen as transactional rather than relational and may therefore fall outside the value creation framework. One might even question if it really is a professional service.

However, the respondents also pointed out that working on client cases is an important mechanism through which learning is achieved. This kind of learning might be viewed simply as a cost of getting the employee to a state of better performance due to the lack of methods to quantify the value of the increased knowledge. A more modern approach of accounting for intangible assets could make a dramatic difference. Leif Edvinsson pioneered the accounting of intangibles such as knowledge and introduced what he termed the Intellectual Capital Rating to measure it. Such principles would make it easier for companies to look at knowledge creation as a value creating process (investment) rather than just as a cost. This thinking is supported by Drucker (1999) who pointed out that “the knowledge worker must be treated as an asset not a cost”.

4.7 Diversification

One respondent highlighted a problem that many audit firms are facing since the introduction of new regulation, standards and procedures: “Many firms are at the moment struggling to be effective in their audits.” This is caused by the dramatic changes experienced in the industry and might potentially reshape it. There is a high probability that many small auditors will face difficulties coping with the increasingly complex regulatory environment. Many audit firms responded by diversifying into less regulated consulting business. However, considering the very different internal operational requirements such as the firms business model, its information technology investments, human resource strategies and also taking into account the resource-based view (Grant, 1991) that stresses the need to develop unique capabilities, it seems unlikely that a single firm simultaneously will be able to develop capabilities necessary for achieving sustainable competitive advantage in both audit and consulting services. The different economic engines are too large. This thinking is supported by the late Peter Drucker (1992) who wrote: “An organization is effective only if it concentrates on one task.” Many
firms might therefore find themselves in position of “strategic stretch”, where they are not managing their traditional audit business nor able to effectively offer consulting services.
5 Conclusions

Unsurprisingly the interviewees perceived knowledge as the tool they need to perform their job. Knowledge was said to be important, but the empirical results reveal a surprisingly low sophistication in the understanding of the concept. This was apparent through the interviewees’ vocabulary, the lack of systems and procedures to work with knowledge (other than traditional training) and the lack of enabling organizational structures. It is reasonable to believe that one cause of the low sophistication in the understanding is a shortage of tools and methodologies to tie the “management of knowledge” with the bottom line.

On the other hand did the empirical results are also point in the direction that there exist large differences in the need for knowledge creation between procedure-based and expertise-based firms. This is related to the need of innovation. Firms less dependent on innovation for their survival seem to need less knowledge creation and hence might have a lower sophistication in their understanding of the concept. Therefore one could argue that there is a need for a greater sophistication in the understanding of knowledge also in the research community. All firms do not seem to be in need of creative chaos, environmental fluctuation, autonomy and other knowledge enabling factors to the same extent even though they are all operating in the knowledge economy.

The dramatically increasing complexity in the audit firms’ operating environment caused by rapid changes in regulation and standards is putting pressure on the firms. Many audit firms respond by attempting to diversify into less regulated areas such as consulting, without taking into consideration the knowledge creation implications. Since the importance and usage of knowledge is different between a procedure-based operation such as an audit firm and an expertise-based operation such as a consulting firm, diversification from one type to the other will prove difficult. To move from an environment where the service delivery and knowledge requirements are specified by the law, to one that is limited by only your imagination could put, especially smaller firms, in an awkward position. The operational requirements will prove very different.

Many complains by the audit firms related to the increasing amount of different legislation and standards that had to be learned. It is interesting to think of other industries to better understand how differently the problem can be perceived. If one for instance would compare the IT industry where standards and “rules of the game” change far more rapidly and without any formal control, the problems in the audit industry appear in a new light. The
IT industry have learned to adapt to the environment probably due to well developed knowledge creation abilities while the audit industry with less developed capabilities are facing difficulties. For the small firm the challenge will lie in finding a service offering that is close enough to the core competence of an audit firm but on a distinctive distance to the current operating environment. This means finding a middle way between Taylor’s task optimization and Drucker’s knowledge creation.

5.1 Research reflections

The definition of knowledge used in this thesis is justified true belief. Even though this is a classic definition used by many scholars, it might have been more fruitful to attempt finding a narrower definition or perhaps only investigate a certain type of knowledge. This is particularly the case considering that the autopoietic epistemology is relativistic, which makes the concept of truth less static. Hence the already far-reaching term knowledge becomes even broader leading to very general research conclusions.

In the empirical chapter the four modes of knowledge creation were presented and it was argued that knowledge is created in the conversion between the two knowledge type. Knowledge creation is hence seen as a process or a side effect of a process when people interact with each other or manipulate data and information. The model is a good tool to get a better understanding of the processes at work during knowledge creation. However, it is important to remember that it is a simplification of a complex and ambiguous phenomenon. The different conversions are probably taking place in a simultaneous dynamic interplay. One should therefore resist the temptation to interpret an instance of knowledge creation simply as an isolated incidence of combination, socialization, internalization or externalization. Perhaps it is even misleading to speak about “an instance of” knowledge creation since it is continuous process sometimes taking place outside the realm of consciousness.

Considering the difficulties facing small and medium sized audit firms, what is the way forward? An interesting research question would be what exactly their core competencies consist of and how/where can they be applied in a non audit setting. The increasingly global world where geographical distance becomes more and more irrelevant and where services and products are disintegrating and produced at different locations, the skill sets of small audit firms might perhaps become useful in auditing flows of information and data rather than flows of money. But this question will be left for other to uncover.
References


7 Appendices

7.1 Request for interview

Knowledge creation in Professional Service Firms

I am finalizing my bachelor thesis (Jönköping International Business School, Sweden) on knowledge creation in PSFs with special focus on audit firms. Many researchers are arguing that knowledge creation is the only core competence that can generate sustainable competitive advantage. However, not enough thinking has been dedicated to it. What does this mean for the SMP’s in Malta? Some of the questions that my research will try to answer are:

- What is knowledge creation in general and how important is it for the future of the firms?

- How is knowledge creation approached in audit firms?

- Does the fact that many firms today rely on consultancy services for their profitability change the way they should be looking at knowledge creation? Moreover, can a SME simultaneously have a competitive knowledge creation strategy for the increasingly complex compliance business and the demanding consultancy business?

- Does the firm’s handling of knowledge creation have an effect on the future client and employee base and thus their profitability and possibly their survival?
7.2 Interview guide

Introduction:
Present the aim of the study, why the interview must be recorded and how data will be handled. Explain confidentiality. Ask for a description of the respondents position and duties.

What is knowledge and knowledge creation?
How would you define knowledge?
How would you define knowledge creation?
Is knowledge creation important in the traditional audit functions? Why?
What are the necessary conditions for knowledge creation to occur?

Is knowledge creation on your company’s agenda?
  How does your company work with knowledge creation?
  Do you have policies relating to knowledge creation?
  Are structures developed to enhance knowledge creation?
  Do you have a strategy to manage knowledge creation?
  What is your company’s objective with knowledge creation?
Is knowledge creation important to perform the traditional audit functions?

How do you share knowledge in your company?
Who’s responsibility is it to create knowledge?
Do you control and manage knowledge creation?

Knowledge creation and the client
How would you define the client’s role in a traditional audit firm?
Is the client involved in the company’s knowledge creation?
Theory is suggesting that the interaction with clients is the most important knowledge creation opportunity in a professional service firm, do you agree? Why?
What can you learn from clients during traditional audit jobs?
What structures do you have in place to internalize clients knowledge into the organization?