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## Sustainable Growth for the Small Business: A Theory of Organizational Transition

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**Sustainable Growth for the Small Business:**  
**A Theory of Organizational Transition**

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# **Sustainable Growth for the Small Business: A Theory of Organizational Transition:**

## **Abstract:**

Accepted theories provide insight into the structure and processes of successful “larger” organizations. Successful, large organizations don’t “materialize” out of thin air, they begin as entrepreneurial firms. Transitioning from an entrepreneurial to a larger organization is challenging to both the founding entrepreneur and the firm. Theorists have shown that a transition occurs, and have identified some of the behavioral aspects influencing the entrepreneur. Less is known about how the structures and processes are put into place. This paper presents a conceptual framework with five factors to enable longitudinal, international research to understand how the entrepreneurial structure can successfully be transformed into a hierarchical organization structure.

## **Introduction:**

How does a small, entrepreneurially founded business transform itself to enable sustained growth? Research has shown that over half of all businesses fail within one and a half years of being started. Most of those enduring this initial “survival” stage will remain small businesses. This is not unique to any industry, culture, or country. The transition from a surviving entrepreneur to a growing organization presents personal challenges to the founding entrepreneur as well as to the firm. Very few succeed in making the transition to a dynamic, growing, and successful organization. Some that do are forced to make the transition by leaving the founder

behind (Fenn, 1996). Among one of the author's<sup>1</sup> clients is a family with a history of entrepreneurial ventures. Many of their businesses had a 5 to 7 year cycle. They grew quickly from the beginning, then stabilized, reaching a point where they required resources to continue growing. Without additional resources, they stagnated, and declined. As stated by XM (37yrs old, married with two small daughters):

*“We are falling because we did not know how to focus on the development in agreement with the growth.”*

Researchers have considered the problems associated with entrepreneurial growth by focusing both on the “person” or the entrepreneurial founder, and also by analyzing the firm: the “growing” organization. For the individual, this has yielded a multitude of prescriptive suggestions ranging from the entrepreneur’s communicating their vision and values (Baum, Locke and Kirkpatrick, 1998), surrendering power (O’Neill, 1983), increasing their “executive competence,” (Osborne, 1994), recognizing specific psychological phases that they will undergo (Greco, 1996), changing their management style (Waldrop, 1987), acquiring and building specific management skills (Johnson, 1989), and relying on other people (Fenn, 1996).

For the organization, recommendations have included bringing in management personnel (Stevens, 1988), implementing organizational systems and structures (Lee, 1989), and undergoing fundamental shifts within the organizational processes (Hayes and Wheelwright, 1979). This is required because organizations making the transition from start-up to the growth stage(s) become increasingly complex, formalized, and decentralized (Miller and Friesen, 1984, Olson and Terpstra, 1992).

Each of the above observations is correct - in part. Regrettably, there is much we do not

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<sup>1</sup> Atilio Penna & Associates: Consulting in organizations and Human Resources, Buenos Aires Argentina

know, there are dynamics that have not been investigated. This paper seeks to initiate discussion and research to enhance our knowledge about the change process of small companies becoming larger, “structured” companies. While the subject of inquiry is the change process, the focus of observation must be dual: The behaviors and decisions of the CEO (entrepreneurial founder), and the managerial structure of the firm.

### **Theoretical foundation**

Joseph Schumpeter has been instrumental in shaping our concept of entrepreneurial activity, identifying the existence of a transition from being entrepreneurial to a traditionally managed organization (1983). The entrepreneur is creative and innovative, whether by invention or by innovative combinations of previously existing elements. This entrepreneurial behavior is driven by opportunity, and in turn, drives economic progress. As the “innovation” is assimilated over time and becomes established (the firm is successful), Schumpeter observed that the firm changed from being entrepreneurial to being managerial; administered and managed as a traditional, established organizations (Schumpeter 1983). This was the vehicle by which the organization achieved economy of scale and efficiency. This transition was important to Schumpeter. The process of venture formation, or any stages following a firm's having achieved operational success were not as significant - from either the economic or managerial views.

Peter Drucker also saw this transition, but focused on the managerial difficulties presented by growth. Focusing on the managerial activities associated with the firm provides insight regarding the size of the company, its evolution, and a very specific linkage to the behavior of the entrepreneurial individual:

*“The size, then, changes neither the nature of the business nor the*

*principles of its direction. It does not affect the basic managerial problems of managers. It does not affect in any way the direction of the work or the worker. But the size does affect to a great extent the management structure. A certain size requires a certain kind of behavior and attitude from the management bodies. And even more important than the size itself is the change in size, i.e., growth.”*

*“In the small business, neither the active position of the chief executive nor the task of setting the goals requires a full-time occupation. The person in charge of a small company can even simultaneously manage the business and perform another function such as being in charge of sales or manufacturing. Yet, the business does require a management organization,”* and, most importantly,

*“The following stage of the size of the business is probably the most common; and it is also one of the most difficult to handle. The disability to solve the problems of the managerial organization in this stage is one of the most common and more serious causes of difficulties. Yet this stage does not have its own name and is not even recognized customarily as a specific stage.”* (Drucker, 1999, Chapter 14)

Concurrently, Arthur Chandler’s seminal research into successful organizations (1962, 1980) looked at the relationship between an organization’s intentions (strategy) and its structure. Underlying his work is the central assumption that organizations seek growth. His discovery that the organization’s structure was the result of the organization’s strategy was revolutionary. Organizations begin as entrepreneurial (having no structure). As a result of entrepreneurial strain, the organization implements a functional structure to gain efficiency. As it once again

encounters pressures<sup>2</sup>, the functional structure is modified to incorporate additional structures for vertical integration. Subsequent pressures result in divisional levels being added, retaining the central efficiencies of functional structures. Subsequent research has not altered this understanding of an organization's initial stages of structure. These fundamentals are taught to every business student as the basic concepts of organization theory. Furthermore, based on the work of Chandler and others, measures for determining an organization's "structure" are generally accepted, and likewise have been taught to business students for at least 30 years. Conceived as being relative, these measures include: formalization, standardization, centralization, span of control, specialization, hierarchy of authority, complexity, professionalism and personnel ratios (eg. Hall, 1972; Daft, 2001).

While Chandler's work focused on large firms, Churchill and Lewis's (1983) seminal work focused on small, entrepreneurial businesses. They identified some of the problems and patterns exhibited by growing entrepreneurs, and discovered that firms could be classified within five growth stages. A firm begins its existence as an entrepreneurial firm, without formality of processes or organizational structure per se. The entrepreneur fulfills multiple roles - performs multiple tasks, including the tasks of management by direct supervision. The initial stage of venture initiation is followed by the survival stage. With success, resources are required to facilitate growth. While Churchill and Lewis emphasize the resource requirements and the varying demands placed upon the entrepreneur during growth, their stages of growth parallel Chandler's. The resource requirements at formation are predominantly financial, whereas during growth, managerial skills and human resources become critical. As a result of growth, the entrepreneur transitions into 2 stages of functional structure, then into a divisional structure.

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<sup>2</sup> The structure changes only after strategic initiatives have failed, resulting in crises. The crises may be due to resource inadequacies, market demands, or cost pressures.

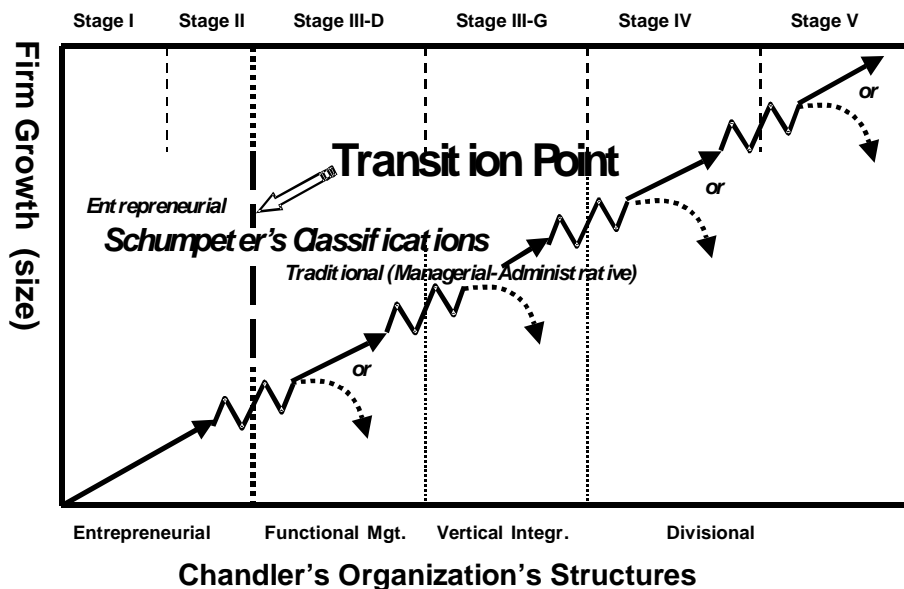


Churchill and Lewis' research complements Chandler's research with large, established organizations. Both sets of researchers identify organizational characteristics that can be associated with stages of growth and expansion. As the firm experiences challenges (or crises), the firm both adapts and changes, or it fails. Each change modifies the firm's management and structure. The firm transitions from an entrepreneurial firm to a functional structure, seeks economies of scale and efficiencies. This requires the implementation of formal structures and a functional style of management - a significant change from the previously unstructured entrepreneurial firm. Overlaying these two researcher's classification systems with the Schumpeter's simple point of demarcation reveals theoretical accord about there being a critical transition point - the point at which the entrepreneur (and the entrepreneurial firm) makes a transition to a functionally managed organization. (See Figure 1 below)

**Figure 1**

**Reconciling Theories of Structural Stages of Growth**

**Churchill & Lewis' Entrepreneurial Growth Stages**



Although this transition has been recognized for over half a century, existing research has focused primarily on the “person” of the entrepreneur, or on the structures and processes within the organization – not on both. Looking at how the entrepreneurs adjust to and manages growth provides meaningful information about managerial behavior. But, this tacitly ignores what is perhaps the most crucial point in the transition from the “entrepreneurial,” directly supervised firm to the successfully growing firm - the dynamics of injecting the first layer of management within the organization. Looking at the structural characteristics and processes of an established organization provides insight into characteristics of the structures once they do exist, but does not inform us about their creation.

### **Conceptual Framework**

“Transition” is defined as the process in which something changes from one state to another (Collins Cobuild English Dictionary). We apply this definition to the proposed framework, since the transition in the organization is the object of inquiry. The organization undergoes change in size (from small to quite large), managerial structure (from entrepreneurial to functional), and requires a different behavior from the CEO. We are proposing a “mezzo” theory – combining elements of organization theory (where the organization is the level of analysis) and organization behavior (where the behavior of individuals is the level of analysis).

Some work in this direction has occurred. Elliot Jaques notes that differing levels of cognitive ability appear repeatedly in the increasingly complex settings in higher organizational levels (1986). He labeled this as “intellectual capability.” Michael Hay and Peter Williamson proposed a stair-step approach to developing strategy and the ensuing organizational structure (1991). Based upon a clearly defined goal, they argue that it is necessary to sequentially develop

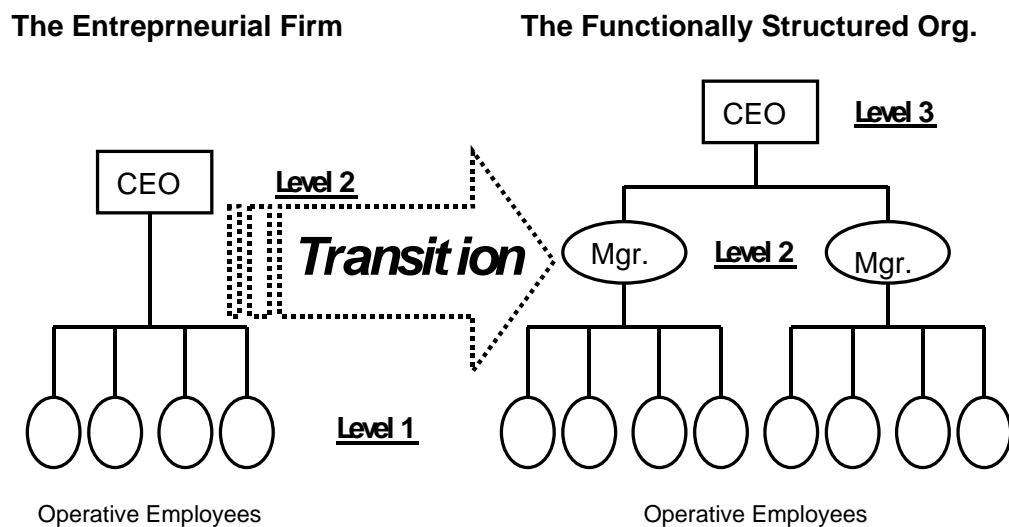
the requisite skills and capabilities to achieve the mission. Jaques subsequently defines requisite managerial leadership as being “*structures and processes, and methods of human resourcing and growth, that can beget the highest levels of performance and human satisfaction*” (1992, p.42). For Jaques, this specifically relates to managerial hierarchies – managerial layers which are intentionally structured to achieve the required, specific tasks. His research (and the greater part of the modern Theory of Management) has focused on large, highly structured organizations. He does, however, stress the need to analyze the environmental conditions in which the founding CEOs of small companies develop their work, in comparison with the actors of a highly structured organization (1993).

The initial phase of this research (Penna 2000) provides strong support for the need to analyze the behavior of the CEO, the performance of job tasks and functions, as well as environmental factors. It was discovered that producing written records allowed a reduction of the “verbal culture” of small companies (one of Jaques’ environmental conditions), and provided insight into other interesting effects. The CEOs were urged to systematically write their instructions to their personnel (as well as their statements of work incidents). On the one hand, the highly emotional nature of these organizations began to diminish dramatically because of the CEOs new methods. On the other hand, the CEOs themselves became more auto-reflexive. A third effect was also observed. The employees’ tasks were being achieved on a more solid (consistent) basis – a higher level of standardization was being achieved. Not surprisingly, the firms that initiated documentation and established practices of formalization and standardization were successful in making the transition to successful large firms. Two of these firm's growth patterns are graphically depicted in Appendix 2, where sales and employments figures are shown as relative percentages, with the initial year of recording being the basis. (See Appendix 2)

These early findings suggested a conceptual framework for gaining insight into the processes whereby the executive (entrepreneur) developed the requisite capabilities, as well as the processes whereby the organization developed the structural characteristics to facilitate its becoming a large organization. Conceptually, the organization level for this transition is depicted in Figure 2 (see Figure 2), wherein the simple, two-level entrepreneurial structure transitions to the first stage of a hierarchically structured organization, becoming a three-level structure.

**Figure 2**

Transition in Organizational Structure for a Growing Firm



To observe, record, and analyze the dynamics of this transition, data should include the following five informational factors over time (to permit identifying their relationship to changes being undergone by both the individual and the organization).

Factor 1 - Evolution of formalization: This entails the CEO's utilization of writing as a work habit, the existence of documentation (e.g. job analysis, procedures, policies, etc.), and the

use of written records within the organization. This is the most critical of the factors, as it directly relates to two of the accepted dimensions for an organization's structure; formalization and standardization.

Factor 2 – Delineation of functions: Beyond identifying and inventorying the functional tasks performed by the CEO, this should include relative time spent occupying each position. As pointed out by Drucker (19XX), the CEO of an entrepreneurial firm customarily performs multiple functions. This can be tracked by means of the ChATT (Chart of Analysis of Task Transitions of the CEO), developed by Penna (2000), and affixed as appendix 1. A crucial point within the transition is anticipated to be when the time demands for both managerial and functional tasks exceed the personal capacity of the CEO.

Factor 3 - Identification of motivating influences acting upon the CEO. By inventorying the specific points that demand the attention of the CEO, environmental effects can be observed. While it is anticipated that there may be different “triggers” for the insertion of an intermediate level of management (eg. the entrepreneur's desire to decrease their involvement with the firm versus growth beyond the entrepreneur's capability to manage), documentation of the influences will permit isolating self-induced influences from environmental factors. The ChATT will provide insight into these influences as well.

Factor 4- As identified by Jaques (1992), as well as Hays and Williamson (1991), the cognitive processes of the CEO undergo change as managerial tasks change and as managerial capabilities are developed. It is proposed that the “way of thought” will be reflected through explicit behaviors that are also directly related to generally accepted measures for organizational structure and strategy: specifically the planning, measurement and control schemes used by the CEO. The transition may be observed, for example, in the way that inventory is controlled;

watching, using a schedule, watching and using a schedule, following inventory by personal computer, delegating physical control to other personnel. Further indications of personal changes that the CEO is undergoing could be measured by application of the Myers Briggs Typological Inventory, which provides a useful measure of personality on the basis of individual preferences. Having the CEO complete the MBTI inventory on an annual basis will provide an indication of changes in their preference structures. Likewise, any individual placed within the new managerial level would also be administered the MBTI inventory on an annual basis.

Factor 5 - The developments of strategic processes. The development of strategy precedes growth. The ability of the CEO to articulate and communicate strategy and vision is instrumental to the success of the firm, and by articulating the values of the entrepreneur, becomes the foundation for the other four factors.

### **Foreseeable Influences**

The above conceptual framework presents a simplified representation of what is being measured, and identifies the necessity for longitudinal measurement of the factors. Further insight is provided into the behavioral aspects of the conceptual framework by detailing the anticipated influences that also affect the transition.

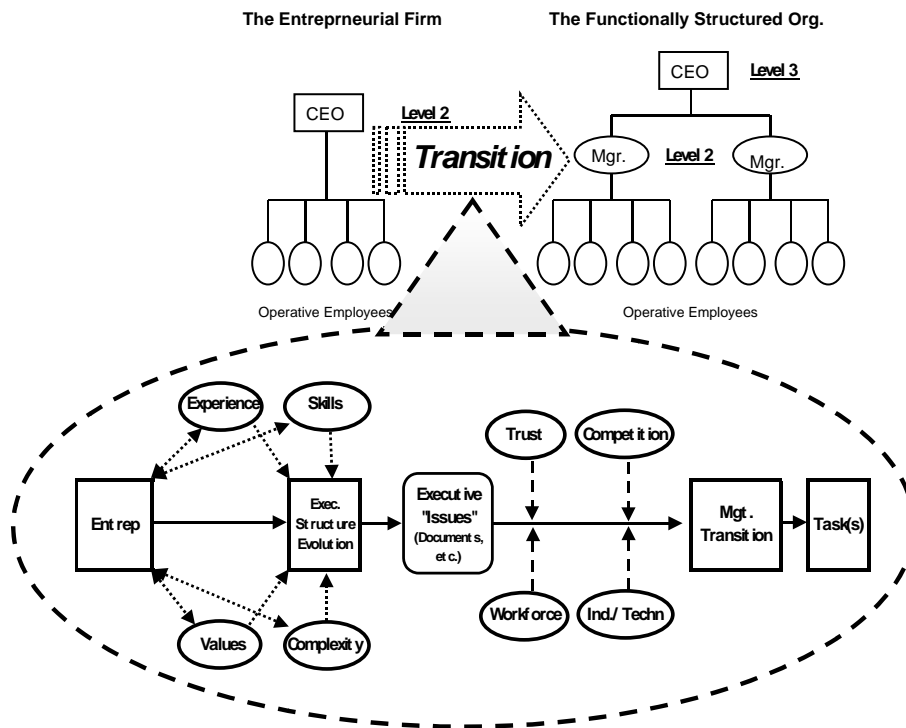
The entrepreneur's personal values, experience, and specific skill sets drive the starting point and any transition. However, the complexity of tasks encountered due to and with growth will likewise act as a potential trigger, or to modify the structural evolution. The tasks, in turn, are affected by the industry or technology (Perrow, 1967), by the nature of the processes used to produce the products (Woodward, 1965), and by the life cycle of the product (Hayes and Wheelwright, 1979).

Beyond the foundation values, knowledge, skills and abilities, the CEO's willingness and ability to document values and decision making criteria (as well as the other requisite elements) will be affected by factors internal and external to the firm. Internally, the capabilities of the employees (or the available workforce), and the level of trust that the executive is willing to extend will affect it. Externally, the industry or technology in which the firm participates, and the competitive factors will affect it.

These influences can be depicted as Figure 3, in effect magnifying the transition “arrow” to show some of the influences anticipated to be causing the effects which will be observed in the 5 factors.

**Figure 3**

Effects Influencing the Transition



## **Discussion:**

This paper presents a theory of organizational transition and a framework for longitudinally researching entrepreneurial organizations making the transition into structured organizations. While based upon previous, broadly accepted research, we have integrated previously separate constructs. A research framework for studying the crucial, missing element of our understanding of organizations has been presented – specifically how the entrepreneurial firm transitions to a structured firm. While we know “what” happens, we do not know “how.” Gaining insight into the “how” will strengthen our ability to assist the entrepreneurial community's achieving successful, sustained growth. Indications from the pilot project have improved the original framework (Penna, 2000), and have provided positive stimulation to continue the research. The project will be expanded, and will incorporate countries in both Argentina and the United States, where the companies (1) Have the strategic intent to grow and be profitable, (2) Are being currently managed by the founding owner, (3) That are at least 4 years old, and (4) Are in the process of, or have recently incorporated an intermediate level of manager between operative employees and the CEO.

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## Appendix 1: ChATT

Chart of Analysis of Task Transitions of the CEO

Process (X) →	Tasks Valorization						Specific Knowledge								Specific Skills						Specific Experiences							
Kind of Task execution (Z) →	Performs by himself			Performs through others			Performs by Himself				Performs through others				Performs by himself			Performs through others			Performs by himself				Performs through others			
Kind of Tasks (Y) ↓	-	N	+	-	N	+	DH	L	A	M	DH	L	A	M	TWD	PAWD	DTWD	TWD	PAWD	DTWD	DH	L	A	M	DH	L	A	M
Substantial Technology																												
Administrative Economic and Financial Task																												
Commercial, analytical and Contextual task																												
Organization, coordination, motivation and leadership task																												

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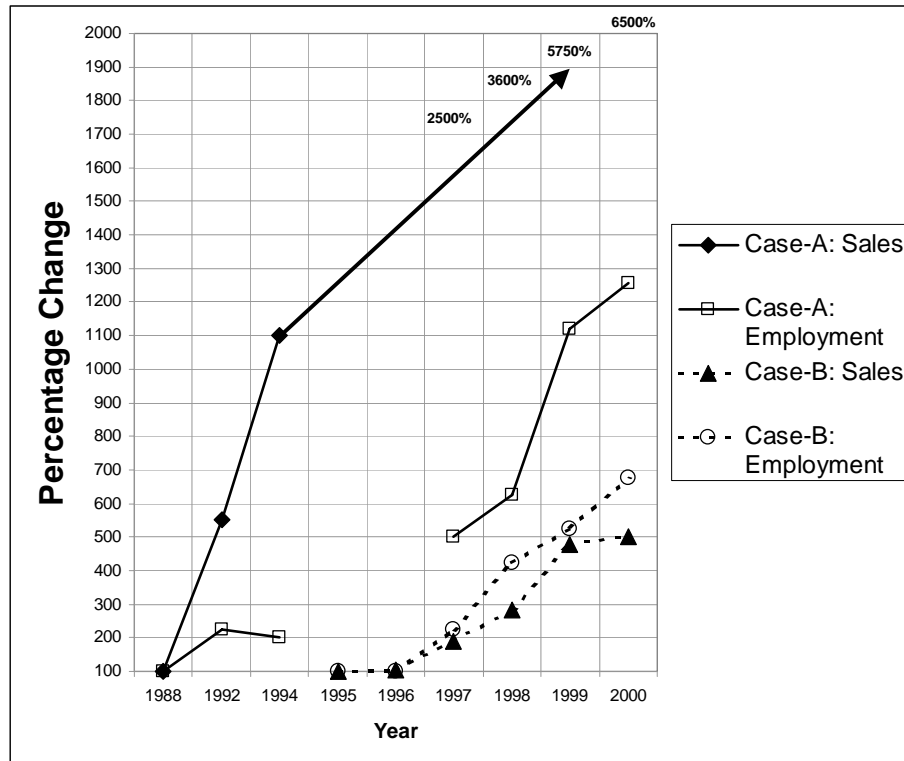
**Tasks Valorization:** (-) Negative, N Neutral, (+) Positive

**Specific Knowledge:** DH Does not Have, L Little, A Average, M Much

**Specific Skills:** TWD Thinks when doing them, PAWD Pays attention when doing them, DTWD Does not think when doing them.

**Specific Experiences:** DH Does not Have, L Little, A Average, M Much

## Appendix 2: Examples of Growth





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