



**EXTERNAL ENVIRONMENT AND FIRM PERFORMANCE: THE ROLE OF FIRM'S DYNAMIC CAPABILITIES: A
CRITICAL REVIEW OF LITERATURE**

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ABSTRACT

Firm performance is dependent on how major decisions are made in anticipation of or in response to external environmental conditions. The process of making decision within environment is never ending and therefore a continual reassessment of the status of the strategic factors in this environment must take place. As the environment change therefore, organization's survival entirely depends on devising appropriate responses to unforeseen discontinuities. Empirical evidence emerging from studies and theory on the relationship between external environment and firm performance suggest that the external environment is a source of opportunity, threats and resources as inputs for firms. The theoretical frameworks upon which external environment, firm's dynamic capabilities and firm performance are based are varied and include the institutional theory, Dynamic capabilities theory and open system theory. Great performance is assured when the responsiveness of an organization's dynamic capabilities matches the turbulence in the environment. Performance is a reflection of how leaders align their organizations to the environment, through firms' dynamic capabilities practices, so as to be successful and to outdo competition. How well an organization fits itself within the external environment determines its level of performance since organizations are environment dependent and serving. Equally, firm dynamic capabilities play a pivotal role in determining the performance of the firm. In this regard, firms that are able to align certain firm features with the environment outperform other firms. Therefore, firm dynamic capabilities are essential determinants of firm performance and success. Furthermore, many firms today are facing extraordinary challenges in maintaining commercial survival and success. Arising from rapid changes happening in today's marketplace and emerging business practices, it is more likely for firms to fall behind by not keeping up with tendencies of their external environments.

Key words: External Environment, Dynamic capabilities, Firm Performance

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INTRODUCTION

A firm's external environment as defined by several authors (Hitt et al, 2011; Machuki and Aosa, 2011) is a firm's aggregate of external factors that have impacts on its functioning. It is the source of constraints, contingencies, problems and opportunities that affect the terms on which firms transacts business. External environment comprises of factors that originate beyond and usually irrespective of any firms operating situation (Hitt, Ireland & Hoskinson, 2011). No enterprise of any kind can operate in the absence of environmental constraints, or restrictions imposed by the firm's surroundings. The process of decision within environment is never ending and therefore a continual reassessment of the status of the strategic factors in this environment must take place. Kariuki et al. (2011) argue that the operating environments have direct impacts on corporate strategy. Firms therefore depend on the environment for performance to be realized.

Organizational performance is therefore highly influenced and related to the changes and the dynamism nature of the relationship that exist between the organization and the operating environment (Machuki & Aosa, 2011). As the environment change therefore, organization's survival entirely depends on devising appropriate responses to unforeseen discontinuities. The environment can either be perceived to pose a threat or offer opportunities necessary to steer the performance (Hubbard, 2009). However, the flexibility in corporate governance mechanisms coupled with positive attitudes towards environmental uncertainty, organizational capabilities may find even the most perceived environmental turbulence to be the source of opportunities as opposed to threats. While performance can be affected directly by environment, it will largely be influenced by the capabilities in the response to the changes in the external environment (Pearce et al, 2012).

Capabilities can be defined as the firm's ability to integrate, build, and reconfigure internal and

external competences to address rapidly changing environments (Lin & Wu, 2014). Firms require firm dynamic capabilities in order to be able to compete in the ever changing market environment (Pohjola & Stenholm, 2012). They derive from the bundle of resources that a firm possesses. A capability, therefore, is the capacity or ability for a team of resources to perform some tasks or activities (Pearce et al, 2012) for the purpose of achieving a particular end result.

Firm's dynamic capabilities enable the firm to readjust its competences to adapt to volatile markets, environmental uncertainty and environmental changes. Performance variations may be subject to influence of firm's capabilities (Makkonen, Pohjola, Olkkonen & Koponen, 2014). The challenge then is for firms to effectively manage the current firm capabilities while simultaneously developing new ones. However, which capabilities inform specific types of strategic response is not well empirically grounded in literature.

Firm performance comprises the actual output or results of an organization as measured against its intended outputs (Ongeti, 2014). Mahapatro (2010) observes that firm performance is the ability of an organization to fulfil its mission through sound management, strong governance and a persistent rededication to achieving results. Measurement of firm performance continues to be a contentious subject among firm researchers, both in terms of definition and measurements because of its multifaceted and multidimensional nature (Ongeti, 2014). However despite this argument, organizations with defined measurable performance indicators perform better than those without.

Performance evaluation is done by considering the company 4 (four) perspectives (Kaplan & Norton, 2008), namely financial perspective, customer perspective, internal process perspective, and learning and growth perspective. Awino, (2011) argues that no single variable that can effectively influence firm's performance. Marn and Romualid

(2012) posits that the contemporary approaches to performance measurement include the intangible dimensions, such as public image and perception, customer satisfaction, employee satisfaction and attrition, skills levels, innovations in products and services investments into training and new value streams.

THEORETICAL FOUNDATIONS

The theoretical frameworks upon which external environment, firm's dynamic capabilities and firm performance are based are varied and include the institutional theory, Dynamic capabilities theory and open system theory.

Institutional Theory

The main idea of institutional theory is that the organizations are exposed and linked to external environment accordingly; CG should ensure that, there is a clear link between the organizations and environment based on organizations goals and objectives. CG should have an effective influence and involvement in formalizing and identifying corporate goals. Cohen et al. (2007) suggested that, in order to formulate a compensation policy senior manager should understand all norms and traditions of the organization. However, those policies are resistant to change even in the face of major changes in job content and technology complexity. According to Weir et al. (2002) CG consists of external governance mechanisms and internal governance mechanisms that are linked to the concept of institutional theory.

The weaknesses of the theory according to Lin and Wu (2014) are that it explains the deeper and more resilient aspects of social structure, processes, schemes, rules, norms and routines that have become established as authoritative guidelines for social behavior and fails to integrate the financial structure and capital structure which are key to corporate governance. It also looks at how these elements are created, diffused, adopted and adapted over space and time, and how they fall into decline and disuse but fails to clearly show the applicability in organizations especially during

corporate governance decision making process. Basically, institutional theory asserts that organizational structures and procedures are adopted because important external institutions prefer them. Institutional networks are not merely control and co-coordinating mechanisms for economic transactions, they socially construct rules and beliefs for conformity and reward.

Dynamic capabilities theory

The dynamic capabilities theory argues that capabilities are a firm capacity as well as abilities to deploy resources, usually in combination using firm's processes, procedures and demand effect as well as other resources (Pearce et al, 2012). The theory emphasizes the key role of strategic management in appropriately adapting, integrating, and reconfiguring internal firm's skills, resources and functional competences to much requirements of a changing environment (Pohjola & Stenholm, 2012). The major critique of the dynamic capabilities theory is that it often aims to understand a firm's growth and survival and it is therefore not surprising that it draws from a range of theoretical perspectives which are hypothetical in nature. Moreover, it aims at explaining the foundation of long-term profitability instead of the overall growth of the enterprise.

EMPIRICAL LITERATURE

External Environment and Firm Performance

Several scholars are in agreement that the external environment influences firm performance (Okeyo, 2013; Kariuki et al. 2011). Firms adjust to the external environment and use it as a mechanism to transform the advantages into above average performance levels (Rosenbusch, et al, 2013). The scholars explore the links between environmental munificence, hostility, dynamism and complexity, and firm performance. The results suggest that environmental munificence, hostility, dynamism and complexity affect firm performance. Environmental dynamism and uncertainty arise from a lack of information about future events and their consequences (Hubbard, 2009). Although

dynamic environments create difficulties for strategic decision making, firms that explore and exploit opportunities in such environments can outperform their rivals. The rapid rate of change and difficulty in predicting future events requires a high degree of pro-activity.

Studies that exclusively link external environment and performance are rare, yet performance is contingent upon firms' appropriate alignment with environmental changes (Machuki and Aosa, 2011). Literature on the external environment of a firm and its direct and indirect impact on firm's processes and outcomes have been in formative stages since insinuations by Osborn and Hunt (1974). However, several studies thereafter have treated environment as an independent variable and performance as dependent (Machuki and Aosa, 2011).

The performance implications of the major decisions that are made in anticipation of or in response to external environmental conditions are of interest to strategy researchers. The external environment has played various roles in research, that of the independent, co-alignment and moderating to influencing performance (Hitt, Ireland & Hoskinson, 2011). Empirical evidence emerging from studies and theory on the relationship between external environment and firm performance suggest that the external environment is a source of opportunity, threats and resources as inputs for firms. Perceiving, understanding and responding to the environmental upheavals have implications on individual firm performance. The literature reviewed maybe a subject of debate since it considered only one measure of external environment and measured against performance and also done in different environmental context. This study may yield different results since it will consider all external environment measures and also done in different environmental context.

Dynamic capabilities and firm performance

Empirical testing concerning the influence of dynamic capabilities on firm performance has been hampered by difficulties regarding their description, operationalisation and measurement and by their assumed tautological relationship with firm performance. For instance Wildden, Gudergan, Nielsen & Lings, (2013) argues that a firm's dynamic capabilities significantly affect firm performance and that a firm's ability to integrate knowledge from external sources is positively related to its research productivity, measured by patent counts.

Pohjola & Stenholm (2012) also suggests that dynamic capabilities, which can be defined as higher-order or meta-capabilities are important because they may help firms to avoid path dependencies imposed by their current lower-order competences. Therefore, a firm has to develop capabilities to learn and redefine its resource base in order to overcome the trap laid by their existing competences and create new sources of competitive advantage. It's further argued that dynamic capabilities build and reconfigure resource positions, operational routines (Zollo and Winter, 2002) or operational capabilities and, through them, affect performance. This chain of causality designates an indirect link between dynamic capabilities and performance (Li & Wu, 2014). However, the mechanisms by which dynamic capabilities influence firm performance are not well understood. Despite the ongoing progress made in the empirical inquiry of the differential effects of specific dynamic capabilities, it seems that few studies have provided a comprehensive account of their precise impact on firm performance which provides a gap for the current study to fill.

Conceptual Framework

This is a combination of concepts that integrate and interpret information. In the framework, the relationship between external environment and mediated by firm dynamic capabilities on performance. This emerging proposition, knowledge gaps has led to the formulation of the conceptual model as an area for further research.

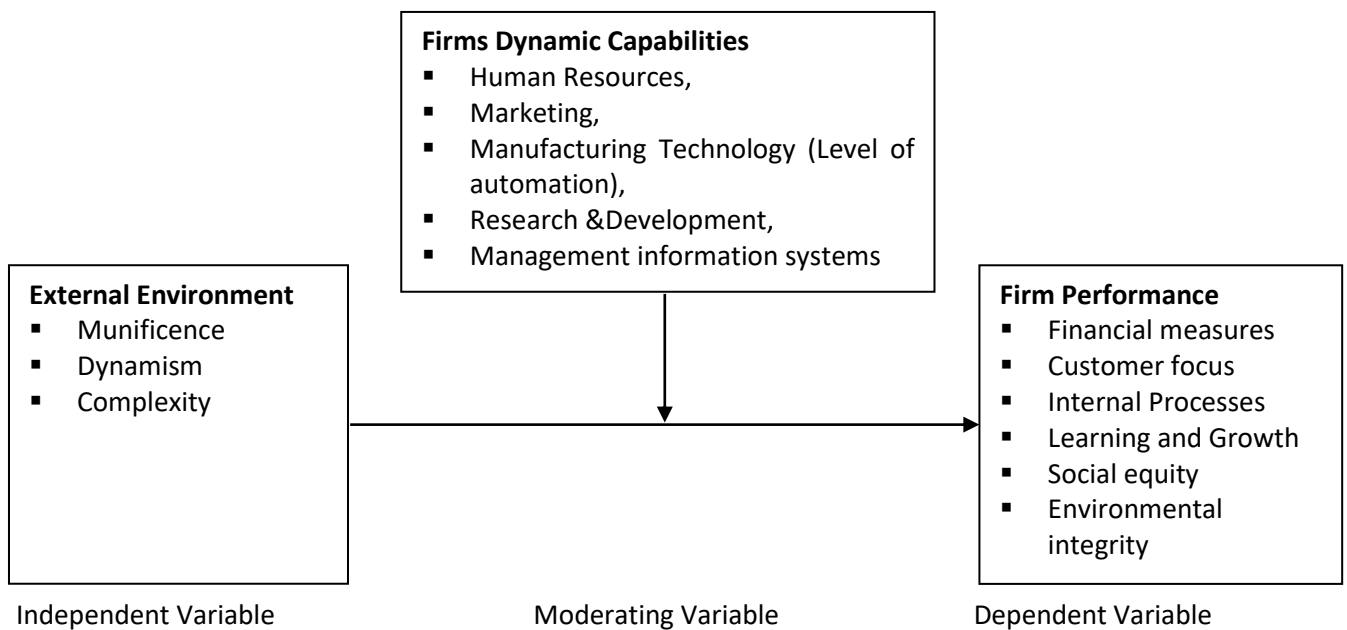


Figure 1: Conceptual Model

CONCLUSION AND STUDY IMPLICATIONS

Great performance is assured when the responsiveness of an organization’s dynamic capabilities matches the turbulence in the environment. Performance is a reflection of how leaders align their organizations to the environment, through firms’ dynamic capabilities practices, so as to be successful and to outdo competition. How well an organization fits itself within the external environment determines its level of performance since organizations are environment dependent and serving. Equally, firm dynamic capabilities play a pivotal role in determining the performance of the firm. In this regard, firms that are able to align certain firm features with the environment outperform other firms. Therefore, firm dynamic capabilities are essential determinants of firm performance and success. Furthermore, many firms today are facing extraordinary challenges in maintaining commercial survival and success. Arising from rapid changes happening in today’s marketplace and emerging business practices, it is more likely for firms to fall behind by not keeping up with tendencies of their external environments.

On practice, managers who have adopted best corporate practices by adapting to changing external environment conditions and firms’ capabilities should find the results of this study useful. Further findings showed that firm capabilities mediate the relationship between external environment and performance. This should form the basis of how firm capabilities have to be developed within the firm if it has to succeed.

Theories that underpinned this study may also be built basing on the arguments related to the critique of the same variables. Institutional theory, Dynamic capabilities theory and open system theory may be informed by the literature on their weaknesses and strengths and the ways on which such gaps in the theories can be filled. The study is also of value to several areas of theory testing. It may offer significant testing to the already existing theories which offer the theoretical framework for the study. The research findings are expected to contribute to a better understanding of external environment and the associated theoretical arguments.

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