Effect of organizational risk orientation and change disposition on dynamic capabilities: An emerging markets perspective

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Abstract

This conceptual paper address an important gap in the dynamic capabilities literature by conceptualizing that organizational risk orientation and organizational change disposition are critical determinant factors that affect the creation as well as utilization of dynamic capabilities. While fields such as entrepreneurship, innovation, change management and strategic decision making have theorized the effect of risk orientation and change disposition on various organizational outcomes, the dynamic capabilities theory has a gap as it largely ignores these aspects. Further, we put forward several propositions that relate these determinant factors to each of the micro-foundations of dynamic capabilities, i.e. (1) sensing opportunities and threats; (2) making timely decisions; (3) making market oriented decisions; and (4) changing resources base.

Keywords: dynamic capabilities, risk orientation, change disposition, determinants

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The dynamic capabilities view (Teece, Pisano, & Shuen, 1997) was put forward to explain inter-firm performance heterogeneity under changing environmental conditions, thereby overcoming limitations of the resource based view (Barney, 1991) that was deemed as a static approach. Researchers have extensively explored the relationship between dynamic capabilities and various firm level outcomes such as performance (Augier & Teece, 2009; Teece, 2007; Wang & Ahmed, 2007), competitive advantage (Ambrosini & Bowman, 2009; Teece, 2007), and innovation (Abell, Felin, & Foss, 2008; Eisenhardt & Martin, 2000; Jantunen, Ellonen, & Johansson, 2012). In contrast, the determinant factors affecting dynamic capabilities are relatively under-explained (Abell et al., 2008; Felin, Foss, Heimeriks, & Madsen, 2012; Teece, 2007). Our review of extant literature reveals that dynamic capabilities of an organization are affected by various factors such as managerial human capital (Adner & Helfat, 2003; Hsu, 2008; Youndt, Subramaniam, & Snell, 2004), managerial social capital (Adner & Helfat, 2003; Blyler & Coff, 2003), managerial cognition (Adner & Helfat, 2003; Ambrosini & Bowman, 2009) organizational learning (Eisenhardt & Martin, 2000; Zollo & Winter, 2002), existing knowledge resources (Cepeda & Vera, 2007; Chien & Tsai, 2012; Griffith, Noble, & Chen, 2006), knowledge management mechanisms (Cepeda & Vera, 2007). However, we argue here that the extant literature does not delineate all the determinants of dynamic capabilities and has in fact missed out on two crucial factors that affect dynamic capabilities i.e. organizational risk orientation (Pablo, Sitkin, & Jemison, 1996; Sitkin & Pablo, 1992; Sitkin & Weingart, 1995) and change disposition (Armenakis & Harris, 2002; Holt, Armenakis, Feild, & Harris, 2007; Rosenzweig & Roth, 2007).

Creation and maintenance of dynamic capabilities is a risky investment as it is a costly proposition with uncertain (and often non-immediate) benefits (Winter, 2003). Our claim, therefore, is that the creation and utilization of dynamic capabilities will itself depend upon the risk orientation of the organization. We also argue here that the capability to respond to the demands of a dynamic environment will be affected by the organization’s disposition towards change. Organizations that are positively disposed towards implementing change are more likely to develop dynamic capabilities required for systematic changes to their resources base.

A systematic search by us in the dynamic capabilities literature found over 60 papers that look at a variety of antecedents, determinants or factors affecting dynamic capabilities. A close reading of these papers reveals that the role of risk orientation and change disposition has been completely missed out in extant dynamic capabilities literature. Also, a recent and fairly comprehensive review of dynamic capabilities literature by Barreto (2010) does not uncover any previous study that conceptualizes, hypothesizes or empirically tests the relationship between dynamic capabilities and either organizational risk orientation or change disposition. We did come across a few studies that have looked at the relationship between entrepreneurial proclivities and dynamic capabilities (Griffith et al., 2006; Zhou, 2007). However, given that risk taking is only one of the multiple components of entrepreneurial proclivity (Griffith et al., 2006; Lumpkin & Dess, 1996; Matsuno, Mentzer, & Özsomer, 2002; Stopford & Baden-Fuller, 1994), these studies provide an inadequate theorization of the relationship between risk orientation and dynamic capabilities.

Our contribution is especially pertinent in the context of emerging economies. This is because organizations in emerging economies need to address demands put on them by changing and in many instances, risky, highly uncertain and ambiguous business environment (Hoskisson, Eden, Lau, & Wright, 2000; Wright, Filatotchev, Hoskisson, & Peng, 2005). Their response to these environmental demands would depend upon their risk orientation and their capabilities to sense opportunities/ threats and their disposition towards making systematic changes to their resources base.

Given this context, the rest of this paper is organized as follows. We start off by a review of the dynamic capabilities construct and elaborating upon the type of demands that are made by institutional environments in emerging economies. We then briefly discuss the risk orientation and change disposition constructs. Following this, we put forward several propositions that relate the organization's risk orientation and change disposition to each of the micro-foundations of dynamic capabilities as conceptualized by Barreto (2010).

Literature review

Based on an integrative review of previous literature, Barreto (2010) has defined dynamic capabilities as "the firm's potential to systematically solve problems, formed by its propensity to sense opportunities and threats, to make timely and market-oriented decisions, and to change its resource base." (Barreto, 2010, p. 271). We follow the definition of dynamic capabilities provided by Barreto (2010) in this study as it allows us to make a richer contribution by theorizing the effects of risk orientation and change disposition on the micro-foundations of dynamic capabilities. Most scholars of dynamic capabilities agree that the nature of the environment faced by the organization affects the presence and usefulness of these capabilities, and, in general dynamic capabilities are more useful when the organization faces a dynamic environment (Barreto, 2010; Teece et al., 1997; Teece, 2007; Zollo & Winter, 2002). A key aspect of the overall environment that an organization faces is the set of institutional (Hoskisson et al., 2000; Scott, 1987) environments prevalent in the economy. Emerging markets are considered as difficult institutional environments – with a key characteristic being that of rapid and sometimes unpredictable changes to regulatory requirements (both in terms of direction as well as speed). Thus organizations operating in emerging economies such as India face frequent misalignment of fit between their resources base and the environment (Peteraf & Reed, 2007; Venkatraman & Prescott, 1990) and therefore require dynamic capabilities to handle the changing demands of the institutional environments they face (Wright et al., 2005).

Institutional environments in emerging economies.

In the emerging markets context, changes to regulations are frequent and their broad direction towards liberalization of the economy is largely predictable. However, while countries like India have over the last two decades (since 1991) espoused a commitment towards economic liberalization, the required regulatory changes have often been bunched up, sporadic, delayed and have involved flip-flops in direction based on political compulsions and other economic or non-economic reasons. In certain sectors of an emerging economy, regulatory policies may be absent or may be ambiguous, actual implementation of policies may be slower than initially indicated timelines, direction of policies may change substantially and quickly due to unstable political regimes, and the interpretation of policies may vary across institutions such as the executive and the judiciary (Tan, 1996, 2001). All these factors add to the risks faced by organizations operating in or looking to enter an emerging economy such as India. For instance, in recent years, India has seen FDI related regulations emerge, change radically and sometimes even reverse in many key sectors such as organized retail, 3G mobile telephony and domestic aviation.

Two types of regulatory changes are considered here. Firstly, compliance type regulatory change – i.e a change requirement that all organizations in the particular sector(s) mandatorily need to comply with. For instance a new banking sector regulation that makes usage of pin-based transactions mandatory for all debit cards issued in India after a cut-off date declared by the central bank (Chugh, 2013; Parvatha, 2012). In this type of regulatory demand, organizations have to appropriately comply within the mandated timeframe or face sanctions including penalties or prevention of continuation in business.

The second type of regulatory change is one that throws up new business opportunities that some organizations may decide to take up while others may not. For instance a new FDI regulation that partially opens up the Indian organized retail sector to foreign players (Bahree, 2011; Kalhan, 2007). In such a case the opportunity exists but is in no way mandatory for new or existing organizations to comply. In the case of a compliance type change, all organizations, irrespective of their risk orientation or their disposition towards change, need to take timely decisions and make changes to be compliant with the new regulatory regime. However, in the case of regulatory changes that throw up new opportunities, the behavior would vary across firms based on their risk propensity and dynamic capabilities.

Organizational risk orientation.

The terms risk and uncertainty have been used in an overlapping manner in strategy literature (Baird & Thomas, 1985) and includes knowledge of alternatives, consequences of choosing any alternative, and the probability of occurrence of the consequence. Risk propensity or orientation is defined as the general tendency to prefer a risky alternative (Pablo et al., 1996; Sitkin & Pablo, 1992; Sitkin & Weingart, 1995). Risk orientation influences whether a particular level of risk can be deemed acceptable by an organization, the overall tolerance for risk (Walls & Dyer, 1996) and tolerance for failure (Danneels, 2008). Risk orientation will affect whether organizations label a situation as an opportunity or a threat; and also what kind of decision is likelier and what investments are made in changing the resources base.

Change disposition.

Change disposition is an organization's readiness to accept and implement change (Rosenzweig & Roth, 2007). An organization's disposition towards change is a critical factor in determining the effectiveness and efficiency with which the transformations related to strategy, structure, processes, culture etc. take place (Armenakis & Harris, 2002; Rosenzweig & Roth, 2007). In the DC context, capability of timely and market oriented decision making as well as capability to change resources base are affected by the firm's readiness for change. If a firm is not positively disposed towards change, the initiatives related to change are likely to face resistance from managers and/ or result in low motivation or disgruntlement among managers.

Risk involved in creation and maintenance of dynamic capabilities.

Creation of dynamic capabilities requires investment of resources and ongoing maintenance of these capabilities is not costless for the organization (Winter, 2003; Zott, 2003). If the dynamic capabilities are left unused or are under-utilized then the organization's upfront and ongoing investments in these capabilities would result in a loss. However, in order for the capabilities to be available when needed in future, these investments need to be made upfront without full ex-ante knowledge of whether they will be fruitful or not (Winter, 2003). Organizations that have a higher risk orientation are more likely to make investments even in the presence of such uncertain information. Also, organizations with higher risk propensity are likely to make relatively larger investments based on the same information uncertainty when compared to organizations with lower risk orientation. Organizations with high risk orientation are more likely to favorably consider experimenting with a larger number and a greater variety of opportunities and therefore faced with a large and diverse set of changes to their customers, products and environments. They would therefore benefit more by having capabilities that would help them sense opportunities and make quick decisions and implement these by making appropriate changes to their resources base. Based on this we propose that:

Proposition 1: An organization's risk orientation positively affects its dynamic capabilities.

An organization's perception and cognition of its environment affects the direction and speed of its strategic response (Adner & Helfat, 2003; Baum & Wally, 2003; Nadkarni & Barr, 2008). Thus, organizations that perceive the overall risk levels to be high due to the presence of a difficult or hostile (Covin & Slevin, 1989; Tan, 2001) institutional environment would be more likely to invest in creating dynamic capabilities to respond to the risks. In contrast, organizations that perceive a benign environment (Covin & Slevin, 1989), that does not currently or in the future lead to a high level of risk for the organization, would find it difficult to justify investments in dynamic capability creation and maintenance. Organizations with high risk orientation are more likely to continue operating in difficult environments, label changing demands as opportunities to explore and pursue, and therefore require dynamic capabilities. We therefore propose:

Proposition 2: The positive relationship between risk orientation and dynamic capabilities is moderated by the organization's perception of its institutional context.

Risk orientation and propensity for sensing opportunities and threats.

Orientation towards risk taking affects how organizations label a situation (Sitkin & Pablo, 1992). The same context may be referred to as an opportunity or a threat based on the organization's propensity for risk taking. Organizations that have high for risk taking orientation are tolerant of greater degree of uncertainty and ambiguity and therefore may search for less deeper information about a particular problem.

Also, higher risk taking organizations may be willing to carry out a wider exploration (Danneels, 2008), consider a wider variety of alternatives as opportunities and therefore may engage in sensing that is of a wider and more-distant-from-core-business nature. These organizations may even develop the propensity to sense opportunities and threats based on changes happening in unrelated sectors of the economy, where they are currently not operational. In contrast, organizations that have low orientation for risk taking are likely to seek detailed and comprehensive information before reaching a state where they consider themselves ready to make a strategic decision. Their sensing of opportunities and threats is therefore likely to be more focused and deeper.

The sensing of opportunities/ threats also involves conjecturing and hypothesis building about future scenarios (Teece, 2007). Risk orientation will affect the number of hypotheses/ conjectures as well as the type of hypotheses that the organization allows to proceed to a decision making stage. Firms that have higher risk orientation will consider plausible a larger number of conjectures and also be willing to include radical conjectures about future opportunities and threats. We therefore propose that:

Proposition 3: Higher the risk orientation, the greater the propensity to sense opportunities

Risk orientation and propensity for timely decisions.

In the context of economies undergoing rapid changes we conceptualize the ability to take timely decisions to be almost equivalent to the ability to make fast decisions (Barreto, 2010; Teece, 2007). In situations when the environment is changing rapidly and consequently opportunities are transient, organizations that have the capability to make fast decisions are able to capitalize on the opportunities and are therefore often better off than those who do not (Baum & Wally, 2003; Eisenhardt, 1989; Forbes, 2005). In general, organizations with higher risk orientation would be inclined to capitalize upon an opportunity as soon as it arises and therefore need to have the capability to make fast strategic decisions when the environment throws up an opportunity based on changes to regulations. However, a decision before its time may lead to losses in the scenario where regulations are still being firmed up and may change direction after the organization has decided and made investments – a risk that organization's with high risk orientation accept. Previous researchers have stated that fast decisions can be reached by using more real-time information and developing and simultaneously analyzing multiple alternatives (Eisenhardt, 1989). For an organization to react quickly once regulations are in place, preparations need to start in advance of availability of complete knowledge of the final new regulations. An organization with high risk orientation may be willing to rely upon incomplete information, often use information leaked by sources in the government, early drafts of regulatory proposals and the like for making decisions. If the final regulation is either significantly delayed or changes significantly in form from the initial drafts, the organization faces a loss on the investments it had made in anticipation of a particular regulatory change coming about. Before a particular set of regulations are formally in place, an organization with a high risk orientation may not just consider real time information but also base its decisions on its own hypotheses, conjectures and projections about what regulatory changes are in the offing. Therefore the organizations with high risk orientation are likely to build a greater propensity for timely decision making. In contrast, an organization with low risk orientation is likely to adopt a wait and watch approach until all the details of the opportunity are available and the new regulatory environment appears stabilized. Thus in the context of regulatory changes leading to potential new opportunities we propose:

Proposition 4: Higher the risk orientation, greater is the propensity to take timely decisions

Risk orientation and propensity for market oriented decisions.

Market orientated decisions are those that align to the requirements of customers and thereby create superior value for customers (Barreto, 2010; Jaworski & Kohli, 1993; Narver & Slater, 1990). Previous researchers such as Jaworski and Kohli (1993) have argued that if the top management is risk averse they will have lower propensity to innovate and introduce new products and services to meet evolving customer needs and therefore such organizations would not be market oriented. It is also possible that organizations that have higher orientation to take risks may not always align their decisions to the needs of current customers only (Hult & Ketchen, 2001). They may take decisions based on their bet on futuristic customer needs or an unproven cutting-edge technology. They may explore opportunities thrown up due to regulatory changes even in sectors that do not relate to their existing businesses. In the context of opportunities thrown up due to regulatory changes, we therefore propose that:

Proposition 5: Higher the risk orientation, greater is the organization's propensity to take market oriented decisions and seize opportunities thrown up by regulatory changes

Compliance demands put by regulatory institutions often do not allow for large interpretive latitudes and also are usually not negotiable. Therefore in the context of compliance demands, an organization needs to have the capability to understand what changes are required and comply accordingly. However, organizations with a very high level of risk taking orientation may in some cases decide to not comply with regulatory requirements or may try to "manage" the institutions. This is possible where the propensity of risk taking is high and the perception of the risk is low in a specific instance. In emerging economies such as India, prevalence of corrupt officials, weak implementation of regulations and slow judicial systems makes this type of organizational behavior a possibility in many sectors. In such a case the organization does not rely on propensity to take market oriented decisions. Therefore in the context of regulatory changes that require mandatory compliance by all organizations, we propose that:

Proposition 6: Risk orientation negatively affects propensity to take market oriented decisions in the context of regulatory changes that require mandatory compliance

Risk orientation and propensity for changing the resources base.

Changing the resources base (Barrales-Molina, Benitez-Amado, & Perez-Arostegui, 2010; Eisenhardt & Martin, 2000; Helfat et al., 2007) of the organization involves higher costs, higher risks and longer term commitments than simply indulging in sensing opportunities and decision making. To develop the propensity to make changes to resources base, an organization has to be modularized or made flexible – both easier said than done and may expose an organization to high level of risks. If organizations uses its dynamic capabilities to make changes to its resources base in anticipation of a potential opportunity that might arise based on a future change to regulations, it is accepting many risks. Firstly, the content of the regulatory change may be different from what was expected; thereby, saddling the organization with a resource-configuration unsuitable for immediate opportunities. Also, the regulation may not change in the timeframe expected thereby exposing the changed resources-set to a risk of obsolescence. For instance, the regulation to allow FDI in the organized retail sector in India has been in the works for many years now and is still restrictive enough to prevent global giants such as Walmart and Tesco from making a large scale foray (Bahree, 2011; Joseph, Soundararajan, Gupta, & Sahu, 2008; Kalhan, 2007). However, organizations with high risk orientation would in anticipation of high future rewards, be willing to accept the associated risks and develop a propensity to change their resources base. We therefore propose:

Proposition 7: Higher the risk orientation, greater is the propensity to change resources base

Change disposition and dynamic capabilities.

The DC literature focuses on the capabilities of the firm in spotting opportunities, taking decisions and changing the resources base. It does not overtly refer to the challenges a firm faces in all these steps. We argue that the capabilities to make market oriented decisions and make changes to resources base depend upon the orientation of the firm towards accepting and implementing changes. Change disposition is an organization's readiness to accept and implement change (Rosenzweig & Roth, 2007). Especially in the context of decision making and implementation of changes to the resources base, the organization's change disposition is critical to the efficiency and effectiveness with which the required changes take place. There are two aspects to consider. Firstly, managers who are aware of negative change disposition may avoid taking decisions that will lead to change. There would be situations where the decision making process will get stuck because some members of the decision making team may continually resist these decisions. Secondly, when decisions are made that would lead to changing the resources base; managers may not be able to effect the changes due to internal resistance to change. The organizational change literature states that changes take place in phases wherein firstly people need to be made ready for change and support change. This is followed by adoption of the change as a trial and lastly leading to the institutionalization of the change in the organization (Armenakis & Harris, 2002). Firms that are positively disposed to making organizational changes are those where managers are supportive of changes and people thrive in change related roles. Managers in such firms find it relatively easy to run change initiatives and employees are positively inclined towards adjusting to new demands (Rosenzweig & Roth, 2007). Based on these arguments we propose:

Proposition 8: Higher the change orientation, greater is the propensity to make timely and market oriented decisions.

Proposition 9: Higher the change orientation, greater is the propensity to change the resources base.

Discussion and conclusion

While related fields such as entrepreneurship, innovation and strategic decision making have thoroughly analyzed the role played by of risk orientation and change disposition on various organizational outcomes, the extant field of dynamic capabilities only distantly and obliquely refers to it. Since dynamic capabilities are related closely to organizational change, the absence of risk orientation and change disposition related discussion in this theory is a significant gap that needs to be filled. Our attempt has been to start off this discussion by theorizing the relationships between the constructs of risk orientation and change disposition and the micro-foundations of dynamic capabilities.

This paper is a proposal that sketches theoretical work that is at an initial stage of development. A more detailed and richer explanation of the relationship between risk orientation and dynamic capabilities is required. We aim to develop this work further in the near future by sharply conceptualizing the relationships, developing testable hypotheses and empirically testing it in the Indian context.

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