EVALUATING PERFORMANCE: REFERENTS IN ENTREPRENEURIAL AND SMALL BUSINESSES

Christopher L. Shook Jeffrey E. McGee
University of Texas at Arlington

ABSTRACT

It is widely accepted that performance impacts subsequent strategic action. However, how managers evaluate a business' performance is not well understood. Managers are thought to evaluate their organization's performance by comparison to various referents. Given the differences between entrepreneurial businesses and established small businesses, it is likely that different performance referents are used. Hypotheses that predict which referents entrepreneurial firms and established small businesses use are developed and tested. Results indicate that managers of entrepreneurial firms place more importance on comparing their firms' performance to organizational goals, and the performance of firms managed by acquaintances than do established small businesses.

INTRODUCTION

The relationship between strategic action and performance is a cornerstone of small business research. Although action and performance generally are considered to be reciprocally related (Milliken & Lant, 1991), most research attention has focused on the influence of strategic action on subsequent performance (e.g., Litz & Stewart, 2000; McGee & Peterson, 2000; Miles, Preece, & Baetz, 1999). However, understanding the influence of performance on subsequent actions is equally important because the quality of performance is thought to provide a basis for adjustments in strategy (Milliken & Lant, 1991). Yet, little empirical research has examined the performance-action link. In order to help small businesses meet their unique challenges, researchers must develop an understanding of how performance outcomes influence subsequent strategic actions.

With this in mind, the domain of this paper is building knowledge about how small business managers and owners interpret their organization's performance. We do not question the logical assumption that small businesses react to their achieved performance. Instead, we focus on how small businesses attach meaning to performance. Viewed in isolation, a performance indicator provides little information. It is only when compared to a reference point that the meaning of achieved performance emerges.

For example, a small business owner may view inventory turnover as a measure of performance. Consider a retailer that turned over its inventory 3 times in a given year. By itself, this information is equivocal. However, when compared with relevant reference points, assignment of meaning becomes possible. The retailer's performance appears strong if the prior year's inventory turnover was 2 times, but weak if the prior year's turnover was 4 times. External comparisons also may be used. Given the inventory turnover ratio of 3, the retailer's performance appears weak if peer retailers averaged 4 times. In contrast, if the inventory turnover ratio exceeds the average peer ratio, it will be seen more favorably. Thus, referents seem likely to play an important role in shaping decision makers' perceptions about an organization's performance.

Early in the history of small business research, Carland, Hoy, Boulton, and Carland (1984) made an important distinction between entrepreneurial firms (EFs) and established small businesses (ESBs). Subsequent research has affirmed that this distinction is meaningful (e.g., Kaish & Gilad, 1991; McGrath & MacMillan, 1992). EFs and ESBs operate in different environments (Hudson & McArthur, 1994), and, thus, have different objectives (Dodge & Robbins, 1992), internal processes (e.g., strategic planning, Matthews and Scott, 1995) and different contracting strategies (Hudson & McArthur, 1994). Given these distinctions between EFs and ESBs, it is likely that they would not find the same performance referents equally relevant. Accordingly, this study explores one research question: (1) are there differences in the performance referents used by EFs and ESBs?

BACKGROUND AND THEORETICAL DEVELOPMENT

Entrepreneurship research long has held that entrepreneurs are different than the owners and managers of established firms (Carland et al., 1984). This distinction is necessary because EFs and ESBs operate in different environments (Hudson & McArthur, 1994). Thus, the skills necessary across contexts are different. ESBs operate in an environment marked by relative equilibrium (Kaish & Gilad, 1991). Typically, products are relatively well developed, markets and distribution channels are established and production is standardized. In contrast, EFs operate in an environment marked by disequilibrium (Kirzner, 1973). EFs often introduce new goods or a new method of production, open new markets or open new sources of supply (Vesper, 1980). Whereas, an ESB may be content with maintaining the status quo, an EF emphasizes profitability and sales growth (Carland et al., 1984).

The Nature of Performance Referents

Entrepreneurs are concerned with identifying clear measures of performance (Jenkins & Johnson, 1997). Indeed, successful entrepreneurs need to receive rapid feedback on their performance in order to monitor the development of their businesses (McClelland, 1987). Entrepreneurs utilize more performance referents than do non-entrepreneurs (Jenkins & Johnson, 1997), but extant research has not examined any differences in the choice of referents.

It would appear that the specific referents used play a key role in determining how managers interpret performance. For example, consider a small business owner deliberating over news of $100 thousand in sales generated during the third quarter. This data is only meaningful when evaluated in terms of relevant performance referents. If the $100 thousand represents a marginal 1% decline over second quarter figures and sales among peers fell an average 12%, managers may believe the existing strategy is superior to their competitors'. Under this scenario, management would be expected to persist with their current strategy. In contrast, if sales among similar organizations rose dramatically, the firm's slight decline appears dismal and would likely promote discussions about a change in strategy. Under both scenarios, the objective data is the same -- $100 thousand in third quarter sales. However, the firm's response depends on comparisons to salient referent points including their own recent performance and the performance of competitors. Thus, insofar as the interpretation of performance shapes subsequent strategic action (Milliken & Lant, 1991), the specific referents used to "make sense" of performance play a critical role in organizational activity.

Companies use a wide variety of performance referents, but how are particular referents chosen? Insights from social comparison theory (Festinger, 1954) suggest that referents are selected if they are similar, relevant, and focus on achievable performance improvements. As a central element of social comparison theory, referents provide a means by which individuals evaluate themselves through comparisons against the opinions and abilities of relevant others (Festinger, 1954). Our understanding of phenomena at the individual level may enrich our understanding of phenomena at the organizational level (Staw, 1991). Although organizations do not literally "think", they are led by collectivities of thinkers, top management groups, (or, in the case of some small businesses, one key decision maker) who develop common understandings of their environment as a basis for directing organizational action (Daft & Weick, 1984). Social comparison theory, therefore, has considerable potential to be applied fruitfully to performance interpretations conducted in small businesses.

Planning Referents

Strategic management is predicated on the importance of planning (Andrews, 1971). Planning develops benchmarks against which performance can be compared (Robinson, Pearce, Vozikis, & Mescon 1984). Thus, small businesses may find great salience in performance referents comprised of unique, internally derived aspirations. Indeed, planning is positively related to performance in small and entrepreneurial firms (Shrader, Mulford, & Blackburn, 1989). Thus, we expect that managers will judge their organization's performance relative to their aspirations. However, we anticipate that EFs and ESBs will place different emphasis on goals as a performance referent.

Carland et al. (1984) noted that EFs have the primary goals of profitability and growth with a long-term intent of market dominance. In contrast, ESBs are likely not dominant in their industry and do not engage in innovative production, marketing, or distribution practices. In addition to the different levels of uncertainty associated with environment of ESBs and EFs, there are likely differences associated with their managers. EFs often will have an owner who exhibits a stronger entrepreneurial orientation, which has been positively related to strategic planning practices (Keats & Bracker, 1988). Indeed, Matthews and Scott (1995) found that EFs exhibited more sophisticated planning than ESBs. Thus, we predict that:

Hypothesis 1: EFs will place greater importance on comparing performance to stated goals than will ESBs.

The time frame associated with performance referents may vary across organizations. Because EFs suffer a distinct liability of newness (Stinchcombe, 1965), survival is a key concern. Thus, short-term goals (e.g., the benchmarks associated with survival) should be an important referent for EFs. In contrast, ESBs operate in a stable environment and make incremental adjustments; thus, short-term goals may be of lesser importance to ESBs than EFs. EFs are growth and future oriented (Carland et al., 1984). In addition, EFs often require external funding to support their growth objectives and these sources often require extensive, long-term plans (Matthews & Scott, 1995). Accordingly, we expect that EFs will find more relevance in long-term goals than will ESBs.

Hypothesis 1a: EFs will place greater importance on comparing performance to short term goals than will ESBs.

Hypothesis 1b: EFs will place greater importance on comparing performance to long-term goals than will ESBs.

National Industry Average Referent

The *modus operandum* in organizational research has been to adopt industry averages as a proxy for the reference point that distinguishes between satisfactory and unsatisfactory performance. Typically, firms with performance above the industry median are compared statistically with those below along an important dimension, such as the riskiness of subsequent actions (e.g., Bromiley, 1991; Fiegenbaum & Thomas, 1988). Although much of this research does not adopt a cognitive view, one important cognitive assumption embedded in the use of an industry average is that it constitutes, or at least approximates, a salient reference point that guides strategic decisions. Strategy researchers who have explicitly incorporated industry average performance referents into their research designs (e.g., Bromiley, 1991; Fiegenbaum & Thomas, 1988) commonly refer their readers to earlier research by Lev (1969) who demonstrated that firms' financial ratios converge toward industry averages. Conventional wisdom, coupled with common research practice, suggests that industry averages are likely to be an important performance referent for many managers. However, EFs and ESBs may not find the industry average equally important.

As mentioned previously, EFs can be distinguished by their emphasis on new goods, new methods of production, new markets and new sources of supply. In addition EFs are sometimes involved in industrial reorganization (Carland, et al., 1984). Individuals utilize referents that they perceive to be most similar to themselves (Festinger, 1954). Because of EFs emphasis on innovation, it is likely that the decision maker(s) at EFs will not see the "average firm" embodied in an industry average as similar to their firms. Thus, we predict:

Hypothesis 2: ESBs will place greater importance on comparing performance to the national industry average than will EFs.

Acquaintances as Referents

An important source of information for entrepreneurs and small business managers can be acquaintances. However managers of EFs and managers of ESBs tend to have different types of acquaintances. Entrepreneurs are more likely to join business-oriented civic organizations to establish credibility for their business. In contrast managers of ESBs join socially oriented civic organizations to enhance personal prestige in the community (Hudson & McArthur, 1994). Because there is more similarity to the firms managed by peers in business-oriented civic organizations, the information gathered from those peers would likely be more relevant. It is, therefore, likely that EFs will find more relevance in referents comprised of their social networks than will ESBs. Hence, we predict:

Hypothesis 3: EFs will place greater importance on comparing performance to firms managed by acquaintances than will ESBs.

METHODS

Sample

Our hypotheses were tested using a sample of small businesses in a large city in the southwestern United States. We had the opportunity to collect data in conjunction with an annual survey conducted by the local chamber of commerce. The chamber's survey was designed to elicit local businesses' views on the area's economic outlook for the coming year. This survey was sent to 1000 randomly selected small businesses (under 500 employees). The cut off of 500 employees or less was established for this study to ensure consistency with extant research and standards established by the U.S. Small Business Administration (1992)

Data Collection

Data on performance referents was collected through a questionnaire distributed to the highest-ranking official (e.g., CEO, Manager, and Owner) at each business. The number of organizations represented by usable responses was 212, or 21.2%, which is comparable to other small business studies (e.g., Matthews & Scott, 1995). Of the usable responses, 148 (70%) were completed by a chief executive officer/president/owner, 15 (7%) were completed by a vice president, 29 (15%) were completed by a general or department manager, and twenty surveys (9%) were completed by other managers. Given that late responders have been shown to similar to non responders, we checked for response bias by comparing the earliest responders to the late responders (Armstrong & Overton, 1977). More specifically, we compared the first 25% of the responses received to the last 25% and found no significant differences on the variables of interest in this study. Thus, we have no reason to believe the there was response bias.

Measures

The correlation table for the variables in this study is presented in Table 1.

Table 1. Correlations Among Study Variables

Referent	Stated Goals	Short Term	Long Term	Nat'l Average	Acquaint-ances
Stated Goals	1.0				
Short-Term Goals	.34***	1.0			
Long-Term Goals	.48***	.36***	1.0		
National Average	.23***	.32***	.26***	1.0	
Acquaintances	.15*	.30***	.24***	.41***	1.0

* = p<.05
*** = p<.001

__Entrepreneurial Firms__. Companies that responded that they expected a major increase in sales (11% or more) in the coming year were judged to be EFs. Of the responding firms, 48 firms were classified as EFs. All other firms were considered to be ESBs. This method for determining the entrepreneurial nature of firms is consistent with Jenkins and Johnson (2000), who used intent to grow sales as an indicator of entrepreneurial firms. Further, support for this operationalization is found in the concept of a small business lifecycle (Dodge & Robbins, 1992) and empirical findings that associated higher growth rates with entrepreneurial firms (Matthews & Scott, 1995). The average respondent expected a marginal increase in sales (between 1 and 5%).

Referents. Using a five-point scale, the small business executives identified the importance of the various performance referents when making performance judgments about their firms (1=referent is not important; 5=referent is very important). The question and referents are presented in the Appendix.

Data Analysis

Multivariate analysis of variance (MANOVA) and subsequent individual analysis of variance (ANOVA) were used to determine if the importance of specific performance referents differed for EFs and ESBs.

RESULTS

MANOVA was used to determine if there were differences in the importance of performance referents between EFs and ESBs. MANOVA is the appropriate technique because the dependent variables are correlated, and because MANOVA controls for experiment-wide error (Hair, Anderson, Tatham, and Black, 1998). The results of the MANOVA indicated that there were differences ($F=1623.4$, $p<.001$). Individual ANOVAs were then performed to determine the exact nature of the differences. Hypothesis 1 suggested that EFs place greater importance on stated goals than do ESBs. As shown in Table 2, this hypothesis was supported. EFs rated the importance of stated goals as 4.51. In comparison, ESBs rated the importance of stated goals as 4.29. The difference is significant at the $p<.03$ level. Hypothesis 1a predicted that EFs would place more importance on short-term goals than would ESBs. This hypothesis received only moderate support. Although EFs did place greater importance on short-term goals than did ESBs (EFs = 4.17, ESBs=3.95), the difference was significant only at the $p<.056$ level. Hypothesis 1b predicted that EFs would place greater emphasis on long-term goals as performance referents than would ESBs. This hypothesis was supported ($p<.015$). EFs rated the importance of long-term goals as 4.6. In contrast, ESBs rated long-term goals importance as 4.35.

We argued in Hypothesis 2 that because of the unique context in which EFs operate, ESBs would find more relevance in the industry average than would EFs. This hypothesis was not supported. ESBs and EFs reported approximately the same importance rating for the average performance of firms in their same industry nationwide (NESB mean=3.51, ESB mean 3.55). It is noteworthy that both EFs and ESBS found this performance referent to be much less important than their internally-generated goals.

Finally, in Hypothesis 3, we predicted that EFs would rate the performance referent of firms managed by acquaintances as more important than would ESBs. This hypothesis was supported. The mean rating for this referent as reported by EFs was 3.59. The mean importance rating for this referent, as reported by ESBs, was 3.26. This difference is significant at the $p<.045$ level.

Again, it is interesting to note that this referent was rated as less important than stated goals by both EFs and ESBs.

Table 2. ANOVA Results

Referent	EF Mean	ESB Mean	F
Stated Goals	4.51	4.29	3.41*
Short Term Goals	4.17	3.95	2.56+
Long Term Goals	4.60	4.35	4.58*
National Average	3.51	3.55	.04
Acquaintances	3.59	3.26	2.89*

+ = p<.10
* = p<.05

DISCUSSION

We sought to identify differences in performance referents used by managers of EFs and ESBs. The results demonstrate that social comparison theory offers powerful insights into referent selection. According to social comparison theory, individuals select referents that: 1) have the most relevance to their immediate behavior; and 2) focus attention on achievable performance improvement (Festinger, 1954). As we examined the specific referents that managers rated as important, we saw evidence of these particular insights. Managers recognized that benchmarks associated with their goals provide an appropriate means to evaluate current effectiveness. The most important referents, both for EFs and NESB, were stated goals, both long term and short term. Interestingly, the long-term goals were rated as most important of all the referents; thus, our findings are consistent with widespread beliefs that organizational effectiveness is enhanced when top management creates, and articulates, long-term oriented strategic visions (Gioia & Chittipeddi, 1991; Oswald, Mossholder, & Harris, 1994).

Small business managers judged industry averages to be relatively unimportant when making judgments about their performance. A common practice among strategy researchers is to assume that a principal role is played by industry averages. Indeed, there are many reasons why industry averages may provide important information to decision makers. The applied finance literature is replete with advice that a firm's key financial ratios are best evaluated against industry averages (e.g., Barren, 1992). Accordingly, the banking industry commonly draws on industry comparisons when making commercial credit decisions (Laudeman, 1994). From a managerial perspective, however, the relevance of industry averages depends on the extent to which the average performing, or central tendency, firm represents actual firms in the industry -- especially the manager's (Dess, Ireland, & Hitt, 1990). In the small business context, managers apparently saw little similarity between their businesses and the industry average. Nonetheless, when testing theory derived from the other organizational sciences, small business researchers should be aware that small business managers might not view the industry average as salient to their decision-making.

This study offers further evidence of the importance of accurate planning and goalsetting. The most important performance referents for both EFs and ESBs were their internally generated goals, both long- and short-term. Given that satisfaction with performance impacts subsequent strategic action, small business owners and managers should set their goals carefully.

Limitations

Although the use of retrospective data collection is not unusual in the organization sciences (Golden, 1997), a limitation is the possible presence of retrospective errors (i.e., misreporting the past -- Golden, 1992). To prevent and reduce their likelihood, the cover letter was designed to motivate managers to provide accurate information (Golden, 1992). Despite this effort, it is possible that managers may have misreported the referents they used.

A second limitation is the operationalization of EFs and ESBs. This means of determining which firms were EFs is highly related to a firm's entrepreneurial intentions (i.e., what the company intended to do) rather than entrepreneurial outcomes (i.e., what the company actually did). Future research should examine whether those firms that realized their entrepreneurial outcomes used different performance referents than those whose entrepreneurial intentions were unrealized.

Future Research

Organizations adapt based on shared interpretations (Ford & Baucus, 1987). Thus, referents are important not only because they are used to interpret performance, but also because the frames they generate play an important role in strategic decision-making and subsequent action (Meyer, 1982; Thomas, Clark, & Gioia, 1993). However, extant research has not examined the direct effects of referent characteristics on small business strategy formulation. Thus, there is considerable appeal in investigating whether or not referents are systematically related to small business strategic choices. External information sources have been linked to changes in an organization's product and service offerings (Thomas, Clark, & Gioia, 1993). Thus, future research could determine whether the distinction between internal and external referents is meaningful when examining the impact of specific referents on strategic actions.

Given that we anticipate that referents are systematically related to strategic choices, future research also could examine the choice of referents and ethicality of decisions. At the individual level, engagement in unethical behavior is influenced significantly by the behavior of referent others (Ford & Richardson, 1994; Trevino, 1986; Zey-Ferrell, Weaver, & Ferrell, 1979). Thus, the choice of referent others may be an important determinant of whether or not a company will act in an ethical manner. Future research should seek to link exclusive reliance on internal referents and unethical behavior.

CONCLUSIONS

There is much we still need to learn about how small businesses interpret their performance and use those interpretations in important decisions. Yet, we do know that the success of future decisions depends upon accurate interpretation of information. Our results have implications for ESBs and EFs. First, we found that ESBs do not place as much importance on comparing performance to stated goals. One implication of these findings is that ESBs owners and managers should be encouraged to place more emphasis on goals setting as a way to avoid stagnation. With regard to EFs, our results suggest that managers of EFs place greater importance on comparing performance to stated goals, both long and short term. Thus, a key task for EFs owners and managers is to develop goals that are short-term indicators of progress toward sustained competitive advantage.

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APPENDIX

Performance Referents:
As you evaluate your organization's performance, how important are the following comparative benchmarks?
1) Your company's stated goals and objectives
2) The short-term financial performance goals of your company
3) The long-term financial performance goals of your company
4) The average financial performance of your industry nationwide
5) Firms managed by people you know socially or professionally.

About the Authors

- **Christopher Shook**, Ph.D., is Assistant Professor of Strategic Management at the University of Texas at Arlington. He received his Ph.D. from Louisiana State University in 1997. Dr. Shook's research has been published in the *Strategic Management Journal, the Academy of Management Journal, Academy of Management Executive, Journal of Management* and *Journal of Small Business Strategy*. His research interests include methodological issues in strategic management research, strategic decision making, venture creation and strategic management in the context of small businesses.

- **Jeffrey E. McGee** is an Associate Professor and the Chair of the Management Department of the University of Texas at Arlington. He teaches courses in strategic management, entrepreneurship, and small business management. His research interests include new business development and the strategic management of small businesses. Dr. McGee holds a Ph.D. in strategic management and entrepreneurship from the University of Georgia. His work has been published in *Management Science*, *Journal of Business Venturing*, *Strategic Management Journal*, *Entrepreneurship Theory and Practice*, *Journal of Small Business Management, Journal of Applied Business Research*, *Journal of Small Business Strategy*, and *Journal of Business & Entrepreneurship*.