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**The impact of internal and external market orientations on firm performance.**

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## **The impact of internal and external market orientations on firm performance.**

### Abstract

The role of internal marketing in developing organisational competencies is identified as a key area for continued research (Rafiq and Ahmed, 2003). One competence of particular interest to marketers is market orientation. This paper examines the impact of internal marketing, operationalised as a set of internal market orientated behaviours (IMO) on market orientation (MO), and consequently organisational performance, and provides the first quantitative evidence to support the long held assumption that internal marketing has an impact on marketing success.

Data from UK retail managers were analysed using structural equations modelling employing LISREL software. These data indicate significant relationships between internal market orientation, employee motivation and external marketing success (market orientation, financial performance and customer satisfaction). Our results also support previous findings indicating a positive impact of external market orientation on customer satisfaction and financial performance. For marketing practitioners, the role of internal market orientation in developing marketing strategies is discussed.

**Keywords:** Market Orientation, Internal Marketing, Internal Market Orientation, Performance, Measurement, SEM

## **Introduction**

Generating, disseminating and responding to customer and competitor information (i.e. being market orientated) is generally accepted as an important organisational competence (Jaworski and Kohli, 1993; Chang and Chen, 1998; Vorhies, Harker and Rao, 1999) and has been shown to have significant benefits for organisational financial performance (Langerak, 2001; Matear, Osborne, Garrett and Gray, 2002). Whilst much is known about what market orientation is and does, relatively little attention has been dedicated to understanding its antecedents. Consequently, whilst companies know that they have to develop a market orientation, the means to do so are not apparent. A review of the extant literature identifies several mechanisms that have been suggested to give rise to higher levels of market orientation (Bansal, Mendelson and Sharma, 2001), although empirical evidence to support these claims is lacking. Internal marketing is one such mechanism, and a common view amongst scholars is that internal marketing will enable employees to behave in a more market oriented manner and motivate them to do so (Grönroos, 1985; Gummesson, 1987; Piercy and Morgan, 1990; Harris and Piercy, 1999). George and Grönroos (1991) suggest that internal marketing is a philosophy for satisfying and motivating employees based on a marketing perspective; it is based on the belief that satisfied and motivated employees are essential if customers are to be satisfied. Lings and Greenley (2005), report five managerial behaviours (internal market orientation) associated with implementing the internal marketing philosophy. These behaviours relate to internal market research, internal communication, and the development of job-products to satisfy the wants and needs of employees. Although Lings and Greenley (2005) report that IMO has positive consequences for some employee behaviours, its much mooted impact on market orientation (see for example Harris, 2002; Harris and Piercy, 1999) remains unconfirmed. The impact of internal market orientation on market orientation, and the combined impacts of these internal and external orientations on performance (e.g. profitability, and customer satisfaction) continue to be signalled as important areas of study (see for example Gounaris, 2006)

Our study examines the role of internal market orientation in developing an external market orientation and seeks empirical evidence of the impact of internal marketing (operationalised as IMO) on market orientation within the established nomological network. See figure 1.

[INSERT FIG 1 ABOUT HERE]

Figure 1: IMO and Market Orientation within a nomological network

### ***Market Orientation***

Prior to any examination of market orientation it is essential to establish the conceptual background of market orientation used in this study. The majority of literature examining market orientation takes one of two views, (Homburg and Pflesser, 2000). In the first, market orientation is viewed as a business philosophy representing the marketing concept (see for example Webster, 1992; Lichtenthal and Wilson, 1992). In the second, market orientation is seen as a set of behaviours representing the implementation of the marketing concept (see for example Narver and Slater, 1990; Kohli and Jaworski, 1990; Slater and Narver, 1994; Kohli, Jaworski and Kumar, 1993). As we are particularly interested in the development of internal marketing activities on the behaviour of front line service staff we adopt a behavioural perspective to market orientation and follow the conceptual foundation of Jaworski and Kohli (1993) that market orientation consists of a set of organisation wide behaviours associated with implementing the marketing concept. Although specific nomenclature varies, within the behavioural camp of market orientation, there appears to be broad consensus that market orientation involves the collection of market information, its analysis and dissemination and an appropriate response to that information. See for example Day and Wensley, (1988); Narver and Slater, (1990); Kohli and Jaworski, (1990); Deng and Dart, (1994); Hunt and Morgan, (1995); Sigauw, Simpson and Baker (1996) and Wright, Pearce and Busbin (1997). This is represented in an operationalisation of market orientation by Kohli and Jaworski (1990), who consider market orientation to be the organisation wide generation, dissemination and responsiveness to market information.

Jaworski and Kohli, (1993) first operationalised market orientation using a 32-item scale measuring information generation, dissemination and response, and later modified this to a shortened version (Kohli, Jaworski and Kumar, 1993). This conceptualisation and operationalisation of market orientation has been shown to be robust under several different research contexts (see for example Pitt, Caruana and Berthon, 1996; Martin, Martin and Grbac, 1998; Siguaw, Simpson and Baker, 1996; Vorhies, Harker and Rao, 1999). Several adaptations of the scales have also been employed and found to be robust (see for example Baker and Sinkula, 1999; Wood, Bhuian and Kiecker, 2000; Cadogan, Paul, Salminen, Puumalainen and Sundqvist, 2001).

#### *Consequences of Market Orientation*

The positive role of market orientation in the firm is also widely supported, (see for example Jaworski and Kohli, 1993; Chang and Chen, 1998; Vorhies, Harker and Rao, 1999). It is reported to have both financial and non-financial consequences for the firm [see (Langerak, 2003) for a comprehensive review of the business consequences of market orientation]. Of particular interest here; MO has been shown to have positive consequences for the profitability of the firm (see for example Avlonitisa and Gounaris, 1997; Homburg and Pflesser, 2000; Matear et al., 2002; Langerak, 2001). MO has also been shown to be related to employees' attitudes and behaviours (see for example Ruekert, 1992; Jaworski and Kohli, 1993; Siguaw, Brown and Widing, 1994; Piercy, Harris and Lane, 2002; Jones, Busch and Dacin, 2003) and customers' attitudes and behaviours (see for example Qu and Ennew, 2003; Singh and Ranchhod, 2004; Kaynak and Kara, 2004).

*Market Orientation and Employees.* There is strong evidence to support the relationship between market orientation and employee attitudes and behaviours; however, the causal direction of this relationship remains unclear. Several authors report that market orientation has positive consequences for employee behaviours such as customer orientation, job satisfaction, organisational commitment and role stress (see for example Ruekert, 1992; Jaworski and Kohli, 1993; Siguaw, Brown and Widing, 1994; Piercy, Harris and

Lane, 2002; Jones, Busch and Dacin, 2003). However, others argue that effective market oriented activities require the motivation and participation of employees at all levels of the firm, and in all functions (Gummesson, 1991; Kelley, 1992; Harris, 1998; Martin, Martin and Grbac, 1998). In order to engage employees in the adoption of a market oriented strategy, it is essential that they are motivated to perform in a market-oriented manner, (see for example Harris, 2002). Given the organisation wide nature of market orientation (all employees act in a marketing capacity and generate and disseminate information and respond in a customer focused manner) it is plausible that employees who are motivated will be more likely to undertake these positive behaviours and act in the best interest of the firm. Consequently we hypothesise that:

**H<sub>1</sub>:** The more motivated front line staff are, the greater the firm's market orientation

*Market Orientation and Customers.* The market sensing and responding competencies implied by high levels of market orientation result in highly market oriented firms knowing what their customers want and what the market offers, and responding with a service or product that meets the needs of target customers better than competing offerings. Consequently, the success of a market-oriented strategy can be measured in terms of the customer satisfaction that it generates. (see for example Web, Webster and Krepapa, 2000; Qu and Ennew, 2003; Kaynak and Kara, 2004; Singh and Ranchhod, 2004; Caruana and Calleya, 1998), As a consequence of increased customer satisfaction, it is reasonable to assume that repeat purchase and customer loyalty would be enhanced, and consequently profitability. (see for example Maydeu-Olivares and Lado, 2003) These observations lead us to our second hypothesis:

**H<sub>2</sub>:** The greater the firm's market orientation, the higher the satisfaction of customers.

**H<sub>3</sub>:** The greater the firm's market orientation, the more profitable the firm will be.

#### *Antecedents to Market Orientation*

Tuominen and Möller, (1996) emphasise the role of management in developing appropriate systems and structures to create market-orientated behaviours. They suggest that organisational systems, including recruitment, training and rewards systems impact the adoption of MO within the firm (see also Ruekert,

1992). Harris (2002) argues that managerial behaviours (such as internal market orientation) are a major determinant of market orientation success (see also Harris and Piercy, 1999). At this juncture, it appears that training and motivating employees to perform market-oriented behaviours is a major consideration for organisations wishing to implement the marketing philosophy (Jaworski and Kohli, 1993; Heskett, Jones, Loveman, Sasser and Schlesinger, 1994). Internal marketing has long been discussed as a means of motivating employees to perform customer focused and market oriented behaviours (see for example Azzolini and Shillaber, 1993; George, 1990; Gummesson, 1987; Harari, 1991, 1993; Harrell and Fors, 1992; Piercy and Morgan, 1991; Piercy, 1995; Mohr-Jackson, 1991). However, there is a lack of empirical evidence to support this assertion (Conduit and Mavondo, 2001).

This paucity of systematic research into the role of internal marketing and its impact on company performance, both directly and by facilitating market orientation in the firm, suggests the need for information concerning the internal marketing – external market orientation link.

### ***Internal Marketing***

Internal marketing is grounded in the belief that external marketing success is, in part, contingent on the firm having satisfied and motivated boundary-spanning employees (see for example Sasser and Arbeit, 1976; Berry and Parasuraman, 1991; Greene, Walls and Schrest, 1994). Recent advances in the field of internal marketing have led to the identification of behaviours associated with internal marketing, their conceptualisation as a multidimensional internal market orientation construct, and the development of an instrument to measure these (Lings and Greenley, 2005). IMO is reported to have several important consequences for the firm. Firstly IMO is thought to influence employee attitudes and behaviours, in particular employee motivation to provide good customer service (Tansuhaj, Randall and McCullogh, 1988; Comm, 1989). Consequently;



**H<sub>4</sub>** : The higher the level of IMO exhibited by managers, the greater the motivation of service staff to provide exceptional service.

IMO behaviour displayed by managers is thought to foster employee identification with the organisation, and to reduce their dysfunctional behaviours, such as service sabotage or false reporting (Ramaswami, 1996). In addition to reducing dysfunctional behaviours, internal market oriented behaviour increases behaviours, which are compliant with organisational strategies (Piercy and Morgan, 1990).

The market sensing, communication and responding capabilities implied by the internal market orientation construct represent the facilitation of information transfer between front line employees (who are also important sources of market research information) and managers (Ballantyne, 2003), a consequence internal market orientation is expected to have a positive impact on the information generation dimension of market orientation, as the route for market information to be communicated to managers becomes more utilised and routine. Furthermore, the adoption of internal market orientation within the organisation results in employees being better informed and motivated to carry out the strategic responses of the firm to its market (Rafiq and Ahmed, 1993; Wasmer and Brunner, 1991). Consequently IMO is expected to have a positive impact on the responsiveness dimension of market orientation (Piercy, 1995; Naude, Desai and Murphy, 2003).

Consequently we hypothesise:

**H<sub>5</sub>**: The higher the level of IMO exhibited by managers, the greater the market-orientated behaviour of the firm.

In addition to its impact on employees, and perhaps as a result of this, IMO is suggested to have important consequences for customer attitudes and behaviours. Motivating employees to deliver exception service is thought to be a key determinant of customer satisfaction. This relationship has been discussed for more than two decades (see for example George, 1977) and, although widely accepted, it remains a

contentious issue (Piercy, 1995; Rafiq and Ahmed, 1993) with limited literature exploring the exact nature of the relationship between the two constructs. Despite this lack of empirical evidence, most researchers operate under the belief that employee satisfaction and customer satisfaction are significant and positively correlated.

We hypothesise therefore that:

**H<sub>6</sub>** : The higher the motivation of employees , the greater the satisfaction of customers.

And

**H<sub>7</sub>** : The higher the level of customer satisfaction, the greater the financial performance of the firm.

### ***Method***

We collected data to examine the relationship between the constructs in our study by means of a survey. A total of 3,500 retail managers from a wide range of retail organisations, all providing multiple product lines, were surveyed. These included supermarkets, department stores, clothing retailers, and retailers of health and beauty products. Retailers were chosen on the basis that their advertising and other corporate communications made explicit statements about high levels of customer service, and emphasised service personnel as a factor differentiating them from competitors. Store managers were chosen as respondents because of their unique influence on the achievement of organisational objectives. At the local level, store managers act simultaneously as a merchandiser, salesperson, financial officer, marketer, researcher, strategist and supervisor of other employees (Lusch and Serpkenci, 1990). This range of activities makes store managers knowledgeable respondents for performance measures. It is the behaviours of the store manager that constitute internal market orientation. The majority of previous studies examining market orientation have been conducted using data collected at the strategic business unit (SBU) level (Uncles, 2000). Using store managers to report on levels of market orientation is consistent with this approach as, in this instance, the retail store can be thought of as the SBU equivalent.

All respondents received a package containing a letter explaining the purpose of the study, the questionnaire and a return envelope. Reminder notices were posted two weeks after the initial mailing. A response rate of 22 percent was achieved (828 completed questionnaires, 766 usable). Respondents were roughly equally split between male and female managers (male 57.4 percent, female 42.6 percent). Ages ranged from 20 years to 61 years, with a mean of 36.6 years ( $\sigma = 8.6$ ), the mean length of service with the company was 13.8 years ( $\sigma = 7.6$ ).

### ***Measures***

IMO was measured using the scale reported by Lings and Greenley (2005). This scale consisted of 16 items measuring the five behavioural components of IMO (4 items measuring informal information generation, 3 items measuring formal face to face information generation, 3 items measuring formal written information generation, 3 items measuring information dissemination, and 3 items measuring responsiveness).

Market orientation was measured using an adaptation of the MARKOR scale (Kohli, Jaworski and Kumar, 1993).

Performance was measured using managers' subjective evaluations of their achievement of financial objectives and internal and external marketplace success. The distinction between objective and subjective measures lies in whether the measure is based on empirical observation or, alternatively, on beliefs, perceptions, or attitudes (Wang and Gianakis, 1999). Subjective evaluations of performance were used in preference to objective measures, as in this context it was felt that managers' day-to-day behaviours would be driven by their beliefs about the performance of their store, rather than an objective evaluation of their performance.

A comparison of the mean values for key items of interest revealed no significant differences between early (those who responded within the first 3 days) and late (those who responded after the follow up) respondents. In addition 50 randomly selected non-respondents were contacted by telephone and asked why

they had not responded. The main reasons given were that they did not receive the questionnaire and that time pressure prevented participation in the survey. None of these reasons suggests that non-response bias was an inhibiting factor in the analysis and interpretation of the data (Leslie, 1972; Armstrong and Overton, 1977).

## **Results**

To be consistent with other research examining the impact of market orientation, scores for each generation, dissemination and responsiveness were computed by averaging the scores for all item included in each of the subscales, and market orientation was modelled as a higher order construct. A similar approach was taken to modelling IMO. Scores for each of the five dimensions of IMO were calculated by averaging the scores for the items associated with each dimension and then IMO was modelled as a higher order construct. The psychometric properties of these new scales were tested and found to be acceptable i.e. coefficient  $\alpha$  for each scale and composite reliabilities of each of the scales exceed the recommended minima suggested by Churchill (1999), Gerbing and Anderson (1988) and Hair et al. (1998, p.611). (See Table 1:

[INSERT TABLE 1 ABOUT HERE]

Table 1: Coefficient alpha and composite reliability for scales used in the study

Following this a structural model was estimated to examine the relationships between the constructs in the hypothetical model show in Figure 1. The theoretical model yielded the following fit statistics. The Chi square statistic was 237.7,  $df = 163$ ,  $p = 0.00$ . Although the Chi square statistic is not significant it is susceptible to large sample sizes and under such circumstances the relative chi square ( $\chi^2/df$ ) may be used to indicate the adequacy of fit of the model to the data. The relative chi-square for the model is 1.46. A ratio in the range 1-2 suggests an adequate fit between the theoretical model and the sample data (Carmines and McIver, 1981, p.80). The goodness of fit statistic were GFI=0.913, IFI=0.996, CFI=0.995, RMSEA=0.029, StRMR=0.049. All exceed the recommended cut offs for these measures of model fit. The next stage of analysis was to examine the path coefficients for the hypothesised relationships in the model.

These are presented in Table 2.

[INSERT TABLE 2 ABOUT HERE]

Table 2: Maximum likelihood estimates of structural parameters and model fit statistics

[INSERT FIGURE 2 ABOUT HERE]

Figure 2: Maximum likelihood estimates of hypothesized model

### ***Discussion***

The results of the model estimated above illustrate the roles of both internal and external market orientations in retailing organisations. Specifically, our results confirm the findings of other researchers who have examined the impact of market orientation on organisational performance in other contexts (see for example McCullough, Heng and Khem, 1986; Narver and Slater, 1990; Ruekert, 1992; Day and Nedungadi, 1994; Pelham and Wilson, 1996; Vorhies, Harker and Rao, 1999). We provide additional quantifiable evidence of the impact of market orientation on financial performance, in the context of retail stores in their local environment.

We also find support for the many assertions that internal market orientation has a significant role to play in retail service organisations. Specifically, our data support assertions that internal market orientation has a significant positive impact on external market orientation (Hypothesis 4) and employee motivation (Hypothesis 3). This addresses the limitations of current research in this area and supports the notion that creating market oriented organisations requires a balanced internal and external focus (Piercy, 1995). Our findings suggest that managerial behaviours associated with viewing employees as being important enough to warrant attention to their wants and needs does indeed create a more motivated workforce. This, in turn, has positive consequences for customer satisfaction (Hypothesis 5) and profitability (Hypothesis 6). Also, we find that employee focused IMO behaviours give rise to higher levels of market focus in the work force as evidenced by increased market orientation. Interestingly the data do not support the moderating role of

employee motivation in this relationship (Hypothesis 1), rather they suggest that internal market orientation has a direct impact on external market orientation.

Our data also support the assertion that market orientation has positive consequences for customer satisfaction (Hypothesis 2), suggesting that consumers do notice organisations efforts to identify and meet their needs. We also find support for the relationship between customer satisfaction and profitability (Hypothesis 6). This is particularly important as both internal and external market orientation involves investment of resources, both financial and non-financial, and most organisations seek some financial return on this investment.

### ***Implications for Theory and Directions for Further Research***

The contributions of this study are manifold. One major contribution is the presentation of the first empirical evidence supporting the positive correlation between internal and external market orientations. Although it is not possible to unambiguously infer causal direction from structural equations models, our results, in conjunction with theoretical arguments, suggest that internal market orientation plays an antecedent role in the adoption of an external internal market orientation. The ability of the organisation to generate, disseminate and respond to information may represent an underlying capability of the firm; applying these capabilities to the internal market of service employees and the external market of service customers represents the stakeholder focus of the firm. (Greenley and Foxall, 1997). Examining the associations between internal market orientation and other external orientations of the firm may prove a fruitful area of further research to elucidate further mechanisms by which internal market orientation may influence the external market. Additionally, a longitudinal study, examining the impact of internal market orientation initiatives undertaken by an organisation, would provide further evidence of the causality between in the intern and external orientations and the direct consequences of such an initiative on service employees.

This study also provides evidence that, despite their conceptual similarities, internal and external market orientations are distinct constructs, both representing capabilities in information generation, dissemination and responsiveness of the firm. Given the prevalence of alternative conceptualisations of market orientation (see for example Narver and Slater, 1990) it would be beneficial to replicate this study using an alternative operationalisation of market orientation to provide additional support for the beneficial association between the internal and external foci of the firm.

Finally, the major limitations of this work arise from the use of retail managers as the sole respondents used. Despite being knowledgeable respondents, managers can only report their opinions of how staff and customers behave and so deduce how motivated and satisfied they are. If possible, any replications of this work should collect data directly from these stakeholders in a matched triadic study. Although obtaining such matched data would be challenging, and would come with its own set of limitations (such as obtaining responses from customers that relate to specific staff members and not to their overall evaluations of the service), such data would better represent the actual attitudes of employees and customers.

In the same vein, managers were used in this study to report their subjective views of the performance of their operations. As discussed earlier, subjective views do have the advantage of linking directly with managers' behaviours; however, more objective measures of performance may provide additional insights into the impact of both internal and external market orientations.

Finally, all data in this study were collected from a relating environment. Further replications need to examine other service contexts to provide additional support for the generalisability of the findings reported here.

### ***Implications for practice***

Our findings have important implications for the management of market focused service organisations. Firstly, they suggest that, in addition to understanding the external market, services managers must develop a

better understanding of the wants and needs of employees. Managers need to enhance their listening skills and learn to generate information about the wants and needs of employees using formal and informal techniques. Service organisations also need to facilitate the dissemination of this information throughout the organisation and to encourage debate regarding the most appropriate response to employees' wants and needs, and how best to balance these with the objectives of the firm.



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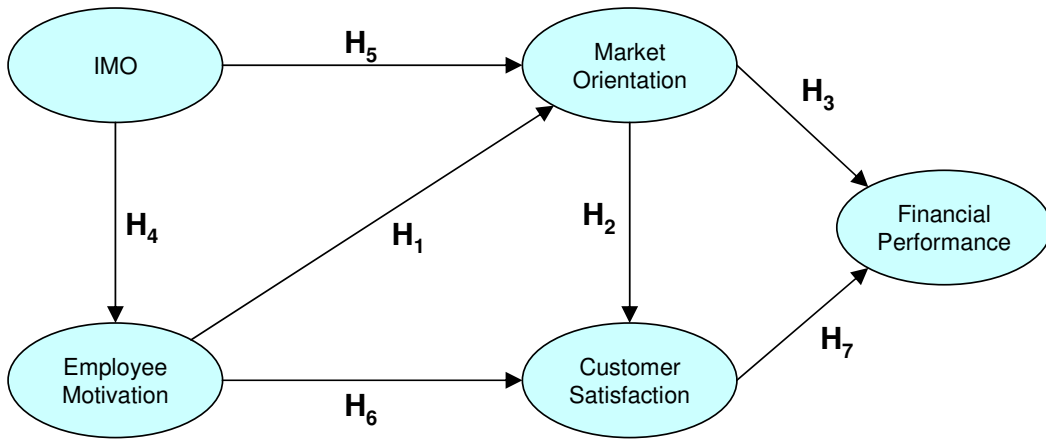


Figure 1: IMO and Market Orientation within a nomological network

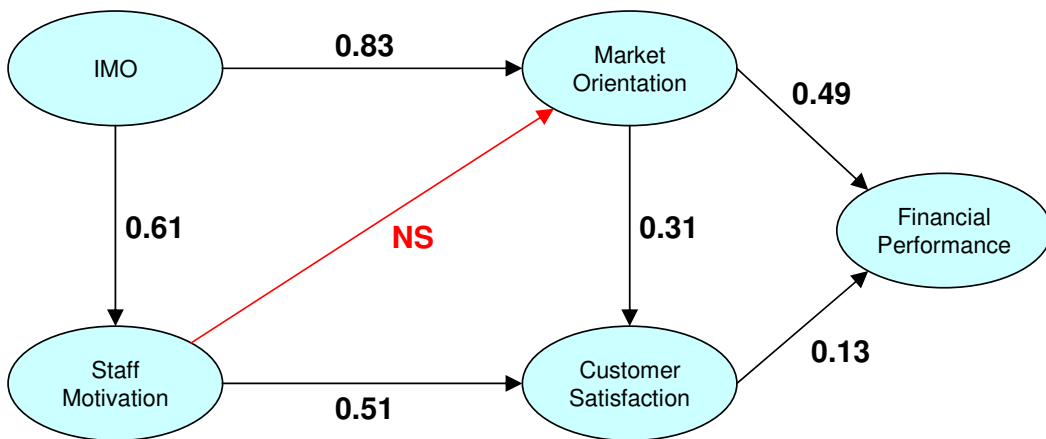


Figure 2: Maximum likelihood estimates of hypothesized model

Scale	Coefficient $\alpha$	Composite Reliability
Internal Market Orientation (5-items)	0.794	0.801
Market Orientation (3-items)	0.757	0.755
Financial Performance (4-items)	0.786	0.788
Customer Satisfaction (4-items)	0.871	0.870
Employee Motivation (4-items)	0.863	0.869

Table 1: Coefficient Alpha and Composite Reliability for scales used in the study

Hypothesis	Hypothesized Path	Standardized Coefficient	t-value
Hypothesis 1	Employee Motivation $\rightarrow$ (+) Market Orientation	Ns	
Hypothesis 2	Market Orientation $\rightarrow$ (+) Customer Satisfaction	0.305	3.641
Hypothesis 3	IMO $\rightarrow$ (+) Employee Motivation	0.613	7.530
Hypothesis 4	IMO $\rightarrow$ (+) Market Orientation	0.830	7.207
Hypothesis 5	Employee Motivation $\rightarrow$ (+) Customer Satisfaction	0.505	6.057
Hypothesis 6	Customer satisfaction $\rightarrow$ (+) Financial Performance	0.133	1.368
Hypothesis 7	Market orientation $\rightarrow$ (+) Financial Performance	0.494	4.391

$\chi^2 = 190$ ,  $df = 163$ ,  $n = 200$ , Goodness of Fit Index (GFI) = 0.913, Adjusted Goodness of Fit Index (AGFI) = 0.888, Standardized RMR = 0.049, Root mean square error of approximation (RMSEA) = 0.029

Table 2: Maximum likelihood estimates of structural parameters and model fit statistics