Causation or covariation: an empirical re-examination of the link between TQM and financial performance

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Received 11 February 2003; received in revised form 1 January 2004; accepted 25 February 2004
Available online 30 April 2004

Abstract
Total Quality Management (TQM) is an integrated management system designed to focus an organization’s resources on increasing the quality of a firm’s products/services, satisfying customer needs and improving the efficiency of the processes that produce the firm’s products/services. Advocates of TQM have suggested that there should be a positive relationship between implementing TQM practices and financial performance measures. The empirical evidence supporting this assertion, however, is limited at best. Most of the research has been limited to surveys of managers’ perceptions of the effect of TQM on financial performance. A few empirical studies using financial performance measures have been done, and have shown that TQM firms have better financial performance than other firms. However, better performing companies may be more likely to adopt TQM, so that rather than being a path to improved financial success (causation), TQM merely “comes along for the ride” (covariation). This study examined the relationship between TQM and financial performance, using a sample of Baldrige Award winners and replicated with a second sample of state quality award winning companies, and three different sets of financial performance measures. Both Baldrige and state quality award winners generally had better financial performance than their peers after winning a quality award, and before.

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Keywords: Quality; Financial performance; Empirical research

1. Introduction
Total Quality Management (TQM) is a set of management methods and tools focused on providing superior value to the customer through identification of customers’ expressed and latent needs, responsive-
Other studies have examined TQM failures and the various precursors to such outcomes (Murugesh et al., 1997), still other studies have explored the combined impact of TQM and other initiatives like JIT (Sriramavasu and Gupta, 1997; Flynn et al., 1995), business process re-engineering (Gonzalez-Benito et al., 1999) and other types of business innovation (Martinez-Lorente et al., 1999) on various aspects of business performance such as worker productivity, cycle times, defect rates and competitive advantage (Flynn et al., 1995). While these studies do seem diverse, the unifying empirical question underlying much of this literature stream seeks to determine if TQM actually impacts firm performance and if so, how.

Advocates of TQM have suggested a link between the implementation of TQM methods and financial performance based on the costs associated with poor quality, rework, and warranties. In essence, rather than increasing costs, improving quality should actually reduce costs, and therefore have a positive effect on measures of financial performance. In addition, increasing the quality of the product or service should increase the retention rate for current customers and attract new customers, thereby improving market share and revenues (Rust et al., 1994, p. 5; Jaworski and Kohli, 1993; Kohli and Jaworski, 1990; Narver and Slater, 1990; Slater and Narver, 1995; Sterman et al., 1997). Further, superior quality products or services should also produce greater customer loyalty, higher stock prices, reduced service calls, and greater productivity (Omachonu and Ross, 1994, p. 14; Hendricks and Singhal, 1996; Rust et al., 1994, p. 1).

The purpose of this study is to re-examine the link between TQM and financial performance both in the literature and through additional empirical examination. This paper builds on and improves on previous studies in the following ways. First, this paper compares the financial performance of each quality award winner against its entire SIC group. Second, financial performance is compared against the reference group both before and after winning a quality award. Third, three sets of financial performance measures are used to evaluate performance. Finally, we replicate our results using a sample of state quality award winners.

2. Literature review

The basic theoretical foundation for the link between the effective implementation of TQM methods and financial performance is based on two expected relationships. First, TQM focuses on the organization’s efforts to create and retain customers, which leads to increased revenues by gaining a market advantage, and reduced costs through product design efficiency. Second, TQM focuses on the organization’s efforts to improve the processes that produce their products and services, which leads to increased revenues through product reliability, and reduced costs through process efficiency (George and Weimerskirch, 1998, p. 7; Reed et al., 1996; Anderson et al., 1995). In short, doing the right thing, and doing it more efficiently, should have a positive effect on many measures of the financial performance of the firm. The conceptual model of TQM is shown in Fig. 1.

![Fig. 1 TQM and financial performance model.](image-url)
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