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Dark side of investment in employee education in privately-held companies

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ABSTRACT

Using a sample of over half a million observations, we explore how investment in employee education affects cost of debt of privately held companies. Findings indicate that, although employee education does help enhance firm performance, it results in a higher cost of debt. However, this negative effect of employee education on cost of debt is weakened by better regional development.

1. Introduction

Employee education has been widely explored in the management literature (Becker and Huselid, 2006; Guest et al., 2003; Georgiadis and Pitelis, 2016), and is intended to increase the productivity and efficiency of individual workers and ultimately boost firm performance. It is also perceived as a way to improve employees' attitude and commitment toward their employers. According to social exchange theory (SET), investment in employee education by firms could enhance employee engagement in positive and fulfilling ways, enhance employees' dedication and focus, and prompt them to devote extra effort to their jobs (Frank et al., 2004; Meyer and Allen, 1991; Schaufeli et al., 2002).

While existing studies (Sejits and Crim, 2006; Harter et al., 2002; Kumar and Pansari 2014, 2016) provide consistent evidence for the positive effect of employee education on firm business outcomes, the perception of investment in employee education by potential capital providers has never been explored. In addition, considering that managers decide the amount of investment in employee education, previous studies might have neglected a potential dark side of employee education: managers can please employees through education and gain their support to become further entrenched.

In this study, we attempt to fill this gap in the finance literature by addressing two specific research questions. First, we ask whether, and if yes how, lenders price debts by incorporating a firm's investment in employee education. Second, we ask whether lower level of information asymmetry and better regional development, including legal environment, can moderate lenders' perception of employee education, due to the high risk of managers engaging in opportunistic behavior. We use a sample of 578,794 firm-year observations from non-listed Chinese companies during the 1998–2012 period for the empirical analysis. The findings suggest that although employee education can benefit firm performance, lenders are more likely to view employee education negatively, seeing it as a tactic to strengthen management entrenchment for opportunistic behavior and raise the cost of debt. We consistently find that methods to reduce opportunistic managerial behavior, such

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as lower level of information asymmetry can alleviate the negative view of employee education from lenders, and reduce the cost of debt accordingly. Our findings contribute to the existing literature in the following respects. First, there is a consensus in the existing literature that employee education helps improve firm performance. However, we add to the finance literature by proposing a new and opposite channel through which employee education strengthens management entrenchment, presents a negative image to outside lenders, and raises the cost of debt. Second, we extend the literature on corporate governance by indicating that investment in employee education can be a way to please employees and thus gain their support and commitment to further management entrenchment. The findings therefore alert corporate monitors to the side effects of managerial investment in employee education.

The remainder of this paper is structured as follows: Section 2 reviews the literature and develops two hypotheses. Section 3 introduces our sample and research methods, followed by Section 4 in which the empirical results are presented. Section 5 concludes the paper and suggests future research directions.

2. Hypothesis development

2.1. Employee education, employee engagement, and firm performance

Employee engagement measures the extent to which employees express themselves "physically, cognitively, and emotionally" in their work role (Kahn, 1990: p.694) and deliver their commitment to the firm (Meyer and Allen, 1991). Schaufeli et al. (2002) also noted that employee engagement is positive and fulfilling, and drives employees' dedication and focus. Frank et al. (2004) defined engagement as the amount of discretionary effort that employees spend in their job. A more comprehensive definition is proposed by Kumar and Pansari (2014), who see employee engagement as a dynamic process that encompasses all attitudes and behaviors towards the organization. Although there is no consensus on how to define employee engagement (Roof, 2015), most scholars agree that employee engagement has a positive effect on firm business outcomes (Sejits and Crim, 2006; Harter et al., 2002, Kumar and Pansari 2014, 2016). In 2013, a Gallup survey reported that 22% of U.S employees are fully engaged in their work, and that their efforts result in 7% increases in revenue (Vitt, 2014; Kumar and Pansari, 2016). On the flipside, a large proportion of disengaged employees can cause significantly reduced revenue. In addition, in the US the engagement gap is estimated to result in lost productivity equivalent to US$300 billion annually (Bates, 2004; Johnson, 2004; Kowalski, 2003; Saks, 2006).

This varied level of employee engagement raises the question: what motivates an employee to be engaged? Saks (2006) argued that SET provides a strong theoretical foundation to understand this issue. The theory claims that relationships among parties evolve over time via interaction those results in obligation. Under this framework, as employees obtain more resources (such as salaries, bonuses, and training) from the organization, they feel obliged to contribute more to the organization through a higher level of engagement (Cropanzano and Mitchell, 2005). In addition, the level of engagement depends on the amount of resources that the employees receive from the organization. Employee education encompasses the extra resources beyond salaries that a company directly spends on their employees, including their care and value of their workers, and the potential firm- and industry-specific knowledge and human capital that employees can build up. The Randstad Pharma Engagement Study, a biannual research report, found that educational investment in employee careers was a factor driving pharmaceutical/biotech employee engagement (PR Newswire, 2013).[1]

Shore and Tetrick (1995) showed that developmental experience such as training and education that organizations provide for employees can increase their support for the organization, and enhance their engagement. Thus, higher spending on employee education is expected to correspond with a higher level of employee engagement. An engaged employee is enthusiastic about his or her work and exudes the positive emotion towards customers, resulting in higher levels of service satisfaction (Harter et al., 2002). Sejits and Crim (2006) maintained that compared with those that are disengaged, highly engaged employees believe that they can improve the quality of their firm's product, enhance customer service and reduce costs in their job. At the firm level, high employee engagement is seen as a competitive advantage over other firms, and contributes to profitability and better financial performance (Harter et al., 2002; Kumar and Pansari, 2014, 2016).

2.2. Employee education and management entrenchment

Although the organization (or owner) offers the training resource to its employees, the top management team determines the amount of training resource that is allocated. According to SET, when they are given larger amounts of training resources, employees will also feel obliged to provide greater support and loyalty to top management, which can lead to greater management entrenchment. Surroca and Tribo (2008) found that entrenched managers can seek to please their stakeholders (in our case, employees) to strengthen their entrenchment, because stakeholders can participate in costly boycott and media campaigns (Baron, 2001; Feddersen and Gilligan, 2001; John and Klein, 2003), which can exert great pressure on board directors to dismiss managers. In addition, if entrenched managers have a good relationship with their stakeholders, the company will be less attractive to potential acquirers in the market due to future profit concerns (Surroca and Tribo, 2008).

[1] Detailed information can be retrieved from http://www.prnewswire.com/news-releases/pharmaceutical-and-biotech-professionals-flexibility-and-continuing-education-are-key-to-employee-engagement-214739831.html.