Journal of Business Research 76 (2017) 24–33

Contents lists available at ScienceDirect

Journal of Business Research

Cure or curse: Does downsizing increase the likelihood of bankruptcy?

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A R T I C L E I N F O

Article history:
Received 24 June 2016
Received in revised form 10 March 2017
Accepted 10 March 2017
Available online xxxx

Keywords:
Downsizing
Bankruptcy
Organizational change
Resource-based view
Intangible resources

A B S T R A C T

Downsizing is a common organizational practice, yet research on the outcomes of downsizing has produced mixed findings. To contribute to this debate, we use an organizational change perspective to investigate whether the large-scale changes inherent in downsizing set firms on a negative path that is difficult to overcome and ultimately increases the likelihood of bankruptcy. Additionally, we investigate what factors, if any, can mitigate this likelihood. To do so, we build on the resource-based view to suggest that valuable resources can reduce the likelihood that downsizing will lead to bankruptcy. We find support for our theorizing across a sample of publicly traded firms. Our findings suggest that downsizing firms are significantly more likely to declare bankruptcy than firms that do not engage in downsizing and that intangible resources help to mitigate this likelihood. We do not, however, find support for the role of physical and financial resources in preventing bankruptcy.

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1. Introduction

“To stay afloat, companies have cut costs by announcing layoffs and slashing their spending on projects.” (Gensler, 2016).

“GoPro Inc. is cutting 15% of its workforce after attempts to expand beyond its core business of action cameras failed to gain traction.” (Wells, 2016).

Statements such as these are prevalent in the business press and downsizing has become a part of the ongoing life of organizations (Jung, 2015). Irrespective of their current financial positions, firms of all types engage in employee downsizing to reduce their costs, adjust their structures, and create leaner more efficient workplaces (George, 2014; Lewin, Biemans, & Ulaga, 2010). Despite its continued and frequent use, research on downsizing continues to yield mixed results. Proponents of downsizing argue that downsizing is an effective strategy with benefits such as performance and sales increases (De Meuse & Dai, 2013; Love & Nohria, 2005; Yu & Park, 2006). Yet, other studies point to negative consequences for firms and employees, with results demonstrating that firm performance, productivity, and customer satisfaction tend to decline after downsizing (Goesaert, Heinz, & Vanormelingen, 2015; Guthrie & Datta, 2008; Lewin et al., 2010). Further, surviving employees can experience a variety of adverse effects including decreased morale, greater job insecurity, decreased creativity, and increased stress and burnout (Fisher & White, 2000; Niehoff, Moorman, Blakely, & Fuller, 2001; Probst, 2003; Probst, Stewart, Gruys, & Tierney, 2007; Rusaw, 2004; Shaw, Duffy, Johnson, & Lockhart, 2005).

These mixed findings suggest that important questions about what contributes to the viability of downsizing remain unanswered. To add to this line of inquiry we theorize that, while capable of producing positive returns, downsizing may have unintended consequences that are not fully captured in prior studies. Specifically, we build on the organizational change literature to suggest that downsizing disrupts organizations, increasing the likelihood of bankruptcy. Thus, it is essential for managers to understand what might mitigate these negative consequences and prevent their firms from declaring bankruptcy. In this study, we investigate whether firms' resources might lessen the likelihood of bankruptcy by helping firms overcome the challenges inherent in downsizing. Our study extends prior work by ascertaining whether and which types of resources help in staving off bankruptcy.

The contributions of our study lie at the intersection of the study of bankruptcy and downsizing. While both of these phenomena have been widely studied, there are few studies at the intersection of the two and there is more to be learned in each of these streams. Our literature review generated only two studies that have focused on whether downsizing is associated with subsequent bankruptcy (Powell & Yawson, 2012; Smith, 2010) and a third that briefly mentions an ad-hoc analysis of this relationship (Reynaud, 2013). Each of these studies suggests that downsizing does, indeed, increase the risk of subsequently declaring bankruptcy. We build on these studies, where the most recent year of downsizing examined was 2002, to further investigate this relationship in a sample of US firms in 2010. By comparing our results with these prior works, we are able to shed light on whether bankruptcies are

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http://dx.doi.org/10.1016/j.jbusres.2017.03.006
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still more likely for firms that downsize in an era when downsizing has become ingrained as an accepted practice.

Second, we take a different approach from prior studies by using the organizational change literature to theorize that the disruptive changes inherent in downsizing increase the likelihood of bankruptcy. Specifically, we suggest that this likelihood increases because downsizing interrupts organizational routines, reduces the productivity and increases the stress of remaining employees, and impedes knowledge transfer and organizational learning. By theorizing and empirically demonstrating that downsizing increases the likelihood of bankruptcy we contribute new evidence to the continuing debate surrounding the viability of downsizing.

Third, we submit that the mixed findings in the downsizing literature may be explained, in part, because large-scale changes have the potential for positive and negative outcomes and firms must find ways to counteract negative effects. Drawing on the resource-based view, we suggest that a firm's stock of resources may be one mechanism that helps to reduce the negative effects from downsizing, and therefore can help firms avoid bankruptcy. Surprisingly, extant research has just scratched the surface in delineating the role that organizational resources can play in downsizing outcomes (Brauer & Laamanen, 2014; Coucke, Pennings, & Sleuwaegen, 2007; Norman, Butler, & Ranft, 2013). For example, Norman et al., 2013 examined the role that resources play in subsequent bankruptcy, but did so with a sample that included only downsizing firms and thus could not compare downsizing firms to non-downsizing firms. Accordingly, we add to previous findings by using a sample of over 4000 firms, both downsizing and non-downsizing, to investigate the differential effects that resources have on bankruptcy and whether certain resources are particularly important for its prevention.

We also contribute to the bankruptcy literature. In assessing the likelihood of bankruptcy, both quantitative and qualitative information is useful. Yet, most prior studies have focused on quantitative data in the form of financial ratios and stock-based data because qualitative factors are more difficult to measure in an objective manner (Boratyńska, 2016). Nevertheless, recent studies have started to examine more closely the role that various qualitative factors play in the risk of bankruptcy. For example, recent studies have combined financial and market data with other "soft information," such as legal actions, timeliness in filing financial reports, employee loyalty, and management quality (Altman, Sabato, & Wilson, 2008; Boratyńska, 2016). Our study adds to this emerging stream of by testing whether another piece of "soft information," organizational downsizing, influences the likelihood of bankruptcy.

2. Does downsizing increase the likelihood of bankruptcy?

Downsizing involves workforce reductions undertaken with the goal, and under the economic assumption, that they will improve efficiency and performance (Datta, Guthrie, Basuil, & Pandey, 2010). While poor performance can trigger downsizing, even healthy firms downsize because the practice has, consistent with institutional theory, become legitimized as a way to enhance firm value (Jung, 2015) and "… how an organization should be structured to be effective" (McKinley, Zhao, & Rust, 2000, p. 231). Adjustments to workforce composition are increasingly accepted as a way to change existing human capital configurations and reconfigure routines (Brauer & Laamanen, 2014). Thus, at the socio-cognitive level, downsizing has become engrained as an effective schema (McKinley et al., 2000). While managers hope for positive outcomes, research examining performance outcomes of downsizing is equivocal (Datta et al., 2010; Love & Nohria, 2005) and there is some evidence that downsizing increases the risk of bankruptcy (Powell & Yawson, 2012; Smith, 2010). Indeed, some firms experience increased efficiency from downsizing (Yu & Park, 2006), while others struggle with organizational decline (Goesaert et al., 2015; Guthrie & Datta, 2008; Ndofor, Vanevenhoven, & Barker, 2013).

The organizational change literature has shown that large-scale changes can be a source of significant disruption to a firm's processes as employees face challenges to unlearn prior patterns of actions and discover and develop new routines (Miller, Pentland, & Choi, 2012). Further, these changes can introduce a host of emotional changes in remaining employees. Infrequent changes of large magnitude are especially challenging because they create incoherence or disruptions in organizational memory (Scalzo, 2006), which can lead to consequences such as deviations from established policies or procedures (Ramanujam, 2003) and the need to significantly alter routines (Brauer & Laamanen, 2014; Feldman, 2000).

Building on this literature, we theorize that downsizing, like other large-scale changes, disrupts organizational processes through multiple mechanisms. First, downsizing damages psychological contracts between a firm and its remaining (surviving) employees (Arshad, 2016). Psychological contract theory suggests that individuals and employers enter into a trust-based informal agreement, whereby employees exchange their work in return for fair pay and a positive, secure work environment. Downsizing breaches this contract, which can lead to negative employee behaviors including a lack of engagement, reduced loyalty, and fewer organizational citizenship behaviors (De Meuse & Dai, 2013). Survivors often come to view their firms as less than ideal employers and thus turnover is likely to increase (De Meuse & Dai, 2013; Arshad, 2016). In addition, remaining employees may be overworked, leaving them less time for important activities such as developing external networks, which has been linked to value-generating activities like innovation (Rusaw, 2004; Scalzo, 2006). Other well-documented survivor reactions include increased stress (Brockner et al., 1994; Jacobson, 1987), loss of managerial trust (Aryee & Chen, 2004), and increased workloads (Amabile & Conti, 1999). Ultimately, breaches in psychological contracts can reduce productivity and therefore reduce performance (De Meuse & Dai, 2013). Such consequences make bankruptcy more likely.

Second, downsizing firms often lose valuable knowledge and human capital. Human capital has been shown to lead to higher performance and is even more critical when it is firm-specific. While firms may try to retain their most valuable employees, unintended human capital losses are likely (Fisher & White, 2000; Schmitt, Borzillo, & Probst, 2011) and remaining employees may be incapable of extending their skills to fill these gaps (Massingham, 2008).

Third, and even more critical from an organizational change perspective, is the loss of social capital when employees exit. Social capital exists within networks of relationships internal and external to a firm, and is an essential ingredient in the creation of competitive advantage (Nahapiet & Ghoshal, 1998). It is needed to effectively reconfigure routines, which are recurrent patterns of activities that emerge over time (Brauer & Laamanen, 2014), and upgrade capabilities after downsizing (Schenkel & Teigland, 2016). These changes, however, are more difficult because social capital losses from downsizing damage existing routines, social networks, and organizational memory (Shaw et al., 2005; Schenkel & Teigland, 2016) by increasing the time required to access information and solve non-routine problems (Rusaw, 2004; Scalzo, 2006) and reducing the breadth of potential solutions generated (Moorman & Miner, 1998). Survivors must focus on transferring and acquiring knowledge rather than applying knowledge they already have (Kacmar, Andrews, Van Rooy, Steilberg, & Cerrone, 2006), resulting in lower productivity and decreased efficiency (Holtom & Burch, 2016). Similarly, groups become less effective in how they communicate and interact, reducing their task accomplishments, and adversely impacting firm outcomes (Anderson & Lewis, 2014). These disruptions can increase the likelihood that firms will fail (Hannan & Freeman, 1984).

Given that these disruptions can inhibit the effective functioning of firms, we suggest that downsizing sets firms on a negative path that may be difficult to reverse (Datta & Iskandar-Datta, 1995; Hambrick & D'Aveni, 1988). Supporting our theorizing, research has shown that organizational changes increase the likelihood of failure (Amburgey, Kelly,

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