



Downsizing and the fragility of corporate reputation: An analysis of the impact of contextual factors

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ARTICLE INFO

Keywords:

Corporate reputation
Downsizing
Layoff
Restructuring
Stakeholders

ABSTRACT

This study extends prior research on the impact of downsizing on corporate reputation by investigating how specific aspects of downsizing measures influence this relationship. Using panel data on the S&P 100 companies for the period 1990–2000, we find that downsizing affects corporate reputation negatively and that the size of the effect depends on the content and the context of the downsizing announcement. More specifically, we find that the motive for downsizing, the time period in which it is announced as well as the extent of previous layoffs significantly influence the reputational penalties that are associated with corporate downsizing. Our results thus elucidate how contextual factors of a downsizing decision can influence the extent of the reputational damage of this measure.

1. Introduction

Since the late 1980s, many US-based firms have adopted downsizing programs and reduced their workforce in order to cut costs and improve their performance (Baumol, Blinder, & Wolff, 2003; Davis & Haltiwanger, 1999). In the US, the Bureau of Labor Statistics counted on average over 1300 mass-layoff events per month in the period 1995–2001, which resulted in millions of job losses (Bureau of Labor Statistics, 2017). Research on corporate downsizing has so far focused predominantly on analyzing the effects of downsizing on a firm's performance and on employees (for an overview, see Datta, Guthrie, Basuil, & Pandey, 2010). Few studies, however, have investigated how downsizing influences other organizational outcomes, such as a firm's creativity, innovative capability or reputation, although these are crucial to a firm's performance. To our knowledge, only the studies by Flanagan and O'Shaughnessy (2005), Love and Kraatz (2009) and Zylidopoulos (2003, 2005) have analyzed the impact of downsizing on corporate reputation. The findings of these studies concur that, on average, corporate downsizing has a negative impact on a firm's external reputation. Moreover, they show that the relationship between downsizing and corporate reputation is moderated by firm-specific attributes, such as a firm's age or performance. With these exceptions, however, research has so far neglected the impact of other contextual factors, particularly those that are associated with the downsizing announcement. Datta et al. (2010, p. 339) have lamented the lack of studies on how contextual factors affect the outcomes of downsizing.

Responding to their criticism, we aim to address this gap and analyze how the contextual conditions that are associated with the downsizing announcement – namely, the motive for downsizing, the time period of the decision, and previous layoffs – influence the relationship between downsizing and corporate reputation.

Corporate reputation is one of the most important strategic resources for firms (e.g., Fombrun, 1996; Roberts & Dowling, 2002; Weigelt & Camerer, 1988). Defined as “a perceptual representation of a company's past actions and future prospects that describe the firm's overall appeal to all its key constituents when compared with other leading rivals” (Fombrun, 1996, p. 72), corporate reputation can be regarded as a general organizational attribute that is based on stakeholders' perceptions of a firm's past actions. Reputation constitutes an intangible resource that is hard to replicate. Crucially, it can facilitate access to resources controlled by key stakeholders and in that way influence a firm's ability to create and sustain a competitive advantage that ultimately results in better firm performance (Barney, 1991; Benjamin & Podolny, 1999; Deephouse, 2000; Fombrun & Shanley, 1990). Indeed, previous research has shown that corporate reputation is positively associated with a firm's financial success (e.g., Deephouse, 2000; Eberl & Schwaiger, 2005; McGuire, Schneeweis, & Branch, 1990; Raithel & Schwaiger, 2015; Roberts & Dowling, 2002; Rose & Thomsen, 2004). For that reason, managers seek to improve and sustain the firm's good overall reputation through their strategic decisions and actions.

A firm's reputation is not static but evolves continuously:

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stakeholders observe the strategic choices its managers make and infer from their outcomes the firm's ability to create value for them (Basdeo, Smith, Grimm, Rindova, & Derfus, 2006). In that respect, certain strategic actions may improve a firm's reputation, if they are perceived as appropriate choices in a given context. Such strategic choices may involve, for example, the introduction of popular management techniques (e.g., total quality management, quality circles or job enlargement) (Staw & Epstein, 2000) or market actions that signal a firm's competitiveness (Basdeo et al., 2006). Other decisions, however, may severely damage a firm's reputation. If managers make decisions that are mainly motivated by managerial self-interest or favor the interests of some stakeholders at the expense of others – in short, if a firm acts in ways that are perceived as controversial by some of their stakeholders (Bednar, Love, & Kraatz, 2015), it may incur reputational penalties. Bednar et al. (2015), for example, found that the use of so-called “poison pills,” i.e. measures taken by the board of directors to deter hostile takeovers, has a negative impact on a firm's reputation. Similarly, Williams and Barrett (2000) have shown that legal infringements have a negative impact on corporate reputation.

One prevalent management practice that is likely to impact a firm's reputation is corporate downsizing. Previous research has shown that downsizing, a cost-cutting measure aimed at improving a firm's performance, tends to affect negatively a company's stock-market performance and, thus, shareholder wealth (e.g., Chen, Mehrotra, Sivakumar, & Yu, 2001; Elayan, Swales, Maris, & Scott, 1998; Farber & Hallock, 2009; Hallock, 1998; Hillier, Marshall, McColgan, & Werema, 2007; Lee, 1997; Nixon, Hitt, Lee, & Jeong, 2004). The effect of downsizing on a firm's operational performance remains unclear. Some studies have found that its effects are positive, while others have shown that its effects are negative (e.g., Brauer & Laamanen, 2014; Cascio, Young, & Morris, 1997; Guthrie & Datta, 2008; Love & Nohria, 2005). In addition, prior research has shown that various internal and external stakeholders view corporate downsizing negatively. Employees, as important internal stakeholders, are likely to view reductions in their firm's workforce as a serious violation of their moral contract with the firm, as it threatens their job security (Morrison & Robinson, 1997; Turnley & Feldman, 1998). As a consequence, layoffs can weaken employee commitment and job satisfaction (Armstrong-Stassen, Cameron, & Horsburgh, 1996; Brockner, Grover, Reed, & Dewitt, 1987). There is also evidence that downsizing has an adverse impact on work performance, which is manifested in reduced organizational creativity and innovative capability (Amabile & Conti, 1999; Bommer & Jalajas, 1999). The effects of downsizing on external stakeholders have also been researched. For example, Homburg, Klarman and Staritz (2012) found that downsizing tends to increase customer uncertainty and, as a result, to affect negatively a firm's relationship with its customers.

Given the various negative effects that corporate downsizing has on a firm, it is not surprising that previous empirical research on the reputational effects of downsizing has shown that, in general, its impact on a firm's overall reputation is negative (Flanagan & O'Shaughnessy, 2005; Love & Kraatz, 2009; Zyglidopoulos, 2005). However, it remains unclear whether the effects of downsizing on a firm's reputation are uniformly negative or whether they depend on the specific measures that a firm takes. Past research on stock-market responses to corporate downsizing has shown that how a firm's shareholders assess downsizing varies according to the extent of the layoffs announced, the official reason for downsizing, whether the layoffs are permanent or temporary and the number of previously announced decisions to downsize (Chalos & Chen, 2002; Chatrath, Ramchander, & Song, 1995; Chen et al., 2001; Elayan et al., 1998; Farber & Hallock, 2009; Hahn & Reyes, 2004; Hallock, 1998; Hillier et al., 2007; Lee, 1997; Lin & Rozeff, 1993; Palmon, Sun, & Tang, 1997; Worrell, Davidson, & Sharma, 1991). This suggests that how other stakeholders perceive and evaluate a company is also likely to depend on the specific aspects of the downsizing announcement. In this study, we will build on the results of previous studies on the impact of downsizing on corporate reputation by

analyzing in depth the attributes that characterize specific instances of downsizing; namely, the motive that has led a company to lay off staff, the time period of the downsizing and how it relates to previous layoffs. To answer this research question, we will analyze data on a sample of firms drawn from the S&P 100 Index for the period 1990–2000, which subsequently became known as the “downsizing decade” (Wagar, 1998, p. 34).

Our study makes an important contribution to management research and practice. The findings of our study provide insights into how corporate downsizing affects organizational outcomes. Previous research has focused on investigating the direct relationship between downsizing and firm reputation and on how firm-specific attributes moderate this relationship. Our study, however, is the first to examine how the attributes of specific instances of downsizing affect corporate reputation. In this way, our findings also shed more light on the antecedents of corporate reputation. Moreover, we contribute to the emerging research on the impact of critical events on a firm's behavior. Our study examines how a particular type of critical events – namely, layoffs – may influence the media and other stakeholders' perceptions of downsizing. Furthermore, our study has also important implications for the communication of downsizing.

2. Theoretical background and hypotheses

2.1. The impact of downsizing on corporate reputation

Corporate reputation can be viewed as one of the most important strategic resources a firm has at its disposal (e.g., Fombrun, 1996; Roberts & Dowling, 2002; Weigelt & Camerer, 1988). An established reputation reduces uncertainty, guides the actions of a firm's stakeholders (Dowling, 1986; Fombrun & Shanley, 1990) and can thus significantly influence the firm's performance. A good corporate reputation may reduce customer uncertainty about the quality of a company's products (Shapiro, 1983). It may also reduce the uncertainty that employees feel about their employer (Cable & Graham, 2000), as well as uncertainty among actors on the capital market about future stock performance and corporate earnings (Beatty & Ritter, 1986). Firms with a good reputation are in a better position to charge premium prices for their products (Milgrom & Roberts, 1986) and are more attractive to skilled employees or investors than firms with a poor reputation (Beatty & Ritter, 1986; Roberts & Dowling, 2002). Unsurprisingly, research has found that a firm's reputation has a positive impact on its financial performance (e.g., Deephouse, 2000; Eberl & Schwaiger, 2005; McGuire et al., 1990; Raithel & Schwaiger, 2015; Roberts & Dowling, 2002; Rose & Thomsen, 2004) and that managers consequently have an interest in building and preserving a good overall corporate reputation and avoiding reputational damage (e.g., Roberts & Dowling, 2002).

Corporate reputation is determined by various factors and is constructed through the perceptions of external observers on the basis of available information about a firm's activities (Fombrun & Shanley, 1990). External stakeholders perceive news about a firm's financial performance, quarterly results, and strategic actions and achievements, or advertising as important signals on whose basis they assess the status of a company and its future prospects. This information is released by the firm in the form of annual or quarterly reports, conference calls, press releases or marketing activities that influence the corporate brand or image of the firm. So-called “information intermediaries,” such as the media and financial analysts, play an important role in the way information is processed and distributed to external stakeholders (e.g., Fogarty & Rogers, 2005; Pollock & Rindova, 2003; Zuckerman, 1999). They collect, process and distribute information through various channels (e.g., newspapers, magazines, blogs, research reports) to the stakeholders of the firm who develop perceptions and internal assessments regarding the firm's actions. Their individual perceptions and assessments are then aggregated to form collective judgments that amount to a firm's corporate reputation (DiMaggio & Powell, 1983;

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