

How does employee stock ownership affect the strategic management process and performance in dynamic industries?

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January 2009

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Abstract.

Employee Stock Ownership (ESO) schemes have been widely discussed in the financial literature as a solution to agency problems in dynamic environments. This study examines companies in the Danish IT industry to analyze if the share of companies using ESO is higher than in more stable industries. Furthermore, it investigates the reasons for implementing ESO and whether or not the conception of the scheme by the top management is congruent with the experience of the middle management. ESO is expected to increase the employees' commitment to the company. This study therefore investigates if companies with ESO demonstrate a higher level of participation in the strategy process than companies without ESO. Finally, it is analyzed if companies with ESO have a higher performance and if this performance is increased concurrently with a higher level of participation in the scheme.

Keywords: Employee ownership, agency theory, performance, dynamic industries.

INTRODUCTION

In the classical theory of the firm, the agency theory has become a central issue (Baker et al., 1988; Baiman, 1990; Lambert, 2001). The key problem has been to avoid incongruity between the goal of the company (i.e. the owners) and the personal utility maximization of the employees (typically the top management), but the theory has also been used to describe agency problems between agents. It has been argued that incentive programs like options, reward schemes, employee stock schemes etc. could eliminate or reduce agency costs (Eisenhardt, 1989; Lazear, 2000; Prendergast, 1999). The use of incentive programs is commonly referred to as extrinsic motivation and is in early theory seen as a contrast to intrinsic motivation. Recent research no longer holds that position (Harter and Jackson, 1992; Rigby et al., 1992; Sandson and Harackiewicz, 2000); it, however, considers extrinsic motivation a possibility to enhance the intrinsic motivation when administrated correctly (Rigby et al., 1992, p. 169-171).

The research on employee stock schemes has been focusing on either the characteristics of the companies using the schemes (Beatty, 1994; Drago and Heywood, 1995; Kruse, 1996; Jones and Pliskin, 1997) or the performance effect of the schemes (Blasi, Conte and Kruse, 1996; Jones, Kato and Pliskin, 1997; McNabb and Whitfield, 1998; Addison and Belfield, 2000; 2001; Sesil et al., 2002). The literature emphasizes that the use and need of broad general incentive programs like ESO are most relevant to employees with high levels of self management or companies in which the monitoring costs on the individual level are high (Cheadle, 1990; Kruse, 1996, Jones, Kato and Pliskin, 1997), or if it is too costly to operate individual incentive schemes (Jones and Pliskin, 1997). In the literature, employee stock schemes (ESO) have been propounded as an alternative to individual incentive programs, but some recent studies indicate that ESO as a standalone incentive program does not have a significant positive effect on the performance of the company. The argument is that the ESO as a broad incentive program does not infuse the employee with the sense of being able to influence the reward and at the same time, the financial participation per employee is normally rather low compared to the total salary (Oyer, 2004). Research has shown that ESO in combination with other individual incentive programs ameliorates some of the problems of individual performance based incentive programs (such as short-term focus or sub optimization) and shifts focus to a more long-term collective performance outcome and a more cooperative behavior (Holmstrom and Milgrom, 1994; Gibbons, 1998). This is also congruent with the "balanced scorecard" literature (Kaplan and Norton, 1996). Other research indicates the opposite findings indicating a connection between ESO and company performance ((Bradley et al., 1990; Long, 1978a, Pendleton, 1997). The literature suggests that high employee commitment (Long, 1978b; Pierce et al., 1991; Rosen, 1990) and/or low employee turnover (Richardson and Nejad, 1986; Wilson et al., 1990) have an impact on performance. The high employee

commitment is characterized by intensified employee effort, workplace innovation and reduction of wastage (Pendleton, 2006) and referred to as “the golden path” (Sengupta et al., 2007) while the lower employee turnover is referred to as “the golden handcuffs”.

In recent strategic management research, scholars address the role of middle management in the strategy process (Bower, 1982; Burgelman, 1983, 1988; Burgelman and Grove, 1996; Mintzberg, 1994; Noda and Bower, 1996; Floyd and Wooldridge, 1992, 1996, 1997). The focus of the research is on how middle management is the prime source of emergent strategy and some research indicates that this emergent strategy making may prompt a more effective strategy process in dynamic environments (Fredrickson, 1984; Fredrickson and Mitchell, 1984; Fredrickson and Lacquinto, 1989; Powell, 1992), while other research indicates the opposite (Brews and Hunt, 1999).

Comment [LVS1]: oHvad refererer 'latter' til?

Emergent decentralized strategy making has often been considered to be the opposite of strategic planning occasioning pro and con debates (Ansoff, 1991; Goll and Rasheed, 1997; Mintzberg, 1990, 1994), while others try to combine the two (Bourgeois and Brodwin, 1984; Hart, 1992; Mintzberg and Waters, 1985; Nonaka, 1988). The emergent strategy process has been analyzed at the organizational level addressing the different political (Bauer, 1968; Eisenhardt and Zbaracki, 1992; Pettigrew, 1973; Mintzberg, 1983; Pfeffer, 1981) or social aspects of the process (Deal & Kennedy, 1982; Johnson, 1987; Poole et al., 1989).

When changing an organization for better performance it is contingent on external and internal factors as the contingency theory has shown. Contingency theory includes many of the factors that create better performance in an organization. Most research on contingency theory has been done on individual factors. It is though still not clear how multiple factors in combination affect the organization (Donaldson, 2001). The multi-contingency model developed by Burton and Obel (1998) tries to combine a number of factors. The model is though criticized by its use of the original studies (Zammuto and O’Conner, 1992) and that the interactions between the rules are not accounted for. Interaction Value Analysis (IVA) attempts to create both the rules for organizational effectiveness based on the factors and their interrelationship (Nasrallah et al 2008). The model is based upon transaction cost economics (Williamson, 1979; Coase, 1988) which postulates that an organization is formed to amortizes the set-up costs of multiple value-adding transactions between the same parties or agents in the organization (Nasrallah et al. 2008). The more successful the agents are in interacting with other agents in the organization the lower is the transactions costs and the more effective is the organization. The model tries to find a way to maximize the sum of products of the form:

$$Effectiveness = \sum_i \sum_j h_{ij} \times p_{ij} \times s_{ij}$$

Where h is the benefit from an interaction, p is the frequency of the interactions and s is the probability of a successful completion of such an interaction. I and j represents the number of agents. The probability of a successful communication depends on responsiveness and accessibility (Nasrallah, 2006). The model assumes that if two agents actually meet a successful interaction will take place. It can though be argued that high employee commitment will increase the responsiveness (the agent's willingness to favor high-value interactions over others) but also increases the mutual effort to ensure that the interaction is successful. In dynamic industries where decisions often need to be decentralized and interactions needs to be ad-hoc based on the individual employees conceptions of value creating activities the employee commitment could be the key to higher effectiveness. Since it can be seen that ESO creates higher employee commitment and that employee commitment creates more successful interactions and thereby more effective organizations in dynamic industries it could be assumed that dynamic industries would foster an enhanced amount of companies with ESO. It can also be argued that if middle management involvement in the strategy process leads to higher performance in dynamic industries, companies with ESO will have a higher chance of gaining competitive advantage, since the expected higher commitment of ESO-companies will increase the probability of involvement from the middle management. This leads to the first hypothesis that

Comment [LVS2]: Vær lige opmærksom på, at jeg ikke gør vold på sætningens mening.

The share of companies employing ESO is higher in dynamic industries.

The expected higher commitment in companies employing ESO and the need for employee participation in the strategy process in dynamic industries lead to the second hypothesis:

The employee participation in the strategy process is higher in dynamic industry companies which have implemented ESO.

Because of the expected ESO induced higher level of employee involvement in the strategy process and previous research showing that employee involvement in dynamic industries prompts higher performance, the third hypothesis states:

Companies in dynamic industries employing ESO demonstrate increased performance.

Defining Employee Stock Ownership schemes

The definition of ESO may be based on previous definitions regarding a company with at least one employee receiving payment from employee share ownership schemes as an ESO employing company (Sengupta et al. 2007) or it may be based on a more restricted definition requiring that a majority (60%-100%) of the non-managerial employees to participate in the schemes for the company to be considered ESO employing (Robinson and Zhang, 2005). This thesis will initially use the Sengupta definition and thus includes all companies in which at least one employee (not the CEO) receives payment from an ESO scheme. It is normally assumed that the higher scheme participation, the higher effect. The thesis will therefore analyze if the effect of the ESO schemes increases if the amount of people participating in the scheme increases and if the financial participation (the share of the company owned by the employees) increases.

Defining dynamic industries

The dynamism of an industry can be calculated as the standard error of the regression coefficients of the ten year time series on net sales and operating income (Dess and Beard, 1984; Keats and Hitt, 1988, Andersen, 2004). Samples of North American manufacturing firms from Compustat have shown high dynamism in the computer product industry while showing low dynamism in the household industry.

Defining employee participation in the strategy process

The participation of employees in the strategy process can manifest itself in at least two ways. First, the employees' ideas can be accepted by the top management and implemented in the strategy of the firm; in the literature referred to as participation in decisions (Andersen, 2004) or in the terminology of the different archetypes in strategy formation as Adaptive (Mintzberg, 1973), Collaborative (Bourgeois and Broadwin, 1984), Transactive (Hart, 1992) or Reactive (Ansoff, 1987). Second, the strategic decision-making authority can be distributed to the employee; in the archetypes defined as Cresoive (Bourgeois and Broadwin, 1984), Generative (Hart, 1992), Emergent (Mintzberg, 1978), Organic (Ansoff, 1987) or Inductive (Nonaka, 1988).

Defining company performance

The company performance can be measured in different ways, for instance as growth in turnover and net profit (Dess and Robinson, 1984), subjective evaluation of organizational performance (Machin and Stewart, 1996, Wall et al. 2004, Sengupta, 2007), return on assets (ROA) (Burton et al., 2002; Donaldson,

Comment [LVS3]: Mener du 'arketyper'?

2001) or growth in number of employees (Kraus, Harms and Schwarz, 2006). This thesis will use the growth in turnover and net profit despite their limitations (Machin and Stewart, 1996).

The thesis will contain four articles on the topics:

Article 1 will be a conceptual paper combining the agency theory, motivations theory, finance theory and organizational theory in defining the boundaries the finance literature on ESO and the strategy literature on commitment and participation I the strategy process.

Article 2 analyze the prevalence of employee ownership in the Danish IT industry. The industry is chosen based on high dynamism and the sample includes the entire population. The sample will be compared with a randomly chosen sample of companies in low dynamism industries. The article will also analyze the reasons for choosing employee ownership in the company and the different methods used in the schemes to distribute the shares and the methods used in setting the price of the shares based on a number of case studies.

Article 3 will analyze the strategy process in companies with employee ownership, testing the hypothesis that companies with employee ownership feature a higher degree of employee participation in the strategy process.

Article 4 will analyze the economic performance of companies with employee ownership defined as growth in turnover and net profit.

Methodology

To investigate hypothesis 1, the level of dynamism in the Danish IT industry is calculated and compared to the level of dynamism in more traditional production industries. Then, the entire population of a part of the industry is contacted using a questionnaire to calculate the share of companies employing ESO, the amount of employees involved in the scheme and the share of the company owned by the employees. The population is delimited to all limited companies with more than 20 employees. The sample contains 312 companies. The organizational levels participating in the scheme will also be identified. The dynamism of more traditional industries is calculated and within low dynamism industries, an identical analysis is conducted on a control sample. To ensure the validity of the answers a subsample is chosen and the

questionnaire is sent to another person in the organization. The answers of the two questionnaires from the same company are then compared.

From the sample 5 case companies are randomly chosen and a number of interviews is conducted in order to analyze the reasons behind and the observed consequences of the employee stock schemes. The interviews will be with both employees at the top level and the middle management level analyzing the commitment, results, use of additional individual incentive programs and the degree to which the top management's conception of the scheme agrees with the middle managers' conception.

To investigate hypothesis two, the participation in the strategy process, a number of questions is added to the questionnaire (Andersen 2004) reflecting the middle managers' participation in decisions like 1) change in market position, 2) movement into new customer segments, 3) major product/service introductions, 4) development of important capabilities 5) adaptation to new policies and practices. To investigate the distributed decision authority, questions are added to the questionnaire (Andersen, 2004) establishing whether managers reporting to the top management can 1) start major market activities without approval, 2) move into new customer segments without approval 3) initiate new product development, 4) introduce new practices and 5) develop new internal capabilities. The analysis will be conducted using a five point Likert scale.

Hypothesis three will be investigated by gathering annual reports of companies employing ESO and a control sample in the same industry and information on turnover growth and growth in net profit will be compared.

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