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MANAGERIAL DISTANCING FROM PROBLEMATIC STRATEGIC ACTION: EVIDENCE FROM THE DIVESTMENT OF POORLY PERFORMING ACQUIRED UNITS

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Although reversing action can be awkward, embarrassing and costly managers do reverse actions as a way to correct poor decisions, reassert control and move on to other things (Deogun and Lipin, 1999). Amongst other things, examining this construct might identify conditions that cause managers to end rather than fuel their commitment to a losing course of action; declare rather than conceal outcomes; and learn from their mistakes (Finkelstein, 2003).

Our central thesis is that, as the performance of one's action declines, stronger distancing lessens protagonists' embarrassment from the action and therefore increases the likelihood that they will reverse it. We define distancing conditions as "any routine (circumstances), policies or actions that are intended to circumvent the experience of embarrassment or threat by bypassing the situations that may trigger these responses" (Argyris, 1996: 164 our brackets). By mitigating the embarrassment of reversing actions, such conditions are instrumental to sustaining the self-concept and esteem of those who undertake and reverse action (Greenwald, Bellezza & Banaji, 1988). Therefore, our interest centers on the conditions in which managers can distance themselves from poorly performing action. In particular, we examine how the interaction between poorly performing action and distancing conditions increase the likelihood of reversing that action because distancing conditions become more relevant as managers experience more dissonance between the rationale for an action and its performance.

In testing our hypotheses, we have sought a setting in which managers unequivocally and visibly embark on a material and reversible course of action that is subject to clear performance metrics. Acquisitions are quite visible events that almost invariably require substantial CEO attention, signal CEOs' personal and strategic intent and shape CEOs' fortunes (Hayward & Hambrick, 1997; Morck, Shleifer & Vishny, 1990). In choosing to divest acquired units, CEOs must renegotiate or withdraw from the major financial, personal and organizational commitments involved in buying and integrating that unit (Shleifer & Summers, 1988). Often, the cost to CEOs and their firms of such restructuring are enormous (Rosenfeld, 1984).

THEORY AND HYPOTHESES

Reversing Poor Performing Action.

As poor performance of an action becomes more self-evident and less defensible, its protagonists face more pressure to terminate it (March & Olsen, 1976). Acquired units that perform especially badly or well become more visible to internal and external stakeholders (Weisbach, 1995). Following such failure, consensus can quickly galvanize within and outside the firm that the acquisition has failed, especially as performance declines become more marked and widely identified and understood (Meindl, Ehrlich & Dukerich, 1985; Tetlock, 1985). CEOs

must then seek to come to terms with the increasing emotional and financial drain that the unit places on themselves and their firms.

Hypothesis 1: The lower the performance of an acquired unit, the more likely that it will be divested.

Because we are unable to directly observe the psychological dispositions of large numbers of CEOs who contemplate divestments, we direct theory towards firm level conditions that may predict CEO distancing.

“Not My Decision”: Ability to Downplay Personal Responsibility for Deciding on Action

There is considerable theory and evidence to suggest that managers only reluctantly reverse strategic actions in which their organizations have invested material resources (e.g. Porter, 1987; Staw, Barsade & Koput, 1997). Poorly performing acquired units are difficult and embarrassing to CEOs who are responsible for managing them. But, by attributing troubled acquisitions to predecessors, CEOs can simultaneously disown losing actions, deflect blame and sustain the perception that they are in control of the overall enterprise (Salancik & Meindl, 1984). However, this distancing is less available to managers who were at the firm when the decision to acquire the unit was made and subsequently became CEOs (Shleifer & Summers, 1988). If they were not at the firm when the acquisition was made, they can more readily attribute it to their predecessor(s), strengthening their ability to distance themselves from the poorly performing acquisition.

Hypothesis 2: Arrival of a new outside CEO who was not involved in acquiring a focal unit increases the likelihood that the firm will divest the weakly performing acquired unit.

“Not my fault”: Ability to Downplay Personal Responsibility for the Consequences of Action

Kahneman and Tversky (1984) emphasize that the consequences of losses can be framed by the context in which the decision arises or within a ‘topical account’. Following this reasoning, distancing can become more salient for actors who can attribute poorly performing actions to factors that are outside of their control. One such dynamic is an unstable industry environment. Industries undergo periods of unexpected change in technological advances, customer preferences, competitor intensity and so forth (Stearns & Allan, 1996); and, as industry change intensifies, managers can more readily attribute the failure of an acquisition to such change as opposed to their own actions. Therefore, unstable conditions strengthens managers’ distancing and motivation for divesting a poorly performing unit.

Hypothesis 3: Greater industry volatility increases the likelihood that the firm will divest the weakly performing acquired unit.

Another means by which social observers can distance themselves from a bad decision is to refer to the reversal of a similar decision that they and their peers have once made as socially legitimate, even expected. Stakeholders who observe that CEOs are well practiced at divesting might also characterize any focal divestment by those CEOs as a routine organizational development. That is, divesting might be seen as a legitimate ‘modification routine’ insofar as ‘the more experience an organization has with a particular type of change, the more that the change will be seen as a solution to a broader and broader set of problems’ (Amburgey, Kelly & Barnett, 1993: 56).

Following this reasoning, we also expect that CEOs can more effectively distance themselves from a poorly performing acquisition when there is greater divestment activity in the *acquired unit’s* industry. Managers socially compare their actions with peers who make similar

acquisitions and divestments in order to show that their own actions are perceived as legitimate if not valuable (Haunschild & Miner, 1997; Staw & Epstein, 2000).

Hypothesis 4A: Greater divestment experience by the acquiring firm increases the likelihood that a weakly performing acquired unit will be divested.

Hypothesis 4B: Greater recent divestment in the acquired unit's industry increases the likelihood that a weakly performing acquired unit will be divested.

“Not Material”: Ability to Downplay the Results of the Action.

The discomfort that CEOs might experience from divesting poorly performing acquisitions might be mitigated if such action is more exploratory and involves fewer firm resources, such that the loss can be framed as ‘expected or immaterial’. The stakes of this failure are lower because, to state the obvious, there is less of the firm’s capital at stake when the size of the acquisition is small relative to the size of the acquirer; and the smaller acquisition requires less intensive ex post evaluation (Thaler, 1999). Because losses at these smaller units are less material and noticeable to stakeholders, CEOs have greater scope to distance themselves from those units, thus increasing the likelihood that they will divest them, as suggested below:

Hypothesis 5: The smaller the poorly performing acquired unit relative to the size of the acquirer, the more likely that the unit will be divested.

Taking losses from divesting poorly performing acquired units is less painful to CEOs who can better integrate those losses within their firms’ overall gains and prospects. As the overall performance of the firm declines, managers face increasing Board and stakeholder scrutiny over the adverse performance of focal activities (Zajac & Westphal, 1996). In contrast, overall firm performance may improve to a point where managers can easily point to success stories that override the importance of reversing action, thereby creating a context in which reversals are more likely.

In a related dynamic, CEOs have greater scope to distance themselves from poorly performing acquisitions if their firms have greater slack with which to absorb the effects of those actions (Cyert & March, 1963). This runs counter to free cash flow theory that suggests that greater slack provides a financial cushion that limits managers motivating for freeing cash by divesting assets (Jensen & Ruback, 1983; Jensen, 1986). As cash availability increases, managers need less of it and so have less incentive to raise cash from divesting units. In contrast, when managers lack cash, they face greater pressure to sell units and other assets to free cash and to service debt and meet other obligations.

In contrast, we think that greater slack allows managers to integrate losses from poorly performing activities when their firms have greater overall financial strength. This then helps CEOs to distance themselves from poorly performing acquisitions in the process of divesting them. Conversely, divesting the unit when the firm has less slack and higher leverage draws greater attention to the magnitude of the loss and adverse performance at other units, thereby increasing organizational distress and attracting greater CEO scrutiny (Ocasio, 1997).

Hypothesis 6A: Better performance of the acquiring firm increases the likelihood that its weakly performing acquired unit will be divested.

Hypothesis 6B: Greater slack at the acquiring firm increases the likelihood that the weakly performing acquired unit will be divested.

Along similar lines, CEOs might distance themselves from poorly performing acquired units that become unrepresentative of their firms’ strategic direction. In obtaining anecdotal evidence for this study, we noted CEOs’ propensity to describe failed acquisitions as a thing of the past and unsuitable to the future (Deogun & Lipin, 1999; Porter, 1987). One indicator of

whether firms have moved in a new strategic direction from the focal acquisition is the number of unrelated moves (e.g. acquisitions, joint ventures) that the firm subsequently made (Westphal, Seidel & Stewart, 2001).

Hypothesis 7: Greater investment in businesses that are unrelated to the weakly performing focal acquisition increases the likelihood that such acquired unit will be divested.

METHODS AND RESULTS

Sample and Analytical Approach

The sample consists of U.S. based, publicly held firms that acquired another U.S. company and divested it between 1988 and 1998. From the screening processes, 587 divestments of formerly acquired firms were identified (570 firms). We used *COMPUSTAT* Business Segment Tapes to obtain longitudinal, quantitative data. Segment data on acquired units are very difficult to attain even for US data, such that these data were not available for many units. Accordingly, the final sample consisted of 68 cases and 68 firms that disclosed the acquired and then divested unit's performance.

Event history analysis allows us to predict both the timing and the occurrence of an event, by incorporating longitudinal data with time varying variables (Allison, 1984). To avoid misspecification, we used a conservative Cox proportional hazard model.

Dependent and Independent Variables

Divestment. We used the announcement dates of the acquisition and divestment to measure the time between the two events. This dependent variable is dummy coded in each spell.

Acquired unit performance. Acquired unit performance was measured annually over the years from the acquisition to the divestment. The performance of the acquired unit was measured as the percentage of ROA (return on assets) of the acquired unit minus the mean ROA of the 2-digit SIC industry of the unit to control for potential industry effects.

A new outside CEO. Arrival of a new CEO from outside of the acquiring companies was operationalized by a dummy variable (new CEO = 1, no = 0).

Industry volatility. The environmental volatility of the acquired unit industry was operationalized using the approach adopted by Bergh and Lawless (1998).

Divestment experience. The divestment activities of the last three years by sample and control firms were counted and accumulated as a running average each year (Amburgey et al., 1993).

Industry divestment frequency. To capture the influence of the industry movement, the growth of the number of divestitures within the same industry defined by the 2-digit SIC code of the target unit each year was counted for each year from SDC database.

Relative size. Relative size of an acquired unit to the acquiring firm was measured as annual sales of an acquired unit relative to its parent firm sales. These data were collected yearly.

Acquiring firm performance. Performance of the acquiring firm was measured as the percentage of ROA of the firm relative to the industry (2-digit SIC) average ROA.

Slack. The measure of absorbed slack is the change of debt to equity ratio that reflects the healthiness of the balance sheet and borrowing capacity. We reverse signed this variable such that a negative sign indicates the decrease of slack and positive sign indicates increase of slack.

Unrelated investment. Strategy change by unrelated investment was operationalized by the number of strategic initiatives that are unrelated to the focal acquisition.

As control variables, we included *outside director ratio*, *the presence of blockholders*, *deal value unit relatedness*.

Results

Table 1 presents the results of the event history analysis based on the Cox proportional hazards model. We centered the independent variables along the lines of Aiken and West (1991).

Table1 about here

DISCUSSION

“Not My Decision”.

Whereas prior research shows that new CEOs are more likely to divest units, we find that this is exacerbated when such unit is poorly performing consistent with our distancing arguments (Weisbach, 1995). While these results are not surprising, they corroborate the perspective that divesting a poorly performing acquisition is less personally painful to CEOs who did not make those acquisitions in the first place.

“Not My Fault”.

Our study examined whether CEOs could attribute the acquisition’s performance to factors outside their control, especially the volatility in the acquired unit’s industry (Kelley, 1971). However, we received opposite results, which may highlight the tension between CEOs’ need for time to turn around a poorly performing action and desire to achieve distance from such poor performance (Staw, 1997). Taken together, these results suggest that poorly performing acquisitions are not more likely to be divested by CEOs who can attribute such performance to factors that are outside their control. Perhaps CEOs are thought to be in control of their firms’ performance and prospects and thus have less ability than other actors to make such attributions. It is also possible that our characterization of CEOs’ situation is incomplete insofar as that situation may be either stable and different from that surrounding the initial decision to acquire, invoking distancing or stable and similar to that at the acquisition decision, inhibiting the CEO’s ability to attribute the outcome to a changed situation.

“Not Strategically Material”.

CEOs may consider a prior decision to be presently immaterial because its implications are relatively trivial, if not irrelevant, thereby distancing themselves from the acquisition and increasing the likelihood that they will divest it. CEOs can better distance themselves from smaller acquisitions that are less salient and material to stakeholders. Contrary to the predictions of theory on free cash flow and escalating commitment, we found that stronger performance and greater slack at the acquiring firm increase such likelihood (Cyert & March, 1963). With greater profitability and a stronger balance sheet, CEOs can more readily pass off losses from a poorly performing acquisition as immaterial to their firms’ overall welfare. Greater slack may mean that CEOs lack financial motives for attaining resources by selling a poorly performing unit, but also foster the distancing that makes such outcome more likely.

Furthermore, we found strong evidence that unrelated strategic initiatives that were made between the time that the poorly performing unit was acquired and divested increased the likelihood that a poorly performing acquisition would be divested. Together these results support predictions from behavioral decision theory. Namely, when a poorly performing acquisition is treated as an isolated case, managers may tend to be averse to taking losses from it. But, this dynamic breaks down when acquisitions are viewed as part of a comprehensive account that involves strong overall firm performance (Thaler, 1999).

Synthesis

Our study developed theory and evidence on distancing to help understand how managers come to terms with poorly performing actions that they are intensively engaged in. This is novel insofar as it examines how and when actors will distance themselves from actions that they have actually made, a dynamic that seems critical to explaining the course of many strategic decisions. We borrowed from behavioral decision theory to examine how actors mitigate the personal pain they feel from closing a loss action by referring to the initial action as belonging to someone else (Ross & Sicoly, 1979), resulting in poor performance that is outside of one's control (Miller & Ross, 1975) and being immaterial to or representative of one's overall enterprise. Our thesis that distancing allows actors to lessen their embarrassment from reversing actions seems most applicable to the first and third of these dynamics.

In closing, a more positive spin is that distancing might help CEOs accept the failure of their actions and move to reverse the downward spiral that those actions can produce (Hambrick & D'Aveni, 1988; Ross & Staw, 1993). If CEOs can learn how to distance themselves from bad actions, they can prepare to jettison the ensuing action, attenuating potential losses. Our study suggests that CEOs who can distance themselves from public strategic actions are less inclined to seek the time and resources that they think will make bad actions work.

REFERENCES AVAILABLE FROM THE AUTHORS

TABLE 1
Results of Event History Analysis

	Hypotheses	Variables	Expected sign	Results
Base Model	H1	Unit performance	-	Supported
"Not My Decision"	H2	Unit performance X Outside CEO	-	Supported
"Not My Fault"	H3	Unit performance X Industry volatility	-	+ (opposite)
	H4A	Unit performance X Divestment experience	-	Not significant
	H4B	Unit performance X outside CEO	-	Not significant
"Not Strategically Material"	H5	Unit performance X Unit size	+	Supported
	H6A	Unit performance X Firm performance	-	Supported
	H6B	Unit performance X Slack	-	Supported
	H7	Unit performance X Unrelated business investment	-	Supported