Why Some CEOs Are More Likely to Engage in Corporate Downsizing

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A firm's decision on whether to downsize when facing performance shortfalls may depend on the CEO's internal attribution tendency.

When a firm's performance falls short of aspirations, organisational changes can help stop the bleeding and get things back on track. Broadly speaking, firms have two strategic avenues to consider. The first is growth-related strategies to improve the firm's position and performance, which could range from **mergers and acquisitions** to introducing new products and expanding factories. The second is corporate downsizing actions such as divesting from loss-making units, closing production facilities, selling peripheral assets and conducting layoffs.

Compared with other forms of restructuring, corporate downsizing, especially workforce reduction, is regarded as a quicker and simpler way to respond to performance shortfalls and is therefore widely used to address such issues. By releasing resources and enhancing operational efficiency, it is more effective in improving financial performance than other restructuring activities.

However, CEOs generally don’t like to engage in corporate downsizing, even if it may be the best way to address poor performance. Given its association with reducing operational scope and laying off workers, it can be viewed negatively by external stakeholders and provoke internal resistance. It also reduces the size of the firm, and, as CEO compensation is often tied to firm size, can adversely influence their salary.

In **our recent study** published in the *Journal of Management Studies*, my co-authors (**Wei Shi** and **Boshuo Li** from the University of Miami) and I examine how a CEO’s internal attribution tendency – the extent to which they attribute an observed outcome to internal factors – can affect whether they undertake corporate downsizing activities in response to performance shortfalls.

How attribution biases affect downsizing decisions

Our research focuses on internal attribution tendency – a fundamental cognitive trait that shapes CEOs’ awareness of their responsibility for performance shortfalls. Individuals who possess a strong internal attribution tendency will tend to take personal responsibility for an observed outcome, whether it be favourable or unfavourable, while those with a weak internal attribution tendency will tend to assign responsibility to external factors.

We hypothesised that CEOs with a strong internal attribution tendency will attribute performance shortfalls to their own poor performance and take responsibility. Accordingly, they will be more willing to learn from past experiences and proactively take strategic actions to address the issue by engaging in downsizing activities, even if these run counter to their own interests in the short run.

In contrast, those with a weak internal attribution tendency will blame external factors outside their control – including the economy, market competition and regulators. They will be especially concerned about the negative impact of downsizing actions on themselves and emphasise that there is little they can do to improve performance. As they perceive downsizing as sending a signal about them having chosen poor growth strategies in the past, they will eschew doing so to avoid being blamed for bad performance.

Taking or avoiding responsibility

Using the **awareness-motivation-capability (AMC) framework** from competitive dynamics research, we argue that a CEO’s internal attribution tendency affects their *awareness* of responsibility for performance shortfalls, and whether they engage in downsizing actions in response. This effect is amplified when CEOs have the *motivation* (e.g. scrutiny from financial analysts) or *capability* (e.g. an unfavourable external environment) to avoid taking responsibility.

Our data included a sample of 3,977 CEOs of 2,424 listed firms in the United States between 2002 and 2013. We used quarterly earnings conference call transcripts to measure a CEO’s internal attribution tendency and counted the number of downsizing actions announced by the firm in a year. We accounted for two moderating factors: analyst coverage, measured as the number of financial analysts covering a firm in a year, and if the external environment was unfavourable (such as during the 2007 and 2008 financial crisis).

As predicted, we found that CEOs with a strong internal attribution tendency increased the number of downsizing actions in the presence of performance shortfalls, whereas those with a weak internal attribution tendency decreased the number of downsizing actions under similar conditions. The effect of CEO internal attribution tendency was stronger when firms were faced with intensive scrutiny by financial analysts and an unfavourable external environment.

When firms are covered by many financial analysts, CEOs are subject to scrutiny from these external performance evaluators and therefore have strong motivation to project a favourable image. Corporate downsizing in response to performance shortfalls could signal that they have made unwise strategic decisions, such that CEOs that have a weak internal attribution tendency will be reluctant to undertake downsizing activities to address such shortfalls.

The external environment is closely related to a CEO’s “capability” to avoid responsibility for firm performance. A less favourable external environment, like an economic crisis, makes it easier for CEOs with a weak internal attribution tendency to blame external factors for poor performance. While CEOs with a strong internal attribution tendency are less influenced by the external environment when making strategic decisions, those with a weak internal attribution tendency react differently in favourable vs. unfavourable external environments.

Pay attention to CEO attribution biases

Our research will be of interest to both **corporate boards** and executives. For starters, the findings suggest that it is vital for board members to understand a CEO's internal attribution tendency, as those with a weak internal attribution tendency are less willing to undertake downsizing activities in response to poor performance. This could hamper a firm in a turnaround situation if the CEO isn't willing to make the necessary internal changes to ensure the organisation's survival.

While our study focuses on performance shortfalls, there are much broader implications for having a CEO with a weak internal attribution tendency. For instance, when dealing with issues like corporate misconduct or customer dissatisfaction, they could be more likely to blame external actors and factors instead of critically examining internal processes and aspects of firm culture that may need fixing.

Board members could intensify their monitoring to ensure that CEOs have properly considered downsizing actions in the face of performance shortfalls. When hiring new CEOs, board members should avoid the temptation to appoint an individual **based primarily on their charisma**, especially when looking for transformative leadership. It is also key to consider fundamental psychological traits such as attribution biases, but this is currently being overlooked.

Our study also suggests that executives should assess their own internal attribution tendency to be aware of how much it may bias their decisions and constrain their strategic options. Additionally, firms can consider pairing executives with respectively strong and weak internal attribution tendencies in the top management team to enhance diversity in mindset.

Find article at
https://knowledge.insead.edu/strategy/why-some-ceos-are-more-likely-engage-corporate-downsizing

About the author(s)

Guoli Chen is a Professor of Strategy at INSEAD. His research focuses on the influence of CEOs, top executives, and boards of directors on firms' strategic choices and organisational outcomes, as well as the interaction and dynamics in the top management team and CEO-board relationships.

About the research

"Problem Solving or Responsibility Avoidance? The Role of CEO Internal Attribution Tendency in Shaping Corporate Downsizing in Response to Performance Shortfalls" is published in the *Journal of Management Studies*.