Strategic Actions, Structural Choices, and Performance Implications

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ABSTRACT

This paper examines the existing literature on the relationship between strategy and structure. It first discusses the traditional research advanced by Chandler (1962) and Williamson (1975). It then evaluates criticisms toward the traditional strategy-structure research and Williamson’s “M-form Hypothesis”. While admitting the contribution of the traditional research, this paper places emphasis on the new stream of research that has been taking a more comprehensive and contingency view of the strategy-structure relationship.

INTRODUCTION

Research on strategy and structure was initially triggered by Chandler's (1962) seminal work on the emergence of multidivisional structure in diversified firms such as Du Pont and General Motors. Chandler's basic argument is that structure follows strategy. Then Williamson (1975) provided a transaction cost analysis of the rationale underlying multiproduct firms’ adoption of M-form structure. Almost in the mean time, Rumelt (1974) published his work on strategy, structure, and performance of diversified firms. Most of the criticisms toward the traditional strategy-structure research and Williamson’s “M-form Hypothesis” came out in the 1980s (i.e., Hill & Pickering, 1986; Hill and Hoskisson, 1987; Hill 1988, Hoskisson, 1987, Palmer et al. 1987; Sanchez-Bueno & Suarez-Gonzalez, 2010). In these theoretical and empirical studies, Charles W. L. Hill, Robert E. Hoskisson, Donald Palmer and their colleagues critically challenged the oversimplified arguments such as economic efficiency is the only driving force of multiproduct firms' adoption of M-form structure and M-form is almost unconditionally superior to other administrative structures. In the 1990s, research on strategy and structure was scattered over various areas and based on different disciplines. Palmer et al. (1993) extended their original work to a more comprehensive study of the institutional, political, and economic accounts of late adoption of the multidivisional form by large U.S. corporations. More recently, Liebeskind (2000) provided a systematic analysis of the benefits, costs, and organizational arrangements of internal capital markets.

CREATION OF MULTIDIVISIONAL FORM IN DIVERSESIFIED FIRMS AND ITS ADVANTAGES

Chandler's (1962) pioneering work has constituted the foundation for research on strategy and structure, while Williamson's (1975) transaction cost analysis has provided the theoretical ground supporting M-form's effectiveness and efficiency. Prior to the emergence of the multidivisional structure, firms were organized along functional lines that were referred to as unitary form (or U-form). Radical expansion of the U-form enterprise (1) experienced cumulative "control loss" effects, which had internal efficiency consequences, and (2) eventually altered the character of the strategic decision process in ways that favor attending to other-than-profit objectives.

Faced with various types of internal operating problems that emerged as the U-form enterprise increases in size and complexity, the multidivisional structure was created in large American companies such as Du Pont and General Motors in the early 1920s. This organizational innovation involved substituting quasi-autonomous operating divisions (organized mainly along product, brand, or geographic lines) for the functional divisions of the U-form structure as the principal basis for dividing up the task and assigning responsibility. In relation to the U-form organization of the same activities, the M-form organization of the large, complex enterprise served both to economize on bounded rationality and attenuate opportunism.
Williamson attributed the advantages of M-form over U-form to more effective and efficient strategic control and internal capital allocation. Moreover, the M-form firm serves effectively as a miniature capital market. These advantages lead to Williamson's famous "M-form Hypothesis": The organization and operation of the large enterprise along the lines of the M-form favors goal pursuit and least-cost behavior more nearly associated with the neoclassical profit maximization hypothesis than does the U-form organizational alternative.

CRITICISMS OF THE TRADITIONAL STRATEGY-STRUCTURE RESEARCH

The traditional research on strategy-structure relationship represented by Chandler (1962) and Williamson (1975) has been widely received since its inception. However, their theories have also been subject to various criticisms from the 1980s. The traditional research presumed a hierarchical link, with strategy determining structure. But evidence has been found that structure has substantial impacts on strategy, which I will discuss in more details in the next section. The traditional research also assumed that the M-form structure can better accommodate diversification strategy because in the M-form the corporate headquarter has better strategic control, and the internal capital market will outperform external capital markets. But these assumptions are far from universally valid. I discuss some relevant criticisms as follows.

Political and Institutional Accounts of M-form Adoption

Most theorists attribute the M-form adoption to economic factors, arguing that the M-form structure is to better serve the functions of strategic control and internal capital reallocation. While admitting the prominent role of economic factors, more recent studies such as Palmer, Friedland, Jennings, and Powers (1987) and Palmer, Jennings, and Zhou (1993) have refocused on political and institutional explanations of M-form adoption and diffusion. According to the political approach, organizations are composed of coalitions possessing different and often conflicting interests. Coalitions are engaged in an ongoing struggle for dominance, and the balance of power between them affects the organization's goal and structure. Palmer et al. (1987) restricted their attention to the conflict between top management and two types of external ownership interests: families and financial institutions. Based on a study of the M-form adoption behavior of large U.S. corporations in the mid-1960s, the results show that both family and bank-dominated firms are less dispersed and less likely to use the M-form. Family-dominated firms resist adopting the M-form structure mainly because family coalitions prefer centralized organizational structures that allow them to control the day-to-day affairs of the firms in which they have an interest. Similarly, the bank-dominated firms are also slow to adopt the M-form because bank coalitions wish to protect their institution's position in the economy and the M-form internalizes the capital market, in which banks play a central role.

In Palmer et al. (1993), substantial support for the institutional explanation of M-form adoption is also found. Institutional theory assumes that organizations are situated in networks of social relationships and adopt structures irrespective of efficiency considerations; therefore organizations adopt structures that are considered legitimate by other organizations in their field. The authors find evidence that corporations whose primary industry included many M-form firms were more likely to adopt the M-form than those producing in sectors with few such firms. In addition, corporations whose CEOs had graduate degrees from elite business schools were more likely to adopt the M-form than were firms whose top executives did not have such degrees. Therefore the results suggest that institutional processes, including coercive and normative dynamics, substantially underpinned the M-form's diffusion during the 1960s.

Potential Incompatibility between Strategic Control and Internal Capital Market

The "M-form Hypothesis" assumes that the M-form structure can simultaneously improve the effectiveness and efficiency of both strategic control and internal capital allocation. The objective of the organizational features of an M-form firm is to establish a system within which divisions can be held accountable for their performance. But a contingency approach suggests that the control systems necessary to realize benefits from internalizing capital market transactions may be incompatible with those necessary to realize benefits from interrelationships (Hill and Hoskisson 1987, Hill 1988, Langlois 2007, Verbeke & Kenworthy, 2008). To exploit benefits from synergies or interrelationships,
a firm should simultaneously differentiate and integrate (Lawrence and Lorsch 1967, Smothers et al., 2010). As pointed out by Hill (1988), differentiation involves placing each business into its own division, while integration involves establishing linkages between divisions to realize the benefits from interrelationships. The logical way to integrate divisions in these circumstances is to centralize control at a higher level, for centralization facilitates coordination. But operational decision making by the head office creates problems of equivocality. When there are attempts to exploit interrelationships, the problem of equivocality implies that the returns earned by a division do not constitute an unambiguous signal of its efficiency. Hill's (1988) study of the strategy, structure, and performance of over one hundred and fifty large UK industrial and commercial firms revealed some surprising findings. One of them is that M-form firms were the worst performers. Another striking result is that the lower the extent to which the head office of a firm based control on abstract profit criteria, the greater the corporate profitability. These results are in conflict with Williamson's (1975) predictions.

**Fit between Strategy and Structure**

Instead of being a generally most efficient organizational structure for diversified firms, evidence has been found that the relationship between M-form structure and performance is contingent on some key factors such as control system and diversification strategy. As pointed out by Hill and Hoskisson (1987), an assumption implicit in the "M-form Hypothesis" and other follow-up studies is that the M-form structures used to manage diversified firms represent a homogeneous set of organizational arrangements. Consequently, within the strategy-structure framework it is strategic differences that account for performance variations. However, Hill and Pickering (1986) indicate that substantial organizational differences exist among M-form firms.

Hill and Hoskisson (1987) focus on three strategies for realizing economic benefits from the multiproduct firm: vertical integration, related diversification, and unrelated diversification. The study identifies economic benefits of the strategies and links them with the organizational control requirements necessary to realize these benefits. It is argued that control systems consistent with realizing financial economies are characterized by relatively high degrees of decentralization of decisions to divisions, decomposition between divisions, and consequently, high accountability for divisional profits. In contrast, control systems consistent with realizing vertical and synergistic economies will be characterized by relatively low degrees of decentralization to divisions, decomposition between divisions, and consequently, low accountability for divisional profits.

The contingency argument is supported by Hoskisson's (1987) empirical study. The results are consistent with the prediction that there is a good match between firms pursuing an unrelated diversification strategy and firms implementing an M-form structure that results in more efficient capital allocation. However, resource allocation based on objective financial performance criteria and implementation of an internal capital market does not bring increased efficiency in vertically integrated M-form firm. On the whole, related diversifiers have somewhat better allocative efficiencies upon implementing an M-form than vertically integrated firms.

**Relative Efficiency of Internal vs. External Capital Markets**

The internal capital market role of M-form is generally viewed as the most fundamental attribute of the M-form enterprise. According to Williamson (1975), the external capital market is beset by market failure. Investors experience information and control disadvantages in their relationship with the firm. The separation of ownership and control, and ambiguity of measuring performance make it possible for managers to maximize their own utility function rather than that of shareholders. By contrast, the headquarter of the M-form is argued to be able to overcome these disadvantages in its relationship with divisions. It can use internal audits to overcome the information asymmetry problems and thus identify opportunism by divisional managers. In addition, it can employ a series of mechanisms, such as performance monitoring systems, hire and fire policies, reward and incentive schemes, and internal competition for capital resources to enhance control. Therefore by internalizing capital market functions, the M-form is relatively more efficient that external capital market.

However, the validity of the above argument has been challenged, both theoretically and empirically. In an intensive review of the benefits, costs, and organizational arrangements of internal capital markets, Liebeskind (2000)
identifies two major effects that capital market internalization has on the governance of capital flows: changes in the identity of the lender and centralization of investment decisions. These two effects are then considered in relation to the three broad classes of efficiency gains which have been attributed to internal capital markets: (1) improvements in lender information; (2) improvements in the reliability of capital supply; (3) reduction in agency costs. Based on a comparison of (a) access to information in internal and external capital markets and (b) the degree of lender specialization in internal and external capital markets, it is argued that no generalized statements about the comparative informational advantages of internal and external capital markets can be made.

Empirical studies have provided concrete evidence in the inefficiency of internal capital market in many cases. Instead of always assigning cash flows to high yield uses, top managers are frequently found to subsidize poorly performed divisions with money from profitable business lines. For example, Berger and Ofek (1995) studied the effect of diversification on firm value by estimating the value of a diversified firm’s segments as if they were operated as separate firms. The results show that diversified firms invest too much in lines of business with poor investment opportunities. Unprofitable lines of business create greater value losses in conglomerates than they would as stand-alone firms.

**STRUCTURE AFFECTS STRATEGY**

As mentioned before, Chandler and his followers proposed a hierarchical ordering between strategy and structure in which strategy precedes structure. But other researchers have argued that the causal relationship between strategy and structure is reciprocal, that structure also influences strategy. For example, Rumelt (1974) argued that a high degree of decentralization, in the form of a divisionalized structure, increases the time and objectivity of senior managers, which in turn make it likely that they will perceive opportunities outside their areas of expertise. As a result, decentralization will lead to greater diversification.

Williamson (1975; 1985) suggested that the M-form structure could be seen as a governance device which overcame the problems of managerial discretion found in large, functionally organized firms. Therefore managers in M-form firms, especially division managers, would be more aligned with profit maximization objectives than managers in freestanding U-form firms. Separate divisions would be held accountable for their profits by the corporate office, and the corporate office would allocate cash according to highest yield uses among divisions. Under such ideal conditions, internal capital market would function better than external capital market.

However, Hoskission and Hitt (1988) argue that the control systems associated with the highly diversified M-form firms may lead to a focus on short-term efficiency and risk avoidance. Hoskission and Turk (1990) further argue that even though the M-form as a governance device may curtail division-level managerial discretion to some extent, it may not bridle corporate-level managerial discretion. As a result, the M-form, without adequate governance, may not curtail deviations from firm value maximization that result from corporate-level decisions. Therefore the characteristics of governance structure may have substantial impacts on corporate strategy, especially diversification strategy. The primary internal mechanisms that govern managerial discretion of corporate executives in M-form firms are direct owners, boards of directors, and managerial compensation arrangements. Further, the extent of free cash flows provides an indication of the extent of management discretion.

**EVALUATION OF THE FINDINGS**

Overall, the findings from research on strategy and structure have been rather consistent. Despite all those criticisms it faces, the traditional research advanced by Chandler and Williamson has been a solid foundation for other studies. Their basic arguments, such as strategy determines structure, and M-form structure leads to more strategic control and internal capital allocation advantages over U-form structure in diversified firms, are still valid under many circumstances after decades of extensive examination. Criticisms of traditional research on strategy and structure have been largely based on Chandler and Williamson’s contributions and have never fundamentally invalidated their arguments. However, the new stream of research has been taking a more comprehensive and contingency view of the
strategy-structure relationship. While admitting that strategy affects structure, researchers have paid increasing attention to structure's impacts on strategy. Furthermore, researchers after Chandler and Williamson have tried to find out the contingencies that determine whether M-form firms have better strategic control and internal resource allocation efficiency compared with that of U-form firms. Both the traditional and new research on the strategy-structure relationship has substantially contributed to the field of strategic management.

REFERENCES