

The Hidden Cost of Mergers and Acquisitions

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EXECUTIVE SUMMARY

A lack of consideration for employees might explain the high failure rate of mergers and acquisitions. The authors conducted a study to investigate the prevalence of unmet employee expectations in the M&A process and the unintended consequences.

At the 2017 IMA® (Institute of Management Accountants) Annual Conference and Expo, Michelle Mikesell and Jalyn Noel of Insperity, a company that provides human resources services, said the average loss from an organizational change is 12% to 15% of revenue. The two speakers discussed how the majority of change-management initiatives fail because companies do not consider the impact on employees.

Many companies experience major organizational changes, including mergers, demergers, acquisitions, and restructuring/reorganization. Companies make merger and acquisition (M&A) decisions using accounting information including financial results and projections. About 30% to 50% of mergers and acquisitions, however, decrease shareholder value, and 60% to 80% do not add any shareholder value.¹ This implies that companies are using flawed financial projections to make M&A decisions.

A possible reason for these flawed financial projections is that companies incur unexpected costs due to unmet employee expectations. Employees are greatly affected by mergers and acquisitions, and, unfortunately, their expectations are often unmet throughout the M&A process. When making M&A decisions, companies are unlikely to include employees' reactions, which can create unanticipated costs.

Even though employees play a critical role in the ultimate success or failure of a merger or acquisition, companies often overlook the human element.

Our research investigated the pattern of organizational change failures by identifying specific employee concerns that companies often disregard in the context of mergers and acquisitions. These include pay raises, bonuses, promotions, career development, job security, and job responsibilities, which are psychological contracts. Since companies often breach these psychological contracts in the M&A process, we looked at whether these breaches are a possible missing factor in M&A projections.

In this article, we provide background on the formation of these expectations as well as a discussion of employee reactions to unmet expectations. The results of our online survey provide management with insight on what is most important to employees during a merger or acquisition.

PSYCHOLOGICAL CONTRACTS

A psychological contract is a belief in a promise by an employee, an anticipatory contribution made by the employee, and a perceived future obligation on the part of the organization to provide benefits to the employee.² Psychological contracts differ from traditional contracts in that they are not formalized or negotiated, and, in fact, an employer might not even be aware an employee has formed a psychological contract. A psychological contract is a perception, which can be based on interviews, orientations, written policies, conversations with colleagues, and personal observations. Examples of psychological contracts that companies might breach during mergers and acquisitions are pay raises, bonuses, promotions, job responsibilities, job security, and career development.

There are two types of psychological contracts: transactional and relational. Transactional psychological contracts are “specific, short-term, and monetizable obligations entailing limited involvement of the parties,” while a relational psychological contract “entails broad, open-ended and long-term obligations.”³ Mergers and acquisitions often affect transactional psychological contract elements such as pay raises, promotions, and bonuses. For example, if a company is in the

practice of providing a holiday bonus, employees will come to expect this. If the company no longer gives bonuses after the organization changes, employees will feel the company has taken something away even though the company is not required to give bonuses. Organizational changes that commonly impact relational psychological contract elements include job security, job responsibilities, and career development. For example, in order to retain employees from a newly merged or acquired company, the employer might assign some people to a new department or location, and if this has not been a common occurrence in the past, it can be unexpected and unwanted.

A company breaches a psychological contract when it does not meet employees’ expectations. This might lead employees to experience feelings of violation, which are “affective and emotional experience[s] of disappointment, frustration, anger, and resentment that may emanate from an employee’s interpretation of a contract breach and its accompanying circumstances.”⁴

EXPECTATIONS

Research has proposed that employees are less likely to perceive a breach in relational psychological contracts.⁵ Other research has suggested that more relational expectations might be better able to endure threats to the psychological contract.⁶ It has also been proposed that employees might not be as quick to identify a breach in a relational contract since the expectations form over a longer period and might not be as straightforward as a transactional contract breach. When a relational contract breach takes place, the magnitude and consequences tend to have a larger impact on the employee; therefore, when employees perceive the employer has breached a relational psychological contract, the feelings of violation are stronger than when a transactional psychological contract is breached.⁷ Companies can remedy violations of transactional contracts with an adjustment to the obligations, but violations of relational contracts can damage the relationship between employer and employee.⁸ The goal of this research is to test these two hypotheses.

SURVEY METHODOLOGY AND DESIGN

We used Amazon’s Mechanical Turk (MTurk), an online

crowd-sourcing tool, to survey people who experienced a merger or acquisition in the United States. Using an online survey allows for the current study to assess a broad range of companies and include employees who have left one of the organizations in the sample. We tested the effects of psychological contract breaches during mergers and acquisitions. The respondents for this study must have worked or currently work for a company that experienced a merger or an acquisition in the U.S. in order to participate in the study.

The survey consisted of established scales for psychological contract breaches and feelings of violation.⁹ We asked respondents to indicate their level of agreement with each statement on a five-point Likert scale, with 1 representing “strongly disagree” and 5 representing “strongly agree.”

Organizational changes that frequently impact psychological contracts include pay raises, bonuses, promotions, job security, job responsibilities, and career development. We tested each element as a separate psychological contract in order to identify the individual effects a merger or acquisition has on the various psychological contracts. Statements on the survey for a psychological contract breach related to a promotion are “I have not received everything promised to me [about promotions] in exchange for my contributions” and “My employer has broken many of its promises [about promotions] to me even though I’ve upheld my side of the deal” as well as several others.¹⁰

We also measured feelings of violation from a breach in raises, bonuses, promotions, job responsibilities, job security, and career development. The statements to which respondents indicated their level of agreement for feelings of violation from a psychological contract breach in job responsibilities include: “I feel a great deal of anger toward my organization [over job responsibilities]” and “I feel betrayed by my organization [with regard to job responsibilities].”¹¹

Past articles on the topic have assumed groups that have less psychological attachment to the employment relationship are employees who are of low rank, have a shorter tenure, are younger, and/or are female.¹² Therefore, we included rank, organizational tenure, age, and gender as demographic variables. The options for employee rank included professional with no manager-

ial duties, lower-level management, middle-level management, and top-level management. We measured tenure and age in years.

The survey included 500 respondents. We discarded respondents who did not successfully complete the survey, resulting in a final sample size of 493. Of the 493 usable responses, the average age was 34 (with a range of 18 to 69), and 62.5% were male. The average length of time respondents had worked at their respective companies was almost seven years, with a range of six months to 45.5 years. With respect to employee rank, 51.6% were professionals with no managerial duties, 22.7% were lower-level management, 22.5% were middle-level management, and 3.2% were top-level management.

RESULTS

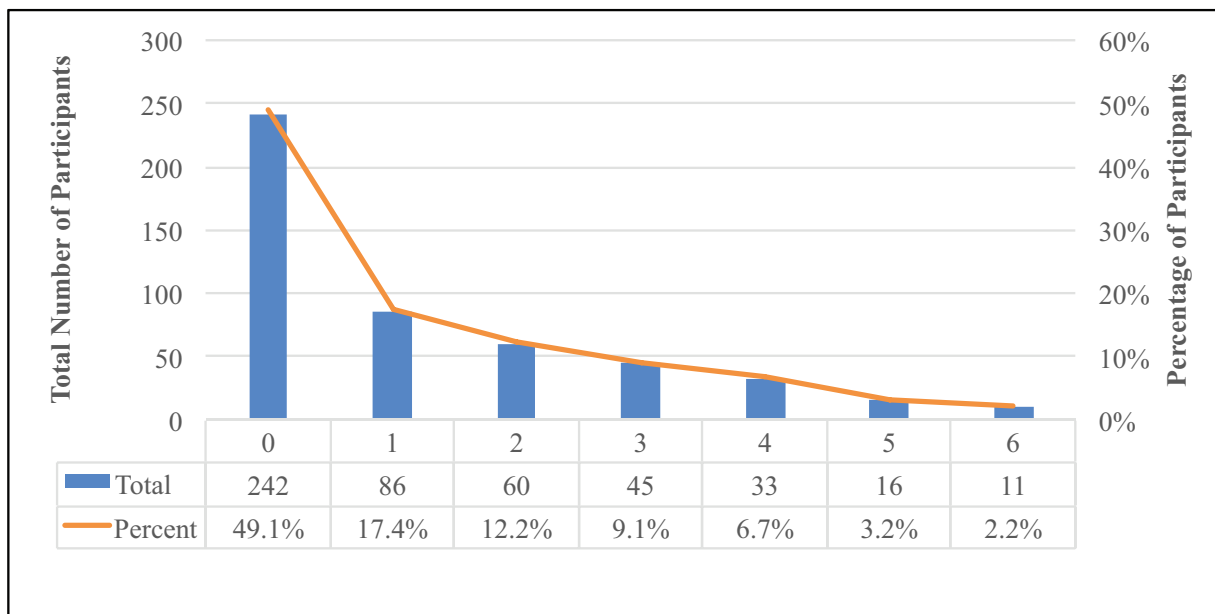
The psychological contract breaches of raises and promotions are negatively and significantly correlated with tenure. This indicates that employees with a shorter tenure perceive more severe psychological contract breaches relating to raises, promotions, and career development. The psychological contract breach of job security is positively and significantly correlated with age, which indicates that the severity of psychological contract breaches in job security is likely to be higher for older employees. Those with fewer managerial responsibilities are also likely to perceive a more severe psychological contract breach in job security, as indicated by a significant, negative correlation. Employee rank and tenure are negatively and significantly correlated with feelings of violation from breaches in the psychological contracts for raises and job security. This suggests that those with fewer managerial responsibilities and shorter tenure are more likely to have stronger feelings of violation.

Table 1 and Figure 1 provide the frequency of psychological contract breaches. The results indicate that 50.9% experienced at least one psychological contract breach during a merger or acquisition, and 12.2% (60 respondents) experienced four or more psychological contract breaches. This finding demonstrates the prevalence of psychological contract breaches during mergers and acquisitions. As Table 2 and Figure 2 show, the most commonly experienced psychological contract

Table 1: Number of Psychological Contract Breaches Participants Experienced

	Number of Breaches						
	0	1	2	3	4	5	6
Total	242	86	60	45	33	16	11
Running Total	242	328	388	433	466	482	493
Cumulative Percentage	49.1%	66.5%	78.7%	87.8%	94.5%	97.8%	100.0%

Figure 1: Number of Psychological Contract Breaches Participants Experienced



breach is a breach in raises (23.3%) followed by promotions (23.1%), career development (23.1%), bonuses (20.5%), job security (17.8%), and job responsibilities (17.6%).

A respondent's average score for a psychological contract breach ranges from 1 to 5. We measured frequency as the number of average breach scores greater than 3.5, which is the midpoint between "neither agree nor disagree" and "agree." At 3.5, the average response is no longer neutral and indicates some level of agreement with a psychological contract breach. We tested three transactional and three relational psychological contract

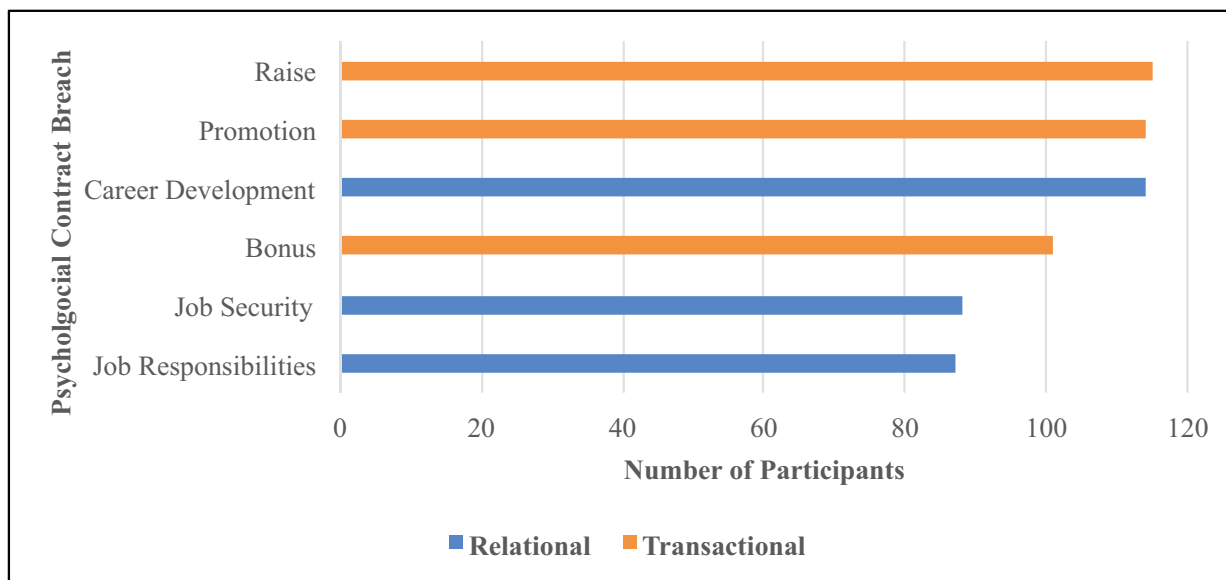
breaches, so the maximum number of breaches experienced is three for transactional and three for relational psychological contracts.

Transactional psychological contract breaches (promotions, pay raises, and bonuses) are predicted to be more frequent than the relational psychological contract breaches (job security, career development, and job responsibilities). We used a dependent paired-sample t-test, a comparison of averages, to test the average frequency of transactional psychological contract breaches compared to the average frequency of relational psychological contract breaches. The mean number of transac-

Table 2: Number of Participants Who Experienced Psychological Contract Breaches

Breach Type	Contract Breach	No Breach	Breach
Transactional	Raise	378	115
	Bonus	392	101
	Promotion	379	114
Relational	Job Responsibilities	406	87
	Job Security	405	88
	Career Development	379	114

Figure 2: Number of Psychological Contract Breaches Participants Experienced



tional psychological contract breaches is 0.67, and the mean number of relational psychological contract breaches is 0.59. This difference is significant at $p=0.042$.

As Table 3 shows, a large portion of the sample did not experience psychological contract breaches and scored zero for the frequency of psychological contract breaches, resulting in the low means of 0.67 and 0.59. The results demonstrate that these transactional psychological contract breaches are in fact perceived more frequently than the tested relational psychological contract breaches.

Based on suggestions from prior research, we pre-

dicted that the feelings of violation from breaches of relational psychological contracts are stronger than the feelings of violation from the breaches of transactional psychological contracts.¹³ Respondents may have experienced one, two, or three breaches of transactional psychological contracts and one, two, or three breaches of relational psychological contracts. We included only the respondents who experienced at least one transactional and one relational breach in the analysis, resulting in a sample size of 122. To determine the severity of feelings of violation from transactional psychological contract breaches, we averaged the scores on the feelings of violation scales associated with the transactional psycho-

Table 3: Frequency of Transactional and Relational Breaches

Frequency	Transactional Breaches	Relational Breaches
0	295	318
1	98	89
2	68	58
3	32	28

logical contract breaches that each respondent experienced.

We compared the mean severity of feelings of violation from transactional psychological contract breaches to the mean severity of feelings of violation from relational psychological contract breaches using a paired-sample t-test. The mean severity of feelings of violation from transactional psychological contract breaches is 3.45, while the mean severity of feelings of violation from relational psychological contract breaches is 3.26. Since the mean severity of feelings of violation from relational psychological contract breaches is lower than the mean severity of feelings of violation from transactional psychological contract breaches, this outcome is contrary to expectations. It is important to note, however, that feelings of violation were experienced for both types of psychological contracts.

IMPLICATIONS FOR MANAGEMENT

The overall findings suggest that many employees have a negative experience during mergers and acquisitions. The results reveal that, on average, employees perceive breaches in transactional psychological contracts (pay raises, bonuses, and promotions) more frequently than relational psychological contracts (job security, career development, and job responsibilities). Not only do the employees perceive these breaches more often, but the feelings of violation are more severe. The results suggest that these elements matter more to employees during a merger or acquisition.

So what does this mean to management? While change is inevitable during mergers and acquisitions, acquirers should familiarize themselves with the expectations of employees at the acquired organization.

Asking employees about their expectations gives them a voice during an uncertain time. To do this, employers can conduct informal interviews and/or utilize surveys. Based on the results of this study, employers should make it a higher priority to honor the transactional elements of the employees' expectations vs. the more relational aspects of the job.

Although aligning employer and employee expectations reduces the chances of perceived psychological contract breaches, managers must also recognize that it might not be possible to honor all existing psychological contracts. This is especially true during periods of organizational change. Therefore, clear and honest communication with employees is vital because the more information employees have about changes, the more accurately they can adjust their psychological contracts.

FUTURE RESEARCH

Despite encouraging financial projections, most mergers and acquisitions ultimately fail to add shareholder value.¹⁴ This research demonstrates that employees' expectations are often unmet in the M&A process, which might be a contributing factor. Future research should identify more specific consequences of psychological contract breaches and how they might lead to organizations not meeting financial projections.

Potential constructs to explore include job performance, organizational commitment, job satisfaction, organizational citizenship behaviors, and organizational deviance. Obviously, an unsuccessful merger or acquisition is costly for a company. Consequently, more information on the actual costs is needed. Research could also examine this phenomenon in the context of downsizing.

BE AWARE OF EMPLOYEE EXPECTATIONS

This study researched a possible contributing factor of unsuccessful mergers and acquisitions by examining employee expectations with respect to pay raises, bonuses, promotions, career development, job security, and job responsibilities. This research found that companies often breach these expectations during organizational change. Further, the results showed that employees perceive breaches in transactional psychological contracts more frequently than relational psychological contracts and that the subsequent feelings of violation are also more severe for transactional psychological contract breaches. Therefore, we suggest that managers include psychological contracts in their assessment of a target company to reduce the likelihood of committing breaches that might occur in the merger or acquisition process. ■

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ENDNOTES

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