NEW DEVELOPMENTS, RESEARCH AND IDEAS IN MANAGEMENT

ORGANIZATION

The Flattening Corporation

A trend toward fewer managerial layers may be a response to technological and environmental change.

“He has flattened the pyramid — there were too many bosses,” a J. Crew financial executive told the New York Times in May 2003, referring to the actions of J. Crew CEO Millard S. Drexler. Anecdotal evidence has long suggested that in American corporations increasing numbers of managers now report directly to the CEO, and division-manager roles are broadening.

Now two researchers provide corroboration through an in-depth study of confidential compensation data from 300 large American companies gathered between 1986 and 1999 by consulting firm Hewitt Associates, based in Lincolnshire, Illinois.

In their working paper “The Flattening Firm: Evidence From Panel Data on the Changing Nature of Corporate Hierarchies,” Raghuram G. Rajan, professor of finance at the University of Chicago’s Graduate School of Business, and Julie Wulf, assistant professor of management at the University of Pennsylvania’s Wharton School of Business, draw two conclusions.

First, the perception of flattening is justified. Although the number of managers reporting to the CEO has increased steadily, the managerial levels between the CEO and the lowest-level managers with profit-center responsibility (division heads) have decreased by more than 25%. In addition, the average number of division heads reporting directly to the CEO has tripled.

Second, compensation in the flatter organizations is moving toward a culture of ownership — that is, toward a partnership such as one might see in companies using an employee-ownership plan. As employees are promoted, their compensation emphasizes long-term company goals and may include pay incentives such as stock.

Do any of the changes indicate that CEOs are micromanaging more? In fact, lower-level managers are taking on more responsibility. The authors say that the trends seem to be organizational responses to technological and environmental change.

Consider the dissemination of knowledge through technological advances, which Rajan, Wulf and previous researchers believe is one reason for flattened hierarchies. “Technology has put information at everyone’s fingertips,” Wulf says, enabling lower-level profit-center managers to handle more decisions effectively.

In their analysis, Rajan and Wulf focus on two main parameters: depth (number of positions between the CEO and the lowest level of profit-center responsibility) and breadth (span of control or number of people reporting directly to the CEO). They find that mergers, acquisitions and diversification have not significantly added to the number of CEO direct reports. Nor does the abolition of the intermediary role of chief operating officer entirely account for the trend. Instead lower-level managers have become more integral to operations.

“In fact, some of the CEO’s authority devolves upon the divisional manager,” say the authors. Hence, an interesting paradox arises: Although the CEO is becoming directly connected more deeply within the organization, decision-making authority is becoming more decentralized, transferring lower into the managerial ranks.

Regression analysis reveals that neither empire building on the part of CEOs nor entrenchment in their positions significantly influenced the flattening trend, say the authors. And only a weak relationship exists between greater outside scrutiny by shareholders and either organizational flattening or CEO survival rates. In U.S. companies, the advent of the flatter organization does appear to correlate with companies becoming more human-capital intensive, which is reflected in the fact that more human-resources directors now report directly to the CEO.

CEOs are “getting more involved with operational activities in the sense of being closer to the action,” says Bengt Holmstrom, professor of economics, finance and accounting at the MIT Sloan School of Management. “For scientists, it is always important to document the precise nature of the movement.”

Paulo Costa, president and CEO of Novartis Pharmaceuticals USA, expands on that: “Over the last 15 years or so, as more and more successful companies talk about strategy and execution in the same sentence, ... senior executives have become a lot closer to the operational details.”

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— Caroline Ellis