



# 'You try to be a fair employer': Regulation and employment relationships in medium-sized firms

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## Abstract

In this article, we explore the dynamic, indirect effects of employment regulation through a qualitative study of three medium-sized enterprises and their ongoing, everyday employment relationships. Whereas owner–manager prerogative is generally associated with informality in small and medium-sized enterprises, we identify instances of formal policies and procedures implemented in response to regulation being instrumental in exerting this prerogative. Furthermore, employees reinforced this process by making judgements regarding the employment relationship in terms of their perceived informal psychological contract rather than external regulatory obligations. This article extends understanding of dynamic, indirect regulatory effects in relation to the interplay of informality and formality within psychological contracts in medium-sized enterprises.

## Keywords

employment relationships, medium-sized enterprises, psychological contract, regulation

## Introduction

Business regulation represents an attempt by governments and other bodies to influence or control organisational practices, for example, in maintaining open markets but also in areas such as

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protecting employee rights. Such attempts have received particular attention in relation to small and medium-sized enterprises (SMEs) (Kitching, 2006; Westrip, 1986) associated with the dominant political narrative of enterprise and business growth (Perren and Jennings, 2005). In this context, regulation is frequently considered as over-complicated, unnecessary and burdensome, with these problems falling disproportionately upon SMEs (Edwards et al., 2004; Young, 2012). However, the effects of regulation on such firms, which can take dynamic and indirect forms, merits further critical consideration (Kitching et al., 2013a, 2013b). Thus, our critical underpinning research question critically analyses: ‘how does regulation influence medium-sized firms in dynamic and indirect ways?’ with a particular focus on employment regulation.

In addition to the operating contexts and competing external influences upon firms such as market forces, the effects of regulation should be understood in terms of what is happening inside the firm since neither owner–managers nor their employees are passive recipients of such influences (Marlow et al., 2005; Ram, 1994). To explore this internal negotiation and adaptation, we present empirical material from qualitative, semi-structured research interviews across three medium-sized enterprises. Our findings illustrate that compliance with regulation does not necessarily constrain the exercise of informal management prerogative, but rather alters how it is exercised. Furthermore, employees apply a broad sense of the psychological contract to evaluate the employment relationship and management in their firms, only rarely referring to specific external regulatory provisions. The interpretive insights that emerge from these findings aid the conceptual development of the psychological contract in the specific context of medium-sized enterprises in terms of the interplay between formal and informal elements of the employment relationship. It is through this development of the psychological contract that we advance an understanding of the dynamic, indirect effects of regulation within these firms.

To critically explore our research question, this article is structured as follows: the literature analysis locates our work in the debates surrounding the regulatory context of SMEs and the psychological contract as a valuable approach to understanding employment relationships in these firms. The ‘methodology and method’ section describes how the empirical materials were generated and analysed, followed by a presentation of the key findings on a firm-by-firm basis. Our discussion develops insights into dynamic, indirect regulatory effects in relation to the interplay of informality and formality within psychological contracts in medium-sized enterprises. The article concludes by outlining the implications and limitations of our work along with opportunities for further research.

## Literature analysis

Firms relate, by degrees, to a regulatory context that, as well as supporting the markets in which they operate (Kitching et al., 2013a), can reduce or constrain owner–manager prerogative and influence employment relationships, for example, through a minimum-wage or working-time regulations (Arrowsmith et al., 2003; Marlow, 2003). However, in the neo-liberal discourse of economic growth, within which a prominent place is given to SMEs, regulation has been framed as inhibiting their ability to operate and is considered a burden (Kitching, 2013b). In response, governments such as that of the United Kingdom, seek ‘to reduce the number of unnecessary regulations that hold back businesses while ensuring that both workers and the public are protected’ (Department for Business, Innovation and Skills (BIS), 2013). However, it is difficult to identify what effects regulations actually have or to link the mandates and prohibitions to particular business outcomes (Edwards et al., 2004; Kitching, 2006). Instead, it is necessary to adopt a more nuanced, dynamic understanding of regulation and SMEs.

Furthermore, there is a need to recognise the distinctive contexts of those organisations typically grouped under the ‘SME’ banner. Sectoral considerations aside (Arrowsmith et al., 2003), the challenges and responses one might encounter in a small business could differ from those found in medium-sized enterprises that may retain a degree of owner–manager control and informality (Mallett and Wapshott, 2014) while also possessing a greater degree of formality (Kotey and Sheridan, 2004). This coexistence of informality and formality provides interesting sites in which to explore how regulation is enacted through employment relationships (Marlow, 2003; Marlow et al., 2010). However, a focus on medium-sized firms also provides difficulties in relating to the existing literature where small and medium-sized enterprises are rarely treated as distinct. Despite this limitation, taking the field as we find it permits engagement with regulatory issues discussed in the literature, while our empirical material speaks specifically to the experiences of medium-sized enterprises.

### *The regulatory context of SMEs*

SMEs, broadly defined as those with up to 249 employees (Office for National Statistics (ONS)/Department for Business, Innovation and Skills, 2013), are context-sensitive and dominated internally by the interests and goals of owner–managers (Marlow, 2005). Even as such firms adopt formal policies, often to accompany growth (Phelps et al., 2007), owner–managers frequently retain preferences for informal and individualised practices (Hoque and Noon, 2004; Mallett and Wapshott, 2014), which can contribute to a higher incidence of employment tribunal applications (Saridakis et al., 2008). Viewed as dominant influences within their firms, owner–managers are, therefore, often the target of regulatory interventions, debates and research projects.

Commonly cited objections to regulations include compliance costs associated with understanding and adapting to new rules and obligations (Smallbone and Welter, 2001) and affinity costs where regulatory compliance requires accompanying changes (Edwards et al., 2004), often without the necessary resources or expertise of in-house human resource (HR) professionals (Harris, 2002; Hart and Blackburn, 2005). Furthermore, owner–managers generally express a dislike for any measures that interfere with their managerial prerogative (Atkinson and Curtis, 2004; Westrip, 1986). Accordingly, firms may avoid growth through outsourcing to circumnavigate the regulatory obligations and scrutiny associated with the employment relationship (Bischoff and Wood, 2013; Perraudin et al., 2013).

Studies into the effects of regulation on SMEs, however, suggest that its role in day-to-day operations may be overstated and more nuanced than business lobby groups suggest (Carter et al., 2009; Edwards et al., 2004; Westrip, 1986). Owner–manager understanding is often vague on the details of employment regulations (Hart and Blackburn, 2005; Marlow, 2003) and, while they express *general* dissatisfaction with regulatory conditions, relatively few report being affected by *specific* provisions (Atkinson and Curtis, 2004; Carter et al., 2009). This may derive, in part, from the dominant socio-historical discourses around the burdens of regulation but also those that construct SMEs as unlikely to comply with these regulations.

In practice, the situation may be more complicated than is often presented. Kitching et al. (2013a) argue that ‘there is no typical “small business effect” of regulation; outcomes vary over time, contingent on the agency of small businesses and their stakeholders’ (p.7). Particular regulations, and how they are interpreted, will affect businesses in different ways owing to differences in firm size, age and sector (Arrowsmith et al., 2003; Hart and Blackburn, 2005; Morris et al., 2005) as well as to competitive conditions, degrees of regulatory enforcement and the responses of others in the firm’s external and internal environments (Harris, 2000; Kitching, 2006). This creates a range of particular understandings of how given sets of regulations may apply to an organisation

with owner–manager understanding often negotiated, drawing on a variety of sources such as external advisors, customers and employees (Kitching, 2006). Not all regulatory effects will be perceived or understood by owner–managers who are, for example, less likely to acknowledge any enabling effects (Kitching et al., 2013b).

Furthermore, we should not overlook the importance of employees in influencing how regulations may impact upon organisational practice. For example, highly skilled workers might exert additional, informal pressure on their employers to secure their rights and interests (Bacon and Hoque, 2005; Wapshott and Mallett, 2013). However, even the highly skilled may have little awareness of their legal rights (Bacon and Hoque, 2005) so, while regulatory non-compliance by owner–managers can negatively impact employee views of the employment relationship (National Association of Citizens Advice Bureaux (NACAB), 2000), it does not necessarily lead to explicit action to enforce employment rights (Ram et al., 2007). To encompass these internal forces and the potential for negotiation, this article will focus predominantly on employment regulation.

Taking a process perspective, the effects of employment regulation are influenced by a range of factors including ‘the nature of different laws, the mediating effect of competitive conditions, and the context of relationships inside small firms’ (Edwards et al., 2004: 247). Discussing the generic effect of regulation is too crude; such effects are dynamic, positive and negative, direct and indirect (Kitching et al., 2013a) and businesses of similar size cannot be assumed to be homogeneous (Burrows and Curran, 1989; Marlow et al., 2005). Furthermore, regulatory effects need to be understood in terms of not only formal contracts and policies but also the day-to-day informal employment relationship and individual perceptions of the psychological contract.

### *The psychological contract in SMEs*

The close physical proximity and interpersonal contact that breed high degrees of informality in SMEs (Bacon and Hoque, 2005; Ram and Edwards, 2003) involve improvised ad hoc solutions and compromises, producing or adopting formal policies and procedures but also unwritten practices, routines and tacit understandings (Brown et al., 2010; Ram et al., 2001). Even as firms grow and attempt to formalise (Phelps et al., 2007), degrees of informality remain an important part of everyday employment relationships (Mallett and Wapshott, 2014). Different degrees of (in)formality may be deployed in response to particular internal and external demands and, instead of a competing duality, informality and formality can be considered as coexistent (Marlow et al., 2010).

This close proximity and coexistence of informality and formality produces interpersonal forms of negotiation and interaction where it is clear who the employer is and where differences in the application of policy or practice are more likely to be felt at an individual level (Ram, 1994). This employment relationship is interpreted like a contract albeit, given its intersubjective nature (Wapshott and Mallett, 2013), one liable to misinterpretation and breach (Guest, 1998) and likely to escape conceptualisations of traditional, formal contracts. The interplay between informality and formality that informs the negotiation and maintenance of these employment relationships in SMEs can be best considered in terms of a psychological contract (Atkinson, 2008; Nadin and Cassell, 2007).

Psychological contracts consist of the perceptions of both parties to the employment relationship and the reciprocal obligations implied within it (Guest and Conway, 2002). Such contracts are considered transactional and relational (Rousseau, 1990), where the former reflect obligations around pay and advancement and the latter, areas such as job security and development. Relational breaches are likely to have deeper impacts than transactional breaches, although these differences are not always clear and are dependent upon context (Atkinson, 2007; Guest, 1998). SMEs represent such a context where psychological contracts may differ from the larger firms featured in

most studies, for example, owing to the distinct mix of close social and spatial proximity, resource constraints and degrees of informality and formality (Atkinson, 2008; Nadin and Cassell, 2007). However, there have been very few studies of psychological contracts in small and, especially, medium-sized enterprises, and the implications of the concept are underdeveloped in these contexts.

There are difficulties in drawing out meaningful generalisations about SMEs given the context-dependent nature of the contract and the variety of employment practices adopted (Cassell et al., 2002). Furthermore, some studies have focused exclusively on one party to the employment relationship, such as Nadin and Cassell's (2007) study of small firm owner-managers, which highlighted their unwillingness to make obligations explicit. There is also a risk in applying the psychological contract as a conceptual framework since, as Dick and Nadin (2011) found, it can lack relevance for some participants, specifically those in small firms with low-status, low-paid jobs. Partly as a result, the degree to which these perceived rights and obligations represent a contract is disputed in as much as it is not freely entered into, negotiated or agreed upon (Cullinane and Dundon, 2006).

This however, misrepresents how formal employment contracts operate in practice (Cullinane and Dundon, 2006; Guest, 1998) where they are infused with an informality that is largely unrecognised. This can take the form of (mis)interpretations, implied terms around fair treatment or in relation to common law rules based around sectoral norms (Middlemiss, 2011). This may be especially important with low-status employees in relatively informal, non-unionised SMEs lacking awareness of their rights (Arrowsmith et al., 2003), where understanding may be derived directly from employers, second-hand interpretations and broader socio-historical discourses, such as those around health and safety or part-time working (Barrett et al., 2014; Cullinane and Dundon, 2006; Middlemiss, 2011). As a result, managers and employees can come to fill in the gaps they perceive in the ambiguities of policies and HR guidance (Dick, 2010), constructing more specific obligations and expectations.

While recognising the psychological contract as a discursive product derived, in part, from broader neo-liberal discourses (Cullinane and Dundon, 2006), it can, nonetheless, help counterbalance a purely legalistic, formal view of the employment relationship, embracing the importance of subjectivity and indeterminacy (Cullinane and Dundon, 2006). The sense of contractual obligation usefully conceptualises the experiences and expectations of employees, especially in the more informal working environment of SMEs (Atkinson, 2008; Dundon and Wilkinson, 2009). While such perceived rights and obligations are rarely explicit and may, or may not, be shared (Arnold, 1996), failure to fulfil an obligation still has potentially negative consequences for the employment relationship (Robinson and Morrison, 2000). Accordingly, when conceptualising the dynamic, indirect effects of employment regulation within SMEs, it is important to consider how it may affect psychological contracts in terms of the perceived rights and obligations of both employees and employers.

## **Methodology and method**

This project began with the research question: how does regulation influence medium-sized firms in dynamic and indirect ways? The chosen focus to explore this question is the internal understanding and negotiation of employment regulation in ongoing, everyday employment relationships. To this end, we studied three quite different medium-sized enterprises via an in-depth, qualitative multiple-case study approach (Yin, 2003). The focus on medium-sized enterprises arose from an interest in the negotiation and interpretation of regulation in firms retaining a degree of informality and owner-manager control while also having formalised and introduced a range of employment

policies and practices (Kotey and Sheridan, 2004; Marlow et al., 2010). These firms also provided opportunities to talk to multiple employees who may interpret or experience regulations and their rights and obligations differently.

The three firms explored in this study were selected via purposive sampling to identify owner–managed businesses with between 50 and 100 employees. Using a university’s business contact list, access was negotiated by telephone to three firms in the North of England. The firms shared a relatively high degree of formalisation in terms of the existence of policies and procedures and their espoused approach to regulatory compliance. Each firm was headed by owner–managers, emphasising the notion of personalised management, and were small in comparison to their perceived competitors, competing in markets where large firms dominated.

The firms were drawn from the financial services, manufacturing and information technology sectors. Consistent with the exploratory nature of this study, this range of sectors was adopted to offer scope for variety in the everyday nature of the employment relationships, with employees possessing different levels of status, education and skills (Bacon and Hoque, 2005). This approach was in line with our aims not to generalise to a specific population but, instead, to examine the ongoing, everyday processes and dynamics within each case, supported by some comparisons between sectors to generate additional insights (Ram et al., 2001).

Given some of the sensitive material discussed, all three firms and each participant have been given pseudonyms. Due to potential commercial sensitivity, gaining access to each firm required assurances that anonymity would be protected and only general, non-specific data would be published.

### *Generating empirical materials*

Qualitative studies are well-suited to the complexity and messiness of regulatory effects but under-used in relation to SMEs and, more broadly, in terms of exploring the psychological contract or with low-status employees (Dick and Nadin, 2011; Kitching et al., 2013a). Furthermore, heeding Kitching’s (2006) warnings against focusing narrowly on the employer perspective upon regulation as cost or constraint, our approach incorporated employer and employee viewpoints to help understand the range of responses and to explore the different interpretations of the psychological contract.

To explore how understandings of employment regulation were negotiated within the employment relationship, empirical materials were generated from documents and semi-structured interviews. The documents were primarily in the form of employee handbooks and policy documents where the firms typically set out their formal interpretation of regulation and the employment relationship. Between 12 and 15 semi-structured interviews were conducted in each firm, giving a total of 41 interviews. The interviews were held with owner–managers, managers and employees, lasting between 30 and 60 minutes. The interviews were recorded and then transcribed verbatim to facilitate subsequent analysis.

The research participants were drawn from a range of departments and hierarchical levels to capture a variety of experience. However, through necessity, access to participants was negotiated with owner–managers and participants. In general, the participants in all three firms appeared willing to be part of the research process and most welcomed the opportunity to air their views. Their responses appeared to be frank, expressing a range of opinions and experiences. We will briefly describe the participants for each firm in the relevant subsections of the ‘Findings’ section.

Each interview started with a general discussion of working lives before focusing in greater detail on the understandings of regulation and the role it played in shaping organisational practices and psychological contracts. This approach sought to explore the general perceptions of respondents regarding their everyday experiences in relation to a broad regulatory context, with a

particular focus on employment regulation. To help elicit more detail, respondents were also asked to describe critical incidents (Herriot et al., 1997) where they or others had engaged with regulation to their benefit or detriment. Not all respondents were able to cite a critical incident but those accounts that were discussed provided a powerful means of generating insight (Purvis and Cropley, 2003) and, in many cases, critical incidences also emerged in more general discussions around each participant's working life. These incidents were discussed in terms of what happened, why it happened, how it was handled and the consequences (Cope and Watts, 2000).

## **Analysis**

Using NVivo software, sections of transcribed interviews and materials such as the employee handbook were organised by coding examples in which regulation was cited in relation to particular aspects of employment relationships, for instance, prompting or constraining particular actions as well as instances of perceived expectations, rights or obligations. We did not create a formal coding dictionary owing to the inductive nature of the coding process. Instead, consistency of interpretation was achieved by resolving any disagreements by revisiting and discussing the empirical source materials until consensus was reached.

When the coding was completed, the empirical material was organised in relation to a broad range of codes covering different aspects of regulation and the perceived rights and obligations of employees and employers. The codes and relevant extracts of empirical materials were analysed in light of the extant literature on employment relationships, the psychological contract and regulation in SMEs. As we worked through our analysis, we identified several key themes that represented our understanding of the dynamic, indirect effects of regulation within the participant firms and helped to generate interpretive insights. In the next section, we present some of the key themes within the context of each individual firm.

## **Findings**

This section will focus upon each business in turn to maintain the context of the particular sector and firm-specific details. Owing to constraints of space we cannot provide exhaustive details of each relevant instance without losing the detail and nuance facilitated by our qualitative approach, but we have attempted to present those most representative of the emergent themes. The three firms are discussed with a focus on the mix of formality and informality in the different contexts of each firm. Taking each firm in turn, we focus on the following: formal documentation, specifically the employee handbook; a mix of formality and informality around day-to-day relations and health and safety compliance; and the changing role of formality in redundancy processes and their aftermath.

Before discussing each firm, it is worth noting that, reflecting their relatively high degrees of formalisation, management in all three firms had relationships with external specialists who helped them ensure at least minimal compliance with regulation. As such, the specialists were additional partners to the employment relationship. In contrast, none of the employee participants were union members or had recognised specialists of their own to consult or direct contact with the advisers.

### ***InsCo***

InsCo is an insurance broker, operating in a heavily regulated, fiercely competitive market but experiencing high profitability and strong year-on-year financial growth. The current Chief Executive is the son of the founder, providing a consistent management style and exhibiting

apparently harmonious employment relations. Interviews were conducted with 14 from around 95 employees. Interviews were held with the Chief Executive (owner–manager: Fred), the Managing Director, one senior and one middle manager, a supervisor and nine other employees from a range of insurance product teams.

Fred and his employees presented themselves as striving to deliver and receive good treatment, fulfilling a broad range of transactional and relational obligations in the employment relationship. Perhaps supported by the firm's strong financial performance, many employees talked in positive terms about training delivery, bonuses, approach to time off and often used paternalistic phrases such as that the firm 'looked after' its employees. Participants sometimes had difficulty in providing incidents for discussion in terms of breach of obligations.

Several employees described examples of positive experiences. For instance, Peter, who had been with the firm for some time, used relational terms:

I can only relate to when my parents died. Apart from just the general time off for dependants, they were very kind and very caring they came to me and said if you need extra time, don't worry.

Fred was broadly aware of regulatory provisions, taking advice from solicitors as required and indicating that employees were always afforded their rights, although he had little detailed knowledge of these. He suggested, however, that employment regulation was largely irrelevant as it was '30 years behind good business practice' and that he would strive to offer employees more than their minimum rights:

We certainly wouldn't follow legislation if it didn't suit us. And I say this in a positive way, if for whatever overwhelming reason we wanted to do something that legislation said no, we would weigh it up and probably do it anyway.

Employee understanding of regulation was largely derived from the staff handbook. For example, Patricia, when asked about her understanding of employment regulations, replied,

When we join we're given a staff handbook and it's pages and pages and I didn't read through it in much detail but looked through it generally and it's got a copy of all the rights that we have and there's also a copy of that on everyone's computer.

However, staff suggested the knowledge of regulation that was derived from the handbook, or other sources, was limited. An administrator, Emily, explained,

I think it's actually up to you to find out what your rights are. [...] If I wanted to know about something, say maternity leave, I'd have to get the book out. I wouldn't know it off by heart. [...] I know what's in the handbook, but not anything else.

David, the Group Administrator, illustrated how InsCo's conception of the employment relationship engaged with the handbook:

... although the staff handbook does state, I'm not entirely sure, that salary will be paid for the X number of months, in the past, if anybody has been off which has exceeded whatever the arbitrary period is before salary drops, there has always been a decision taken and they are always retained on full pay. They do look after them exceptionally well.

However, David also described the potential weaknesses in management's approach to compliance:



They allow personal preference, personal liking to colour their decisions. In my view, it is probably true to say that that manner of dealing with things costs them money in terms of paying-people-out where, in fact, we could have been more professional in our decision making.

Owner–manager Fred expanded on this approach:

... we have a fantastic sentence which goes at the end of everything, which is in the staff handbook, everybody's basic rights and legal rights are tried and at the end of it we have said this may be altered at the discretion of the directors. So, for example, the paternity leave, we just top it up to the full. [...] But I'm not going to write it down that that is what we are going to do because, well, somebody really tried to take the mickey out of us. We want the flexibility of awarding it as a bonus really, so that's the flexibility.

While he could not think of a situation where he would withhold these rights, Fred's aversion to formalising what was currently achieved via informal, relational arrangements was clear. Thus, at InsCo, formal documents such as the staff handbook filtered understanding of the regulatory context as external consultants ensured it maintained minimal compliance. As with the other participating firms, the handbook was perceived by employees as representing their full rights and obligations in an equitable, open manner. However, for management, the handbook was seen as a starting point from which they would exercise their discretion to allow rights that they perceived as 'over and above' regulatory compliance.

### **SteelCo**

SteelCo is a manufacturing firm operating in a regulatory context that highlighted health and safety, a topic that repeatedly emerged in interviews in contractual terms, alongside other transactional elements of perceived rights and obligations (see also Walker and Hutton, 2006). At SteelCo, 12 interviews were undertaken from a total of 65 employees. Interviews were held with the Managing Director (owner–manager Owen), the Divisional Director, the Works Manager, the Works Foreman, seven machine operatives and one sales person. The interviews typically lasted 30 to 60 minutes.

The firm had retained consistent ownership but, despite previously being profitable, at the time of the research it was barely breaking-even with stagnant growth and operating within tight margins. Owen believed he treated employees well, although he felt this was largely not reciprocated. He had some awareness, though little detailed knowledge, of employment regulation and resented the increased formality that procedures to ensure compliance required:

The old method, the old terminology we had was 'smack 'em and sack 'em' and it worked. You can't any more.

Owen saw key incidents relating to employment regulation in terms of issues such as maternity pay that were generally negotiated directly with individual staff, excluding the firm's legal advisers. We quote at length to try to capture Owen's attitude and approach as well as an example of the role of informal negotiation:

The only girls we've got work in the offices and they're all past their sell by date, so I don't think the parental thing comes into it. I say that but the amount of times, we've just [opened a new office] and this girl that's gone down there is going to be a nightmare as an employee because she's been with us for two months, she's already had a week or two weeks off sick, she didn't come in yesterday or the day before because her daughter was unwell. You start to see a pattern, and think there's going to be a problem. [...] We had one incident when one of the reps one day said I've got to go to pick the kids up from school and

I said what about your wife and he replied that she was working, and I told him that so was he. I said to him, your wife works part-time doesn't she? And he said yes, so I said whose job's the breadwinner, whose is more important. He replied that she can't, so I said what are you going to say if I say you can't. You try to be a fair employer.

The relatively low-status employees expressed a clear view that they were afforded little respect by the owner–manager. However, dissatisfaction was not generally expressed in relation to issues such as child care, perhaps reflecting long tenures and a consistent management style. Focused on transactional elements of the psychological contract, concerns instead related more to areas such as overtime availability and promotion procedures. Matthew, for example, explained,

... they said they were going to bring in the bonus scheme which they did. I trust that if they say something then they will do it. It might take a while but they do get around to it.

Owen's resistance to regulation and his opposition to improved terms and conditions were reinforced by his experience of an employment tribunal. He appeared wary of employees and was concerned that he might face further claims, adjusting his behaviour in response to what he perceived as a breach of relational obligations:

I mean there is one of the reps upstairs who's worked with me for nearly 13 years ... I always had this habit with this guy to smack him across the head, but it was a term of endearment honestly and it was just like 'get on with it' in a joke. Apparently he got to the stage where he was going to use that against me and he knew without any question it was done in fun with him.

However, Cliff, a manager with long tenure, explained the value of greater formality in terms of relieving a pressure to worry about compliance and providing clarity for employees:

Where probably a few years ago, [Owen] would say sack him and then we'd end up at a tribunal saying we shouldn't have sacked him, well now it's all done by the book and they know that on the shop floor so they respond to discipline. If I'm going to discipline them then it's for their own good.

The implementation of such policy, as at InsCo, was supported by documents such as handbooks and manuals. Employees signed to confirm they had read the new health and safety manual and thereby took personal responsibility, even though many reported not actually reading the manual.

This lack of engagement with formal policy was despite the dangerous nature of the work. Ralph, a machine operator, explained,

There was one guy who was actually killed in the works last year. [...] he'd got a coil of steel, like a toilet roll, which slipped down, and the guy actually got in amongst them and he got crushed. That's difficult, it's health and safety. I mean obviously there has been no real blame proportioned to anybody, it was basically his own fault for being daft. [...] That caused ructions.

Cliff explained some of the implications:

Apart from me and [colleague], no-one, not the Chairman or [Owen] sat and talked to them about it and people were low. That's bad treatment from them. Because it was over the Christmas period, there was a gap, but me and [colleague] felt that we needed to talk to the staff, we made a point of taking them for a drink, having a chat, making sure they was alright. One of them said they was never coming back, but every one of them came back.

The senior management in the firm appeared to view health and safety predominantly in terms of their insurance policy and health and safety documents. In contrast, employees, who frequently expressed apparently dangerous attitudes to their own safety, perceived such incidents as a serious breach of the employer's obligation to maintain their safety, irrespective of the specific details of what caused the incident. They certainly did not see this obligation as fulfilled by a new policy or by signing the relevant documentation.

## *TechCo*

TechCo is a software house which produces specialised software for an increasingly saturated niche market, and previously strong financial performance over many years had deteriorated. Fifteen interviews were carried out at TechCo, from a total of around 90 employees. Interviews were held with the owner–manager, a senior manager, three team leaders, eight technical employees and two administrative staff.

While the business generally broke even, in some years, it had made losses, leading to two major restructuring programmes and the company being bought out. The new owner, Mark, was more formal and procedure-focused than his predecessor. Increased formalisation was regretted and even resented by employees and it was described as at odds with the family style of the company. Many of the staff had a long tenure and there was a range of transactional and relational obligations perceived by both parties to the employment relationship. Several employees spoke of being supported during difficult periods outside of work although there were also concerns about a lack of investment in training and development.

Susan, an employee with a very long tenure, explained the company's approach to time off in relation to degrees of informality within the apparently formal policies:

We do have formal policies but, again, at the end of the day, if somebody goes to their manager and their manager, and I'm not saying soft touch, that's the wrong word, is more sympathetic, then they may be able to take half day flexi or time off in lieu whereas another manager will say no that contravenes the procedure.

Social relations at TechCo had been severely disrupted by two rounds of redundancies in the previous three years. Power asymmetries were clearly evident throughout these processes, despite a mainly graduate workforce theoretically holding some labour market power. This had contributed to an 'us and them' culture as well as low morale described by several employees.

Development Manager Henry, placing himself with the employees ('us'), gave a representative outline of the employee perspective:

I think they completely cocked up the first round of redundancies, they treated us like commodities, rather than individuals [...] it was completely impersonal [...] they basically sent out an e-mail saying in two weeks' time a group of you will be made redundant, and that was it.

The first, 'cocked up' redundancy exercise still survived as an eagerly told story within the organisation, related in terms of an episode of a popular UK sitcom *The Office* where the fictional office's manager announces redundancies in the context of his own promotion.

However, the owner–manager asserted that these exercises were legislatively compliant and some employees perceived the adoption of a scoring system as lending the second round some legitimacy. Nigel, a project manager said,

Well, certainly the [second] redundancy process was done very fairly I think. The way people were objectively scored, it wasn't just one person's opinion. So, the exec gave quite a lot of credibility in the redundancy process even though it's very stressful for everybody concerned, at least they had a dependable and fair process that they had gone through.

However, a number of other employees suggested that regulations had been used to support a sham selection procedure which justified the selection of those employees senior management already wanted to exit. Terry, a developer commented,

There was a set of criteria basically, so like what skills a person had, how flexible they were, how much this person bought into the company principles and so on. I believe they had already targeted who they wanted to get rid of and then manipulated the scores.

Owner–manager Mark explained how the redundancy selection process was used to address problems ignored by everyday practices in a business that had been reluctant to use disciplinary procedures to address perceived issues such as excessive sick leave. By adopting selection criteria that addressed these areas, staff perceived as problems were made redundant.

Many staff talked about the impact of redundancies on trust. Several mentioned how, after being told the first round would not be repeated, the second round was presented not in terms of financial necessity but rather as a phase of restructuring. Other employees gave detailed examples of specific cases they felt demonstrated either insincerity or incompetence in the selection procedure, such as a colleague who had been laid off due to high levels of sick leave following a miscarriage. It was suggested that the employer had a relational obligation to consider such circumstances alongside the more formal selection criteria. Therefore, even if minimally compliant with regulation, this second exercise was seen by some as a breach of the relational psychological contract.

In the context of the redundancy exercise, there was very little acknowledgement from senior management of a relational psychological contract or any rights or obligations that might be associated with it. Instead, they focused on minimal compliance and, given the financial struggles of the firm, ensuring the best outcome for firm performance.

## Discussion

The effects of regulation can be dynamic and indirect (Kitching et al., 2013a) and so are complex and difficult to understand. This has important implications, not only for individual firms but for broader debates around the 'burdens' of regulation (Carter et al., 2009; Edwards et al., 2004). Our research analyses employment relationships within medium-sized enterprises to examine how the regulatory context might be interpreted, enacted, ignored and negotiated. These are firms that retain owner–manager centrality and a degree of informality but have formalised and, in theory, have more sophisticated policies and practices with which to engage with regulation than more informal small enterprises (Carter et al., 2009). The psychological contract provides a valuable way of conceptualising the interplay of these informal and formal influences within the employment relationship, capturing important perceptions of rights and obligations that fall outside of the formal contract.

Medium-sized firms represent an interesting case, retaining a history of informal negotiation in the context of more formal systems that, in our firms, were established in part to ensure greater regulatory compliance and protection from employment tribunals. Within our research, examples manifested in the staff handbook at InsCo, health and safety at SteelCo and selection criteria for a redundancy exercise at TechCo. The owner–managers of all three firms relied, to varying degrees, on external consultants and expressed the security they felt this helped provide in managing the

employment relationship and protecting them from the perceived dangers of employment regulation. However, the formal policies and practices that represented regulation within the firms not only operated in these relatively direct ways. We suggest that the dynamic, indirect effects of regulation can be valuably understood through the ways in which the development and negotiation of perceived rights and obligations draw upon formal and informal elements of the organisation and the interplay between them.

Despite high degrees of formality, informal practices pervaded the firms and were often preferred to formal procedures. Through this preference for informality, even compliance with regulations served less to remove management prerogative than to reposition its application. Examples of this arose in all three firms, despite their differences in employee status and education, financial performance and management style. For example, at TechCo, while some staff perceived formal selection criteria as lending the redundancy process some legitimacy, others argued that management had, in complying with regulations, constructed the criteria in such a way as to target those staff they deemed problematic and, to a degree, this was supported by senior management accounts. The exercise of informal management prerogative in this example had moved from being exercised explicitly in selecting particular employees for redundancy, to application earlier in the redundancy process when formulating the criteria required, achieving management designs.

Where the relationship was held to be compliant with appropriate employment regulations, management interpreted this as fulfilling the sum of their obligations with respect to staff. At SteelCo, this related even to extreme incidences of health and safety as well as in providing protection and guidance for the owner–manager’s brash management style. At InsCo, more harmonious, informal employment relations were apparent, with the owner–manager suggesting that employment regulations were largely irrelevant and ‘30 years behind good business practice’. However, formal documentation still contained only those rights and obligations relating to minimal compliance, operating on a similar principle to that at SteelCo.

The coexistence of informality and formality within medium-sized firms (Marlow, 2003; Marlow et al., 2010) can be seen in these examples through their informing the perceptions of rights and obligations that draw upon the interplay between informal negotiation and formally recorded policies. Managers interpreted any provisions that went beyond what they understood to be minimal obligations, such as with paid periods of absence at InsCo, as bonuses granted (or withheld) at their discretion. Thus, formal documentation was used to negotiate employee compliance in such a way that there was relatively little fear of breach of the psychological contract. Owner–managers did not feel that these individual bonuses constituted improved rights or created obligations beyond each specific application. Rather, they broadly felt bound only by what was formally set out and that for which they could be clearly and explicitly held accountable, not through direct reference to regulation.

The repositioning of owner–manager prerogative was compounded since, where formality represented external regulation, this was taken by employees as an unproblematic translation. Thus, employees, focused on their perceptions of a psychological contract, effectively ignored the regulation itself, their (mis)understanding mediated by their interaction with the formally produced documents. Employers were not held accountable to the regulation but to its mediated form within the organisation. This led to dynamic, indirect and unpredictable effects, such as an informal bonus system for time-off at InsCo, new forms of ‘by the book’ discipline at SteelCo or the revised basis of redundancies at TechCo. Many of these effects were accepted by a majority of employees across all three firms, irrespective of level of education, pay or status. As a result, employment regulation was not guaranteed to have its desired impacts and owner–managers were rarely burdened beyond the expense of their legal advisors, their informal prerogative largely still governing these firms.

Despite an owner–manager expressing concern that, once a practice was formally recorded in the staff handbook, management could find their discretion constrained, the impact of formal policies in constraining management prerogative can be overstated. In each of the firms, it was management, advised by their specialists, who decided what went into the formal documents. This more informal owner–manager prerogative grants them some discretion over what rights are highlighted to employees and, where possible, allows owner–managers to shape policies that, while ensuring minimal regulatory compliance, maintain their discretion and suit their personal preferences. Furthermore, once a policy is formalised, owner–manager prerogative becomes reified and separated from its source, forming part of the rules on which the company operates and influencing the perceived psychological contract. As such, employees found it hard to negotiate around formal policy because it is the preserve of management, including the discretion to effect alterations, as suggested at InsCo.

The interplay between informality and formality provides a form of negotiation which alters the ways in which regulation dynamically and indirectly influences the employment relationship with effects and outcomes that are difficult to foresee. This can be theoretically understood in terms of the development and negotiation of perceptions of the psychological contract in terms of perceived rights and obligations. For both employers and employees, this draws upon both informal and formal sources and is negotiated on an ongoing, everyday basis. Regulation does not necessarily remove informality, owner–manager prerogative or the role of perceived rights and obligations, although it does influence them and how they are exercised.

## Conclusion

Set within the context of a dominant political narrative of enterprise and business growth, employment regulation is often presented as a particular problem for SMEs. However, despite this popular perception of ‘the effect’ of regulation, research has begun to indicate a more complex scenario, with regulation having dynamic, indirect effects on firms (Edwards et al., 2004; Kitching et al., 2013a). This article has explored these issues with reference to employment relationships in medium-sized firms. It suggests that some of these dynamic, indirect effects can be understood in terms of the psychological contract which helps to conceptualise the interplay of the formal and informal elements of the employment relationship as regards the development and negotiation of perceived rights and obligations.

Our findings contribute to a growing understanding of regulation in medium-sized firms. Through a focus on employment regulation, we have identified a range of both formal and informal processes that, through their interplay, altered the dynamic, indirect effects of regulation within the firms. Formal policy documents and procedures were not predominantly seen by owner–managers as representing (best) practices within their firms, potentially limiting the reliability of studies gathering information only in terms of these policies. Where these formal documents were influential was in shaping the psychological contract, albeit through informal processes of second-hand reports, management interactions and personal experiences, reflecting the firms as informal, storytelling organisations as much as policy-led, formal operations. In each firm, the ways in which regulation was interpreted, enacted, ignored and negotiated therefore produced a variety of unpredictable interactions between the formal policies and the informality associated with owner–manager prerogative and employee negotiation.

This conceptually develops the psychological contract in the specific context of medium-sized firms, which allows us to better understand dynamic, indirect effects of regulation. Employees lacked the ability to enter full negotiations of rights and obligations around the repositioned areas

of informality and owner–manager decision making. This was explained by a lack of knowledge and a tendency to regard formal policies and procedures as representing external regulations unproblematically. What they perceived as their rights and obligations, and where they perceived forms of breach or failure on the part of employers, can be usefully conceptualised in relation to a psychological contract that embraces the formal and informal, direct and indirect influences of regulation within the employment relationship.

There are several limitations with this type of qualitative exploratory study. While studying firms from different sectors allowed us to broaden the scope of our research, for example, in terms of employee education and status, it also limited the degree of between-firm comparison. Employees in the participating firms, especially those of lower status and education level, may not articulate their full understanding or might be alienated by engaging in terms of a psychological contract (Dick and Nadin, 2011). Furthermore, having conducted in-depth research in only three firms, the results are not broadly generalisable, providing instead interpretive insights and avenues for further research. Future research should seek to further develop our understanding of how the interplay between informality and formality influences the psychological contract and, beyond this, to seek further generalisation of the dynamic, indirect effects that regulation can produce within SMEs.

For policy-makers, it seems clear that rights and obligations need to be communicated more clearly and directly to employees. However, this alone may not help redefine perceived psychological contracts that had few reference points outside of the firm beyond the owner–manager’s legal advisors and dominant neo-liberal and managerialist discourses. This suggests some of the complexities and nuances in the role of the psychological contract.

This article has critically analysed, using empirical illustrations, how the interplay between informality and formality informs an ongoing negotiation within the employment relationship that alters the dynamic, indirect effects of regulation. We suggest that, theoretically, this can be understood through the development and negotiation of perceptions of the psychological contract which, for both employers and employees, draws upon informal and formal sources and is negotiated on an ongoing, everyday basis. These insights suggest why, in practice, the claimed burdens on employers of regulation may be exaggerated and, moreover, that regulation must speak to the psychological, as well as the formal written contract if it is to be effective.

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