2002

Someone Old or Someone New? The Effects of CEO Change on Corporate Entrepreneurship

J. L. "Bert" Morrow Jr.
Birmingham-Southern College, bmorrow@bsc.edu

Follow this and additional works at: https://digitalcommons.sacredheart.edu/neje

Part of the Business Administration, Management, and Operations Commons, and the Entrepreneurial and Small Business Operations Commons

Recommended Citation
Available at: https://digitalcommons.sacredheart.edu/neje/vol5/iss2/6

This Article is brought to you for free and open access by the Jack Welch College of Business at DigitalCommons@SHU. It has been accepted for inclusion in New England Journal of Entrepreneurship by an authorized editor of DigitalCommons@SHU. For more information, please contact ferribyp@sacredheart.edu, lysobeyb@sacredheart.edu.

JEANNETTE OPPEDISANO (oppedisanoj1@southernct.edu) is an associate professor in the School of Business and is a participant in the Women’s Studies program at Southern Connecticut State University.

Dr. Oppedisano has practitioner experience as an executive administrator, teacher, researcher, and entrepreneur. For more than 10 years, she has been writing about and encouraging the direct approach of economic independence for girls and women as a faster, more effective, less emotionally debilitating route to equality. In the fall of 2000, Dr. Oppedisano published the first Encyclopedia of American Women Entrepreneurs 1776 to the Presend (Greenwood Press). Her articles and case studies have appeared in several journals as well as in many academic proceedings. Dr. Oppedisano established the first women’s multidisciplinary entrepreneurship course at Skidmore College and the first to be offered at Southern Connecticut State University. While at Skidmore, she also spearheaded the effort to bring the summer entrepreneurship program for teenage girls, Camp Start-Up, to the college.

SANDRA LUEDER (luederst1@southernct.edu) earned her B.A. from the University of Wisconsin at Madison, M.C.P. from the University of Cincinnati, M.B.A. from the University of Connecticut, and Ph.D. from the City University of New York. She is a tenured associate professor in the Marketing Department/School of Business at Southern Connecticut State University where she has been on the faculty since 1981. Her degrees cover the topical areas of American institutions, community and comprehensive health planning, marketing, and consumer influences of retail store quality.

Prior to coming to SCSU, Dr. Lueder was a principal planner for the state of New Jersey in the Department of Institutions and Agencies and the Department of Community Affairs. Subsequently, she joined United Engineers and Constructors, Inc., a subsidiary of Raytheon, as a manager of technical subdiscipline and environmental planning.

The following quotation, attributed to Sir Joshua Reynolds (1732–1792), illustrates the important role that individuals play in the creation of value: “Invention is little more than a new combination of those images which have been previously gathered and deposited in the memory. Nothing can be made of nothing. He who has laid up no visible or material facts can scarcely make any visible new fact. Nothing can be made of nothing.”

JOHN L. MORROW, JR.

The Effects of CEO Change on Corporate Entrepreneurship

Boards of directors often attempt to foster corporate entrepreneurship by replacing a firm’s chief executive officer (CEO). Compelling theoretical arguments and anecdotal evidence suggest that when firm performance has suffered, a new CEO is best suited to lead the firm’s creative endeavors. On the other hand, among firms that retain their existing CEO after a decline in performance, manipulating the CEO’s compensation package is a common governance practice used by boards to encourage innovation. In these cases, some have argued that increasing the CEO’s pay will encourage corporate entrepreneurship, because the CEO has been compensated for assuming additional risk. Counter to these propositions, this study develops theoretical arguments that a firm’s existing CEO is better equipped to foster corporate entrepreneurship and that this probability increases when the CEO’s cash compensation is decreased. Results from a sample of 100 single-product manufacturing firms suggest firms that retain their current CEO and decrease the CEO’s cash compensation are most likely to engage in corporate entrepreneurship. Implications that this research has for corporate entrepreneurship, corporate governance, and firm performance are discussed.
EFFECTS OF CEO CHANGE ON CORPORATE ENTREPRENEURSHIP


Firm Resources and Entrepreneurship

Schumpeter (1942) viewed entrepreneurship as the process of carrying out new combinations (e.g., new products, market products, processes, technologies) by relying on the firm’s existing stock of resources. He also suggested that the purpose of the firm is to seize competitive opportunities by creating or adopting innovations that make competitors’ positions obsolete. Similarly, Penrose (1959) argued that the firm is not created by the marketplace but instead by the creative capabilities of the firm’s managers as they seek to take advantage of the firm’s opportunities. Rumelt (1984) echoed the arguments made by Schumpeter and Penrose by suggesting that strategy should be viewed as entrepreneurship. If managers can create competitive advantages that are ambiguous, these processes have uncertain imitation and any benefits that accrue to the firm from these processes may be lost (Rumelt, 1984). Schumpeter and Rumelt each stressed that entrepreneurship is the source of change and growth within a firm. Under this view, firms that seek to change should use externally generated information that is integrated with internal knowledge to develop new ways of exploiting the firm’s existing resources.

New CEOs Are Needed

Some organization theorists have argued that executive succession is a key role in corporate entrepreneurship. For example, the entrepreneurial process is enabled by the allocation of resources and the articulation of a strategic vision, roles that are traditionally reserved for top management. In addition, systems (Wright and Duncombe 1982) foster corporate entrepreneurship “through the building of an entrepreneurial organizational environment and human resources” (Hoskisson and Hitt 1990). Similarly, resource champions may be a key element in any attempt to sustain or improve firm performance following periods of environmental turbulence (Virany et al. 1992).

The second cost associated with CEO change is the loss of valuable relationships or “social complexities” that the current CEO may have developed (Barney 1986). Besides the immediate human and social capital (e.g., stories of knowledge, life experiences), corporate entrepreneurship is also influenced by complex social interactions among different groups and organizations within an organization (Ford and Woolridge 1999). Group composition, leader involvement in the organization and is not tied to the organization’s “dominant logic” that may lead to such counterproductive behavior.

New CEOs to the Rescue

Rumelt each stressed that entrepreneurship is the source of change and growth within a firm. Under this view, firms that seek to change should use externally generated information that is integrated with internal knowledge to develop new ways of exploiting the firm’s existing resources.
This study also placed the issue of CEO compensation in an action-based framework by focusing on the desired behavior of the CEO, specifically the desired actions taken by the firm. This is consistent with the view that one role of executive compensation is to encourage departures from the status quo (Gomez-Mejia and Wiseman 1997) and implies that changes in CEO compensation are reflected in some action taken in an effort to improve firm performance (in this case, corporate entrepreneurship). Gomez-Mejia and Wiseman (1997) suggested researchers should examine individual elements of the CEO's compensation package focusing on total compensation. However, which elements of the CEO's total compensation are most likely to encourage corporate entrepreneurship? Top managers receive compensation in one or more of the following forms (Castanias and Helfat 1991): salary, bonuses, deferred compensation (e.g., stock options), and perquisites. Wiseman and Gomez-Mejia (1998) argued that managers distinguish between the cash component (salary plus bonuses) of the compensation and the deferred compensation component.

Hypothesis 1: CEO change will have a negative effect on corporate entrepreneurship.

Hypothesis 2: Changes in the CEO's cash compensation will be inversely related to corporate entrepreneurship.
EFFECTS OF CEO CHANGE ON CORPORATE ENTREPRENEURSHIP

27

During the year of decline (t), a change in the firm's chief executive officer (NEWCEO).

The panel consisted of four doctoral students, majoring in strategic management, who were at the dissertation stage. Each of the students held a master of business in strategic management, who were asked to consider whether this value would be difficult for competing firms to imitate within one year. The panel was asked to identify those announcements from each firm's proxy statement during the year that followed their year of decline. A summary of the topics of the students' dissertation research closely paralleled the topics of the announcements they were asked to code (e.g., strategic management of innovations, internalized alliances).

The panel was asked to identify those announcements most likely to be perceived by the firm's investors (or potential investors) as signaling new product markets, processes, or technologies. They were also asked to consider whether this value would be difficult for competing firms to imitate within one year. The dependent variable, corporate entrepreneurship (CE), was dummy coded (1=0) for the presence or absence of a valuable announcement regarding new products, product markets, processes, or technologies that should be difficult to imitate within one year. Cronbach's alpha was used to test for interrater reliability and it exceeded .70 in all cases.

Change in CEO Cash Compensation. The percent-age change in the CEO's cash compensation (salary plus bonuses) following the year of declining performance was used to operationalize corporate entrepreneurship. The percentage change in the CEO's cash compensation also had an inverse relationship to the direction of that effect. CEO cash compensation is treated as a control variable (Gray and Ariss 1985).

Finkelstein (1992) created a structural power scale that included an item measuring compensation by the compensation of the highest paid manager in the firm and noted that "compensation can be consider-ed an important indicator of formal power" (1992: 512). Others have found that powerful CEOs may use their power to "help them obtain higher levels of compensation" (David, Kochhar, and Levitas 1998: 204). In the research reported here, power was operationalized as the proportion of the CEO's salary relative to other members of the firm's top interrater team (president and vice president). The results of this operationalization capture a firm's ability to meet its liabilities divided by total assets (t). These data (CASHCOMP) were obtained from each firm's 10-K report.

Model 1 presents the means, standard deviations, and correlations of the variables used in this study. The results of the logistic regression model used to test the hypotheses are presented in Table 2. The model overall parameter estimate (Chi-Sq) was statistically significant (p<.05). CEO change (p<.01) and change in the CEO's cash compensation (p<.05) were statistically significant and both had negative signs. Among the control variables, CEO power (p<.10) was statistically significant and had a negative sign. Firm size and slack were not statistically significant. These results support hypothesis 1, which stated that CEO change would have a negative effect on corporate entrepreneurship. The percentage change in the CEO's cash compensation also had an inverse relationship to corporate entrepreneurship, which supports hypothesis 2. Powerful CEOs have a negative effect on corporate entrepreneurship while entrepreneurship does not appear to be further test the validity of the coding methodology used to operationalize corporate entrepreneurship. If these announcements are truly indicative of corporate entrepreneurship, then they would be expected to have a positive effect on firm performance. Ordinary least squares regression was used to estimate a model to test the influence of these announcements on firm performance (operational-ized as the firm's return on investment [ROI] in time t+1). ROI has been suggested as an appropriate performance measure to assess the success of corporate ventures (Elder and Shimanski 1987). After controlling for ROI in this model, the dependent variables were included as control variables. The results of the logistic regression model used to test the hypotheses are presented in Table 1. The dependent variable, Corporate Entrepreneurship (CE), was dummy coded (1=0) for the presence or absence of a valuable announcement regarding new products, product markets, processes, or technologies that should be difficult to imitate within one year. Cronbach's alpha was used to test for interrater reliability and it exceeded .70 in all cases.

Results Table 1 presents the means, standard deviations, and correlations of the variables used in this study. The results of the logistic regression model used to test the hypotheses are presented in Table 2. The model overall parameter estimate (Chi-Sq) was statistically significant (p<.05). CEO change (p<.01) and change in the CEO's cash compensation (p<.05) were statistically significant and both had negative signs. Among the control variables, CEO power (p<.10) was statistically significant and had a negative sign. Firm size and slack were not statistically significant. These results support hypothesis 1, which stated that CEO change would have a negative effect on corporate entrepreneurship. The percentage change in the CEO's cash compensation also had an inverse relationship to corporate entrepreneurship, which supports hypothesis 2. Powerful CEOs have a negative effect on corporate entrepreneurship while entrepreneurship does not appear to be further test the validity of the coding methodology used to operationalize corporate entrepreneurship. If these announcements are truly indicative of corporate entrepreneurship, then they would be expected to have a positive effect on firm performance. Ordinary least squares regression was used to estimate a model to test the influence of these announcements on firm performance (operational-ized as the firm's return on investment [ROI] in time t+1). ROI has been suggested as an appropriate performance measure to assess the success of corporate ventures (Elder and Shimanski 1987). After controlling for ROI in
time, the announcements that were coded by the panel had a positive effect on ROI in time t+1 (p<0.05), which suggests the announcements that were coded by the panel as entrepreneurial events had a positive effect on ROI. The finding from this post-hoc analysis provides additional evidence of construct validity for the coding methodology used in this study.

Finally, logistic regression allows the computation of probabilities for the presence of corporate entrepreneurship (CE=1). The coefficients are interpreted the same as in ordinary least squares regression except that they refer to the probability of the dependent variable being present, rather than to the level of the dependent variable (Alirdiz and Nelson 1984). Using equation 2, values for the variables can be substituted and then multiplied by the coefficients from Table 2 to arrive at the probability of corporate entrepreneurship under various conditions (Mendenhall and Sincich 1989). This analysis provides a clearer picture of the effects of changes in the independent variables on the probability of CE=1.

\[
\text{Probability CE=1} = \frac{1}{1 + e^{-(b_0 + b_1 \text{CASHCOMP} + b_2 \text{NEWCEO})}}
\]

(equation 2)

The mean change in cash compensation for CEOs in the sample was an increase of 11 percent with a standard deviation of 36. Table 3 presents the probabilities of corporate entrepreneurship under the conditions of CEO change and no CEO change, when the percentage change in cash compensation is zero, is decreased by one standard deviation above the mean (–25%), is increased by one standard deviation above the mean (+25%), or is not changed. When no CEO change, the probability of corporate entrepreneurship increases as cash compensation is decreased. This analysis provides additional support for hypothesis 1, which stated that changes in CEO cash compensation will have an inverse relationship with corporate entrepreneurship. Also note from Table 3 that the probability of corporate entrepreneurship when there is no change in the CEO’s cash compensation is 78 percent when the current CEO is left in place but only 53 percent if the firm hires a new CEO. This analysis provides additional support for hypothesis 1, which predicts that CEO change will have a negative effect on corporate entrepreneurship. Consistent with the theoretical arguments, the probability of corporate entrepreneurship following a decline in firm performance is minimized by retaining the current CEO and decreasing his or her cash compensation, while the probability of corporate entrepreneurship is minimized by hiring a new CEO.

Discussion

Most studies of CEO change have focused on the effect of executive change on subsequent firm performance (Kesner and Sebora 1994). However, these new CEOs must first “do something” before firm performance can be affected and relatively few studies have focused on the effect that CEO change has on these other “intermediate” organizational outcomes (Friedman and Saul 1991; Greiner and Bhamri 1989; Miller 1993; Welsh and Dechler 1988). If corporate entrepreneurship, such as innovation and creativity, is the basis for competition among organizations (Fennrose 1959; Rumelt 1984; Schumpeter 1942), and if organizations often experience CEO change, then understanding the effect that CEO change has on corporate entrepreneurship has important implications for both research and practice.

The theoretical arguments offered in this article for the important role that existing CEOs play in corporate entrepreneurship are grounded in the belief that corporate entrepreneurship is the result of people working together in a social context and that disruptions to this social context (CEO change) are more likely to foster corporate entrepreneurship. This view, and the supporting empirical results, are consistent with a narrow rate of entrepreneurship and only 5 of these changed CEOs. Of these 5 new CEOs, 4 were insiders and 2 were related to the portfolio investment, which is a deviation of almost all of the new CEOs possessed firm-specific knowledge, only about half of those new CEOs were able to use that knowledge to pursue corporate entrepreneurship. This seems to indicate that social complexities within the organization play an important role in corporate entrepreneurship (Floyd and Woolridge 1999; Greene et al. 1999), perhaps a more important role than specific knowledge of the firm’s resource base.

At least one qualification seems in order to the finding that CEO change has a negative effect on corporate entrepreneurship. The announcements were collected in the year of decline if the average CEO enjoys cash compensation (+11% and CEO turnover was measured at the end of the year of decline (t). It is possible that organizations that changed CEOs experienced an improvement in corporate entrepreneurship and that CEO change delayed, rather than stifled, the creativity of those within the organization. Thus, to be more precise, changes in CEO compensation during the period of CEO turnover immediately following the year of succession (t+1). Whether this effect holds in subsequent years is an interesting question for future research.

The results of this study also support the arguments made by Woodward and his colleagues (1993) that contextual factors, such as the organization’s reward system, may be used to foster, or inhibit, creativity by individuals working together in a complex social system. This argument is supported in part, suggests that an organization’s incentive system may be used to encourage the actions of managers with the goals of the shareholders, and has received widespread support in other research studies (Baysinger and Hoskisson 1990; Goodstein and Boecker 1991; Hoskisson et al. 1989). The results presented in this study, point to the fact that cash compensation plays an important role in encouraging CEOs to pursue corporate entrepreneurship. Specifically, reducing a CEO’s cash compensation during the period of performance decline appears to encourage corporate entrepreneurship. This argument is also supported by Carpenter (2000), who found a negative relationship between changes in the cash component of the CEO’s salary package and subsequent strategic change (measured by deviation from industry strategy norms).

Interestingly, while all of the firms in the sample experienced a decline in firm performance, the average change in the CEO’s cash compensation following this year of decline was an increase of 11 percent. At least two interesting differences can be drawn from this observation. First, much work remains to be accomplished by boards of directors in the areas of corporate governance in general, and CEO compensation incentives in particular. Second, it should not be surprising that only 17 percent of the firms in the sample exhibited corporate entrepreneurship after a year of decline if the average CEO enjoys cash compensation increases of 11 percent during this period regardless of any firm innovations. This also appears consistent with a proposition by Gomez-Mejia and Wiseman (1997: 358) that executive compensation designs similar to those of their competitors (e.g., those that increase CEO pay despite a decline in performance) will serve to foster strategic conformity rather than strategic change.

Conclusions

This research has explored the effect of CEO change on corporate entrepreneurship following a year of poor firm performance. Given the frequency of CEO change within organizations and the role of corporate entrepreneurship in gaining and sustaining a competitive advantage, the findings from this study have interesting implications for both academic researchers and management practitioners. Conventional wisdom suggests that when firm performance suffers, firms often need new CEOs. However, this research indicates that it is not only when a new CEO’s tenure begins that changes in CEO compensation have a negative effect on corporate entrepreneurship, perhaps because of the loss of firm-specific skills and the disruption of social complexities within the firm. Clearly there are cases where new CEOs are needed to lead an organization. However, replacing a CEO simply because a firm has experienced a decline in performance may be analogous to replacing a bus driver just because he or she made once a wrong turn and became lost. By changing CEOs, firms may be eliminating the one person who not only may know where the firm took a wrong turn, but may also know how to lead the organization back on the road to recovery.

Acknowledgments

An earlier version of this article was presented at the 1999 annual meeting of the Academy of Management, Chicago, Illinois. The author wishes to thank Allen Amason, Richard Woodward, Mason Carpenter, and Jim Bloodgood for their assistance on earlier drafts of this manuscript.
Endnotes
1. The CEO’s employment contract may be structured so that cash compensation is automatically reduced when performance suffers without any additional action by the firm’s board of directors. This suggests that the board may be fulfilling its fiduciary oversight role on behalf of the firm’s shareholders, in part, through the incentives provided in the CEO’s employment contract.
2. For a detailed explanation on the calculation of Jensen’s alpha, see Hoskisson et al., 1994, p. 1221.

References


