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

J. L. Morrow, Jr.

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.

T he CEOs of profit-seeking organizations are charged with organizing the firm’s resources to create value. The search for value has prompted some researchers to theorize about the CEO’s role in corporate entrepreneurship (Brazeal and Herbert 1999; Floyd and Woodridge 1994; Greene, Brush, and Hart 1999; Penrose 1959). Indeed, Nonaka (1994: 21) argued that “tacit knowledge possessed by individuals is critical to the knowledge base and level of expertise possessed by the firm” (Amabile 1979; Castanias and Helfat 1991; Greene et al. 1999; Penrose 1959). Nonaka (1994: 21) argued that the individual who is the “prime mover in the process of organizational knowledge creation” and that the quality of tacit knowledge possessed by individuals is critical to the creation of new strategies. Thus, firm-specific tacit knowledge may be used to formulate valuable organizational strategies, but such knowledge can only be developed by repeated experiences with an organization’s routines (Nelson and Winter 1982).

The following quotation, attributed to Sir Joshua Reynolds (1732–1792), illustrates the important role 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 material can produce no combination” (quoted in Offner 1990). Reynolds was suggesting that the knowledge and information possessed by individuals, which may be viewed as the sum of one’s life experiences, is a crucial element in creative behavior. However, the question addressed in this study is whether individuals who currently lead an organization, or individuals newly appointed to lead an organization, are most likely to have the greatest relevant stocks of knowledge and information that are useful for corporate entrepreneurship. Also examined is the question of what type of governance mechanism is most likely to provide the CEO with the proper incentive to lead and foster corporate entrepreneurship within the organization. In other words, it is not sufficient that new CEOs just bring about changes in the organization, but most importantly, these changes should create value that has the potential to be a source of sustained competitive advantage.
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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 entrepreneurship is to seize competitive opportunities by creating or adopting innovations that make competitors’ positions obsolete. Similarly, Penrose (1959) argued that the firm’s growth potential is not 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 processes that are ambiguous, these processes have uncertain imitatibility and any benefits that accrue to the firm from these processes may be long lasting (Rumelt 1984). Therefore, both Rumelt and Rumelt 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.

Sharma and Chrisman defined corporate entrepreneurship as the “process whereby an individual or a group of individuals, in association with an existing organization, instigate renewal or innovation within that organization” (1999: 18). Thus, corporate entrepreneurship is the deployment of new resource combinations to renew an organization (Guth and Penrose 1987). Therefore, corporate entrepreneurship can occur internally, by exploiting the firm’s existing stock of resources (Penrose 1959), or externally, by the acquisition of new assets (Penrose 1959). However, because most attempts to create value in the internal environment through mergers and acquisitions fail (Hoskisson and Hitt 1990; CEO 1999), it seems reasonable to argue that the CEO may be a “central actor” in the eventual emergence of many entrepreneurial initiatives (Stopford and Baden-Fuller 1994). Floyd and Wooldridge (1999) defined central actors as key individuals in the firm’s communication processes who are also likely to have a direct impact on entrepreneurial initiatives.

Brazeal and Herbert (1999) also suggested that top management plays 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, firms (Wiersema and Bantel 1993) may serve in this capacity, it seems reasonable to argue that the CEO may be a “central actor” in the eventual emergence of many entrepreneurial initiatives (Stopford and Baden-Fuller 1994). Floyd and Wooldridge (1999) defined central actors as key individuals in the firm’s communication processes who are also likely to have a direct impact on entrepreneurial initiatives.

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Boeker 1991; Hoskisson, Hitt, Turk, and Tyler 1989). This of managerial incentives as a means of controlling CEO strategy implementation literature that stresses the importance revolutionary behavior of individuals and groups (Woodman et al. 2001). Hypothesis 1: CEO change will have a negative effect on CEOs precisely because they do not have many of these relationships that have been developed with others in the organization. These socially complex relationships may involve such things as friendship, teamwork, and the ability to communicate (Wernfert 1989). Another possible benefit of this social capital is the development of trust, which can be used to foster creativity and the exchange of resources within the firm (Fukuyama 1996; Woodman et al. 1999). Others have noted that corporate entrepreneurship is dependent on the attitude of individuals within the firm (Stevenson and Jarillo 1990), determined in part of the attitude of the CEO. Finally, CEOs may be an integral part of the organization’s culture, and this culture may also be a valuable organizational resource (Barney 1986).

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

Corporate Governance and Corporate Entrepreneurship

Clearly there are contextual factors within an organization that may act to enhance or constrain corporate entrepre- neurship. This is because both material and nonmaterial factors at the group level, CEOs may also create value that would not have been created without the breadth of this social capital is the development of trust, which can be used to foster creativity and the exchange of resources within the firm (Fukuyama 1996; Woodman et al. 1999). Others have noted that corporate entrepreneurship is dependent on the attitude of individuals within the firm (Stevenson and Jarillo 1990), determined in part of the attitude of the CEO. Finally, CEOs may be an integral part of the organization’s culture, and this culture may also be a valuable organizational resource (Barney 1986).

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"refinement or modification of existing policies, procedures, product lines, and services" (1999: 36). Operationalizing corporate entrepreneurship in this manner is also consistent with Venkataraman and her colleagues who viewed corporate entrepreneurship as a process "by which members of an existing firm bring into existence products and markets which do not currently exist within the repertoire of the firm" (1992: 488). Of the 200 firms in the initial sample that had experienced a decline in performance, only 103 firms made some type of announcement regarding new products, product markets, processes, or technologies during the year that followed their year of decline. A summary of these announcements, along with a brief description of the firm and its competitive environment, were provided to an expert panel for coding. The use of a panel to subjectively rate the quality of managerial behaviors (e.g., corporate entrepreneurship) seems an appropriate methodology because "behavior criteria normally involve subjective assessments about executive behaviors" (Gomez-Mejia and Wiseman 1997: 321). The panel was instructed not to consult with each other or with outside sources when coding the announcements and to use only their professional judgment, education, and experiences (along with the information provided) in coding the announcements.

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 administration (MBA) degree before beginning their doctoral program but had different amounts of industry work experience. Three of the four panelists worked in the area of asset valuations with Fortune 500 companies. 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, international strategies, strategic alliances). The panel was asked to identify those announcements most likely to be perceived by the firm’s investors (or potential investors) as valuable new products, 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 for competing firms to imitate within one year. Cronbach’s alpha was used to test for interrater reliability and it exceeded .70 in all cases.

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 as a measure to assess the success of corporate ventures. The results of the logistic regression model used to test these hypotheses are presented in Table 2. The overall model had a chi-square statistic of 13.882 which was statistically significant (p < 0.05). CEO change (p < 0.01) and change in the CEO’s cash compensation (p < 0.05) were statistically significant and both had negative signs. Among the control variables, CEO power (p < 0.10) 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, which does not appear to be influenced by organizational size and slack.

Innovation is a rare event (Simon 1993). Thus, it seems reasonable to argue that corporate entrepreneurship among poorly performing firms would be a relatively rare occurrence. Only 17 percent of the firms in this sample exhibited corporate entrepreneurship, which is consistent with expectations and offers face validity for the measure that was used. A post-hoc analysis was also conducted to 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 (operationalized 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

Table 1

<table>
<thead>
<tr>
<th>Variable</th>
<th>N</th>
<th>Means</th>
<th>s.d</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Corporate entrepreneurship</td>
<td>100</td>
<td>0.17</td>
<td>0.17</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. CEO change</td>
<td>100</td>
<td>0.110</td>
<td>0.314</td>
<td></td>
<td></td>
<td>.267</td>
</tr>
<tr>
<td>3. Cash compensation</td>
<td>100</td>
<td>0.114</td>
<td>0.358</td>
<td>.185</td>
<td>.085</td>
<td></td>
</tr>
<tr>
<td>4. Power</td>
<td>100</td>
<td>0.393</td>
<td>0.129</td>
<td>.042</td>
<td>.230</td>
<td>.192</td>
</tr>
<tr>
<td>5. Slack</td>
<td>100</td>
<td>3.221</td>
<td>1.572</td>
<td>.079</td>
<td>.043</td>
<td>.388</td>
</tr>
<tr>
<td></td>
<td></td>
<td>0.405</td>
<td>0.269</td>
<td>.040</td>
<td>-1.17</td>
<td>-1.79</td>
</tr>
</tbody>
</table>

a. p < .10                         
b. p < .05                         
c. p < .01                         
d. p < .001

Table 2

| Table 2 Results of Logistic Regression Analysis and Significance Tests: Corporate Entrepreneurship |
|-----------------------------------------------|-----------------------------------------------|
| Model                                         | Parameter Estimate |
| Model                                          | Chi-Sq     |
| Intercept                                      | 3.524     | 8.604 |
| CEO change                                    | -2.384    | 8.874 |
| Cash compensation                             | -1.853    | 4.719 |
| Slack                                          | -0.106    | 0.008 |
| Size                                           | 0.081     | 0.176 |
| Power                                          | 3.654     | 2.579 |
| a. p < .10                                      |           |     |
| b. p < .05                                      |           |     |
| c. p < .01                                      |           |     |

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time, the announcements that were coded by the panel had a positive effect on ROI in time $t+1$ (p<.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 (Aldrich 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 1988). This analysis provides a clearer picture of the effects of changes in the independent variables on the probability of CE=1.

Probability CE=1 = $b_0 + b_1(CASHCOMP) + b_2(NEWCE0) + b_3(CASHCOMP) + b_4(NEWCE0)$ (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 at the mean (11%) and is increased by one standard deviation above the mean (+47%). When the CEO change, the probability of corporate entrepreneurship increases as cash compensation is decreased. This analysis provides additional support for hypothesis 2. This general finding 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 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 maximized 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 firms (Penrose 1959; Rumelt 1984; Schumpeter 1942), and if organizations often experience CEO change, then understanding the effect that CEO change has on corporate entrepreneurship is of great importance to 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’s stability (such as CEO change) are more likely to foster corporate entrepreneurship. This view, and the supporting empirical results, are consistent with a narrow stream of research that argued for the recognition that “old” CEOs may represent a potentially valuable organizational resource (Sutton et al. 1988; Virany et al. 1992; Constantinescu and Helfat 1991). New CEOs are less likely to be valuable because they incur liabilities of newness (Amburgey et al. 1993) and need time to understand the firm’s resources, routines, and social relationships that are necessary for corporate entrepreneurship.

Firms that change CEOs might reduce their liabilities of newness by selecting an insider to succeed the current CEO. Insiders would possess firm-specific skills that could be useful in corporate entrepreneurship. However, even though an “insider CEO” would have presumably been a member of the old top management team, the social complexities that the new CEO must overcome may result in the old CEO being disrupted or destroyed. Selecting an insider to lead the firm does little to attenuate the loss of social complexities within the firm, particularly when new CEOs are likely to disrupt organizational structures, alter momentum and alter the context and conditions under which the top management team operates (Keck and Tushman 1993; Miller 1993). The data in this study also seem to support these arguments.

Among the 100 firms in the sample, 17 exhibited corporate entrepreneurship and only 5 of these changed CEOs. Of these new CEOs, 4 were insiders and 1 was a rela-

ted outsider. In all, 11 firms in the sample hired new CEOs and 5 of these demonstrated corporate entrepreneurship. Of the 6 firms with new CEOs that failed to demonstrate corporate entrepreneurship, 4 were insiders and 2 were outsiders. Although 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 indicates that social complexities within the organization play an important role in corporate entrepreneurship (Floyd and Wooddridge 1989; Greene et al. 1999), perhaps a more important role than specific knowledge of the firm’s resource base.

As least one qualification seems in order to the finding that CEO change has a negative effect on corporate entre-

prise. The announcements were collected in the year of decline (year $t$) and CEO turnover was measured at the end of the year of decline (year $t+1$). It is possible that organizations that changed CEOs every year in decline recovers the performance ($t+1$) CEO turnover was measured at the end of the year of decline (year $t$). It is possible that organizations that changed CEOs every year in decline recovers the performance ($t+1$) CEO turnover was measured at the end of the year of decline (year $t+1$). 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 Woodman 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 argu-

ment, and the results in general, suggests that an organi-

zation’s incentive system may be used to align 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 Boeker 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 in the year of a 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 experi-

enced a decline in performance, the average change in the CEO’s cash compensation following this year of decline was an increase of 11 percent. At least two interpreted inferences 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 following a year of decline if the average CEO enjoys cash compensa-

tion 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: 359) that executive compensation designs similar to those of competitors (e.g., those that increase CEO pay despite a decline in performance) will serve to foster strategic con-

formity 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 practition-

ers. Conventional wisdom suggests that when firm per-
formance suffers, firms often need new CEOs. However, this research demonstrates that a new CEO’s 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 when 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 elimi-

nating 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.

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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


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