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The impact of cash incentives on TMT information seeking behavior in entrepreneurial firms

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ABSTRACT

We explore the relationship between cash incentives for the top management team (TMT) and managerial information seeking from sources external to the firm. We hypothesize that TMT cash incentives in tandem with base compensation, the firm's technological intensity and use of an aggregate performance criterion influence TMT information seeking from customers and vendors/suppliers (what we refer to as affiliate sources). Our hypotheses are tested by using data obtained from CEOs and the TMT in 193 entrepreneurial firms. As hypothesized, our results suggest that: a) cash incentives influence TMT information seeking primarily from affiliate information sources, b) the effect of cash incentives on TMT information seeking from affiliate sources is much stronger in technology intensive firms, and c) use of aggregate performance criterion has a negative impact on information seeking from affiliate sources. Our findings also indicate that in technology intensive firms, the positive relationship between cash incentives and TMT information seeking from affiliate sources is strongly moderated by the base pay levels of executives – the relationship is much stronger when executive base pay is low.

1. Introduction

Today's organizations operate in challenging, unpredictable environments that are characterized by compressed life cycles, rapid knowledge obsolescence, and ultra-competitive behavior (D'Aveni, Dagnino, & Smith, 2010; Gemmell, Boland, & Kolb, 2012; Lichtenthaler, 2009; Song & Montoya-Weiss, 2001). In such settings the acquisition of information from outside the firm (henceforth termed external information) is a key activity that enhances organizational decision making (Anand, Manz, & Glick, 1998; Rosenkopf & Nerkar, 2001; Shin, Shin, & Rao, 2012). This is particularly true for entrepreneurial firms (Dimov, 2011). Effective information acquisition enables these firms to better understand their competitive landscapes, anticipate forthcoming environmental changes, and import new ideas that stimulate innovation (Barreto, 2012; Helander & Ulkuniemi, 2012; Macdonald, 1995; Phene, Fladmoe-Lindquist, & Marsh, 2006; Wonglimpiyarat, 2011).

While there is broad consensus about the importance of searching, scanning, and understanding external information, the attention-based view of the firm warns that finite limits to managerial attention preclude executives from adequately addressing all important inputs and stimuli in environment (Ocasio, 1997). This can be particularly problematic for entrepreneurial firms that depend on external information to identify and interpret emerging opportunities under bounded rationality (Barreto, 2012). One aspect that is likely to channel managerial attention and leads executives to "pick and choose" external information sources is the reward structure. Yet little is known about how "incentive alignment" mechanisms in entrepreneurial firms may influence executives' use of information obtained from outside the organization. We address this research gap by examining the impact

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of compensation systems on information seeking behaviors by the top management team (TMT) in a large sample of entrepreneurial firms within and outside the high technology sector. Since technology intensive (high-tech) firms are confronted with greater environmental complexity and need to apply higher levels of knowledge and information to their tasks (Henderson, Miller, & Hambrick, 2006; Vacaro, Jansen, Van Der Bosch, & Volberda, 2012), this sampling design allows us to examine the moderating influence of environmental complexity. We limited our study to those individuals who report directly to the CEO (the TMT) because these were all small entrepreneurial firms without specialized divisions possessing what Chandler (1962) referred to as simple structures.

We focused our attention on the top management team's reward structure (as opposed to other governance mechanisms) for a variety of reasons. First, the behavioral agency model (Wiseman & Gomez-Mejia, 1998) has placed special emphasis on the relationship between features of incentive systems and executive risk bearing, particularly in entrepreneurial firms (Larraza-Kintana, Wiseman, Gomez-Mejia, & Welbourne, 2007; Martin, Gomez-Mejia, & Wiseman, 2012). Risk bearing in turn, has been theorized to influence executive information seeking (c.f. Eisenhardt, 1989a; Gomez-Mejia, Berrone, & Franco-Santos, 2010; McCrimmon & Wehrung, 1986). Second, given bounded rationality and a limited span of attention, time-constrained managers must choose what information to tap during decision making (Fey & Furu, 2008; Johnson & Liu, 2011; Wowak & Hambrick, 2010). It seems reasonable that incentives should cue managerial attention to particular information sources and not to others.

We develop our hypotheses about the compensation–information seeking relationship by relying on the construct of agent risk bearing, extending the behavioral agency model proposed by Wiseman and Gomez-Mejia (1998). Our core argument is that compensation design (and especially cash incentives) affects the risk borne by executives, which in turn channels their information seeking efforts. TMT members of entrepreneurial firms bearing high compensation risk are likely to concentrate on information sources that eliminate uncertainty about the outcomes of decisions they make (and hence reduce their risk borne), while TMT members with lower risk bearing are less likely to use such information sources.[1]

We found general support for our hypotheses in our sample of entrepreneurial firms using survey data obtained in two stages. First, CEOs in our sample of firms were asked to respond to a set of questions that describe their TMT's compensation design. CEOs were also asked to identify their TMT members by name. Second, we separately contacted TMT members identified by CEOs, and asked them to respond to a set of questions about their external information gathering. By crossing these two data sources we were able to test the notion that the reward system in entrepreneurial firms influences managerial information seeking behaviors, and that this relationship is stronger among technology intensive firms.

This study represents an important step toward understanding how the reward system in entrepreneurial firms influences managerial behaviors which are likely to impact firm success. While more than a 1000 studies have been published on executive compensation since the early 20th century (see review by Gomez-Mejia et al., 2010 and a forthcoming metaanalysis by Van Essen, Otten, & Carberry, in press), almost all of those papers focus on the determinants and consequences of CEO pay in publicly traded companies and only a handful concern the TMT. When considering the value added of our empirical setting it is important to note that we could not identify any published studies that focused on the TMT reward structure of entrepreneurial (private) firms and its impact on external information seeking. Hence, we offer a novel theoretical perspective applied to an underexplored empirical terrain by analyzing the behavioral consequences of TMT reward structure in entrepreneurial (non-publicly traded) firms; specifically, we shed light on how incentive systems mold external knowledge seeking behaviors by TMT in an entrepreneurial setting where this is a critical strategic issue. Most small and emergent firms cannot afford a large number of specialized skilled personnel. Thus in order to interpret and act strategically in complex environments the TMT has to depend on outsiders for key knowledge (Anand, Glick, & Manz, 2002; Barreto, 2012; Deeds & DeCarolis, 1999). We show that it is possible to use mechanisms such as cash incentives to influence the nature and amount of external information that the TMT of entrepreneurial firms is likely to access during decision making. External information has historically been viewed as an integral component of decision making but more recently has been found to influence key organizational outcomes such as innovation and operational efficiencies that are often the basis for a firm's competitive advantage (Dyer & Hatch, 2006; Phene et al., 2006). Furthermore, the gathering of accurate and relevant external information is increasingly recognized as a critical component of the strategy formulation process, particularly in dynamic and knowledge intensive environments (D'Aveni et al., 2010). Understanding the impact of TMT compensation on external information seeking in entrepreneurial firms can thus contribute significantly to the design and implementation of effective incentive alignment policies at the top for these organizations. Lastly, by studying these relationships in high and low technology sectors, which reflect different levels of environmental complexity, we add to the limited literature (see, for instance, Balkin & Gomez-Mejia, 1987; Tremblay & Chenevert, 2008) that has examined how strategic context moderates the influence of incentive systems on managerial behaviors.

The rest of the paper is structured as follows: First, we provide an overview of our theoretical framework and generate our hypotheses. Next, we explain our methodology and empirical tests followed by a description of results. The last section discusses the managerial and research implications of our findings.

[1] Our paper is limited to compensation risk to maintain a sharper theoretical focus within page constraints and to reduce the scope of the empirical analysis. However, we acknowledge Wiseman and Gomez-Mejia's (1998) argument that employment risk tends to go hand in hand with compensation risk. In fact, they define employment risk as the ultimate compensation risk since it implies the potential for loss of all earnings in current position and a diminished labor market value that may negatively affect all future earnings. When pay is at risk failure to meet target expectations that trigger the award tends to be perceived by boards as an indicator of disappointing performance, and this may lead to poor performance appraisals and/or increase the probability of termination. Thus, when executives consider external information sources in response to compensation risk-bearing, they are probably aware that what is at stake is not only pay but also their career prospects.