



The evolution of CEO compensation over the organizational life cycle: A contingency explanation



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ABSTRACT

There continues to be an intense debate in the public domain on executive compensation, usually centered on issues related to its effectiveness and fairness. While there are hundreds of publications on executive compensation, relatively few have investigated the role of organizational evolution on CEO compensation design. To address this research gap, we investigate CEO compensation design in the context of organizational life cycle (OLC). Beginning with an extensive review of the potential links between employee compensation and OLC, and of the theoretical explanations of such links, we introduce a contingency-based framework for explaining the relationships between CEO compensation and OLC stages. We further posit a series of propositions on the relationship between the level and mix of CEO compensation and the four OLC stages in terms of start-up, growth, maturity, and decline. We conclude with suggestions on future research directions.

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1. Introduction

There continues to be an intense debate in the public domain on executive compensation, usually with a focus on issues related to its effectiveness and fairness in tough economic times (Dittmann, Maug, & Zhang, 2011; Morgenson, 2012). For academics, executive compensation remains one of the most controversial topics in the literature that has attracted a great deal of research interest from diverse fields over decades (Goergen & Renneboog, 2011).

While there are hundreds of publications on executive compensation, relatively few have investigated the role of organizational evolution in CEO compensation design. Most studies of CEO compensation to date are static in their treatment of organizational development, usually focusing on concurrent associations between CEO compensation and such organizational factors as firm age, size, performance, strategies, or structures (Devers, Cannella, Reilly, & Yoder, 2007; Finkelstein & Hambrick, 1988; Gomez-Mejia, 1994). Consequently, there is little on why and how the levels and structure of CEO compensation change as organizations develop over time. Brandes, Dharwadkar, and Das (2005) also raised concerns about the lack of knowledge of the temporal effects of the stages of organizational institutionalization on stock-based compensation. To address this gap in the CEO compensation research, we investigate CEO compensation design in the context of organizational life cycles (OLC).

As one of the conceptually well-defined models of organizational development (Gupta & Chin, 1991; Moores & Yuen, 2001), OLC has experienced a long history in organizational research (Lester & Parnell, 2008). The basic premise of OLC models is that the development of any organization tends to follow a predictable pattern characterized by progressive and distinctive stages (Dodge & Robbins, 1992; Gupta & Chin, 1991). Using a biological metaphor, OLC stages are commonly identified as birth, growth, maturity and death (Salman & Yazdanfar, 2012). The value of OLC models lies in their acknowledgment of the dynamic and changing nature of organizational development (Bonn & Pettigrew, 2009), and in their theoretically grounded frameworks for explaining

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the temporal effects of organizational evolution on various aspects of human resources management, such as: strategic HRM (Baird & Meshoulam, 1988; Buller & Napier, 1993), recruitment and selection (Martinson, 2012), training and development (Miller, 1985), succession management (Alexander, Fennell, & Halpern, 1993), performance management (Garengo, Nudurupati, & Bititci, 2007), compensation (Balkin & Montemayor, 2000; Kanagaretnam, Lobo, & Mohammad, 2009), employee retention (Lippitt & Schmidt, 1967), international HRM (Milliman, Von Glinow, & Nathan, 1991), effectiveness of HRM (Quinn & Cameron, 1983), HRM outsourcing (Salimath, Cullen, & Umesh, 2008), problems or challenges of HRM (Rutherford, Buller, & McMullen, 2003), human capital (Dadzie & Cho, 1989), and diversity management (Richard, Ford, & Ismail, 2006).

Moreover, there is significant evidence that an organization's internal characteristics (e.g., strategies, structures, processes, and practices) and external contexts (e.g., environment, industries, and technologies) all vary across discrete OLC stages over time (Kallunki & Silvola, 2008; Lester, Parnell, & Carraher, 2003). However, the progression of an organization over its life cycle is not necessarily sequential (Phelps, Adams, & Bessant, 2007). For example, an organization may move from the birth to the growth stage, and then the maturity or decline stage; it is also possible that the organization moves from the maturity or the decline stage to the growth stage (Miller & Friesen, 1984). Given the empirical evidence as reported in the literature (Dickinson, 2011; Lester & Parnell, 2008), we contend that an organization will progress in a predictable but non-sequential pattern. We further argue that both the levels and the mix of CEO compensation are not necessarily static. They are contingent on OLC stages that reflect potentially important organizational and individual characteristics, which an organization must consider in order to make effective decisions on CEO compensation.

A study of CEO compensation in the context of OLC could also address a growing challenge faced by both scholars and practitioners: there are many factors influencing organizational decisions on CEO compensation, and the interactive effects of various factors on CEO compensation are too complicated to predict (Milkovich & Rabin, 1991; Yao & Appelbaum, 2009). As Gomez-Mejia (1994, p. 175) note, "...most variables expected to influence executive pay tend to be highly correlated, and this poses a collinearity problem that makes it difficult to isolate the unique effects of any single factor". When an increasing number of variables (either as independent or control variables) are added into data analyses for explaining the executive compensation phenomenon, more questions than answers arise. For example, some studies have found that firm performance is positively related to CEO compensation (Nourayi & Mintz, 2008; Tosi, Werner, Katz, & Gomez-Mejia, 2000), while others report a negative relationship between the two (Mehran & Tracy, 2001; Ramcharran, 2002). Such contradictions are also reported in the literature for the relationships between CEO compensation and firm size (Ozkan, 2012), corporate governance (Boyle & Roberts, 2013; Cianci, Fernando, & Werner, 2011), and firm risk (Armstrong & Vashishtha, 2012). We agree with Boyle and Roberts (2013) that it is not possible to consider all variables possibly associated with CEO compensation design. Adding more variables into the equation for CEO compensation has caused more difficulties in understanding what factors account for the observed changes in CEO pay over time (Frydman, 2009). Rather than contend that CEOs are paid for luck (Goergen & Renneboog, 2011), we argue that OLC may shed lights on a new way to study CEO compensation; thus, we explore the interactive effects of a configuration of organizational variables on CEO compensation through a single variable: stage in life cycle. Miller and Friesen (1980) defined OLC stages as *gestalts* or commonly occurring configurations of distinct, internally consistent characteristics and contexts. Adopting this widely-accepted definition, we further define OLC stages as a configuration of endogenously-related organizational contingencies (e.g., firm age, size, diversification, innovation, and performance). It is our contention that OLC stages are analytically superior to each of the above singular contingencies and even to the other unidimensional variables that are currently used for predicting CEO compensation.

Although meta-analyses have confirmed firm size to be the primary predictor of CEO compensation (see Devers et al., 2007; Gomez-Mejia & Wiseman, 1997; Tosi et al., 2000), and firm size is one of the three common organizational variables for identifying and defining OLC stages (the other two variables are firm age and firm growth; Ciavarella, 2003; Rutherford et al., 2003), using OLC to analyze executive compensation has three theoretical and/or empirical advantages over firm size for studying CEO compensation. First, after more than four decades of research across disciplines, the OLC literature is rich with theory and empirical analyses. OLC scholars have provided theoretically sound and empirically justified explanations for the complex phenomenon of organizational evolution and for the temporal effects of organizational development on a broad list of organizational variables (Hoy, 2006; Kazanjian, 1988). A study of OLC can offer a more comprehensive explanation of CEO compensation, as suggested by several scholars (Devers et al., 2007; Gomez-Mejia & Wiseman, 1997). Second, there is overwhelming research evidence to support the reliability and validity of OLC stages for predicting organizational development; whereas the predictive power of firm size for organizational development, even for organizational growth, is not guaranteed (Baker & Cullen, 1993; Salman & Yazdanfar, 2012). Moreover, OLC stages have been found superior to firm size for predicting many organizational phenomena, such as: strategic alliances (Hwang & Park, 2006), ethical structures (Morris, Schindehutte, Walton, & Allen, 2002), board governance (Balkin, Markman, & Gomez-Mejia, 2000), use of activity-based cost-accounting systems (Kallunki & Silvola, 2008), stock market reaction to firm performance (Anthony & Ramesh, 1992), and administration reorganization in educational institutions (Baker & Cullen, 1993). OLC stages have also been found to have significant incremental validity over firm size for predicting firm performance and HRM controls (Liao, 2006), firm innovation (Koberg, Uhlenbruck, & Sarason, 1996), CEO human capital (Martinson, 2012), and leadership instability (Alexander et al., 1993). Hence, it is arguable that OLC stages, rather than firm size, is a better predictor of the role of organization development in CEO compensation design over time. Third, in an extensive literature review, Devers et al. (2007, p. 1036) concluded that CEO pay "is not simply a function of size, but can be affected by factors both endogenous and exogenous to the firm". By expanding the above review conclusion, we further argue that OLC stages could capture the interactive effects of these endogenous and exogenous factors on CEO compensation. OLC scholars have identified a list of organizational variables that would cluster together as commonly occurring configurations along with each OLC stage (Miller & Friesen, 1984; Moores & Yuen, 2001). Many variables on the list (e.g., firm age, size,

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