An Empirical Study on the Corporate Performance Change of Top Management Turnover

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Abstract: The level of corporate governance directly determines the future development direction of companies. It’s known to all that the top management turnover plays an important role in corporate governance, and it can make modern company management structure perfect. Looking through available research, we may find most of all introduce different kinds of factors and economic consequences in order to discuss the relationship between corporate performance and management turnover, there are few literatures distinguish the impact on enterprise performance between general manager turnover and board chairman turnover. This paper is based on the present theories, adopting statistical analysis and empirical method in order to compare different influence on the operation performance among various types of management replacement. In the end, empirical studies indicate that the change of top management will improve companies’ performance, but it only leads to a short wealth effect, not in a long run. At the same time, we can also draw a conclusion, that is board chairman turnover makes more sensitive influence upon the enterprise performance compared to general manager turnover, therefore we should think twice before replacing board chairman.

Keywords: top management turnover, enterprise performance, corporate governance

1. INTRODUCTION

When Berle and Means put forward the phenomenon of ownership and management separation in the “modern company and private property” since 1932, principal-agent problem has been treated as a hot field so that scholars dedicated to the tireless research of it. Jensen and Mecking (1976)\textsuperscript{[1]} held the view that someone will be granted part of decision-making power to safeguard shareholders' interests due to limit of energy, but both of them always involve in competitive games in pursuit of self-interest maximization which results in principal-agent problem, thus the core of this principle is to coordinate the decision-making behavior of executives and the private benefit of shareholders in a high degree. In order to achieve the company governance efficient and orderly, the role of managers in charge of daily operations is indispensable, hence the questions related to the CEO selection and replacement have become a hot spot in international corporate governance. There is no doubt that Jensen and Warner (1988)\textsuperscript{[2]} pointed out “Top management turnover is the key variable to understand the power of constraining professional executives and the important index to measure the efficiency of corporate governance mechanism”.

During decades of rapid development, Chinese capital market has made leaps and bounds by leaps and bounds, at the same time it has emerged a great many of executives’ departure events. According to the related statistics over the 1998-2006 time period, there were 3057 companies which have replaced general managers, and 1921 companies which have replaced board chairman. China’s top management turnover rate is significantly higher than other countries compared with the same market economy. Therefore, we can not help to think--Is this regulations of professional executive turnover efficiency? Which is the real operator in practice? Whose leave has a greater impact on the enterprise performance? This paper is aimed at above goals, starting from the quantitative perspective, and use empirical research method to analyze the different consequences on the operation performance between two types of management turnover. Only in this way can we provide crucial suggestions to promote the executive incentives and the level of corporate governance as well.

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2. LITERATURE REVIEW

Corporate governance originates from principal-agent problem, effective institution arrangement can reduce agency cost as far as possible and the level of corporate governance will be measured indirectly by top management turnover. Looking through current research on the issue of management turnover from domestic and overseas, most literatures mainly concentrate in three aspects such as reasons, influencing factors and economic consequences. Here we will focus our attention on the corporate performance change of top management turnover. Generally speaking, there include three views, that is management improve theory, scapegoat theory and vicious cycle theory. Some researchers hold the opinion that executive replacement is susceptible to bad performance and new successor will make efforts to improve company performance significantly. Denis (1995) and Huson (2004) make the similar conclusions that compulsory executive departure could lead to greatly improved performance. However, scapegoat theory advocates, such as Clayton (2005) [3], argues that manager replacement couldn’t be able to increase enterprise profits. Others maintain a view that new successor not only won’t improve performance, but break the internal behavior model and organization relationship across informal networks.

Although domestic research on this issue started late compared with foreign countries, some achievements have been made and the research quality is in improving. Chinese professor Zhu Hongjun (2004) [4] shows that the replacement of major shareholders and senior executives in China’s listed companies can’t radically change company performance, but only bring in serious earnings management. Chen Xuan (2006) [5] notes that a falloff in accounting profits of state-owned companies after CEO quits, yet management departure of other corporate enterprises doesn’t play a significant role in promoting performance. Chen Jian (2006) [6] selects 76 listed companies on the Shanghai and Shenzhen stock exchanges during the period of 1996 to 2001 which major shareholders and top managers have been replaced as samples, and establishes 47 listed companies that executive turnover isn’t coincident with shareholder turnover as contrast, finally finds that performance of the former is better than the latter. Zhang Peipei and Xia Xinping (2006) [7] also discover the fact that if controlling-stake and executives changed, corporate performance could be in rising. In a word, the economic consequences of top management turnover have not come to an agreement because of different research methods and different sample selection.

3. BACKGROUND AND HYPOTHESES

The samples used in this study consist of all A-Share listed companies in the Shanghai and Shenzhen stock exchanges during the period of 2005-2009 excluding discontinued operations reported by firms and ST/*ST companies. Financial and stock returns data on corporate performance of the sampling period are taken from the CSMAR database. We examine annual financial reports over the same time to identify announcements of CEO changes for firms covered by the Ju Chao website. If a firm makes multiple CEO changes within a year, it is commonly believed to be the first event in the database.

According to the incentive theory, professional managers will be replaced when enterprises’ profits are relatively low, thus it is obvious that senior executives are encouraged to improve the corporate performance. As we all known, there exist several views about economic consequences of top management turnover, for instance, management improvement and a lack of correlation conclusions. Chinese scholars such as Zhu Hongjun, Chen Xuan and Gong Yuchi [8] choose different research objects and financial indicators to examine effects of CEO change events. Their studies demonstrate that CEO departure don’t promote increasing in accounting earnings, but only lead to obviously negative earnings management when executives are fired by the board directors.

Hypothesis 1: CEO departure will improve companies’ performance, but it leads to a short wealth effect.
Looking back current literatures about incentive mechanism, western researchers mostly select CEO as research object. However, our state-owned enterprises don’t set up this position, general manager and board chairman also appear at the same time after contemporary company transforming. So it is urgent for us to make clear that which is real operator in practice? Whose departure is positively associated with enterprise performance? Song Deshun (2004) collects a series of incentive characteristic statistics in order to make a comparison between board chairman and general manager, adopting regression method to investigate corporate performance change of top management turnover. Finally, he holds the opinion that the board chairman is top decision maker in nearly every company. Song Zengji (2010) also think general manager is likely to manipulate enterprise performance by earnings management in short term so that this powerful position can be kept. However, the possibility of board chairman’s earnings management is relatively low that resulted from the important decision and control status, thus he or she will pay more attention to make significant decisions from long-term benefits angle. That is to say, board chairman turnover makes more sensitive impact on the corporate performance compared to general manager turnover. In this study, we attempt to take advantage of stepwise regression method that the selection of significant variables for establishing the best regression equation to verify which way of CEO turnover is prior into model.

Hypothesis 2: Board chairman departure has more sensitive effect on the corporate performance in comparison with general manager departure.

4. DATA AND METHODOLOGY

4.1 Sample selection

In order to explore the impact on the corporate performance change of top management turnover in a long time, we need to gather performance indexes before and after two years of top executive departure. Besides, financial statements of 2010 were not full announced when this article was in writing. Therefore, we just choose Chinese listed companies in 2007 as samples and adopt financial data for the period from 2005 through 2009, finally eliminate a few objects with the following principles:

- Banks, financial institutions, insurance companies aren’t taken into consideration, because their capital structure markedly differ from other listed companies;
- Part of financial indicators or important data missing company are also excluded;
- The term of top executives in office less than one year is not regarded as the study object in this paper.

At the end, a total of 272 firms are identified as appropriate samples that meet above conditions. Financial data and stock-price index on corporate performance of sampling period are taken from the CSMAR database. In addition, top management and control structure data are hand-collected from the firms’ annual financial reports, and additional information about senior management changes by searching the Shanghai Securities News, China Securities Journal and other news releases authorized by the China Securities Regulatory Commission (CSRC) for disclosure of corporate information.

4.2 Variable definition and model construction

As a benchmark, we introduce a set of variables to investigate the relationship between senior management turnover and performance figures of the sample firms. Although it’s said that China’s capital market was still immature and the traditional research mostly use financial indicators to measure operating performance, China’s securities market has been got some degree of development in recent years so that the range of dependent variables should be expanded. Furthermore, ordinary return on equity (ROE) is susceptible to be associated with earnings management, thus weighted average return on equity (WAROE) is invited to serve as one of financial indexes. At the same time, evaluating indexes also include the rate of return on total assets (ROA) and earnings per share (EPS). These performance volatility of indicators we just mention are chosen as dependent variables.
The second one is a virtual independent variable which contains general manager turnover or board chairman turnover. Last but not least, quite a few control variables are also important to capture the accounting and financial characteristics of objects, that is enterprise scale and debt-to-assets ratio.

Our initial analysis begins with unary linear regression model to correlate turnover decisions with three financial variables of earnings and stock returns:

\[
\Delta \text{ROA}/\text{WAROE}/\text{EPS} = \alpha + \beta_1 \text{TURN} + \beta_2 \log_{10}(\text{SIZE}) + \beta_3 \text{LEVER} + \varepsilon
\]

The regression reported in this paper is controlled for firm’s size and lever, which are respectively measured as the natural log of total assets and credit capacity in the pre-period when executives quit.

### 4.3 Data collection instrument

The obtained data is originally analyzed through statistical package of social science (SPSS 16.0) in order to predict the relationship between CEO’s turnover and performance volatility by descriptive statistics. Another method we adopt is the positive analysis (SAS 9.1) which will provide empirical evidence on the performance-turnover relation with respect to top management.

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### 5. EMPIRICAL RESULTS

#### 5.1 Descriptive statistics

For the sake of reflecting the corporate performance change before and after executives’ departure, three different figures are selected to explore their relationships, for instance, return on total assets, weighted average return on equity and earnings per share. In this section, we define 2007 as 0, so that -2, -1, 1, 2 correspondingly represent 2005, 2006, 2008, 2009. That is to say, \((X, Y)\) indicates that post-period operating return minus pre-period enterprise performance.

<table>
<thead>
<tr>
<th>Year</th>
<th>ROA</th>
<th>Median</th>
<th>WAROE</th>
<th>Median</th>
<th>EPS</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>-1,0</td>
<td>-4.3458</td>
<td>-0.0064</td>
<td>-4.5492</td>
<td>-1.2300</td>
<td>-0.1512</td>
<td>-0.0584</td>
</tr>
<tr>
<td>-0.1</td>
<td>0.1835</td>
<td>0.0072</td>
<td>1.6948</td>
<td>2.0250</td>
<td>0.1126</td>
<td>0.0444</td>
</tr>
<tr>
<td>1.0,2</td>
<td>-0.1087</td>
<td>-0.0113</td>
<td>-35.4740</td>
<td>0.2195</td>
<td>-0.0341</td>
<td>0.0200</td>
</tr>
<tr>
<td>-0.2</td>
<td>0.0802</td>
<td>0.0063</td>
<td>-0.2295</td>
<td>-0.1000</td>
<td>-2.5658</td>
<td>-1.9353</td>
</tr>
<tr>
<td>(1,1)</td>
<td>-4.1620</td>
<td>0.0018</td>
<td>2.1236</td>
<td>1.5100</td>
<td>-0.0280</td>
<td>-0.0068</td>
</tr>
<tr>
<td>(1,2)</td>
<td>-28.9369</td>
<td>-2.5450</td>
<td>-0.0425</td>
<td>-0.0067</td>
<td>-0.1964</td>
<td>-0.0700</td>
</tr>
</tbody>
</table>

No matter what kind of indexes we take, professional management turnover is preceded by a decline on operating performance in the pre-period. After that the growth rate of earnings per share (EPS) is markedly higher than that of remaining variables. The company’s profits don’t keep increasing instead of reducing ever since approximately two-year period after the CEO departure.

#### 5.2 Unary Regression Analysis

In order to demonstrate hypothesis 1, the most necessary work we need to do is bringing in dynamic performance indexes which measure amount of variation for themselves. Overall, our study could explore accounting or stock-price influence on top executive change events based on empirical evidence.
When dependent variables are $\text{WAROE}_{2008-2007}$ and $\text{WAROE}_{2008-2006}$, the coefficients of alteration types and corporate achievements are positive (21.45603, 26.63550), and the former “TURN” can reject the null hypothesis in 91.13% confidence level, the latter “TURN” will also play the same role in 98.24% confidence level. According to this above data, we are informed that performance has been improving during one year when CEO quits. Besides, the total assets of two models play an important part in enterprise profits improvement and absence of multicollinearity due to variance inflation factor is only one here.

The next problem we should attempt to solve is whether companies’ achievements improvement will be sustained for a long term. With further scientific work, we can draw a conclusion that there exists closer relationship between top management alteration and corporate wealth if $\text{WAROE}_{2009-2008}$ and $\text{WAROE}_{2009-2005}$ are selected as dependent variables.

### Table 3. Parameter Estimates

<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>Variable</th>
<th>Parameter Estimate</th>
<th>Standard Error</th>
<th>t Value</th>
<th>Pr &gt;</th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\sim 1.2\sim$</td>
<td>Intercept</td>
<td>272.13171</td>
<td>88.61731</td>
<td>3.07</td>
<td>0.0024</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>TURN</td>
<td>-24.94517</td>
<td>11.08170</td>
<td>-2.25</td>
<td>0.0252</td>
<td>1.01350</td>
</tr>
<tr>
<td></td>
<td>SIZE</td>
<td>-27.13044</td>
<td>9.41789</td>
<td>-2.88</td>
<td>0.0043</td>
<td>1.01350</td>
</tr>
<tr>
<td>$(1 \leq 2)$</td>
<td>Intercept</td>
<td>245.33771</td>
<td>125.70524</td>
<td>1.97</td>
<td>0.0504</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>TURN</td>
<td>-318.24034</td>
<td>152.43436</td>
<td>-2.04</td>
<td>0.0428</td>
<td>1.01363</td>
</tr>
<tr>
<td></td>
<td>SIZE</td>
<td>-233.08003</td>
<td>132.91968</td>
<td>-1.75</td>
<td>0.0807</td>
<td>1.01363</td>
</tr>
</tbody>
</table>
in land resources and commercial resources idle and wasted, what is worse, limiting operation capacity level.

Having made clear the link of performance-turnover with respect to professional executives, we are interested in investigating who is real operator in practice by stepwise regression.

| Dependent Variable | Variable | Parameter Estimate | Standard Error | t Value | Pr > |t| | Inflation |
|--------------------|----------|-------------------|----------------|--------|--------|--------|------------|
| \( \uparrow 2.0 \)  | Intercept | -0.79411          | 0.55474        | -1.43  | 0.1535 | 0      |
|                    | SIZE     | 0.11507           | 0.05955        | 1.93   | 0.0544 | 1.0619 |
|                    | LEVER    | -0.83638          | 0.08328        | -10.04 | <.0001 | 1.0132 |
|                    | TURN\(_2\) | -0.10342         | 0.05911        | -1.75  | 0.0813 | 1.0122 |
| \( \sim 0.2 \sim \) | Intercept | -0.32494          | 0.05368        | -6.05  | <.0001 | 0      |
|                    | LEVER    | 0.53919           | 0.07604        | 7.09   | <.0001 | 1.0093 |
|                    | TURN\(_2\) | 0.11157         | 0.05400        | 2.07   | 0.0398 | 1.0093 |

Note: TURN1 stands for general manager turnover; TURN2 stands for board chairman turnover.

Taking three different indicators into consideration, earnings per share (EPS) is significantly associated with CEO’s alteration types before and after two years when firms bring in outside talent. All in all, board chairman turnover has priority to enter into the model compared with general manager turnover. To be honest, the board chairman should affect all major aspects of firm at some degree because of decision-making and control status. By the way, China’s securities market has developed rapidly in recent years, internal events as well as external challenges will be able to drive share price rise and fall.

6. CONCLUDING COMMENTS

The empirical results have proved that top executives departure of Chinese listed companies has not fundamentally improve company’s operating performance in the fifth section. As we all known, CEO replacement is negative correlated with performance fluctuation from the second year of senior management turnover. When these enterprises face principal-agent problem, it is worth to spend more time on CEO’s incentive, restriction and supervision to make corporate governance mechanism perfect in the daily life, rather than laying off managers who have little contribution to the increasing profits. Another interesting finding is that board chairman turnover has priority to enter into the model compared with general manager turnover, it means board chairman turnover has more notable impact on the corporate performance in comparison with general manager turnover. Therefore, we should think twice before replacing board chairman and the most imperative task is to hire qualified new successors, so as to ensure long-run development of Chinese listed company and make fully-marketized economy true in its real sense.

Overall, the evidence is consistent with the hypothesis that CEO turnover isn’t disciplinary absolutely in China. We try our best to provide the following suggestions in order to make modern company management structure perfect. Firstly, top managers should improve the executive selecting mechanism. Secondly, they are also required to set up the executive performance evaluation system and compensation system. Last but not least, strengthening the crucial functional construction of both board of directors and supervisors is also imperative.
REFERENCES


