Change of company ownership, CEO turnover and the origin of CEO: case from Indonesia

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Abstract: This study aims to provide empirical evidence that the action on the Chief Executive Officer (CEO) turnover is in line with the change in ownership structure. Data of CEO is collected originally from all companies in Indonesia during 1999–2007. The CEO substitution of selected companies was only taken until the turnover to the year 2003, and during the four years after the turn was never replaced. The result from our study cannot find the relationship between corporate ownership changes and CEO turnover in Indonesia. However, the study finds a statistically significant result on the relationship between CEO turnover and accounting performance. Furthermore, the result of study also showed that the corporate with poor performance over several years before turnover tended to choose a new CEO from external, rather than the corporate with relatively good financial performance. The owners expect the CEO successor from external parties can bring changes to the company through new policies.

Keywords: ownership structure; CEO turnovers; origin of CEO; accounting performance; market performance.

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1 Introduction

The rise of issues about controlling rights owned by the majority of shareholders in the company around the world has become one of the research topics. Nevertheless, there is almost no research found that attempts to highlight the impact of ownership structure on CEO turnover. This is what has motivated us to conduct research on the impact of ownership structure on CEO turnover in Indonesia. It is because CEO has been considered as the most influential figure for the company, the most crucial figure in running the organisational blueprint, the journey and the future within the organisation, so a research analysing the topic of CEO turnover has to be done. Associated with a concentrated ownership, owners need to understand that every change of leadership will affect the organisation that eventually will also affect the organisational performance (Baron et al., 2001). In addition, changing the blueprint merely has the same meaning with disturbing and unsettling the organisation. CEO turnover will not only mean to change the top of management, but also mean to change the company blueprint that lives organisationally in the spirit among the employees. The organisation will be 'sick' owing to a big change inside of it.

This research aimed to provide empirical evidence on the action of CEO turnover after the ownership structure change occurs. This change should not have been carried away without consideration. It is because the change of CEO will affect the company performance. Example is a strategy, which is in an achievement level, can be stopped unpredictably, while the cost and span that have been sacrificed will be in vain and the next is an opportunity and success that are nearly achieved will vanish. However, the result from this research shows that there is no significant finding that the ownership changing has a relationship with CEO turnover. This finding shows that the company performance is the factor that is statistically significant to be related to the turnover. This finding supports the previous researches that found the strong relationship between financial performance and the action in CEO turnover. The works of Warner et al. (1988), Weisbach (1988), Coughlan and Schmidt (1985), Datta and Guthrie (1994), Potter and Dowd (2003), Fee and Hadlock (2004), Huson et al. (2001) and Kaplan and Minton (2006) are the examples.

Contribution of this research is aimed to provide a research model that is still very rare to do in non-western countries, because the data used in this study have to be obtained manually (primary data collected), either for the CEO turnover data or for the majority owners in Indonesia. The CEO turnover data was obtained through the identification of the names to the president of the company listed in Indonesia Stock Exchange in the period of 1999–2009. Meanwhile, the change in majority ownership is, in the study, a change in the ownership of a majority stakeholders of more than 20% of companies listed on the Indonesia Stock Exchange, the period of 1999–2009. The aim is to analyse more deeply the dominance of the owner in the company below 50% and above 50%.

2 Literature review and hypothesis development

The assumption underlying this research is agency theory, which explains that, first, the parties in the agency relationships are the individuals who attempt to maximise their satisfaction/interest through adequate resources and innovation in the act. Second, the parties involved in the agency relationship are able to build expectations that are not biased about the future, which company's management actually bears the cost consequences of differences in behaviour through reduction on the price of the claim or right to the company (Whittred and Zimmer, 1990).

2.1 The changing of ownership and CEO turnover

Hambrick and Finkelstein (1995) explained that since Berle and Means documented a clear separation between control from the owner and manager of a big company in the USA in 1932, many researchers have tested the impact of ownership structure towards actions against the companies. The paper written by Hambrick and Finkelstein was focused in two configurations of ownership structure that were common to be used in the previous studies:

- external party as the controller of the company
- management part as the controller of the company.

The structure of ownership controlled by the external party represents condition where there is at least one shareholder that has a majority of the stock (in the USA, majority rule is the ownership of 5% stock), meanwhile the structure of ownership controlled by management happens when there is no majority shareholder so that the shareholders will have less attention and care for the performance of company management. Nevertheless, it is still needed to be considered that merger configuration is possible to occur, i.e., a joint control between management and non-management party. However, this merger condition is not concerned in this research.

Shareholder theory will be reflected on the condition when the company control is in the hands of the external party, as meant by Hambrick and Finkelstein (1995). Moreover, the majority of shareholders will have the right to control and will be easy to monitor the top management activity (Shleifer and Vishny, 1986; McConnell and Servaes, 1990), change the existing CEO (Denis and Denis, 1997) and even change them with individuals who have a family relationship, to provide the guarantee of increasing the wealth of the shareholders.

Research that tries to relate the CEO turnover and the structure of ownership is still limited indeed. For example, the works of Brunello et al. (2003) that focused on the ownership, which was concentrated on the characteristic of the largest shareholders and the second shareholders, found the concentrated ownership would stimulate the high supervision, high turnovers and high sensitivity of changing towards performance. This finding supports the previous research done by Denis and Denis (1997) that found a significant impact between ownership structure and CEO turnover, by using stock price performance as a control variable. Denis and Denis showed that the pattern of ownership structure has an important impact on the effort to supervise the company internal performance. CEO turnover that happens inside of the company is the effect of the internal supervision activity done by the owner.

This research attempts to analyse the agency problem that happens between the owner and the company management. An issue related to the theoretical base and the previous research result is formulated in the first alternative hypothesis, i.e.:

H1: The change of ownership affects CEO turnover.

2.2 Company performance and the origin of the CEO

The origin of CEO becomes one of the issues discussed throughout the study of CEO turnover. Shen and Cannella (2003) stated that when new CEO comes from inside of the company, offered to replace the previous CEO, it will not only be approved but also get support from the other official. However, when substitute CEO comes from the external party, there will be difficulty in building working association and coalition with the internal party in the company. Meanwhile, Vancil (1987) stated that the most important task to the success of CEO is to build a working association and a strong social environment and coalition. This robust relationship will ease the function of leadership that will coordinate all the bottom lines to work together to achieve the organisational purpose.

The designation of new CEO from the external party is done when the company is in a poor performance (Zajac, 1990). Same case as the result from the research analysing antecedent side of turnover, the result from the research in the study of CEO turnover consequence indicates that the turnover can have a positive result in the performance if CEO who has been replaced cannot create a good performance in the company (see Helmich, 1974; Davidson et al., 1993). Other researchers found negative effects from the turnover (Grusky, 1963; Allen et al., 1979; Carroll, 1984; Beatty and Zajac, 1987; Haveman, 1993) because it can generate disturbance to the organisation. Meanwhile, on the other side, there is also a result from a research considering that turnover does not have consequence if the turnover is merely as a scapegoat action (Gamson and Scotch, 1964; Boeker, 1992).

Palmer (1973) explained that a big management control over the company will encourage the management to be individual that will have more focus to their own interest, and fewer act against the interest to the shareholders. It is different if the control over the company is in the hands of the external party. In this way, management will act hard to maximise the wealth of the shareholders.

Because of these reasons, the CEO has been appointed in the condition and the control is held by the external party, which in turn will result in an accounting and market performance tending to be higher compared with the condition in which the ownership structure is controlled by the management party. From the above-mentioned explanation, alternative hypothesis of this research is:

> *H2: Company performance is related with the origin of the substitute CEO. A worse company performance tends to appoint CEO from the external party.*

3 Methodology

3.1 Data

This study uses data for the period 1999–2007 from the annual report of listed companies in Indonesia's stock market. Data from the year 1999 until 2007 are needed to know the accounting performance before CEO turnover. The focus of CEO turnover that exists is in the period 2001–2007. CEO turnover is chosen if in consecutive three years, in the same company, the CEO turnover did not exist. Final data used in this research are as many as 149 companies ranging from companies that do CEO turnover and those that never do any CEO in the observed period 1999–2007.

3.2 Model

Logit regression model for equation (1) is used to test the first hypothesis that states that the changing of ownership affects the company's CEO turnover.

$$\begin{aligned}\text{Turnover}_{i,t}(1, 0) = \alpha_0 + \alpha_1\text{Own}_{i,t} + \alpha_2\text{Asset}_{i,t-1} + \alpha_3\text{Sales}_{i,t-1} \\ + \alpha_4\text{ROA}_{i,t-1} + \alpha_5\text{Earnings}_{i,t-1} + \varepsilon_{it}.\end{aligned} \tag{1}$$

Turnover is the changing of CEO, 1 if the changing occurs and 0 if others. *Own* is the changing of ownership, 1 if the changing occurs and 0 if others. *Asset*, *Sales*, *ROA* and *Earnings* are the proxies for the company performance that is used as the control variable.

Simple logistic regression model to test the second hypothesis about whether company performance has a relationship with the origin of substitute CEO is shown in equation (2).

$$\text{Origin}_{i,t}(1, 0) = \alpha_0 + \alpha_1 \text{Perfmc}_{i,t-1-3} + \varepsilon_{it}. \quad (2)$$

Origin is the origin of substitute CEO, 1 if coming from outside of the company (external party); 0 if other than that. *Perfmc* is the performance (earnings and assets) of the company, used to measure the managerial performance.

4 Result and discussion

Table 1 (Panel A and B) showed the result from this study. The first hypothesis test's results revealed an insignificant finding on the relationship between the changing of company ownership and CEO turnover. The significance in the relationship between both factors is with a *p-value* = 0.65 means that the hypothesis that predicted there is a relationship between the changing of ownership and CEO turnover is unproved.

Table 1 Result of the test group

	Variable	*z-Statistic*	*Wald*	*Sig.*
Panel A, *N* = 149	Ownership	0.266	0.204	0.652
1 (turnover) = 87	Assets	–2.421	6.435	0.011*
0 (others) = 62	lnTSales	–2.535	8.372	0.004**
	ROA	–1.346	18.709	0.000**
Regression Log test	Earnings	–0.003	4.193	0.041*
	Variable	*z-Statistic*		*Sig.* (*2-tailed*)
Panel B, *N* = 89	Earnings	–2.409		0.0160*
0 = 38; 1 = 51	Assets	–2.464		0.0137*
Regression Log test				

* and ** significance at the 5% and 1% levels respectively.

Nevertheless, the result of statistic test for the four financial variables that become the control variables on the relationship to the ownership changing variable and CEO turnover seems to have a very strong significance. Each of the accounting performances (assets, sales, ROA and earnings) have a *p*-value = 0.01; 0.004; 0.000 and 0.41. This finding indicates that CEO turnover that occurs in Indonesia, commonly, is determined by the company performance and not by the domination of the company owner. The result from this research shows that four accounting variables that were tested as antecedent factors from CEO turnover are related significantly. This indicates that the owners of big companies in Indonesia generally do not have an urge to change the managerial leadership if the leader has a good performance for the company. In other words, a poor performance in a company will determine the CEO turnover and vice versa.

In the second hypothesis, it is stated that the company performance is related with the origin of the substitute CEO. A worse company performance tends to appoint new CEO from the external party in the company. The statistic result of the second hypothesis test shows that a poor company performance tends to make the CEO turnover in which the substitute CEO comes from the external party and vice versa. Earnings are found to have a negative relationship and significant on the CEO from the external party in the company at a *p*-value = 0.0160. Meanwhile, asset is also found to have a negative relationship and significant with a *p*-value = 0.0137.

4.1 Additional analysis

Additional analysis done in this research is meant to provide a further investigation on the company performance associated with the CEO turnover issue in the origin of the substitute CEO.

Figure 1 shows the earnings' performance of companies within five years (three years before and two years after) around the change of CEO with CEO origin from the external and internal party.

Figure 1 Earnings before and after CEO turnover

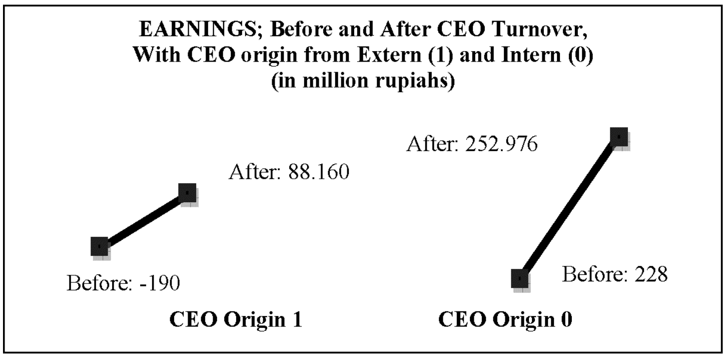
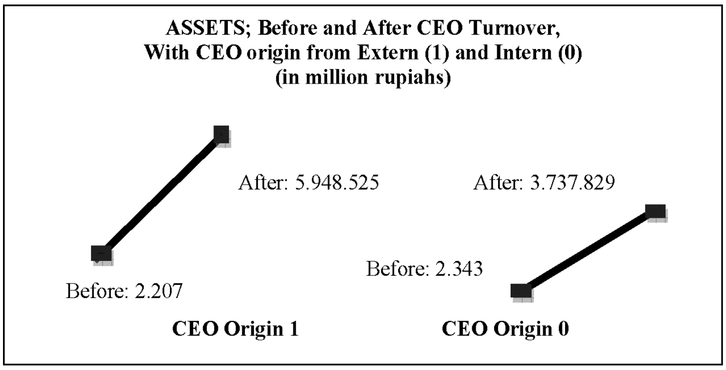


Figure 2 shows that the company assets to a company of which new CEO is from the external party has a better growth compared with a company of which CEO is from the internal party.

The condition of company's assets three years before and two years after CEO turnover, which for the next period those companies are led by new CEO from the external and internal party, is shown in Figure 2. The average of company's assets that the new CEO comes from the external party is less than a company of which CEO is from the internal party (2.207 and 2.343). However, the difference between those assets is not too far.

Figure 2 Assets before and after CEO turnover



The company of which new CEO is from the external party is only able to increase asset's growth as much as 5.950.723 (i.e., from 2.207 becomes 5.948.525), while CEO from the internal party can create a growth as much as 3.740.172 (i.e., from 2.343 becomes 3.737.829). This finding again explains the positive effect as a change in a company (Helmich, 1974; Davidson et al., 1993) because it is proven to be able to increase earnings growth and better company assets. This thing also indicates the achievement of company owner's expectation that the new CEO from the external party can bring a substantial change through new strategic and wisdom to the company.

5 Conclusion

This research does not find a relationship between the change of company ownership and CEO turnover in Indonesia, in the period 1999–2009. This finding indicates that the majority owner did not have a pretension to change the company CEO if the CEO had been considered to be able to lead the company to a better growth. This finding is supported by the statistic result that is significant in the relationship between CEO turnover and four accounting variables. From the statistic result in the first hypothesis test, it is concluded that the owner in the company will only do the CEO turnover if it is proven that the existent CEO cannot show a good performance to the company. Conversely, if the actual CEO is considered to be able to provide the prosperity to the company owner, the CEO will remain the same in the company.

The other thing that can be concluded from the research's results is the company that has a poor performance for years before turnover tends to choose new CEO coming from the external party in the company, compared with the company that has a better financial performance. This thing is allegedly done because the owner expects that the substitute CEO from the external party can bring significant changes to the company by a new wisdom that is different from the previous CEO's wisdom. Besides, it is possible that if the substitute CEO comes from the internal party, the strategy and wisdom applied will not be different with those applied previously so that there will not be any significant change during the development of the company's growth.

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