



Top management team turnover, CEO succession type, and strategic change

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ABSTRACT

While previous research suggests that CEO turnover correlates with strategic changes in firm's operations such as discontinuation of operations, we demonstrate that such findings apply only to specific types of CEO turnover, and only if non-CEO members of the top management team also exit the firm. Our analysis examines cases of contender, follower, and outsider succession and reinforces the key role of non-CEO departures in strategic change at a firm. The results support an integration of the upper echelons perspective and the power circulation theory view of top management team turnover.

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1. Introduction

Research on top management teams (TMTs) recognizes that senior executives rarely work alone. The upper echelons perspective (Hambrick and Mason, 1984) argues that collective characteristics and actions of the TMT may affect organizational outcomes. However, studies of executive turnover in economics and finance typically pay exclusive attention to the CEO and firm performance measures (e.g. Murphy and Zimmerman, 1993; Warner et al., 1988; Pourciau, 1993; Huson et al., 2004). Less research in this literature focuses on strategic changes at the firm coinciding with CEO turnover. In one example, Weisbach (1995) explores the extent to which CEO turnover correlates with the divestitures of recently acquired divisions and concludes that the probability of exiting a line of business and divesting unsuccessful acquisitions is significantly higher with the dismissal of the CEO responsible for the acquisition.

In order to complement the research on strategic changes at the time of top management turnover, our analysis exploits a large representative dataset that allows us to better identify the specific types of CEO turnover that correlate with changes at the firm, including joint turnover of the CEO and non-CEO members of the TMT. We use the accounting disclosure of discontinued operations – exiting a line of business – as a measure of strategic change in firm operations. Such a variable has been used previously in studies of escalation in managerial decisions (Statman and Sepe, 1989) and is similar in flavor to the variable considered by Weisbach (1995). Our analysis helps

reveal a more focused relationship than has been previously documented.

Shen and Cannella (2002) adapt the power circulation theory of control (Ocasio, 1994; Ocasio and Kim, 1999) to the discussion of TMT turnover. In this view, there are three distinct types of CEO turnover – outsider succession, follower succession that includes insider CEO replacement appointed after a retirement of the outgoing CEO, and contender succession that includes insider successors appointed after the resignation of the outgoing CEO. Shen and Cannella demonstrate that these three types of succession have different effects on the subsequent operational performance of the firm. We complement this strand of research by exploring a more precise measure of strategic change in the operations of firms affected by the three types of CEO succession. We also integrate the three types of turnover suggested by Shen and Cannella with the upper echelons perspective by examining TMT turnover scenarios at the time of CEO succession. Our analysis leads to three significant findings.

Our first finding is that CEO departure from the firm is associated with reporting of discontinued operations only if other top executives also exit the firm. Note that limiting the analysis to only cases of CEO turnover was common in earlier empirical studies in the finance and economics literature (e.g. Weisbach, 1995; Huson et al., 2004). We replicate the basic finding of Weisbach that CEO turnover is correlated with changes in the firm's operations. In further analysis, we allow estimates to differ in cases of joint turnover by the CEO and other top managers and in cases when the CEO leaves alone. Doing so demonstrates that the basic result reflects a large and significant link between discontinued operations and CEO departures that also involve departures of other TMT members. This finding supports the upper echelons perspective and questions the merit of theorizing

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about the events surrounding CEO turnover separately from those that relate to the turnover of other members of the TMT.

Second, we find that a significant relationship between CEO turnover and discontinued operations exists in cases of contender succession, but not follower succession. This result supports the application of power circulation theory to the analysis of TMT turnover and suggests that contender succession and a mandate for strategic re-orientation of the firm coincide. Our third result is that in cases of outsider succession, a higher likelihood of discontinuing operations only occurs if outsider succession coincides with the departure of other TMT executives. In cases when outsider succession does not involve turnover in the TMT, or in cases when the outgoing CEO stayed with the firm in another capacity, we find no significant relationship. Karaevli (2007) summarizes conflicting findings of over fifty studies on outsider succession and recommends better measurement of turnover context. We complement the literature on outsider succession by demonstrating the need for integration of outsider succession studies with the upper echelons perspective. In our extensive sample, the apparent significant relationship between outsider succession and change at the firm is driven by the cases when outsider succession also involves departure of non-CEO top managers from the firm.

2. Background and hypotheses

Our analysis complements two distinct strands of research. One such strand, arising in finance and economics, considers changes at the firm that coincide with CEO turnover. For example, CEO turnover has been linked to stock-price movements (e.g., Warner et al., 1988) and changes in accounting variables (Murphy and Zimmerman, 1993; Pourciau, 1993). Less work has focused on the strategic changes at the firm accompanying such movements. An exception noted above is the Weisbach (1995) study of the link between CEO changes and divestitures of recently acquired divisions.

The above turnover studies focused solely on the CEO. However, an emerging literature on the patterns of non-CEO top manager turnover documents that non-CEO departures from the firm are frequent events at the time of CEO departure. Fee and Hadlock (2004) report that the probability of non-CEO turnover increases when the CEO exits the firm. Hayes et al. (2006) find that the probability of non-CEO turnover increases around times of CEO turnover, which may be explained by complementarities among members of the TMT. We extend this research by detailing the patterns of CEO and non-CEO turnover for an extensive dataset of firms and exploring the specific types of turnover that coincide with strategic change at firms.

In contrast to the studies in economics and finance, management literature has long held the view that strategic choices and performance are influenced not only by the CEO, but also by non-CEO members of the TMT (e.g., Hambrick and Mason, 1984; Carpenter et al., 2004). The “upper echelons perspective” suggests that observed characteristics of the TMT may serve as reasonable proxies for the unobserved differences in cognition and values that are related to strategic outcomes. A number of studies have shown that characteristics of the TMT play an important role for changes in the firm's strategy. For instance, Wiersema and Bantel (1992) report that firms are more likely to experience a change in strategy if they exhibit TMTs with shorter organizational tenure and lower average age, while Finkelstein and Hambrick (1990) report that long-tenured TMTs are associated with strategic persistence. Boeker (1997) demonstrates that turnover of individual members of the TMT in an 18-year sample of observations from the semiconductor industry is associated with the strategic action of new product entry. Beckman et al. (2007) indicate that in a sample of 161 technology firms, entry of new members into the TMT increases the likelihood that a firm achieves an IPO, while TMT exits reduce the likelihood of achieving an IPO. Carpenter et al. (2004) provide a comprehensive review of the

theoretical and empirical developments in the related literature. More recent empirical studies explored the impact of TMT characteristics such as gender composition (Krishnan and Park, 2005), power distribution (Smith et al., 2006), and pay dispersion (Ensley et al., 2007).

In this study, we extend the research on TMT turnover by examining coincident strategic change in the firm's operations as measured by new disclosures of discontinued operations. Such disclosures indicate strategic re-orientation at the firm. Adopting this measure of strategic change allows for the creation of a large multi-industry dataset that complements earlier small-sample studies by considering various turnover scenarios.

Studies of turnover in the TMT also explore succession processes and their impact on the relationships among top executives. These studies include research on heirs apparent, defined as insiders who may be in line to replace the CEO (Vancil, 1987). Such heirs are often identified by the title of president or chief operating officer (Cannella and Shen, 2001). The findings in this area include Bigley and Wiersema (2002) demonstration that the heir apparent status carries consequences for strategic decision-making, including the tendency to undertake corporate strategic refocusing after the heir's promotion to CEO.

The power circulation theory of control (Ocasio, 1994; Ocasio and Kim, 1999) focuses on power contests at the firm initiated by non-CEO senior executives as well as by outside directors and suggests that an insider succession may be the outcome of a power contest. In this case, the inside successor is more likely to have a mandate for strategic change. Shen and Cannella (2002) refer to such successors as “contenders”. In contrast, insider successors that follow an ordinary retirement are likely to have the mandate to maintain strategic continuity (Friedman and Oik, 1995). The extensive dataset that we employ allows us to identify cases of contender and follower successions. We anticipate contender succession to be associated with strategic re-orientation and follower successions to have no such association.

Hypothesis 1. CEO departure in a contender succession will be positively associated with discontinued operations reported by the firm.

Hypothesis 2. CEO departure in a follower succession will not be associated with discontinued operations reported by the firm.

In contrast with insider succession, outsider succession is more likely in periods of poor firm performance and may indicate the absence of competent talent inside the firm (Finkelstein and Hambrick, 1996). Outsider successors may have the mandate to change the direction of the firm, but the lack of firm-specific knowledge and the resistance of the remaining TMT members put outsiders at a disadvantage as Shen and Cannella (2002) find a strong negative impact of outsider succession on post-succession operational performance. Zhang and Rajagopalan (2010) present evidence that outsider succession has a complex non-linear relationship with firm performance. In order to further focus on the differences between outsider, contender, and follower succession, we identify turnover scenarios that include the entire TMT. The upper echelons perspective suggests that change in the TMT may be a key indicator of strategic change at the firm. Empirically, Mueller and Barker (1997) report that firms that experience a turnaround are more likely to exhibit turnover in the TMT. Shen and Cannella (2002) conclude that focusing on the CEO alone “cannot fully capture the performance consequences of CEO succession”. Thus, we consider the following hypothesis suggested by the upper echelons perspective:

Hypothesis 3. Joint turnover of the CEO and non-CEO members of the TMT will be associated with discontinued operations reported by the firm.

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