

ANALYSIS OF CEO TURNOVER IN INDONESIA: DOES UNDERPERFORMED ORGANIZATION CAUSE CEO TURNOVER? – CASES OF MERGER COMPANIES IN INDONESIA

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ABSTRACT

The results of previous research on the relationship between organizational performance and CEO turnover have been inconsistent so far. It has shown that the lower the performance, the greater the likelihood of CEO turnover. This negative relationship has been found in many subjects in organization. On the other hand, some studies found a positive relationship between job performance and turnover (in which the higher the performance, the greater the likelihood of turnover). Using a measurement of longitudinal design, this research tested organizational performance, such as stock and financial performance of top management turnover among 129 target and non-acquired firms over a five-year period. This study found significant relationships between them. The results indicated that poor organization performance triggered CEO turnover in Indonesia, especially in merger firms. This result also have an implication for Indonesian business such how organizational performance can affect a merger or an acquisition and, as a straight forward, it also affects the management of an acquired company.

Key words: *CEO Turnover, Accounting Theory, Organizational Theory, Organizational Performance.*

INTRODUCTION

Organizational performance is assumed to determine a standard measurement of either successful or unsuccessful top managers within an organization. Consequently, it is often used as a measurement of institutional reward and punishment. Many studies examining the organizational performance factors are associated with CEO's own intention to resign; yet, several are also indirectly associated with timely turnover and they are supposedly to occur in the organization. Some of the studies indicate that poor performance of the organization becomes the factor causing CEO turnover, while others looking it otherwise where organizational performance is a factor that is influenced by CEO turnover. This paper discusses these two issues, in which organizational performance taken as a factor affecting CEO turnover, and otherwise, organizational performance as a factor being

affected by CEO turnover as well. This study attempts to provide empirical contribution to the issues of CEO turnover occurred in Indonesia, as well as to test whether poor organizational performance is due to the CEO turnover in Indonesia?

In a study carried out by DeFond and Hung (2004), it shows that 195 companies in Indonesia find 31 cases of CEO turnover (or 16% probability of turnover). It draws the interest to conduct a further study to question whether the turnover is actually driven by poor organizational performance. This study aimed to investigate CEO turnover that occurred during the company mergers in 2004 and 2005. During these years, there was no major external force of any kind that could affect the company, thus internal management would entirely be responsible for any poor organizational performance. Therefore, the researcher are assured to justify that CEO turnover decisions during

that time are solely due to poor organizational performance – not because of any external factors.

There have been several studies in relation to the relationship between organizational performance and CEO turnover. Furtado and Karan (1990) attempted to review a number of publications that examined the relationship between organizational performance and CEO turnover. They claimed that this study has been conducted for more than two decades. Some theories predicted the existence of a negative relationship (Gamson and Scotch, 1964; Salancik and Pfeffer, 1980; Salancik and Meindl, 1984; Tushman and Romanelli, 1985), but empirical findings showed that the results still varied. For instance, changes in Return On Equity (ROE) produced significant results in a study by Allen and Panian (1982), and Lubatkin and Chung (1985), but the finding differs from those conducted by Robinson and Brief (1985), or Harrison, Torres and Kukalis (1988). Puffer and Weintrop (1991) stated that the inconsistency in those findings might be flawed from the failing performance indicators used by researchers in assessing the CEO turnover decision. Puffer and Weintrop (1991) applied three assumptions (1) clarity of regulation in compensation contract to assure that actions performed by the management are at the utmost interest of their shareholders, (2) types of organizational performance indicators applied in the compensation contract, and (3) the convergence between the expectations built by the CEO against the actual criteria and performance appraisal. Failures in meeting the expectation could bring result in rejection from the management.

THEORETICAL FRAMEWORK AND HYPOTHESIS

CEO Turnover

CEO turnover Model (Puffer and Weintrop, 1991), which was frequently used in previous studies, included three criteria of performance, namely: stock price

performance, target earnings and financial ratios. Target earnings poses the most difficulties in terms of data collection, especially for the countries in which companies do not have to state Earning Forecast Report as an obligation. In this research, Puffer and Weintrop implemented EPS forecast surrogating the expected target earnings by the board of directors. In category, CEO turnover is often divided into two types: Mandatory and Voluntary. It is a Mandatory when the turnover follows a request or agreement of the stockholders, while it is Voluntary when the turnover follows the the CEO's own desire.

Performance appraisal in CEO Compensation Contract

In general, organizations perform certain contract with their CEO to provide compensation (bonus) on the basis of performance achieved by the CEO. This compensation contract often includes three types of bonus schemes such as (1) *stock option plans* that is based on future stock price, (2) *performance plans* that is for achieving target profit of the organization, (3) and as an additional measurement is the target of accounting ratios. Puffer and Weintrop (1991) described several organizational considerations in implementing several indicators of performance appraisal. Firstly, CEO performance appraisal by using theoretically conceptual contracts is an effective assessment. In experience, since this assessment is applied, there have been some improvements of the performance criteria (Holmström, 1979). Secondly, performance appraisal will have a motivational impact towards CEO's action to consider the most interest of shareholders – although it would eventually have its own impact on CEO's "security" interest as well (Lambert and Larcker, 1985). In addition, analysis conducted by Holmström (1979), and Feltham and Xie (1994) revealed that multiple performance measures would improve the efficiency of the contract.

Puffer and Weintrop (1991) further explained that a contract often contains bonus schemes which are based on more than one performance indicator. There are at least two practical reasons that are derived from the framework of agency theory. Firstly, a theoretical contract model demonstrates that the number of performance criteria increases, so it makes the evaluation of CEO effectiveness become more optimal (Holmström, 1979). As each of the criteria included in the compensation contract can measure performance differently, combining them will help to eliminate flaws in each measures, thus it can provide a clearer assessment of CEO's contribution on the performance in the organization. Secondly, it is to encouraging CEO to act in the utmost interests of shareholders and protecting CEO's particular own interests. Otherwise, CEO may feel under a threat or exploitation which can lead to actions not in the organization's best interests (Lambert and Larcker, 1985).

Agency theory would provide the best ground in assessing manager's compensation towards one or more performance measurements. Thus, the managers, then, are motivated to maximize performance. As higher expected performance demands bigger compensation for managers, likewise the shareholders expect higher dividend payment rate, eventually both are sharing the same goal.

Stock Price in Stock Plans. *Stock plans* are generally perceived as a long-term form of compensation. A CEO is expected to undertake actions in order to increase future stock price for the organization. This type of compensation on one hand is good for the organization. However, it will bring about risks to CEO as stock price itself is driven by many factors that are often uncontrollable by the management. Therefore, the management will most possibly choose a conservative investment strategy to maintain and protect their personal interests by earning better return for their shareholders (Lambert and Lacker, 1985).

A research conducted by Boschen, Duru, Gordon, and Smith (2003) examined the long-term effects on the *unexpected* organizational performance towards CEO compensation. They found that an unexpected-but-good accounting performance, at first, related to CEO increase in payment (bonus). Yet that was only an initial effect which would eventually somehow be back at lower level of payment in the following years. Overall, long-term benefits from this unexpected-but-good accounting performance would have an insignificantly different than null. However, there would be far different from the stock price in a way that stock price performance is positively and significantly associated with the increase in bonus payment for several years. Then, CEO's financial gain from the long-term cumulative unexpected-but-good stock price performance are also positive and significant.

The Positive Theory Accounting (PAT) focuses on predicting managers' action in selecting accounting policies; and on how managers respond to the offer of the new standards. For example, can we predict whether oil and gas organization managers will pick SE as its accounting policy in keeping record of exploration costs or will he choose the FC instead? Can we predict whether the manager to support fair value accounting standards as its financial instrument, or otherwise? PAT perceives that organizations organize themselves in ways it is the most efficient, so that they can maximize their existence. As a *nexus of contracts*, organization can broadly explain the entire contract owned by the organization because an organization is basically a compilation of (bound to) contracts. Furthermore, an organization will make efforts to minimize the cost of its various organization contracts. Contracts at the lowest cost are called the efficient contracts (Scott, 2006). Such contracts would be the main objective of any organization.

Watt and Zimmerman (1986) formulated three hypotheses contained in PAT into (1) The bonus plan hypothesis, (2)

the debt covenant hypothesis, and (3) the political cost. The bonus plan hypothesis stated that managers with bonus plan prefer accounting procedures which report future earnings during the current period. Regarding the income statement, the manager would try to raise his current bonus by increasing income reported. The debt covenant hypothesis considers that an organization usually tries to deviate accounts from which they are required to make loan. While the political cost hypothesis explained that the greater the political cost faced by an organization, it is likely that managers prefer accounting procedures that report earnings differently from the moment until future period. Those hypotheses construct an important component in PAT. By paying concern to the bonus plan, managers may choose less conservative accounting policies, so it can generate better earnings.

Scott (2006) also explained that Executive Compensation Plans (ECP), in which it included a combination of incentives, risks and consideration of long-term decisions, defines the agency contract between the organization and its manager that aims to limit the interests of owner and manager by assessing manager's compensation using one or more performance measures when managing the organization. Many compensation plans are based on two measures of performance, net income and stock price. Furthermore, the amount of bonuses, shares, options, as well as other payments to executives which will be awarded in a given year depends on the performance of net income and stock price.

At the early rise in 1986, PAT was neutral. But then in 1990s, PAT was directed to meet the interests of managers. Such a buzz on meeting their interests is bonus plan, as debt covenants and political costs are more to the interests of the organization. This is between two polar of opportunistic (bonus plan) and efficiency (debt covenant – tend to raise profits, and political cost –in which for giant organizations, monopoly holders, and public utilities, tend to reduce income that is

not preferably for managers).

Target Earnings. When previous researchers used stock price performance measurement with target earnings as an indicator that will be associated with CEO turnover, then the assumptions applied were stock prices and earnings contained different information that provide different performance indicators as well. Information given in earnings statement may distinguish the actions done by CEO against uncontrollable external factors as in the case of stock prices. Target earnings can help balancing the impacts upon the risks imposed when CEO compensation is measured with the stock price (Lambert and Lacker 1985).

Nevertheless, Holmstrom (1979) assumed that agents' way of conduct could not be observed by the principal, but its payments could be observed simultaneously at the end of the period. Feltham and Xie (1994) showed that Holmstrom model broke through unobservable payment became possible to be observed through the course of constant actions performed by managers. Holmstrom explained that performance measures-based contracts, such as net income (earnings) are less efficient than *first-best contract* (which is stock price performance). However, the bonus plan which is based on annual earnings target has been a common feature on the compensation plan in America. In 1980, 90% of organizations of 1000 largest U.S. manufacturing firms in the United States implemented such compensation plan (Healy 1985). Target Earnings-based bonus plan made up a short-term substantial portion for executive compensation. For instance, in 1978 the mean accounting ratio of bonus to basic salary for senior executives was at 52 percent (Fox 1980).

Selected Accounting Ratios. Accounting ratios represent measures of the organization's ability to earn profit (profitability) and to attain efficiencies that are measurable by the internal and external

evaluators in concern of organizational health assessment (Weiner and Mahoney, 1981). Accounting ratios measurement has been tested empirically and widely applied in previous research. They are Return on assets (Virany, Tushman and Romanelli 1985; Harrison, Torres, and Kukalis, 1988), Return on equity (James and Soref, 1981; Allen and Panian, 1982; Lubatkin and Chung, 1985; Robinson and Brief, 1985; Harrison, Torres, and Kukalis, 1988) and the profit margin on sales (Slancik and Pfeffer, 1980; Harrison, Torres, and Kukalis, 1988). Accounting ratios are less frequently applied compared to the stock price and target earnings.

Boschen et al. (2003), which tested the long-term effects on the unexpected performance of the organization towards CEO compensation, found that good (unexpected) accounting performance in fact did not contribute to better long-term cumulative gain for the CEO of the organization. An expectation that there are positive and significant relationship between accounting performance and CEO compensation were not found in their study.

Underperformed Organization Causes the CEO Turnover

Underperformed Stock Prices Forces CEO Turnover. This research noted that CEO turnover followed stock price drop and lower earnings performance (Coughlan and Schmidt, 1985; Warner, et al., 1988; Weisbach, 1988). Thus, it drew the conclusion that CEO turnover most likely due to poor performance. Murphy and Zimmerman (1993) found no evidence of any managerial policy to have caused such CEO turnover in an organization. In the opposite, underperformed CEO did not strongly associated with CEO turnover as reported in Germany and Japan government. Nevertheless, Adam's et al. (2005) found a positive relationship between CEO turnover and performance.

Great concern among researchers in recent years has indeed been around the topic of the importance to understand the potential impact of performance towards employee

turnover process, including CEO (Mobley, 1982; Steers & Mowday, 1981). Related findings in Puffer and Weintrop (1991) study were likely inconsistent. These inconsistencies among previous studies about the relationship between corporate performance and CEO turnover may be due to the ignorance of board of directors as the indicator who are responsible for the CEO turnover decision.

Hypothesis 1: The performance of stock price is positively associated with CEO turnover.

Accounting Performance Engaging CEO Turnover. Accounting performance has been widely researched in recent years. Kato and Long (2006, 2005) examined the relationship between CEO turnover towards accounting performance in China with different scales of sample data in both of their two years of research. In 2006, they found a strong relationship within the companies with concentrated ownership. This relationship is consistent with the findings by Volvin (2002) using Italian companies as research sample. The same thing had previously been found in research by La Porta et al. (1999) as well.

Accounting ratios represent measures of the organization's ability to earn profit (profitability) and to attain efficiencies that are measurable by the internal and external evaluators in concern of organizational health assessment. As empirically tested in previous studies, they are Return on assets/ROA (Virany, Tushman and Romanelli 1985; Harrison, Torres, and Kukalis, 1988), return on equity (Soref and James, in 1981; Allen and Panian, 1982; Lubatkin and Chung, 1985; Robinson and Brief, 1985; Harrison, Torres, and Kukalis, 1988), and the profit margin on Sales (Slancik and Pfeffer, in 1980; Harrison, Torres, and Kukalis, 1988). Accounting ratios provide the information to explain accounting performance, as for better accounting performance decreases tendency of either mandatory or voluntary CEO resignation.

Boschen et al. (2003) examined the long-term effects on organizational performance (unexpected) towards CEO compensation. He found that good accounting performance (unexpected) in fact did not contribute to better long-term cumulative gain for CEO. Thus the proposed hypothesis is:

Hypothesis 2: Accounting performance is positively associated with CEO turnover.

RESEARCH METHODS

Research Sample and Data

Since information on CEO turnover in Indonesia is likely hard to obtain, to collect the required data, this study will conduct a thorough search directly into the company's annual report during the year 1990 to 2004. The data are obtained from the Business and Economics Data Center, University of Gadjah Mada. For each company, five years period – prior to and after the CEO turnover took place – is analysed. For instance, in 2005 CEO turnover, the stock price performance and accounting performance data used will begin with the starting year of 2000_(t-5), 2001_(t-4), 2002_(t-3), 2003_(t-2), 2004_(t-1) and 2000_(t+1), 2001_(t+2), 2002_(t+3), 2003_(t+4), 2004_(t+5).

Research Variables

This study employs stock price performance and financial performance as its independent variables. Referring to stock price performance, the annual average value is used by dividing the sum of the beginning and the end year value into two. On the other hand, Profit Margin on Sales and Return On Assets will measure the accounting performance. These two variables indicating accounting performance are used because they are derived from separate financial statements, Profit Margin on Sales is derived from the income statement, while Return On Assets is obtained from the balance sheet. Therefore, at this early observation, multicollinearity can be avoided.

Econometric Model of the Research

In assessing the probability of company's decisions associated with economic activity, the basic economic models applied are the logit and probit. Andrei, Oancea, Stancu and Iacon (2009), in their research which employed a binary model, recommended the use of those models for a decision over two given activities. In their study, the activities are whether to buy or not to buy a product, as in the following.

$$Y = \begin{cases} 1, & \text{to-buy activity} \\ 0, & \text{not-to-buy activity} \end{cases}$$

The equation below is to explain that β is the vector coefficients to be estimated.

$$P(y_i = 1|x_i) = \begin{cases} \frac{\exp(x_i'\beta)}{1 + \exp(x_i'\beta)} & \text{for logit} \\ \Phi(x_i'\beta) & \text{for probit} \end{cases}$$

Data of this study are cross sectional and will be tested using logit model, a model that aims to linearize the probit model. This model is similar to research conducted by Cramer (2007) which aims to observe the variation of outcome Y that may be associated with a number of covariates X_j . In accounting research, Zhou, Xiong and Garguli (2009) also employed a binary model when they applied adopt IFRS and non-adopt IFRS as dependent variables which they symbolized by ADOPT (1.0). Logit analysis was used to test their independent and dependent variables. Then, logit analysis became an important part in the analysis of strategic studies for the past few years in order to maintain the strength of methodology in high-standard journals. In his research in strategic management, Hoetker (2007) employed this logit model as well.

Below is the research model for hypotheses 1 and 2i,

$$TURNOVER(1,0) = \alpha_0 + \alpha_1 K_jSHM_{it} + \alpha_2 ROA_{it} + \alpha_3 ProMAR_{it} + \epsilon_{it}$$

Where:

TURNOVER (1,0): indicator variable at which 1=no turnover and 0=turnover.

KjSHM: performance of stock prices, obtained from deducting stock price at *t* with stock price at *t-1* and dividing by the stock price at *t-1* (equal the value of the stock return).

ROA: Return on Assets, obtained from dividing earning after tax by the total assets.

ProMAR: Profit margin, obtained from dividing net profit margin by the total sales.

Of the variables above, the linear probability model can be described as follows:

$$Y_i = a_0 + \sum_{i=1}^9 a_i X_i + \varepsilon_i,$$

where ε_i is the residual variable that measures the influence of other factors that might contribute to explain the CEO turnover.

As a basis for estimating the value of the assessed variables above, the estimation parameter of its linear probability model is,

$$\hat{Y}_i = a_0 + \sum_{i=1}^9 \hat{a}_i X_i$$

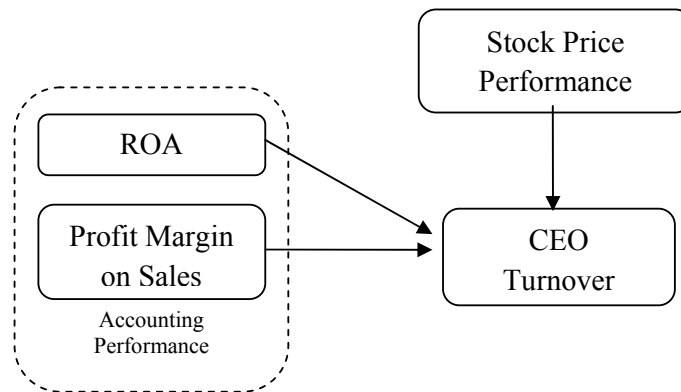
Andrei et al. (2009) defined LOGIT model in a way that repartition function which explains the probability of $p_i = P(y_i = 1)$ refers to the type of logistic below,

$$\begin{aligned} p_i = P(y_i = 1) &= P(v_i^* > v_i) = P(\varepsilon_i > v_i - (a_0 + a_1 x_{1i} + \dots + a_p x_{pi})) \\ &= P(\varepsilon_i < a_0 + a_1 x_{1i} + \dots + a_p x_{pi} - v_i) = F(\varepsilon_i < a_0 + a_1 x_{1i} + \dots + a_p x_{pi} - v_i) \quad (6) \\ &= \frac{1}{1 + e^{-[a_0 + a_1 x_{1i} + \dots + a_p x_{pi} - v_i]}} \end{aligned}$$

As for the repartition function alone is described below,

$$p_i = P(y_i = 1) = \frac{e^{[a_0 + a_1 x_{1i} + \dots + a_p x_{pi} - v_i]}}{1 + e^{[a_0 + a_1 x_{1i} + \dots + a_p x_{pi} - v_i]}}$$

**Exhibit 1
CEO Turnover Model**



Referring to its endogenous variables, this model uses the code 1 and 0, thus the R^2 result from the logit model cannot be analysed or interpreted. Furthermore, since the logit model is one type of non-linear test, the test is intended for the purpose of sign test rather than test of significance.

DATA ANALYSIS AND DISCUSSION

The results obtained from the binary test enclosed in the appendix revealed that an outcome is consistent with the theoretical ground used in this research. In addition, the three variables tested were all significant.

Stock price performance symbolized with X_1 in Table Binary Test Results showed positive coefficient value (0.3384) with significance value at 0.0073. This value indicates that there is a positive relationship between stock performance and CEO turnover in Indonesia. With a justification that if the stock performance increases, then CEO turnover will not occur; and vice versa. In the case of voluntary turnover, it is possible that indications as described in the bonus plan theory will logically occur, as a stock performance-driven CEO would resign if the bonus significantly and systematically decreases. Mandatory CEO turnover is generally in demand from stockholders who have lost trust in the ability that their CEO will prosper them. These results indicate that the first hypothesis is supported by statistical proof as the stock price performance is positively related to CEO turnover.

Return on Assets (ROA) symbolized with X_2 in Table Binary Test results showed positive coefficient value of 1.0231 with significance at 0.000, which means that ROA has a positive relationship towards CEO turnover in Indonesia. With a justification that good ROA performance will not result in CEO turnover in the company; and vice versa as well. ROA is a ratio that measures a company's ability to generate profits by optimizing the use of corporate assets. It is

very interesting to have such consistency between CEO turnover and ROA performance.

These findings are consistent with those found in previous researches which support the positive and significant relationship between ROA and CEO turnover (e.g. Virany, Tushman & Romanelli, 1985; Harrison, Torres, and Kukalis, 1988). These results indicate that the better the organizational performance, the less likely CEO will turnover.

In the third test, accounting performance is examined by analysing Profit Margin on Sales (symbolized with X_3). It is predicted that the test will have a positive relationship towards CEO turnover. From the binary test results, it is shown that the positive coefficient is at 0.6586 with significance value at 0.0016. This result also proves that the profit margin on sales has a positive relationship towards CEO turnover in Indonesia. Furthermore, we can justify as well that good profit margin on sales gives an indication to the least chance that CEO turnover will happen – particularly in mandatory turnover case – vice versa. Binary test results for X_2 and X_3 in this study indicate that the second hypothesis of this study are statistically well supported, that accounting performance is proven positively associated with CEO turnover.

The results of this analysis support those of previous studies conducted by Slancik and Pfeffer, 1980; and Harrison, Torres, and Kukalis, 1988. These findings also state that accounting data can be used to predict the possibilities of CEO turnover in Indonesia. And the three independent variables employed in this study reinforce the contribution of this research for businesses in Indonesia, that accounting information has the power to explain phenomenon of CEO turnover, in particular for companies during merger.

Table 1
Binary Test Results

	Coefficient	Standard of Deviation	Z-statistic	Probability
X ₁	0.338471	0.126234	2.681305	0.0073
X ₂	1.013133	0.139187	7.278957	0.0000
X ₃	0.658657	0.208595	3.157585	0.0016
C	-8.112302	0.244672	-33.15585	0.0000

This analysis is consistent with the theory of rationality Schein (1992) which states that the change agent is a warning to identify and remove barriers from the change in goal to transform the organization into a better (Smith, Wright, and Huo 2008). This indicates that the theory is in deteriorating condition of organizational performance, top management turnover will terjadialah only in form of mergers and acquisitions.

CONCLUSION AND IMPLICATION

This study attempts to provide an empirical contribution to CEO turnover phenomenon in Indonesia. CEO turnover is originally driven by many factors, and this study found that stock performance and accounting performance which are represented by ROA and profit margin on sales are proved positively associated with CEO turnover in Indonesia. The issue made up this research is resolved, that CEO turnover in Indonesia was driven by poor organizational performance. The results are consistent with the Bonus Plan Theory within Positive Accounting Theory. The latter analysis we did on the research results showed that poor stock performance and low accounting performance triggered several companies to conduct mergers.

For further research, it is suggested to perform in-depth studies to find companies that really do turnover their CEO. Extra efforts will be required as such CEO turnover data is rather hard to obtain, however, by doing so it won't require to use surrogating variables which will produce more actual research results. In addition, it would be interesting to consider the characteristics of each CEO of each company that are about to

turnover, such as the relevance with education background, years of service or experience as CEO, and nationality (native or foreign).

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APPENDIX – LOGIT Analysis Result

Dependent Variable: Y
 Method: ML - Binary Logit (Quadratic hill climbing)
 Date: 12/10/09 Time: 09:07
 Sample: 1 129
 Included observations: 129
 Convergence not achieved after 1 iteration
 QML (Huber/White) standard errors & covariance

	Coefficien t	Std. Error	z-Statistic	Prob.
X1	0.338471	0.126234	2.681305	0.0073
X2	1.013133	0.139187	7.278957	0.0000
X3	0.658657	0.208595	3.157585	0.0016
C	-8.112302	0.244672	-33.15585	0.0000
McFadden R-squared	0.885328	Mean dependent var		0.581395
S.D. dependent var	0.495254	S.E. of regression		0.114785
Akaike info criterion	0.217932	Sum squared resid		1.646946
Schwarz criterion	0.306609	Log likelihood		-10.05664
Hannan-Quinn criter.	0.253963	Restr. log likelihood		-87.69905
LR statistic	155.2848	Avg. log likelihood		-0.077958
Prob(LR statistic)	0.000000			
Obs with Dep=0	54	Total obs		129
Obs with Dep=1	75			