Corporate Governance and Top Management Turnover: a Literature Review

Shang Juan
College of Economics & Management, Xidian University
Xi’an, China
juanshang@xidian.edu.cn

Abstract—Effectiveness of top management turnover is an important factor of corporate governance mechanism effectiveness. However, presently there are a lot of controversies on how corporate governance affects top management turnover on the academic circles. Many researchers have been done on this issue from these perspectives of corporate performance, internal governance mechanism, external governance mechanism, and characteristics of top management, and it has got many research achievements. These research papers have important theoretical and practical significance, helping us to better understand corporate governance mechanism and actively improve the level of our corporate governance. The main purpose of this paper makes a summary of these research results so as to provide a reference to our academic research in the field. This provided a new cognitive perspective for the study relatively lack of multi angle of corporate governance and top management turnover; there is less study from the external supervision mechanism to investigate the influence factors of top management turnover.

Keywords—Top Management Turnover; Corporate Governance, Governance Mechanism

I. INTRODUCTION

Effectiveness of top management turnover is an important factor of corporate governance mechanism effectiveness. Turnover is the most extreme constraint for the top management, and also is a correction for past poor performance. A good corporate governance mechanism can make effective assessment to corporate performance, and dismiss bad top managements. However, recent researches show that corporate governance is influenced obviously by the country or region's political environment, cultural customs and institutional background. In these countries having poor external governance environment, corporate internal governance is relatively worse and top management is not easy to be changed. (DeFond, 2004; La Porta, 1998)

Research on top management turnover is a hot issue in the international field of corporate governance, because the factors that affect top management turnover directly decide whether the evaluation system of corporate governance level is scientific and reasonable or not. And how top management turnover affects corporate performance and the adjustment of governance structure is the focus of public and society. Since the 1970s, foreign literatures have researched the affected factors from these perspectives of firm performance, internal governance mechanism, external governance mechanism, and characteristics of top management, and provided different explanations on the reasons of top management turnover. Besides, it has provided some evidences on the basic of different national dates and produced the literatures about the affected factors of top management turnover. However, the research that china scholars make on the top management turnover is still in the infancy stage. The scholars analyze the top management turnover mainly from the perspective of internal governance. The specific features in China transition economic environment provide the conditions to research the influence of external institution on the top management turnover. In 1980s, decentralization reforms in China led to the difference on level and process of law in different areas, which inevitably produce differences of corporate governance in different areas. In view of the above, this paper sorts out and summarize the domestic and international research results in this field, and provide a reference for better understanding the corporate governance mechanism and setting up efficient incentive and restraint mechanisms to regulate the behavior of top managements.

II. THE INFLUENCE OF FIRM PERFORMANCE ON TOP MANAGEMENT TURNOVER

Firm performance is the crucial factor of top management turnover and gets widespread attention by researchers. Coughlan and Schmidt (1985) firstly researched the relationships between firm performance and top management turnover. They found that the lower the shares price of listed companies, the greater the probability of CEO turnover. The empirical study by Warner et al. (1988) also showed that return rate of stock market had a significant negative relationship with the abnormal top management turnover. Weisbach (1988) used the ROA as the variable of the company performance, and found the company ROA during 1 and 3 years before CEO turnover was significantly lower than the average ROA in the industry. Defond and Hung (2004) believed that in the market environment being absence of legal regulation and investor protection, the accounting performance could better explain the reasons for CEO turnover. Enel et al (2003) manifested that the board of directors paid more attention to the accounting performance than the firm stock performance. However, if the firm environment was complex or the market was valid, the decision whether the board of directors dismiss CEO or not had little relation with the accounting performance. Fan et al. (2007) selected Chinese listed companies during 1998 and 2003 as samples and studied the efficiency of corporate governance in the institution background of china fast economy transition. The result showed that the worse the firm performance was, the larger the possibility of top management turnover was, and then the corporate governance is effective.
In recent years, Chinese scholars have begun to pay attention to the relationship between firm performance and top management turnover, and it has made some achievements. Gong Yuci (2001), the earliest scholar studying the field in China, found that the probability of top management turnover was a significant negative correlation with firm performance, especially when firm performance was measured by return rate after industrial adjustment. Subsequently, Zhu Hongjun (2002) found that there were closely correlation between top management turnover and the changes of major shareholders. But the firms having different performances had a great difference in top management turnover, which was specifically manifested that the companies with poor operating performance were easier to change executives. Zhao Zhenyu et al (2007) declared that senior management promotion or demotion in state-owned listed companies was positively correlated with company performance, and in different companies, the index of evaluating general top management’s ability or performance had many differences. The requirements of senior decision-makers for the corporate performance varied with the corporate historical performance.

To sum up, the crucial factors of top management turnover is the firm performance. The study about other factors (such as internal governance mechanism, external governance mechanism, and information disclosure) is done from the perspective whether the firm performance is sensitive to top management turnover.

III. THE INFLUENCE OF INTERNAL GOVERNANCE MECHANISM ON TOP MANAGEMENT TURNOVER

A. Ownership Structure

The available literatures study the influence of ownership structure on top management turnover mainly from these aspects, such as equity property, equity concentration, the stockholding of institutional investors, and the stockholding of top managements.

1) Equity Property

The argument focus of many scholars is whose CEO turnover is most correlated with company performance in the state-owned companies. Firth et al. (2006) found that CEO turnover in China’s state-owned listed companies was less sensitive to firm performance than foreign capital holding company. Kato and Long (2005) found only when the ownership changed from state-owned into private, company performance had a significantly negative relationship with CEO turnover.

2) Equity Concentration

In academic circles the study about substantial shareholder is mostly linked with corporate governance and company performance. The scholars mainly discuss the substantial shareholder and the protection of the interest of minority shareholders, and advocate decentralization of shareholding structure and diversification of investment. They mostly put forward the state-owned share reduction program. Boeker et al. (1992) found that the efficiency of corporate governance declined as the company shares were decentralized, and the negative relationship between of top management turnover and firm performance was weakened. Renneboog et al. (2000) used Belgian listed companies having top management turnover as the sample to research the influence of substantial shareholder control to the top management turnover, and found that substantial shareholders could constrain speculative behavior of top management to some extent, making CEO turnover more likely when the performance was poor. Kato and Long (2005) used LOGIT regression model to study the relationship between equity structure and top management turnover on the basis of the integrated financial dates of the China listed companies from 1998 to 2002. The result showed that top management turnover had significant correlation with firm performance when the state-owned companies were changed into private companies. Sun Yongxiang and Huang Zuhui used all the 503 listed companies on December 31 in 1998 in Shenzhen and Shanghai Stock Exchange as samples and found that the equity structure being concentrated relatively and having major shareholders holding was more beneficial for corporate governance to take effect than the decentralized equity structure. Shen Yifeng et al (2007) used 154 listed ST companies from 2000 to 2004 in Shenzhen and Shanghai Stock Exchange as samples, and verified by empirical test that the shareholding proportion of a major shareholder had significantly positive relationship with top management turnover and the influence extent to top management turnover varied with the shareholding proportion of major shareholder.

3) The stockholding of institutional investors

The available literature review indicates that the institutional investors play positive role in corporate governance (Gillan and Starks, 1998; Karpoff, 1999). The supervision of the institutional investors can improve the structure of corporate governance. But the active participation of institutional investors in corporate governance does not significantly affect the long-term performance (Carleton, Nelson and Weisbach, 1998; Huson, 1997). They found that institutional investors participating actively in corporate governance would affect CEO turnover if the firm could change the governance structure correspondingly. Institutional investors mostly based on the company’s previous business performance to select the supervised targets. So the sensitivity of top management turnover to the performance would increase as the activeness of institutional investors participating in corporate governance increased (Huson, Fattin and Starks, 2001). Fattin et al. (2003) found sophisticated institutional investors had adopted a more positive way to participate in the supervision of incumbent executives, and gradually give up the “Vote-by-foot” approach.

4) The stockholding of top managements

The stockholding of top managements makes some balance between control right and ownership and agency costs will be reduced. As long as top managements have some company shares, they would be monitoring others forces, such as the control right market and the manager market. When top managements get enough voting right to keep their positions, these external forces will be weakened. Therefore, ownership
is the source of power. The present studies have indicated that top managements having large shares were rarely changed even if the business performance is poor. Allen (1981) declared CEO tenure had significantly positive correlation with the stockholding of CEO, but did not be affected by the stockholding of other top managements. Gilson (1989) manifested that poor short-term performance did not affect the position of top managements having shares, but the top managements, even having substantial shares, would be replaced inevitably if the long-term performance was poor.

There are other researches investigates the impact of many types of ownership structures on top management turnover. Liu Min et al (2005) analyzed in theory the characteristics of Chinese Listed Companies, which were coexistence of government control, substantial shareholders control and internal control. They all affected top management turnover and restricted the effect of china corporate governance mechanism. The study by Zhaochao et al (2005) showed that the proportions of major shareholders, circulating shares, and state-owned shares had not significantly correlation with top management’s mandatory or non-mandatory changes, and testified that in the situation of excessive market speculation, lower proportion of circulating shares, and “the owner of absence” of state-owned shares, top managements could not be effectively monitored by substantial shareholder, public shareholder, and state shareholder. However, the stockholding proportion of top managements had significantly negative relationship with top management’s mandatory or non-mandatory changes, which indicated that the phenomenon of “insider control” existed in China's listed companies.

To sum up, the available studies on the influence of equity structure on manager turnover mostly indicates that top management turnover has negative relationship with the stockholding proportion of top management as well as the stockholding proportion of state-owned, but has positive relationship with the stockholding proportion of institutional investors and major shareholders.

B. The Characteristics of Board of Directors

The characteristics of board of directors include mainly the scale of the board of directors, its composition, the frequency of its meetings, the leadership structure, the motivation policies, and the shareholding of the directors. Board of directors, the most important part of the internal governance mechanisms, is directly responsible for the selection, appointment, evaluation and dismissal of the general top management. So there are a lot of domestic and international literatures studying the relationship between characteristics of board of directors and manager turnover, whose aim is to study what kind of board of directors can better supervise and constraint top management so as to improve the firm performance. These literatures can be included in the following six parts.

1) The scale of the board of directors

Many scholars believe that if the performance is poor, the corporate executives would be fired more effectively in small-scale board than in large-scale board. Jesen (1993) hold this view that the optimal scale of the board of directors should be eight to nine people. Before reaching this scale, the efficiency would increase as the member number of the board of directors increased. Once the number exceeded the optimal scale, it would lead to some inefficient phenomenon, such as buck-passing and dispute. Yermack (1996) studied the resignation situation of general top management in United States companies, and confirmed that the smaller the scale of the board of directors was, the more likely the dismissal of general top management happens when the corporate performance was poor. But in a large scale of the board of directors, the possibility would decrease. Huson et al. (2001) found that reducing the scale of the board of directors could enhance the negative relationship between CEO turnover and corporate performance.

2) The composition of the board of directors

The present studies have focused on the composition of the Board, the proportion of internal directors to external directors, as a reflection of the board of directors’ control. Fama and Jensen (1983) declared that the external directors could supervise company more effectively than the internal directors, because they were very concerned about the top managements’ reputation on the market. Weisbach (1988) found that CEO with bad performance was more likely to be dismissed in the company in which independent directors was over 60%. Furthermore, Hermalim and Weisbach (1988) selected 142 companies as the research samples, and found the firms having the poor performance tended to replace internal directors with external directors. Therefore, the increase of external directors will not only enhance the correlation between CEO turnover and corporate performance, but also increase the succession possibilities of external directors. However, Gilson (1989) found that when the company was in serious financial trouble both of the internal and external directors would be likely to be changed.

3) The meeting frequency of the board of directors

At present there are two completely different views on the studies for the relationship between the meeting frequency and its working efficiency. A view is that if the directors have enough opportunity to discuss the company's management it will improve the company's management level and enhance the supervision and constraint to the top managements. Zhang Junsheng and Zeng Yamin (2005) used the listed companies before 1999 in the Shanghai Stock Exchange as the samples to study the influence of some governance variables, like characteristics of board of directors, on the top management turnover. The result indicated that the meeting frequency of the board of directors had significantly positive relationship with general top management turnover in these companies whose performance was poor, which meant increasing the meeting frequency of the board of directors could improve the management efficiency. But Maury (2005) investigated the Finnish listed companies and found that the meeting frequency of the board of directors had not significant correlation with top management turnover.

4) The leadership structure of the board of directors

Jagannathan (1996) found that the general top management was able to be changed in time when the
operating performance declined in the company the positions of the chairman and general manager were held by different people. Goyal and Park (2002) found the correlation between CEO turnover and the performance is significantly weaker in the company the positions of the chairman and general manager were held by one person than in the company the positions were held by different people. The study of Zhao Shan (2001) also showed that the position of the chairman and general manager held by one person reduced the possibility of top management turnover. Therefore, the position of the chairman and general manager held by different persons will increase the correlation between firm performance and top management turnover.

5) The motivation policies for directors

More and more companies have begun the implementation of motivation policies for directors. The purpose is to make the interest of top managements and shareholders coincident. Perry (1998) found that the mechanism of motivation and compensation for directors could affect the decision of CEO turnover. If the independent directors got the motivation and compensation, the correlation between CEO turnover and the stock performance would increase. The mechanism of motivation and compensation for external directors could increase the possibility of external succession. Perry (1999) further investigated how the company’s external directors getting paid or not would affect the correlation between top management turnover and the performance. When the external directors received incentive payment, especially the incentive payment of stock, the top management turnover is more closely related with corporation governance. The conclusion verifies that the decision is more effective if the directors get the incentive payment so that the directors are more professional and independent.

6) The shareholding of the directors

The present studies have found that the possibility of top management turnover increases as the shareholding numbers of the members of the board of directors increases. Bhagat and Black (1999) found that the shareholding numbers of the members of the board of directors had positive correlation with the possibility of CEO turnover. Rachinsky (2002) made the descriptive statistics on Russian companies having top management turnover, also found there were positive correlation between the shareholding proportions of the directors and top management turnover.

In summary, the characteristics of the board of directors having influence on the top management turnover are the proportions of the external directors, the position separation of the chairman and general manager, the motivated compensation for the directors, and the shareholding proportions of the directors, which have positive correlation with top management turnover, and the scale of the board of directors, which has negative correlation with top management turnover.

IV. THE INFLUENCE OF EXTERNAL GOVERNANCE MECHANISM

External governance mechanism also affects the top management turnover, such as the control market, the product market competition as well as laws and regulations, which can influence the agency problem between client and agent together with the internal governance mechanism.

A. The Control Market

The control market theory was proposed by Manne. He defined the control right market as a place where the firm can gain firm control right by mergers and acquisitions and get the benefit. The market can produce three effects: first, disciplining top management and improving management efficiency; second, helping shareholders to obtain residual rights of control and residual claim; third, providing shareholders interest protection. Disciplining top management is an important aspect of the controlling effects of market governance (Manne, 1965).

The foreign studies on top management turnover and the control market theory have basically the following three ideas: first, it uses the various types of top management turnover as the study samples, finding the differences between the control market governance and the board of directors governance. Top management turnover may be caused by the transferring of control rights as well as by the decision of the board directors, but in different governance mechanisms, the companies have significant differences in these aspects of the performance and the characteristics of management. Morck et al. (1989) found that the performance of the company having been taken over was significantly lower than the performance of the one which had top management turnover but was not being taken over. Secondly, the frequency of top management turnover and the sensitive of top management turnover to performance as certification of the recognition function and the punishment function of the control market. The study of Mikkelson and Partch(1997) found that in the active period being taken over, 23% enterprises changed the chairman of the board of directors, top managements and CEO. But in the recession period, only 16% enterprises changed their top managements; in the enterprises with the worse performance, the possibility of top management turnover differed more considerably. In the active period, the rate of top management turnover was 33%, while in the recession period, the rate was 17. Further study indicated that in the active period being taken over, the top management turnover had significantly negative correlation with the management performance; while in the recession period, it had not a negative relationship. Finally, form other affecting factors of the top management turnover to study the effects’ change of the control market. For example, the shareholding of the top managements can strengthen the ability of preventing the external takeover, and reduce the possibility of the successful takeover; the more concentrated the share are held, the more possibly the CEO turnover and the mergers allowed by target company happens under the governance of the substantial shareholder.

There are few domestic research literatures on top management turnover and the governance utility of the control market. Zhang Mubin and Fan Conglai (2005) found that China’s control market had been formed, and the recognition effect of the control market on the enterprise with poor performance already appeared. Besides, they investigated that when shareholders had the control rights and faced the
external pressure being taken over, the management would improve performance very hard to reduce the possibility of them being replaced. Li Zengguan and Yang Chunyan (2003) found that on the year and next year when the control right was transferred, the company was easier to change the top management than the company whose control right did not be transferred. And the frequency of top management turnover had significant negative relationship with the performance, the one before the control of the company was transferred. It indicated that the control market of china's listed companies overall seemed to have a regulatory role. Zhu Hongjun (2002) found through statistical analysis that the top management turnover was closely related to substantial shareholder's change, but the companies had a big differences in top management turnover if they had big differences in operating performance, which manifested particularly in the company with poor operating performance the top management was easier to be changed. However the controlling shareholder's change and top management turnover could not radically change the management performance of the company, and just brought serious surplus management to the company.

In an active control market, the main purpose of mergers and acquisitions is to integrate the target company and obtain the company's resources, or change the top managements to improve firm performance. However, in China control market, the practice situation of mergers and acquisitions is that a non-listed company merges and acquires a listed company. This is because, in an emerging market like China, the license of stock issuance, listing quota and distribution system are tightly controlled by the central government; for the majority of companies, especially the non-listed companies, financing from capital market is difficult, and the acquisition of the control rights of listed companies provides them with an favorable external financing channels. Therefore, in this particular context, the transfer of control right of listed companies in China is radically different from Britain and the USA.

B. Product Market Competition

Product market competition is an important part of corporate governance mechanisms. Domestic and foreign scholars have always been concerned whether it has governance effects for the senior management or not.

Defond and Park (1999) used the Herfindahl-Hirschman Index (HHI) to measure the intensity of competition in product markets. Their study indicated that RPE (relative performance evaluation) was more beneficial to help the board of directors to identify incompetent CEO, and industry competition enhanced the usefulness of RPE. Besides, the frequency of CEO turnover was higher in highly competitive industries than in low competitive industries. In the highly competitive industries, the CEO turnover was more sensitive to accounting performance after industry adjustment, while in the low competitive industries CEO turnover was more sensitive to the performance of the company. Goyal and Park (2002) drew lessons from the study of Defond and Park (1999) when they studied the relationship between the board leadership structure and CEO turnover. Adding HHI in the model, they found that the CEO turnover had significantly negative relationship with HHI. To some extent, the above studies shows that product market competition, as a kind of governance mechanism, has effective supervision and restraint function to the CEO, in which there exists the governance effect. However, they haven’t further studied the influence of the further changes of competition intensity on the CEO turnover when product markets have different competition intensity. At the same time, their study base on the experience of developed market economy countries. The conclusion may not be applicable to this transitional market economy country like china.

C. Laws and Regulations

If a country's legal protection of investors is relatively perfect, the company's governance structure will effectively supervise and restrict the top managements once the company performance is poor, so that the company's board of directors changes the top managements.

Defond and Hung (2003) investigated the relationship between legal protection of investors and manager turnover. The result showed that the sensitivity of top management turnover to the performance depended on the laws and regulations. However, their research samples mainly come from the public companies in the countries implementing the law system of Britain and America. Decentralization of stock ownership is the common characteristic of these companies. In the background that investors can get a good legal protection, corporate governance mechanism can fully play its role of supervision and restraint to the top managements. In contrast, in the countries that do not implement the law system of Britain and America, the legal protection of investors is relatively poor, their public company's ownership structure is very different. LaPorta et al. (2000), Lins (2003) and Mitton (2002) found that ownership structure concentrated particularly in the countries where the legal protection of investors is poorer. Then, in these countries, is there obviously correlation between the top management turnover of the predicament company and the centralization of the ownership structure? Voplin (2002) took the Italy companies as the samples to study the problem and the final results indicated that top management turnover is more likely to happen in the company having poor performance than in the company having a better performance. He believed that, besides the company performance, top management turnover was more likely to depend on the factors such as ownership structure. Shen Yifeng (2007) used the 152 ST companies’ stocks during 2000 and 2004 in Shanghai and Shenzhen Stock Exchange as the samples to test empirically the positive effect of the concentrated ownership structure on top management turnover when the company was already in trouble and became special treatment. Their research indicated: although the highly concentrated ownership structure would bring a variety of problems and was widely criticized by the circles of theory and practice, the present situation was that the legal protection of investors in china is worse, and the highly concentrated ownership structure in china listed companies were combined to some extent with the legal protection of investors, which could play the effective supervision and restriction role of corporate governance; especially when the
company got into trouble or became ST, the company with highly concentrated ownership structure could timely and effectively replace delinquent top management.

V. THE INFLUENCE OF CHARACTERISTICS OF TOP MANagements ON TOP MANAGEMENT TURNOVER

Most of the present studies show that the top management’s age has negative relationship with the possibility of manager turnover when the firm performance has always been poor. Vancil (1987), Jensen and MurPhy (1990) confirmed that top management are more likely to be fired at a young age than at the age of approaching retirement.

At present, there are two representative views about the study of the correlation of top management turnover and the tenure. One is the "entrenchment effect" thesis (Morck et al., 1988), which is the view that along with the tenure extension of top managements, some resources top managements have, just like social networks, is increasing. It is likely to format the power or interest circles, which can resist outside pressure so as to reduce the possibility of them to be replaced. Another is "learning thesis" proposed by Gibbons et al. (1992). The view of "learning thesis" is that the board of directors need take time to understand the real capabilities of CEO. In the early stages of the executive appointed, the board of directors is lack of sufficient knowledge on his management capabilities. So they can tolerate poor performance. But with the deepening of understanding, when the executive cannot quickly improve the company's performance, the board of directors will lose confidence in him, and the probability of top management turnover increased significantly. So "entrenchment effect" thesis and "learning thesis" are two diametrically opposed views about the sensitivity of tenure and top management turnover. But the Allgood and Farrell (2000) thought which view is better depends that CEO is employed from external and internal or is the initiator establishing the company.

The internal supervision among top management is also the key factor of top management turnover. Many studies show that top management team as a whole has interest conflicts with shareholder, and top management often combines each other (Finkel Stein and Hambrick, 1996). In fact, it also has interest conflicts within top managements. It exists supervision and constraint each other. The internal supervision mechanism mainly comes from the power struggle within top managements, which is the reasonable conflict in the interior of team. According to Maslow’s hierarchy of needs, all team members of the top management have the need of self-realization. Shen and Cannella (2002) studied the influence factors of CEO turnover of American listed companies from the perspective of power, and claimed that in the situation of firm having poor performance, the internal interest conflicts and power struggles within top managements would affect the possibility of CEO turnover.

VI. CONCLUSIONS AND FURTHER RESEARCH PROSPECTS

Up to now, the domestic and foreign literatures mainly study the thesis of top management turnover from the firm performance, internal governance mechanism, external governance mechanism, and it has achieved fruitful research results. Undoubtedly, these research results have very important value for understanding the problem of top management turnover. But, with the development of the global economy, the original conclusion might be out of date. Especially in the particular background that China's emerging economies and transition economies coexist, the available researches have some shortcomings. For example, it is relatively lack of the empirical study, even for the empirical study it only investigate the influence factors of top management turnover from the single perspective. It is relatively lack of multi angle analysis and investigation. In addition, the studies are mostly done from the angels of the firm performance and the internal governance mechanism. There is less study from the external supervision mechanism to investigate the influence factors of top management turnover.

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