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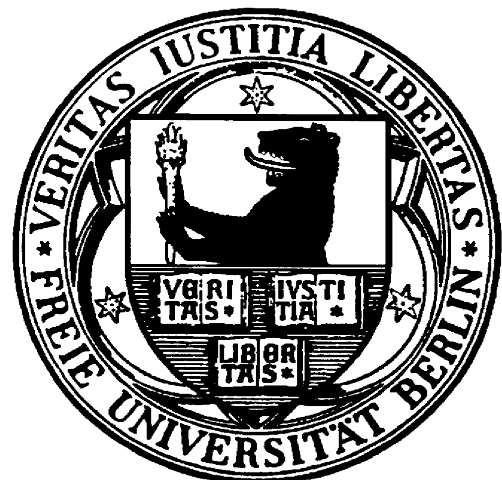

Performance Implications of CEO Dismissals: Evidence from a Stakeholder Environment

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Abstract

Based on a sample of large, publicly traded German companies, we study performance implications of CEO dismissals. We find that measures of accounting performance are good predictors of CEO dismissal events: Low pre-succession accounting performance increases the probability of dismissals. However, replacement CEOs do not manage to turn things around because they do not experience significant increases in either operating or market performance during a two-year post-succession period.

Keywords: Executive Succession, Dismissals, Corporate Governance

INTRODUCTION

The dismissal of a CEO is a dramatic experience for most firms because, typically, it is accompanied by strategic reorientation and reorganization (Denis & Denis, 1995). CEO dismissals have been occurring with increasing frequency both in the U.S. and Europe during recent years, and are often attributed to lackluster financial performance (Wiersema, 2002; Lucier et al., 2004). However, the performance implications of CEO dismissals are far from clear-cut.

Most dismissal research has been conducted in the U.S., where a shareholder value orientation exerts strong pressures on underperforming firms and their CEOs. We address the general question of whether a performance-dismissal link also can be expected for a stakeholder environment like Germany. Specifically, we investigate for the German setting whether bad firm performance is a good predictor of CEO dismissals, and whether successor CEOs manage to turn things around.[1]

CEO DISMISSAL IN LIGHT OF AGENCY THEORY

From an agency perspective, the dismissal of a CEO is the ultimate disciplinary measure a board of directors can adopt (Wiersema, 2002). During the 1980s and 1990s, the executives and boards of poorly performing U.S. firms faced increasing market pressures, such as buyout threats, and institutional investor and shareholder activism (Jensen, 1993; Martin & McConnell, 1991). These pressures led to the institution of more stringent corporate governance mechanisms, such as outsider dominated boards and stock incentive plans, with the objective of committing managers to the pursuit of shareholder value enhancing strategies (Denis & Kruse, 2000). The heightened concern for effective corporate governance prompted research on executive succession events that, specifically, focused on the question of whether underperforming firms dismiss their CEOs (e.g., Denis & Denis, 1995; Denis & Kruse, 2000; Wiersema, 2002).

Since most research on CEO dismissals and other corporate governance mechanisms has been conducted on U.S. firms, it is interesting to study whether linkages between performance and CEO dismissal events also can be observed in other cultures. We draw our sample from German corporations, because Germany is a country with a strong stakeholder value orientation that has, however, adopted several governance reform measures since the middle of the 1990s (Tuschke & Sanders, 2003). For example, there have been various changes in German law, such as the passing of the Corporation Control and Transparency Act. Further, firms voluntarily decided to delineate ethical and responsible business behaviour in a Corporate Governance Code. And finally, many firms voluntarily adopted shareholder friendly accounting standards and stock-based incentive pay systems for their top-management (Tuschke & Sanders, 2003).

In spite of these efforts at corporate governance reform, Germany remains a stakeholder rather than a shareholder value environment. This focus of the German governance system on multiple stakeholders is evident, for example, in the co-determination laws that allocate up to 50 percent of the board seats to labor representatives. A stakeholder orientation is also

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[1] In German, a „chief executive officer“ is called „Vorstandsvorsitzender“ or „Vorstandssprecher“.

reflected in a strong ownership concentration, a (still) dominating role of banks in company financing, and the banks' strong representation on boards of directors in all sectors of the economy (Jürgens et al., 2000; Tuschke & Sanders, 2003).

Shareholders as well as other stakeholders are concerned about company profitability, although they may have different preferences as to the distribution of profits. Therefore, in general terms, we also expect a performance-dismissal linkage in Germany. The traditional stakeholder orientation together with recent corporate governance reforms are likely to exert pressures on poorly performing CEOs, and may lead to the ultimate discipline, dismissal.

PRE-SUCCESSION PERFORMANCE AND DISMISSAL EVENTS

Several studies on U.S. firms provide evidence that CEO dismissals are preceded by poor firm financial performance (Denis & Denis, 1995; Goodstein & Boeker, 1991; Westphal & Fredrickson, 2001; Zajac & Westphal, 1996). There is also some evidence suggesting that boards are likely to force out incumbent CEOs if firms suffer from poor stock price performance for an extended period of time (Denis & Denis, 1995; Wiersema, 2002). However, the evidence also includes conflicting results. The most recent study on U.S. firms by Wiersema (2002) finds that firms with CEOs that have been dismissed do not have lower pre-succession accounting performance than their industry counterparts or companies with routine succession events.

There exists some German evidence that poor accounting performance increases the likelihood of CEO succession events (Leker & Salomo, 1998; te Wildt, 1996; Salomo, 2001). However, these studies do not clearly distinguish dismissals from other succession events, and they use data from a period that preceded the recent corporate governance reforms in Germany.

We have designed our study on recent German dismissal events in close alignment to Wiersema (2002) because her study is recent,[2] methodologically most advanced, and because we wish to facilitate comparisons between U.S. and German findings. Since agency theoretical arguments and empirical evidence suggest that CEO dismissals will be preceded by poor performance, we predict that:

Hypothesis 1: Firms with CEOs that have been dismissed will have lower financial performance pre-succession than their industry counterpart.

Hypothesis 2: Firms with CEOs that have been dismissed will have lower financial performance pre-succession than firms with routine CEO successions.

POST-SUCCESSION PERFORMANCE AND DISMISSAL EVENTS

Much less research exists on performance consequences of CEO dismissals than on antecedents. Some U.S. studies report that the stock market reacts positively to dismissal events (Weisbach, 1988; Denis & Denis, 1995). However, surprisingly, Wiersema (2002) finds that firms with CEO dismissals do not experience significant improvements in either

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[2] Wiersema (2002) analyzed data on succession events for the years 1996 and 1997.

accounting or market performance. German studies are also inconclusive (Gerpott, 1993; Jahn, 1996; Salomo, 2001).

In spite of this mixed evidence, a corporate governance system that encourages the dismissal of poorly performing CEOs can be considered effective if it leads to the appointment of replacement CEOs who will improve the financial performance of their firms. If such improvements do not obtain, the system is flawed. Therefore, we predict:

Hypothesis 3: Firms with CEOs that have been dismissed will have higher financial performance in the post-succession period than in the pre-succession period.

Hypothesis 4: Firms with CEOs that have been dismissed will have higher (a greater improvement in their) financial performance in the post succession period than their industry counterpart.

Hypothesis 5: Firms with CEOs that have been dismissed will have higher (a greater improvement in their) financial performance in the post-succession period than firms with routine CEO succession events.

METHODS

Sample

We collected data on succession events on all large German stock companies (DAX 100) for the years 1998 – 2003 based on the firms' annual reports and the *Hoppenstedt* database. During this six-year period, 94 CEO succession events were identified. After distinguishing between dismissals and routine successions (procedure described below), the final sample consisted of n = 91 succession events.

Measures and Analysis

Dismissal versus routine succession. To verify the type of succession, we content analysed all press articles on each succession event that were included in the *Lexis/Nexis* database. Two authors reviewed each article and classified each succession event independently as either a dismissal or a routine succession. Only those events were classified as dismissals where disagreement between the CEO and the board was given as the reason for a CEO's departure. Routine succession events comprised causes such as retirements (including health-related early retirements), voluntary departures due to personal reasons, and replacements due to the death of an incumbent. 95.6% of the independent classifications were in agreement, corresponding to a Cohen's kappa of .91 ($p < .001$). Succession events that had been classified differently were discussed and either resolved or excluded from the data set. This procedure led to an identification of 32 dismissals and 59 routine successions.

Performance measures. Three accounting measures of performance and one market measure are utilized: operating earnings to total assets (*EBIT/TA*), return on assets (*ROA*), sales growth (*SG*), and total return to the firm's shareholders (*RTS*).

To test for H2, H3, and H5, it is appropriate to use industry adjusted performance measures in addition to unadjusted indicators because industries have different profit potentials (Porter, 1980). For each firm, industry adjusted performance measures were

calculated by taking the unadjusted measure and subtracting the industry average. For example, an industry adjusted ROA (*A-ROA*) was obtained by subtracting the Industry ROA from the firm ROA. The industry averages were calculated on the basis of all firms with the same aggregate SIC code as the sample firm.

All (unadjusted and industry adjusted) performance measures were also calculated in terms of change rates, because H4 and H5 suggest (at least) a greater improvement in performance during the post-succession period.

These three types of performance measures (unadjusted, industry adjusted, change rates) were calculated for both a pre-succession and a post-succession period. The year of the succession event was excluded from the calculation of pre- and post-succession performance because both the outgoing and the incoming CEO have considerable discretion to manipulate the short term financials of the firm. Thus it would be difficult to attribute the performance of the succession year to either CEO. A firm's pre-succession period (performance) is the average of a performance measure of the two years preceding the succession event, and the post-succession period (performance) is the average of the two years following a succession event.[3]

Analysis. Comparisons of performance indicator means during the pre- and post-succession periods are used as the major means of analysis. Depending on the specific hypothesis, the group of firms with dismissals is either contrasted to their industry counterparts (*H1, H4*), to firms with routine succession events (*H2, H5*), or in terms of the firms' pre- and post-succession performance (*H3*). Two-tailed t-tests are used to test for the significance of differences.

PRELIMINARY RESULTS AND DISCUSSION

Hypotheses 1 and *2* are supported based on measures of accounting performance (see **Table 1**). Specifically, when considering *ROA* and *EBIT/TA*, it is apparent that firms with fired CEOs have significantly lower pre-succession accounting performance than their industry counterparts or firms with routine CEO succession events. In contrast, market performance (*RTS*) is not a distinguishing criterion.

These findings are in contrast to Wiersema (2002) who found that accounting performance is not a predictor of CEO dismissals in the U.S. This difference raises the interesting speculation that German HGB accounting norms are better able to capture bad firm performance than US-GAAP norms. HGB norms focus on creditor protection and a principle of prudence when making accounting choices. In other words, a worst case scenario tends to prevail. In contrast, GAAP accounting principles are shareholder oriented, and require more financial disclosure so as to provide information on the current market value of the firm (MacDonald, 1999).[4]

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[3] Since consolidated performance data were only available through 2002 at the time of data collection, tests pertaining to post-succession effects (H3 through H 5) are based on succession events during the period of 1998 to 2000. Thus, a reduced sample of n = 44 (18 dismissals and 26 routine successions) is used.

[4] Interestingly, in order to harmonize accounting standards within the European Union, German HGB norms have been replaced by European IFRS norms as of 2005. IFRS norms are similar to US-GAAP norms.

Hypotheses 3, 4, and *5* are not supported (see **Table 1**). In contrast to predictions, firms that have dismissed their CEO have (in some cases significantly) lower post-succession accounting and market performance than pre-succession (*H3*), and in comparison to their industry counterparts (*H4*) and to firms with routine successions (*H5*). These results are similar to Wiersema's (2002). The only exception concerns the relative improvement of operating earnings (*%-EBIT/TA, %A-EBIT/TA)* when dismissal firms are contrasted with routine succession firms (*H5*). At least, firms with dismissed CEOs manage to improve their operating earnings post-succession more strongly than firms with routine successions. However, such improvements should not be overrated because they are a minimum of what stakeholders will expect from replacement CEOs.

The failure of German and U.S. CEOs to turn things around after they have replaced fired CEOs raises some hard questions. For instance, are boards not sufficiently qualified to make effective succession decisions? Or alternatively, do boards consider CEO dismissals solely as a symbolic act, designed to acquiesce dissatisfied stakeholders, an act that, however, only inadequately considers the qualifications of replacement candidates? Answers to these questions necessitate further research.

Table 1
Summary of Results

	H1	**H2**	**H3**	**H4**	**H5**
RTS			–		
SG	a			(–)	
ROA	**	**		(–)	
EBIT/TA	c	**			
A-RTS					
A-SG		b			
A-ROA		**			
A-EBIT/TA		*			
%-RTS					
%-SG					
%-ROA					
%-EBIT/TA				c	*
%A-RTS					
%A-SG					
%A-ROA					
%A-EBIT/TA					*

Differences are in the predicted direction and significant at: * <.05, ** <.01, a < .07, b < .08, c < .09
Differences are *not* in the predicted direction and significant at: – <.05, (–) < .10

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