

Company Performance Surrounding CEO Turnover: Evidence from the UK

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Abstract

We examine company performance and a range of financial characteristics surrounding announcements of CEO turnover for a sample of UK companies. Firms experiencing forced CEO turnover suffer a decline in operating performance and an increase in financial leverage going back at least three years prior to the announcement. Following forced turnover, firms downsize relative to control firm counterparts and voluntary turnover firms, and experience significant improvements in operating performance. While stock prices react negatively to turnover announcements, this appears to arise from poor information contained about current period earnings in the CEO turnover announcement, rather than downward revisions of long-term performance following forced turnover announcements. Normal CEO turnover does not occur in response to poor performance and elicits a minimal stock price response, but does result in a marginal improvement in operating performance.

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1. Introduction

The downturn in stock markets at the beginning of the 21st century saw a rash of changes in the top management of large publicly listed corporations. Such dismissals provide evidence that markets for managerial labour act to discipline Chief Executive Officers (CEOs) who have made decisions that ex-post have deviated from the goal of shareholder wealth maximization. Fama and Jensen (1983) go so far as to describe CEO replacement decisions as the single most important decision that a firm's board of directors will make.

The existing empirical literature highlights two key facts with regards to CEO dismissals, i) these occur following poor performance relative to industry and market benchmarks (see Coughlin and Schmidt, 1985; and Dedman and Lin, 2002), and that ii) CEO dismissals occur only following a prolonged period of poor performance (see Warner et al., 1988; and Conyon and Florou, 2002). However, the objective and wealth effects of such decisions are not so well understood. On one hand there is a presumption that poorly performing CEOs are replaced by higher calibre successors who are able to reverse the firm's poor performance. Alternatively, CEO changes may arise under a 'scapegoat' hypothesis, where the removal of the incumbent top manager serves to apportion blame, even though poor performance may be due to factors outside of their control (see Khanna and Poulsen, 1995).

In this paper we present new evidence on the performance causes and consequences of CEO turnover for a sample of 705 announcements of top executive changes by UK listed non-financial companies between 1993 and 1998. We find that forced CEO turnover follows a period of poor operating performance and increased financial leverage. However, we find no evidence of poor performance or increased gearing prior to voluntary CEO turnover decisions.

Although CEO turnover follows a decline in operating performance, CEO dismissals still contain a large amount of new negative information concerning the firm's current year earnings. As such, we find that forced CEO turnover announcements are greeted negatively by the stock market, whereas there is no significant stock price reaction to voluntary turnover announcements.

Finally, consistent with the improved management hypothesis of Huson et al. (2004), we find that forced turnover is followed by a significant improvement in operating performance and a decline in leverage. However, we find only marginal evidence of improved performance following voluntary CEO turnover. We also find strong evidence that forced CEO turnover is followed by downsizing relative to non-turnover firms and firms that experienced voluntary top management turnover, as is evidenced by relatively higher levels of asset sales and employee layoffs.

This paper contributes to the literature on CEO turnover in a number of important ways. Firstly, it is the first UK based study to use Barber and Lyon's (1996) control firm approach in examining the robustness of performance changes surrounding CEO turnover. Secondly, we place a greater emphasis on the CEO turnover decision alone, rather than the impact of corporate governance on CEO turnover,¹ which allow us to consider a broad range of outcomes from the decision. As such, we place a greater emphasis on incidences of corporate restructuring, including asset sales and employee layoffs, surrounding CEO turnover than has been considered in prior UK studies.

The remainder of this paper is structured as follows. Section 2 provides our literature review on the causes and consequences of CEO turnover. Section 3 outlines our sample data collection. Section 4 presents results for operating characteristics

¹ For the UK, Dahya et al. (1998), Conyon and Florou (2002), Dahya et al. (2002) and Dedman (2003) study the role of corporate governance characteristics in CEO turnover decisions, but do not place strong emphasis on the outcomes of these decisions.

surrounding CEO turnover, and Section 5 reports results for our event study of the stock price reaction to CEO turnover announcements. Finally, Section 6 concludes.

2. Prior literature

2.1. Factors impacting CEO turnover

Fama (1980) argues that managerial labour markets act to discipline poorly performing management by appropriately adjusting levels of executive compensation to reflect managerial performance. Coughlan and Schmidt (1985) find that changes in managerial salary and bonus reflect the incumbent managers' stock price performance. These authors also find that poorly performing CEOs are more likely to lose their jobs than managers at companies which perform well. This finding is one of the most robust empirical regularities in the corporate finance literature.²

Underlying these 'forced' replacement decisions is a presumption that the departing top officer is accountable for the firm's poor performance. If this is the case, then the firm's poor performance should be reversed upon the appointment of a new CEO. This will be reflected in a positive stock price reaction upon the departure of the incumbent CEO and subsequent improvements in the operating performance of the company. Huson et al. (2004) label this an 'improved management hypothesis.'

Khanna and Poulsen (1995) and Huson et al. (2004) also develop a 'scapegoat hypothesis' of forced CEO turnover. Poor performance is not a result of managerial failings, but rather, arises due to factors outside the control of the departing executive. Under this hypothesis, operating performance is still expected to improve following forced turnover, but this arises due to mean reversion in luck, rather than the increased

² Warner et al. (1988), Weisbach (1988), Gilson (1989), Murphy and Zimmerman (1993), Denis and Denis (1995), Huson et al. (2001), and Huson et al. (2004) provide other examples of such findings in US companies. Dahya et al. (1998), Franks et al. (2001), Conyon and Florou (2002), Dahya et al. (2002), Dedman and Lin (2002), and Dedman (2003) provide UK examples of such studies.

quality of the replacement CEO. The stock market's interpretation of these changes is likely to be minimal.

Performance changes following 'voluntary' CEO turnover are expected to be less visible than those arising in the course of forced turnover. Departures in this case may arise for a variety of non-performance related reasons, and should not necessarily result in predictable changes in performance following the CEO transition.

2.2. The stock price reaction to managerial turnover announcements

Event study evidence of CEO turnover in US firms has generally provided support to an improved management rationale for forced changes. Denis and Denis (1995) and Huson et al. (2001) find significantly positive announcement period abnormal returns for forced CEO turnover, while returns are positive but insignificant for voluntary turnover. In contrast, Warner et al. (1988) find no significant event period abnormal returns upon announcements of forced top management changes.³ Huson et al. (2001) find that the stock price reaction has increased in significance over time, which may explain the discrepancy between the results of earlier and later studies. To the extent that forced turnover removes a poorly performing top officer and replaces them with a CEO of superior quality, as in the improved management hypothesis, a positive market reaction to forced turnover is consistent with this hypothesis.

International evidence on the market reaction to CEO turnover has produced results that have differed from those of US studies. Kang and Shivdasani (1996) find that the market reacts positively to both voluntary and forced turnover announcements. Dahya et al. (1998) find that the market reaction to top management

³ When referring to CEO turnover, this describes studies that have specifically examined turnover of the top company officer. Top management turnover is a reference to studies that examine changes in any of the top management team, generally defined as the Chairman, the CEO and the President when these positions exist in US companies, and both the Chairman and the CEO of UK companies.

turnover in UK companies is significantly positive for forced turnover and insignificantly negative for voluntary turnover announcements.

However, Dedman and Lin (2002) report that a large number of CEO turnover announcements made by UK companies are not officially made to the London Stock Exchange through *FT Extel News Reports*.⁴ They find that the stock price reaction to CEO turnover is significantly negative for all turnover announcements, where this result is largely driven by the negative reaction to turnover announcements that are not officially announced through *FT Extel News Reports*, but are reported through *The Financial Times*. Also, the market reaction is significantly negative for cases where the CEO was explicitly dismissed or left to take up a new job elsewhere. The results of Dedman and Lin are supportive of a scapegoat hypothesis where the negative stock price reaction may reflect the financial costs of compensating the departing CEO for loss of office, or new information that is disclosed simultaneously with the turnover announcement. These authors also offer a thin market for managerial labour, and the resulting poor quality of potential successors in the UK, as a further explanation for the negative stock price reaction to announcements of CEO turnover.

2.3. Outcomes of CEO turnover for firm performance and decision-making

In addition to the stock price reaction to managerial turnover, a further area of interest has been performance changes following announcements of CEO turnover. A number of studies have examined changes in the operating performance of companies following turnover.

A general consistency in this literature has been a large decline in ROA in the year of turnover. This is generally attributed to new managers taking an 'earnings bath', as

⁴ The findings of Dahya et al. (1998) are based only on a sample of firms who report top management changes through *FT Extel News Reports*.

described by Murphy and Zimmerman (1993). Following this, Denis and Denis (1995) and Kang and Shivdasani (1995) report that firms experience significant improvements in industry-adjusted operating performance. Using Barber and Lyon (1996) sample matching criteria, Huson et al. (2004) find that companies experience significant improvements in operating performance following forced and voluntary turnover relative to a control firm, but not their industry.

The evidence on operating performance changes following CEO turnover in the UK is somewhat contradictory to the experience of US companies. Dahya et al. (1998) find that industry-adjusted ROA is significantly worse in the three years following forced top management turnover in UK companies, as compared to pre-turnover performance. Dedman and Lin (2002) present evidence of four years of declining ROA and industry-adjusted ROA up to and including the year of CEO turnover in UK companies. They also report a further performance decline in the year following turnover, which is then followed by improved performance in the next financial year.⁵ The findings of Dahya et al. (1998) and Dedman and Lin (2002) appear to conform to a scapegoat hypothesis of CEO turnover.

3. Sample and data

3.1. CEO turnover characteristics

We construct our CEO turnover sample using a variety of sources to collect data on announcements. Initially, we track CEO changes for firms carried in the *PriceWaterhouseCoopers Corporate Register* between 1st January 1993 and 31st December 2000. The Register provides biographical information on the firm's board roster, which includes information on age. This is important for classifying turnover

⁵ The authors do not report the statistical significance of these changes.

as forced. Turnover is deemed to have occurred where there is a change in the firm's top officer as reported by the Register from one financial year to the next.

We use the Conyon and Florou (2002) definition of a most significant executive to classify the firm's top officer. Where the company reports a Chief Executive Officer this individual is taken as the top officer. In their absence, we examine the firm's board roster for evidence of a Managing Director and/or an Executive Chairman. Where such positions exist, we examine news reports and information in the company's financial reports to determine who is the firm's top officer. Hereafter, we refer to the firm's top executive as the CEO.

To supplement our basic CEO turnover data set, we collect information on turnover announcements from a range of sources. These are: *The Financial Times*, reports from the *UK Regulatory News Service* provided by *FT Extel News Reports*, *McCarthy's News Information Service*, *Lexis-Nexis*, and firms' annual reports.

In order to focus on managerial performance surrounding CEO dismissals we classify turnover as either forced or voluntary. Forced turnover is defined where a news article reports that the CEO was fired, forced out, left following policy disagreements, boardroom shake-ups, poor performance, outside pressure or some other equivalent. For the remaining announcements CEO turnover is classified as forced where the CEO is under 60 and the article does not report the reason for departure as involving death, poor health or the acceptance of a position elsewhere or within the firm. All other turnover announcements are classified as voluntary. Following Dahya et al. (2002), we do not treat the incidence of splitting the roles of the CEO and the Chairman of the Board as CEO turnover.⁶

⁶ Following the publication of the Cadbury Report (1992), Dahya et al. (2002) report a strong increase in the incidence of splitting the top officer functions in response to the recommendations of the report. As such, during our sample period studied splitting the top officer positions is likely to represent compliance with the model board put forth in this report rather than a decision on CEO turnover.

Our initial sampling procedure produces 1200 cases of CEO turnover, to which we apply a number of filters. Firstly, we exclude announcements by financial firms. Secondly, we exclude any announcements where a firm has 2 or more cases of CEO turnover during its financial year. Finally, the report of CEO turnover must be covered by at least one of our available news sources for examining the stock price response at the announcement date of the CEO transition. Table 1 presents descriptive statistics for our sample of CEO turnover announcements.

[Insert Table 1 about here]

These filters produce a final sample of 705 CEO turnover announcements from which we conduct our analysis. Of this, 394 announcements are forced and 311 announcements are classified as voluntary.⁷ The sample time period is restricted to the end of 2000 due to our desire to examine financial characteristics over the seven-year period surrounding the CEO turnover announcement. We collect data on company financial characteristics and stock returns from *Datastream*.

3.2. Company financial characteristics surrounding CEO turnover

We define return on assets (ROA) as earnings before interest, tax, depreciation and amortization (EBITDA) for the financial year divided by the book value of assets.⁸ Leverage is measured on the basis of the firm's debt-to-assets ratio. Debt-to-assets (DEBT) is defined as the book value of total debt divided by the book value of assets.

⁷ While the fraction of CEO turnover announcements that are forced is very high in comparison to prior US research by Weisbach (1988) and Huson et al. (2001), Dahya et al. (2002) find that 57.25% of all turnover announcements for a random sample of UK firms between 1993 and 1996 are forced. The corresponding rate in this sample is 55.88%, which is slightly lower.

⁸ We focus on EBITDA in order to remove the impact of any one-off restructuring charges and/or write downs that occur during the time period surrounding CEO turnover.

In subsequent analysis we examine company performance surrounding CEO turnover announcements in relation to industry and control firm benchmarks. Industry-adjusted financial characteristics are computed by subtracting the median value for the respective financial ratio for all LSE listed firms in the same FTSE level 4-industry group from the observed ratio for our sample company. We construct a control sample of non-turnover firms in a fashion analogous to Barber and Lyon (1996). Specifically, for each sample firm we identify a non-turnover UK listed company that has ROA within +/- 10% of the sample firm's ROA in the financial year prior to the CEO turnover announcement, and has the same FTSE level 4-industry classification as our sample firm. We focus on median performance rather than means owing to the known skewness in financial ratios (see Barber and Lyon, 1996). For comparison with prior studies of restructuring (see Kang and Shivdasani, 1995; and Lang et al., 1995) we focus our pre-announcement analysis on years -3 to 0, and our post-announcement analysis on years 0 to +3.

Table 2 presents data on median changes in sample firm assets, sales and employment over the seven-year period surrounding the CEO turnover announcement, which occurs in year 0. Prior to announcements of voluntary CEO turnover there is an apparent decline in the growth rates of these variables, which recovers in the years following. However, the actual median percentage increase is still significantly positive over each of the time periods that we consider.

[Insert Table 2 about here]

We also find evidence of an insignificant decline in assets, sales and employment in the year of the forced turnover announcement. Furthermore, we find a significant

decline in employment by the end of the second year following forced turnover. While the growth rate of assets is significantly positive by the third year following forced turnover, this is not the case for sales.

It is also apparent that the growth rate of employment, assets and firm sales following forced turnover is lower than that witnessed following announcements of voluntary CEO turnover. Thus, forced turnover appears to be followed by an incidence of relative corporate downsizing and restructuring. Similar findings are observed by Denis and Denis (1995) in the context of firm operations, and Fee and Hadlock (2004) in the context of general board restructuring.

4. Firm performance surrounding CEO turnover

4.1. Firm performance surrounding CEO turnover

We begin our analysis of company performance surrounding CEO turnover by examining industry-adjusted changes in return on assets (IROA) and debt ratios (IDEBT) over the seven-year period surrounding the turnover announcement, which occurs between years -1 and 0 . We present the results of this testing in Table 3.

Panel A of Table 3 reports results for changes in IROA. Overall, our results suggest that CEO turnover is preceded by a decline in operating performance and followed by a modest but significant improvement of 1.5% relative to industry medians. However, of much greater interest is the difference in firm performance surrounding voluntary and forced CEO turnover.

Our results for voluntary turnover suggest a modest and marginally significant increase in IROA by the third year following the turnover announcement. In addition, voluntary CEO turnover is not preceded by a significant decline in operating returns. When we focus on forced CEO turnover announcements, we find a large and highly

significant decline in IROA going back at least three years prior to turnover. In addition, median performance improves significantly by 2% relative to industry by the end of the third year following the forced CEO turnover announcement.

[Insert Table 3 about here]

Panel B of Table 3 reports results for changes in industry-adjusted debt ratios surrounding CEO turnover. Our results highlight a large increase in borrowings prior to turnover announcements, which are again driven by the sub-sample of forced CEO turnover events. We also find evidence of a significant decline in leverage in years 1 and 2 following forced turnover, which is not evident following voluntary turnover.

Consistent with Gilson (1989), our results suggest that the lender monitoring is an important motivator in forced CEO turnover decisions, and that leverage is brought back to more manageable levels following forced turnover. This may arise where forced turnover follows increased rates of equity issuance (see Franks et al., 2001) or where increased profitability allows firms to pay down their debts (Myers, 1984).

4.2. Robustness of improvements in ROA

In examining the robustness of the above results, we are interested in any other factors that may have led to the documented improvement in operating performance. We focus on three distinct issues. Firstly, are the improvements in operating performance due to subsequent merger and acquisition activity? Secondly, can changes in performance be attributed to mean reversion in earnings amongst sample firms? Finally, do our results vary over our sample time period?

Panel A of Table 4 focuses on the issue of subsequent merger and acquisition activity. We remove sample firms from our analysis of IROA where they took over another company at any point over the three-year period following the CEO turnover announcement. For brevity we report results only for performance changes subsequent to CEO turnover. These results suggest that our earlier reported finding of an improvement in operating performance are robust to the exclusion of firms involved in subsequent takeover activity.

[Insert Table 4 about here]

Following Barber and Lyon (1996), we are also interested in whether our results may be attributable to mean reversion in earnings. As such, we match our sample of forced CEO turnover firms with a control sample of firms at the financial year-end prior to the announcement of CEO turnover, as described earlier.⁹

We report the results for differences in operating performance changes between sample and control firms in Panel B of Table 4. We again find evidence of a strong improvement in operating performance for sample firms, which is in excess of that witnessed for the performance matched control sample. Thus, our finding of an improvement in operating performance following forced CEO turnover is not due to mean reversion in earnings.

Finally, we split our sample into equal time periods from 1993 to 1996 and 1997 to 2000 and examine the robustness of changes in operating performance surrounding CEO turnover within these sub-samples. We view these findings as being of interest given the work of Conyon and Florou (2002), Dahya et al. (2002) and Dedman

⁹ Sample firms have a mean (median) ROA of 0.083 (0.118) at year -1 , and the corresponding values for the control firms are 0.086 (0.119). The differences between sample and control firms are statistically insignificant.

(2003), which examines changes in CEO turnover over time. We report results for these sub-periods in Table 5

[Insert Table 5 about here]

Interestingly, we do find significant differences across the sub-samples. Firm performance prior to voluntary and forced CEO turnover is indifferent across the two sub-sample time periods that we consider. However, for both voluntary and forced CEO turnover decisions, the subsequent performance improvement in the earlier part of the sample period is significantly greater than that observed in the latter time period. The fact that this result is consistent across both voluntary and forced turnover suggests that this is due to differences in the efficiency of CEO selection over time, rather than the classification scheme used to categorize turnover as either forced or voluntary.

Our results are inconsistent with Huson et al. (2004) for US companies, who report that the quality of managerial selection decisions has actually improved over time. Although not reported in our own findings, Dahya et al. (2002) find an increase in rates of CEO turnover following the publication of the Cadbury Report (1992). One possible explanation could be that increased monitoring following the publication of Cadbury has led to an increased likelihood of forced CEO turnover where poor performance has not been the direct fault of the departing CEO. This reduces the likelihood of a superior manager being able to reverse the firm's performance subsequently because the departing executive was merely a scapegoat for a more fundamental problem (see Khanna and Poulsen, 1995).

4.3. Corporate restructuring following CEO turnover

We have documented above that forced turnover occurs following a decline in operating profit and increased leverage, and that these decisions are associated with a reversal in both. In this section we document additional evidence on the incidence of corporate restructuring following CEO turnover. Following the arguments of Weisbach (1995), we expect that the CEO turnover process, whether forced or voluntary, provides companies with a means of correcting the mistakes of the outgoing top officer. Given the larger performance and leverage causes and consequences of forced turnover, we also expect to observe a higher incidence of corporate restructuring following these decisions relative to voluntary turnover.

We collect data on corporate restructuring by examining reports of asset sales, employee layoffs and changes in dividend policy over the three years following CEO turnover. Data on asset sales is collected from the *FT Extel Company Research* database until the end of 1998, and the *Sequencer* database between 1999 and 2000.¹⁰ Announcements of employee layoffs are collected from *FT Extel*, *The Financial Times* and the *Lexis-Nexis* newspaper database. Information on dividend changes is taken from the annual dividend per share payout, as reported by *Datastream*.

Table 6 reports the number of companies engaging in corporate restructuring during any of the three financial years following the turnover announcement. Panel A reports results following forced turnover, and Panel B reports results following voluntary CEO turnover announcements. As expected, we find that the incidence of asset sales is greater following CEO turnover, and particularly following forced turnover. These results are even more pronounced when we examine the incidence of

¹⁰ The Extel database was discontinued in its CD format at the end of 1998, which necessitates the change to using Sequencer at this point.

employee layoff announcements, which further supports the findings reported in Table 2 of employee downsizing following CEO turnover.

[Insert Table 6 about here]

We also find that sample firms are more likely to restructure their finances by cutting and omitting dividends over the period following CEO turnover, in relation to control firms. These results are again more pronounced for the sample of forced CEO turnover announcements. This most likely reflects the decline in earnings reported between years -1 and 0 , and increased pressure to meet debt obligations that contributed to CEO turnover in the first instance (see Gilson, 1989; and Ofek, 1993).

Overall, the results presented above suggest that CEO turnover is preceded by a significant decline in performance, and followed by a marked improvement. These results are driven by the sub-sample of forced CEO turnover announcements and are robust to controls for mean reversion in earnings and subsequent takeover activity. We also find that performance improvements following CEO turnover are more pronounced in the earlier part of our sample for both forced and voluntary turnover decisions. Finally, CEO turnover is followed by a high incidence of corporate downsizing activity and changes in dividend policy, which are again more pronounced following forced replacement decisions.

We view our findings as consistent with the general finding of labour market studies that forced CEO turnover tends to follow a period of poor operating returns (see Coughlan and Schmidt, 1985; Murphy and Zimmerman, 1993; and Dedman, 2003). Similarly, we find strong evidence of an improvement in IROA following forced turnover. We also find that lender monitoring plays an important role in the

turnover decision, which is consistent with Gilson (1989) for financially distressed companies. Finally, the higher incidence of corporate restructuring following CEO turnover is consistent with the arguments of Weisbach (1995) that the managerial replacement process provides a mechanism for firms to correct the mistakes of the departing top officer, even where they have left their position voluntarily.

5. Stock price performance surrounding CEO turnover announcements

We now turn our attention to the stock price reaction to announcements of CEO turnover. To the extent that CEO replacement decisions improve the quality of the top manager running the company, as suggested by our finding of an improvement in operating performance, we expect a positive stock price response to CEO turnover announcements. The magnitude of this response is expected to be more pronounced for the sub-sample of forced CEO turnover announcements, relative to voluntary CEO turnover decisions. However, to the extent that firm performance is significantly negative during the year of turnover, the stock price response to turnover announcements may also be negative owing to the new information contained about firm earnings within news reports of turnover.

Given the reported decline in stock price performance that accompanies CEO turnover decisions (see Coughlan and Schmidt, 1985; and Conyon and Florou, 2002) we calculate event period abnormal returns using the simple market-adjusted model. This avoids the problem of biased market model parameters where the likelihood of CEO turnover is negatively related to prior firm performance.¹¹ We use the *FTSE All Share Index* as the benchmark against which cumulative abnormal returns (CARs) are

¹¹ An alternative approach suggested by Denis and Denis (1995) is to use market model parameters estimated over the trading period immediately following CEO turnover. However, to the extent that CEO turnover may induce long-run abnormal stock returns (see Denis and Denis, 1995; and Huson et al., 2004) such an approach has its own shortcomings.

calculated. We calculate CARs over the three-day event window surrounding the announcement date of CEO turnover (day 0), and also report results separately for voluntary and forced turnover announcements. Our event study results are reported in Table 7.

[Insert Table 7 about here]

We find significantly negative stock price returns surrounding CEO turnover announcements. The mean three day CAR is -0.848% , which is significant at the 5% level. However, the results for the overall sample mask strong differences in event window CARs between voluntary and forced turnover announcements. We find significantly negative CARs of -1.369% over the three-day event window for forced turnover announcements, and insignificant returns surrounding voluntary turnover. While inconsistent with prior US research of forced turnover (see Denis and Denis, 1995; and Huson et al., 2001), our findings are similar to Dedman and Lin (2002) for UK companies. Dedman and Lin find negative announcement period CARs surrounding all CEO turnover announcements, which were particularly pronounced when the departing top officer had explicitly been dismissed. In contrast, for a sample of UK companies announcing changes in their CEO and Chairman of the Board, Dahya et al. (1998) find significantly positive event period CARs for top management turnover announcements, and insignificant returns for voluntary departures.

Dedman and Lin (2002) attribute their findings to an increased likelihood of firm failure that is signalled by the CEO departure announcement, and a potentially thin market for managerial labour in the UK. We also expect that the negative stock price response to forced turnover can be attributed in part to a negative earnings surprise in

year 0. Table 3 reports a mean (median) decline in industry-adjusted return on assets of 5.51% (3.15%) in the year of forced CEO turnover, which suggests that forced turnover occurs in response to new information about the firm's profitability during year 0, as well as the documented decline in performance going back three years prior to the announcement. As such, the negative stock price response to forced CEO turnover may arise due to poor information on current earnings, rather than revisions in future earnings forecasts. This is consistent with Farrell and Whidbee (2003), who find that boards focus on deviations from expected performance, rather than performance alone, in making the CEO turnover decision.

6. Conclusions

We have presented evidence that firm performance declines prior to CEO turnover and recovers subsequently. The magnitude of these performance changes are more pronounced surrounding the forced removal of the incumbent top officer. We view these findings as suggesting that managerial labour markets act to discipline poorly performing CEOs, and replace them with higher calibre managers. This is consistent with the improved management hypothesis of managerial replacement decisions put forward by Huson et al. (2004). Our results are robust to controls for future acquisition activity and mean reversion in earnings. However, we also find that the quality of managerial selection, as measured by performance changes following CEO turnover, has fallen over time. This stands in contrast to the findings of Huson et al. (2004) for US companies, and may suggest that CEO turnover is becoming an all too frequent event.

Our results suggest that the subsequent improvement in performance is driven by restructuring that is designed to address the failings of the departing CEO. Following

turnover, companies restructure their operations by reducing leverage, divesting assets, laying off employees and changing their dividend policy. Once again, these results are even more pronounced when we focus on forced CEO transitions.

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Table 1: Descriptive statistics for CEO turnover

This table reports descriptive statistics of a sample of 705 announcements of CEO turnover by UK listed non-financial firms between 1993 and 2000. Forced turnover is defined where a news article reports that the CEO was fired, forced out, left following policy disagreements, boardroom shake-ups, poor performance, outside pressure or some other equivalent. For the remaining announcements CEO turnover is classified as forced where the CEO is under 60 and the article does not report the reason for departure as involving death, poor health or the acceptance of a position elsewhere or within the firm. All other turnover announcements are classified as voluntary. We do not treat the incidence of splitting the roles of the CEO and the Chairman of the Board as CEO turnover.

Year	All changes		Forced turnover		Voluntary turnover	
	Observations	%	Observations	%	Observations	%
1993	94	13.33	41	10.40	53	17.04
1994	92	13.05	36	9.14	56	18.00
1995	104	14.75	39	9.90	65	20.90
1996	87	12.34	43	10.91	44	14.15
1997	104	14.75	59	14.97	45	14.47
1998	73	10.35	48	12.18	25	8.04
1999	72	10.21	58	14.72	14	4.50
2000	79	11.21	70	17.77	9	2.89
Total	705	100	394	100	311	100

Table 2: Median percentage changes in total assets, sales, and number of employees surrounding CEO turnover

The table reports median percentage changes in total assets, annual sales, and the number of employees surrounding CEO turnover for a sample of 705 CEO turnover announcements by UK non-financial firms between 1993 and 2000. Forced turnover is defined where a news article reports that the CEO was fired, forced out, left following policy disagreements, boardroom shake-ups, poor performance, outside pressure or some other equivalent. For the remaining announcements CEO turnover is classified as forced where the CEO is under 60 and the article does not report the reason for departure as involving death, poor health or the acceptance of a position elsewhere or within the firm. All other turnover announcements are classified as voluntary. The significance of changes is measured using a two-tailed Wilcoxon signed rank test; and p-values are reported in parenthesis.

Sample	Observations	Median percentage changes between years				
		-3 and 0	-1 and 0	0 and 1	0 and 2	0 and 3
<i>Panel A: Book value of total assets</i>						
All turnover	685	19.65 (0.000)	2.200 (0.003)	2.750 (0.000)	9.100 (0.000)	19.15 (0.000)
Forced turnover	377	16.75 (0.000)	-0.750 (0.509)	1.000 (0.349)	5.700 (0.007)	14.85 (0.000)
Normal turnover	308	22.55 (0.000)	5.250 (0.000)	4.550 (0.000)	12.50 (0.000)	23.60 (0.000)
<i>Panel B: Annual sales</i>						
All turnover	691	18.60 (0.000)	2.950 (0.000)	3.150 (0.000)	4.500 (0.006)	3.250 (0.239)
Forced turnover	382	13.65 (0.000)	-0.250 (0.815)	1.000 (0.368)	-0.050 (0.974)	0.550 (0.883)
Normal turnover	309	23.70 (0.000)	6.150 (0.000)	5.550 (0.000)	9.550 (0.000)	6.100 (0.136)
<i>Panel C: Number of employees</i>						
All turnover	680	8.750 (0.000)	0.450 (0.439)	-1.250 (0.036)	-0.150 (0.902)	1.900 (0.287)
Forced turnover	374	9.150 (0.000)	-0.700 (0.364)	-3.950 (0.000)	-4.200 (0.021)	-3.300 (0.203)
Normal turnover	306	8.250 (0.000)	1.800 (0.026)	1.550 (0.040)	4.050 (0.014)	7.650 (0.002)

Table 3: Changes in Operating Performance surrounding CEO turnover

The table reports mean [median] changes in industry-adjusted return on assets (IROA) and debt ratio (IDEBT), for a sample of up to 705 announcements of CEO turnover by UK non-financial firms between 1993 and 2000. Forced turnover is defined where a news article reports that the CEO was fired, forced out, left following policy disagreements, boardroom shake-ups, poor performance, outside pressure or some other equivalent. For the remaining announcements CEO turnover is classified as forced where the CEO is under 60 and the article does not report the reason for departure as involving death, poor health or the acceptance of a position elsewhere or within the firm. All other turnover announcements are classified as voluntary. Panel A reports results for changes in IROA and Panel B reports results for changes in IDEBT. Return on Assets is defined as earnings before interest, tax, depreciation and amortization (EBITDA) divided by total assets. Debt ratio is the ratio of total debt to total assets. Deducting the value of the respective financial ratio for the median firm in the same FTSE level 4-industry group from the financial ratio for the firm makes adjustment for industry. P-values of a two-tailed t-test of means and a Wilcoxon signed rank test of medians are reported in parenthesis.

Years Relative to CEO Turnover	All Turnover	Forced Turnover	Voluntary Turnover
<i>Panel A: IROA</i>			
-3 to 0	-0.0470 (0.002) [-0.0275 (0.000)]	-0.0985 (0.000) [-0.0570 (0.000)]	0.0138 (0.570) [-0.0035 (0.523)]
-2 to 0	-0.0313 (0.071) [-0.0210 (0.000)]	-0.0775 (0.002) [-0.0525 (0.000)]	0.0238 (0.302) [0.0030 (0.428)]
-1 to 0	-0.0195 (0.186) [-0.0125 (0.000)]	-0.0551 (0.003) [-0.0315 (0.000)]	0.0244 (0.294) [0.0025 (0.466)]
0 to +1	0.0184 (0.201) [0.0550 (0.120)]	0.0533 (0.001) [0.0190 (0.004)]	-0.0229 (0.348) [-0.0045 (0.263)]
0 to +2	0.0172 (0.321) [0.0140 (0.001)]	0.0340 (0.145) [0.0170 (0.011)]	-0.0032 (0.903) [0.0110 (0.040)]
0 to +3	0.0384 (0.004) [0.0150 (0.002)]	0.0553 (0.009) [0.0200 (0.009)]	0.0179 (0.227) [0.0100 (0.099)]
<i>Panel B: IDEBT</i>			
-3 to 0	0.0284 (0.000) [0.0240 (0.000)]	0.0407 (0.000) [0.0380 (0.000)]	0.0168 (0.037) [0.0100 (0.056)]
-2 to 0	0.0191 (0.003) [0.0165 (0.000)]	0.0295 (0.005) [0.0305 (0.000)]	0.0081 (0.254) [0.0035 (0.473)]
-1 to 0	0.0075 (0.099) [0.0070 (0.017)]	0.0104 (0.153) [0.0115 (0.013)]	0.0044 (0.353) [0.0030 (0.453)]
0 to +1	-0.0035 (0.385) [-0.0030 (0.232)]	-0.0132 (0.018) [-0.0100 (0.009)]	0.0066 (0.266) [0.0040 (0.290)]
0 to +2	0.0011 (0.857) [-0.0065 (0.109)]	-0.0040 (0.664) [-0.0160 (0.012)]	0.0054 (0.511) [0.0030 (0.532)]
0 to +3	0.0024 (0.729) [-0.0045 (0.424)]	-0.0009 (0.934) [-0.0130 (0.130)]	0.0037 (0.668) [0.0040 (0.548)]

Table 4: Robustness testing for operating performance changes following forced CEO turnover

The table reports median changes in industry-adjusted return on assets (IROA) for a sample of 394 announcements of forced CEO turnover by non-financial UK listed companies between 1993 and 2000. Forced turnover is defined where a news article reports that the CEO was fired, forced out, left following policy disagreements, boardroom shake-ups, poor performance, outside pressure or some other equivalent. For the remaining announcements CEO turnover is classified as forced where the CEO is under 60 and the article does not report the reason for departure as involving death, poor health or the acceptance of a position elsewhere or within the firm. All other turnover announcements are classified as voluntary. Panel A reports changes in ROA after removing firms that undertook mergers and acquisitions over the 3-year period following CEO turnover. Panel B reports operating performance following CEO turnover for sample and control firms. Control firms are selected from firms within the same FTSE level 4-industry group as the CEO turnover firm, and having ROA within +/- 10% of the sample firm at the financial year prior to the CEO turnover announcement. ROA is defined as earnings before interest, tax, depreciation, and amortization (EBITDA) divided by total assets. The significance of median changes in performance are measured using a Wilcoxon signed rank test. P-values are reported in parenthesis.

Panel A: IROA excluding firms involved in mergers and acquisitions between years 0 and +3

Years relative to CEO turnover	No. Observations	IROA	
0 to +1		319	0.021 (0.006)
0 to +2		295	0.019 (0.015)
0 to +3		269	0.023 (0.011)

Panel B: Control firm matched ROA

Years relative to CEO turnover	No. Observations	Sample IROA	Control IROA	P-value for difference
-1 to 0	367	-0.034 (0.000)	0.006 (0.110)	0.000
0 to +1	321	0.016 (0.015)	0.006 (0.864)	0.027
0 to +2	283	0.012 (0.082)	-0.010 (0.060)	0.035
0 to +3	235	0.012 (0.112)	-0.013 (0.035)	0.015

Table 5: CEO Turnover-Performance relation over time

The table presents median industry-adjusted changes in return on assets (IROA) for a sample of up to 705 announcements of CEO turnover by UK non-financial firms between 1993 and 2000. Sample firms are divided into two groups, 1993-1996 and 1997-2000. Forced turnover is defined where a news article reports that the CEO was fired, forced out, left following policy disagreements, boardroom shake-ups, poor performance, outside pressure or some other equivalent. For the remaining announcements CEO turnover is classified as forced where the CEO is under 60 and the article does not report the reason for departure as involving death, poor health or the acceptance of a position elsewhere or within the firm. All other turnover announcements are classified as voluntary. Return on Assets is defined as earnings before interest, tax, depreciation and amortization (EBITDA) divided by total assets. Deducting the value of the respective financial ratio for the median firm in the same FTSE level 4-industry group from the financial ratio for the firm makes adjustment for industry. All other turnover announcements are classified as voluntary. P-values of a two-tailed Wilcoxon signed rank test of medians are reported in parenthesis.

	All CEO turnover			Forced CEO turnover			Voluntary CEO turnover		
	1993-1996	1997-2000	P-value for differences	1993-1996	1997-2000	P-value for differences	1993-1996	1997-2000	P-value for differences
Observations	370	335		156	238		214	108	
$\Delta-3$ TO 0	-0.027 (0.000)	-0.027 (0.000)	0.631	-0.059 (0.000)	-0.055 (0.000)	0.564	-0.013 (0.050)	0.017 (0.055)	0.009
$\Delta-2$ TO 0	-0.017 (0.000)	-0.027 (0.000)	0.314	-0.051 (0.000)	-0.054 (0.000)	0.870	-0.000 (0.889)	0.011 (0.085)	0.153
$\Delta-1$ TO 0	-0.008 (0.037)	-0.021 (0.000)	0.171	-0.028 (0.001)	-0.034 (0.000)	0.821	0.002 (0.596)	0.003 (0.647)	0.824
$\Delta+1$ TO 0	0.010 (0.030)	-0.000 (0.953)	0.137	0.030 (0.001)	0.010 (0.322)	0.087	-0.000 (0.923)	-0.016 (0.047)	0.098
$\Delta+2$ TO 0	0.027 (0.000)	-0.006 (0.430)	0.000	0.036 (0.001)	0.002 (0.826)	0.011	0.021 (0.000)	-0.028 (0.056)	0.001
$\Delta+3$ TO 0	0.028 (0.000)	-0.003 (0.668)	0.002	0.044 (0.001)	0.003 (0.742)	0.015	0.019 (0.005)	-0.022 (0.144)	0.007

Table 6: Post CEO turnover restructuring activities

The table reports the number of companies engaging in restructuring activities during the three year period following CEO turnover for a sample of up to 705 announcements of CEO turnover by UK listed non-financial firms between 1993 and 2000. Forced turnover is defined where a news article reports that the CEO was fired, forced out, left following policy disagreements, boardroom shake-ups, poor performance, outside pressure or some other equivalent. For the remaining announcements CEO turnover is classified as forced where the CEO is under 60 and the article does not report the reason for departure as involving death, poor health or the acceptance of a position elsewhere or within the firm. All other turnover announcements are classified as voluntary. Restructuring activities are identified from a search of the *FT Extel Company Research* database, the *Sequencer* database, the *Financial Times* and *Lexis-Nexis*. Panel A reports the incidence of restructuring following forced CEO turnover, while Panel B reports evidence of restructuring following voluntary CEO turnover announcements.

Panel A: Forced CEO turnover

Activity	Sample firms		Control firms	
	Number	Fraction (%)	Number	Fraction (%)
Asset sales	168	42.6	82	20.8
Employee layoffs	53	13.5	6	1.52
Dividend cuts	51	12.9	22	5.58
Dividend omissions	44	11.2	21	5.33
Dividend increases	22	5.58	43	10.9
Dividend initiations	6	1.52	9	2.28

Panel B: Voluntary CEO turnover

Activity	Sample firms		Control firms	
	Number	Fraction (%)	Number	Fraction (%)
Asset sales	103	33.1	56	18.1
Employee layoffs	29	9.3	4	1.29
Dividend cuts	28	9.0	18	5.79
Dividend omissions	20	6.43	14	4.50
Dividend increases	36	11.6	41	13.2
Dividend initiations	12	3.86	7	2.25

Table 7: Stock price reaction to CEO turnover announcements

The table reports the stock price reaction to CEO turnover for a sample of up to 705 announcements of CEO turnover by UK listed companies between 1993 and 2000. Forced turnover is defined where a news article reports that the CEO was fired, forced out, left following policy disagreements, boardroom shake-ups, poor performance, outside pressure or some other equivalent. For the remaining announcements CEO turnover is classified as forced where the CEO is under 60 and the article does not report the reason for departure as involving death, poor health or the acceptance of a position elsewhere or within the firm. All other turnover announcements are classified as voluntary. Day 0 is the date of the first announcement of CEO turnover. Cumulative abnormal returns (CARs) are calculated as the sample firms' daily returns minus the returns on the *FTSE All Share Index* over the corresponding period. Means are tested against zero using a two-sided Student's t-test. ***, ** and * denote statistical significance at the 1%, 5% and 10% level respectively.

	All CEO turnover	Forced CEO turnover	Voluntary CEO turnover
CAR (-1,1)			
No. Observations	704	393	311
Mean %	-0.848**	-1.369***	-0.243
% Positive	48.9	46.6	52.1
