

# STRATEGIC DECISION MAKING ON EXECUTIVE TURNOVER: DOES FIRM PERFORMANCE REALLY MATTER?

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## ABSTRACT

*As the firm's business expands globally, there is a need for strategic decision-making to locate and remain firms flourish in a right marketplace. However, many firms are ill-prepared to carry out effective decision-making for on the executive's selection that leading high performance. To analyse the issue on Malaysian context, the main objective of the study is to examine the effect of decision making on the event of executives turnover which based on performance measures for 173 listed firms on Bursa Malaysia and data for performance measures were represented by accounting and market which were collected from 2000 and 2015. The analysis indicates that firms with negative performance produce high turnover cases; however, weak documentation for both measures to evaluate the turnover decisions. Then, extended empirical examination for the forced turnover by firms emphasises that executives used their shareholding to exercise greater protection from being removed during poor performing stages. This evidence shows an explanation to management entrenchment hypothesis within Malaysian executives by translating greater voting power which makes the executive's position more secure. To curb the issue, there is a need for appropriate legal framework enforcement for monitoring the proportion of executive voting power, particularly in a family founding firm.*

**Keywords:** Strategic Decision-Making, Turnover, Performance.

## INTRODUCTION

The issue of potential agency problems in corporate structures gives interest to a stream of doing research on a range of ownership issues. As a number of scholars observed data that most firms are heavily are in possession of family control, this creates a high frequency for agency cases (La Porta et al., 1999; Claessens et al., 2000). Similarly, when the ownership concentration among the management staffs is greater, the more conflicts are observed among shareholders, rather than a conflict between principal and agent. According to Ghazali (2012), this incidence of conflict between shareholders was highlighted and observed in many studies conducted by developed countries. And this would in turn, places a demand on the minority shareholders to control the executive actions. This is also given a power for majority shareholders to use their position in the boards to pursue own self-interests instead of the firm's interests. A similar discussion has been conducted by Cheung et al. (2006) which reveal that a power to appoint the firm's executives could lead to this action even though all shareholders are governed through shareholders' rights. However, the Malaysian corporate practices of family-

owned business that is largely protected on the country's legal system to monitor the actions of the executives appears inadequate to deal with excessive and unlawful cases by executives which then makes the regulatory system less effective. In family-domination firms, a selection of a firm executive which is commonly appointed from family members as a trust could partially eradicate the problem between shareholders and management. However, this contention has been argued in a study of Rachpradit et al. (2012). Therefore, an examination between the executive turnover and firm performance using the Malaysian listed firms' data could discern whether the decision to executive dismissal has a mitigating effect on firm performance.

## LITERATURE REVIEW

Many discussions in studies highlight the important of performance measures to reflect a decision of executive selection and dismissal. However, the negative outcomes in number of studies were documented between executive turnover and firm status (Kang & Shivdasani, 1996; Warner et al., 1988). For example, Warner et al. (1988) find that stock returns led to executive changes as resulted from board and shareholders monitoring. And Kang & Shivdasani (1996) find the cases of non-routine turnover (forced turnover) are likely to be predicted by performance measures of returns on assets (ROA), stock returns and operating income. The sensitivity of turnover increased when the majority of shareholders were institutional investors. The result is inconsistent when the study adopted for Japanese firms, where the performance was found to have no predictive ability on non-routine managerial turnover. While, Suchard et al. (2001) examined the relationship between the roles of monitoring by inside and outside directors and CEO turnover among the Australian firms and found that directors with non-executive roles are more likely to monitor management behaviour. Extended result reveals the executive turnover is associated with past firm performance rather than current performance as observed in U.S. studies. In a longitudinal study by Shen & Canella (2002) which investigated the impact of CEO dismissal on firm performance, they found that CEO dismissal produce a negative effect. However, the impact on performance followed by inside successor selection suggests a positive outcome. The result supports the presupposition that increasing executive ownerships through equity-based payment in the firm has a significant impact on CEO dismissal due to inside succession, instead of the dismissal impact of outside succession.

More evidences were observed on the relationship between executive turnover and firm performance which showing consistent results. And, the corporate decision to remove inefficient executives is likely to be influenced by the proportion of their stakes in the firm. Consistent with discussion in theory of the agency that posits a conflict of interests can be aligned by power and ownership separation. Related study by Denis et al. (1997) have presented for a lower amount of turnover cases when non- executive directors play their roles in effective monitoring the executive staffs. However, the effect is less sensitive to firm performance. As a study by Huson et al. (2004) emphasized forced turnover cases among executives are more observed during the poor performance stage. And Chang & Wong (2004) found that turnover rate increases as the earnings decrease. While in a later study by Kato & Long (2006) found a negative correlation of executive turnover with accounting and share price performance in the firms with a high fraction of outside directors. In similar year of study, Firth et al. (2006) examined the relationship between turnover and firm performance using the CEO data as their sample of between 1998 and 2002 found that CEO turnover was shown a negative association with profitability. They also found that the presence of majority shareholders and a large size of non-executive directors on the firm board have a sensitive effect to turnover cases. Study by Bouaine et al. (2014) were

empirically evidenced that CEO departures with an inverse relationship with a current and future firm's performance and extended results for board size with the presence of independent directors moderates the relationship between CEO departure and firm performance. This implies that an entrenched firm's managerial staffs can have informal associations with independent directors. And, Maury (2006) concluded the managerial turnover is affected by firm conditions and the likelihood of executive departures increase following poor performance. Iqbal & French (2007) found that firm in financial distress where the executive directors have less voting rights; there is a likely that they would be dismissed as compared to higher-owning counterparts. Also, retained executives tend to increase their shareholding before removal. This is a strategic decision for executives to acquire firm's shares during a financial distress in order to avoid them being removed. A similar content of study by Lu et al. (2007) support a high shareholding executives might exercise greater control for shielding themselves from dismissal during poor performing stages.

An examination for the event of executive replacements as a consequence of firm performance has been discussed by Ballinger & Marcel (2010). The results explained that firm performance is lower following a temporary appointment for CEO position when compared to a permanent appointment. However, researchers fail to provide clear indication whether the firm initiated a forced or voluntary turnover. Then, Vincent and Zhang (2014) investigate the likelihood of the firm's decision to appoint temporary successor could lead to higher firm performance during the study period of 1984 and 2007. They found that underperformance firms have been occurred following voluntary turnover. Extended analysis in this study shows that poor performance status was observed during voluntary turnover by temporary successors when using accounting performance measures such as return on assets (ROA) and return on equity (ROE). Similar evidence has been produced in a study by Conyon & He (2011) which documented a consistent result that turnover cases among the CEOs has leading to a negative correlation with share performance. In detail, the study employed China listed firms with the main aimed of examining the association between turnover and firm performance. The study shows that the prediction for CEO turnover decision is likely to be determined by accounting performance measures. The negative result for an association between firm performance and turnover implies that firms' decision to replace when executives fail to create value to shareholders. And the company would replace inefficient executives as their punishment for the failure to maximise efforts in exercising their core duty. This indicates when the firm performance is poor; executives are treated as an ineffective at formulating and implementing strategies and policies to increase firm value (Dikolli et al., 2014). They found that uncertainty about CEO ability was a better predictor for turnover cases. Then, Fisman et al. (2014) studied on how the firm's decision to retain or replace the CEO may affect a firm value through assessing the corporate governance characteristics. The main finding shows that weak governance may prevent shareholders from controlling the board and protects inferior CEOs from being dismissed. While, Jenter & Kanaan (2015) highlighted on possible reasons the CEOs are being removed when the boards are not performing well if the C.E.Os.' actions affect firm performance. This may be called as a punishment for CEOs as the firm performance has been affected by the downturns change their skills and the boards do not behave optimally for firm value. According to van Dalsem (2009), another motivation on the executive turnover is influenced by compensation agreements. This is consistent with a theory highlighted by which showing that use a contract may reveal a mismatch between executive abilities and the firm needs. So that, the executives who are not a good match for the firm may disclose their mismatch

earlier. By using a logistic regression model for 272 CEOs of S&P 500 corporations shows that fixed-term employment contracts with guarantee payments such as salary and target bonus were likely to increase the forced turnover by shortening a length of tenure during the study period. As a finding by Jenter & Kanaan (2015) which reported the quality of the CEO to firm performance are more noticeable during economic recessions as the turnover rates are more frequent than in good market condition. The result suggests that the decision for forced turnover among underperforming CEOs during recessions are beyond the control of the CEOs.

Although Asian markets have different characteristics from developed market, many Asian studies show in line findings with developed countries for a negative relationship between performance and turnovers. It was evidence in a study by Rachpradit et al. (2012) which examined the relationship between chief executive officer (CEO) turnover and firm performance among the listed companies in Thailand using a logit model analysis. The main findings suggest the turnover was influenced by performance. And, as the firms are under family controlled, the CEO position is less turnover rate. Another study by Setiawan et al. (2017) examined changes effect for Indonesian CEOs on performance show that performance decreases on event year of turnover. And the division analysis between routine and non-routine turnover were tested, it did not improve the result as firm performance decreases and turnover increases. As time progress, in recent years many regional studies extend discussion on turnover-performance effect. In the context of Malaysia corporate environment with the nature of shareholdings structure largely controlled by domestic shareholders such as family and political members who are actively participate in the business operation and serve on the firm boards according to Gibson (2003), it is crucial to re-examine how strategic firm's making decision for executive turnover could lead by performance. In specific, the study discussion also considers the division of forced and non-turnovers as responding to findings as instances by Denis & Denis (1995) and Kang & Shivdasani (1996). It is a crucial for examining how strategic firm's decision making for executive turnover could lead by firm performance. Thus, the study would expect the executive turnover in Malaysia increases during low firm performance.

H<sub>1</sub> Low firm performance leads to executive turnover decision

## RESEARCH METHODS

The initial sample of this study consists of executive's turnover cases in 177 public listed firms, spanning from years 2000 to 2015. Due to missing data and delisting status, the final sample only comprised 173 firms. And the year 2002 is used as the base starting year for data collection due the fact that Malaysian economy began to recover from the Asian financial crisis and the introduction of the Malaysian Code of Corporate Governance (MCCG). Besides, the year 2005, Malaysian firms were subjected to the new Financial Reporting Standards (FRSs) that have an impact on accounting ratio calculation (Ishak et al., 2012). The length of the period covered in this study is sufficient to determine executives' turnover through comparing the names of executives over the sample period.

With regard to the dependent variable for executive turnover, a number of executive replacements and reasons of turnover were identified as recommended by Weisbach (1988) and Denis & Denis (1995). This study follows a similar approach as proposed by Parrino (1997) who examine the number of executives' turnover based on news reports from local newspaper and company website announcement. Based on the initial summary statistics, the study finds that more than 10 percent of executive turnover events occur during the sampling period and this

frequency is slightly comparable to Coughlan & Schmidt (1985) and Mehran & Yermack (1997) who report 13% and 11% respectively. As well for dependent variable, the study used a similar of Maury (2006) to determine the executive turnover types, where 1 is denoted by the executive is being replaced in a given year for reasons of non-routine turnover, 0 otherwise.

As firm performance serves a crucial factor and may influence decisions to replace inefficient executives, particularly during a poor firm performance. Therefore, firm performance measures, which representing by accounting and market measures were employed in this study. However, using the market measures may underestimate the executive turnover effect, particularly when executives were served as the purpose of controlling shareholders (Weisbach, 1988). Thus, the market-based measures might be inappropriate but it is fair enough to explain the management decisions on executive turnover. Due to drawbacks associated with the market measures, a study was extended by employing an accounting measure of Return on Assets (ROA) to proxy firm performance. This also follows Goyal & Park (2002) that use a ROA by estimated the ratio of earnings before interests and tax to the book value of total assets.

Further validation was conducted to examine whether the decision of executives to leave firm is a result of firm poor performance. A dummy variable equal to 1 is assigned to firms which have negative income in both preceding and year turnover event and this approach is used to capture the effect. Nevertheless, using a single form of accounting measure is insufficient to validate the results of the executive turnover-performance sensitivity. Other studies in this field employed market-based indicators to study the relationship between unadjusted and market-adjusted return to executive turnover. So, unadjusted return is used based on computation the firm's stock returns in one year adjusted by the expected returns on FTSE Kuala Lumpur over the same period. Analysis of firm performance takes into account each year under the executive's watch. Based on Shen & Canella (2002), this approach ensures that an overall performance of the firms in the study is considered for determining turnover.

## RESULTS AND DISCUSSIONS

Table 1 presents the results of the study which examine the effects of performance on turnover among the Malaysia executives. In specific, the findings report how strategic decision has been taken in relation to executive turnover and was affected by firm performance. And the analysis shows the performance measures of return on assets (ROA), unadjusted returns and market-adjusted returns and firms with loss operating income (LOSS) for different sub-sample groups. The groups of a sample were included all executive turnover cases, excludes executives turnover cases at the retirement age of 70 years old; and a group covers the event of turnover before the retirement and post retirement age. The overall results for all turnover events presented indicate that poor firm performance status contributes to high turnover cases among executives. This finding is slightly consistent with past studies which found an inverse relationship between executive turnover and low performance (Huson et al., 2004; Chang & Wong, 2004; Conyon & He, 2014). However, the effect is more sensitive to current performance as the three out of four performance indicators are all significant at both the 5 and 10% level (Bouaine et al., 2014; Jenter & Kanaan, 2015). And, this indicates an inverse relationship may support an assumption that firm experiencing low performance leads to high turnover. Where, the model has been replaced with the market returns, the findings confirm a positive association with firm performance with the values are all insignificant. The result implies a weak decision making for removal of inefficient executives across the sample groups.

**Table 1**  
**ESTIMATION MODELS FOR EXECUTIVE TURNOVER & FIRM PERFORMANCE IN ALL**  
**TURNOVER EVENTS AND SUB-SAMPLE GROUPS**  
**(FORCED TURNOVER AND NON-FORCED TURNOVER)**

	All Turnover events		Forced Turnover		Non-forced Turnover	
	Current year (t)	Preceding year (t-1)	Current year (t)	Preceding year (t-1)	Current year (t)	Preceding year (t-1)
ROA <sub>t</sub>	-0.02** (0.03)	-0.001 (0.89)	-0.02** (0.05)	0.002 (0.81)	-0.03 (0.11)	-0.07 (0.22)
Intercept	1.70 (0.00)	1.66 (0.00)	1.82 (0.00)	1.78 (0.00)	0.24 (0.45)	0.32 (0.37)
Number of Observations	1083	1083	1029	1029	55	55
Number of turnovers	909	909	881	881	28	28
<b>R<sup>2</sup></b>	<b>0.008</b>	<b>0.00002</b>	<b>0.0067</b>	<b>0.00010</b>	<b>0.076</b>	<b>0.0213</b>
Unadjusted return	-0.21** (0.017)	-0.12 (0.145)	-0.17* (0.08)	-0.07 (0.416)	-0.37 (0.23)	-0.56 (0.13)
Intercept	1.66 (0.00)	1.67 (0.00)	1.79 (0.00)	1.79 (0.00)	0.15 (0.61)	0.22 (0.47)
Number of Observations	1081	1083	1027	1029	55	55
Number of turnovers	907	909	879	881	28	28
<b>R<sup>2</sup></b>	<b>0.006</b>	<b>0.002</b>	<b>0.004</b>	<b>0.001</b>	<b>0.005</b>	<b>0.032</b>
Market-adjusted return	0.17 (0.101)	0.01 (0.82)	0.19* (0.09)	0.02 (0.62)	0.10 (0.67)	-0.39 (0.30)
Intercept	1.67 (0.00)	1.65 (0.00)	1.80 (0.00)	1.78 (0.00)	0.03 (0.92)	0.16 (0.58)
Number of Observations	1081	1083	1027	1029	55	55
Number of turnovers	907	909	879	881	28	28
<b>R<sup>2</sup></b>	<b>0.003</b>	<b>0.00001</b>	<b>0.003</b>	<b>0.0003</b>	<b>0.0023</b>	<b>0.014</b>
Negative Operating Income	0.37* (0.07)	0.05 (0.81)	0.39* (0.07)	0.05 (0.79)	0.34 (0.59)	-0.54 (0.45)
Intercept	1.57 (0.00)	1.64 (0.00)	1.69 (0.00)	1.77 (0.00)	-0.05 (0.87)	0.13 (0.66)
Number of Observations	1083	1083	1029	1029	55	55
Number of turnovers	909	909	881	881	28	28
<b>R<sup>2</sup></b>	<b>0.004</b>	<b>0.0001</b>	<b>0.004</b>	<b>0.0001</b>	<b>0.002</b>	<b>0.008</b>

Return on assets (ROA) is calculated by dividing a company's annual earnings by its total assets and ROA is displayed as a percentage. Unadjusted return is the firm share price actual returns in one year and market-adjusted return is actual stock returns less the expected returns on FTSE Kuala Lumpur over the same period. LOSS is a dummy variable that is equal to 1 if the firm has negative operating income. Forced turnover excludes executive turnover at the age of 69, 70 and 71 year's old and non-forced executive turnover only at the age of 69, 70 and 71 years old.  
\*\*\* and \* indicate the level of significance at the 1%, 5% and 10%, respectively

Further analysis of turnover effects using previous firm performance indicators reveals insignificant relationship. This finding is a slight comparable to the conclusion drawn from

studies by Suchard et al. (2001) and Tsai et al. (2006). They point to that lagged performance is an important factor in determining executive turnover. Furthermore, a poor performing firm is likely to change an executive based on previous performance, instead of current year performance (Boeker & Goodstein, 1993). The results that estimating the turnover effects for current firm performance using accounting and market-based measures is logically more valid than the preceding year's firm performance. As the study finds both the ROA and unadjusted returns are to be significant for all executives turnover age and non-forced turnover groups, this suggests that neither accounting measures nor market measures are better predictor. In terms of result, it is consistent with Gibson (2003) who noted that imperfections of capital markets in many developing countries such as Malaysia could dedicate to the finding.

When the results were analyzed for sensitivity between executive turnover and performance effects based on the sub-sample groups, it reveals that forced turnover is strongly influenced by firm replacement decisions which impact the current firm performance. The result based on statistics showing that the non-forced turnover events are weakly impacted on previous and current firm performance. However, the result on the coefficient values have shown improvement in firm performance in the current year for all executive turnover ages and excluding the retirement age group between turnover and ROA, which are -0.02. In addition to both turnover types and the unadjusted return presents the coefficient value of -0.21 to -0.17. The significance value (i.e. at the 5 per cent level), indicating that the management makes a strategic decision for executive turnover is influenced by firm condition. In a similar way, the relationship between turnover and market-based performance measures is found to be significant at 10 per cent level. Further analysis for the sub-sample of forced turnover is consistent with the results obtained by Rachpadit et al. (2012) but differs slightly for the results obtained for non-forced turnover groups. This shows that the presence of executive replacement cases in non-forced turnover above the retirement age may be attributed to the legal framework which allows directors to be reappointed after retirement through a resolution of the majority of shareholders approval at a general meeting. Further examination on the effects of executive turnover and firm performance generates a negative operating income (LOSS) for both in the current and previous year across the sub-sample groups. It is noticeable that there is a positive association between a current and preceding year performance which is significant at 10 percent level for all executive turnover and sub-sample excluding turnover for the retirement age. For the sub-sample, which also includes the retirement age, the statistics show an insignificant connection. In this case, a current performance is not a best predictor to determine executive turnover. When, models substituting firm specific performance measures, the results show no improvement for all variables, except ROA. The coefficients relating to ROA are positive and significant at 5 percent level. This indicates that good firm performance for the year preceding executive turnover has no impact on the decision of executives with respect to future replacements. These findings are supportive of the results of Warner et al. (1988); Denis & Denis (1995); Denis et al. (1997); Lausten (2002); Firth et al. (2006); Rachpradit et al. (2012); Bouaine et al. (2014) and Setiawan et al. (2017) which all report an inverse relationship between firm performance and executive turnover.

## CONCLUSIONS

As the main objective of the study is to determine how strategic the decision for executive turnover and responding to this concern, the study identifies the effect of firm performance influencing executive turnover in Malaysian firms. Based on examination for

accounting and market performance indicators, the result shows that poor performing firms could lead to a high turnover rate. Hence, this study could not find clear evidence that accounting indicators is served better than market-based performance to evaluate turnover among executives. When examination for executive replacement decision according to turnover types such as forced and non-forced turnover cases, the findings emphasise that current firm performance influence the decision for an executive to being dismissed. Other factors are likely to bear influence on executive turnover. These findings suggest that the existence of managerial ownership by the executives do not leads to a high turnover rate. This result is in line with conclusions reached by Pergola (2005) who noted that high ownership concentration in ownership structure means that turnovers are not welcome. The implication of this study for Malaysia context for investors to give more attention on the value of executive stakes in the company. Perhaps, the grounds behind this supposition may be that firms with executive stakes ties are reluctant to remove inefficient executives as they may wish to protect themselves from being removed. In other words, this supports the management entrenchment hypothesis. As discussed by Setiawan et al. (2017), the family founding firms may have an effect on turnover decisions, but they were not analyzed the effect on the executive turnover events. This is another route of future research by considering post performance effects. Another future research could use corporate governance attributes in connection with attendance in the meetings for executives who are served as board members. This could explain how executives exercise greater protection from being removed. In respect of study limitation, limited of disclosure for turnover reasons create an information gap that lead to further challenges in the study context.

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