Summary

Governance with Multiple Firm Objectives: evidence from Top Executive Turnover in China

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The Research Question:

The primary research question in the paper concerns the turnover-performance links in China's listed companies, specifically those companies where the state (or state owned) comprises the majority of the shareholding structure. The underlying premise is the consideration that state shareholders have different priorities and objectives from those of a privately held company. Typically, the state considers socio-economic stability, economic growth and equality/justice issues as more important than financial objectives. Moreover, representatives of the state in the Board and shareholding structure do not benefit directly from the fortunes of the company which could lead to mis-aligned interests.

The authors believe that the context in China offers a perspective of multiple interests potentially conflicting within a shareholding structure. This provides the environment to analyze the different incentives on CEO discipline for both profit and loss-making companies.

Contribution:

The authors claim to present three primary contributions to the extant literature:

1. Providing empirical evidence on the existence of different incentives to discipline managers on the basis of financial performance;
2. Providing empirical evidence of different monitoring activities of state shareholders; and
3. Providing evidence that shareholders rely more on average performance over a CEO's tenure rather than evaluating annual financial performance.

In sum, the paper present new empirically based results that determine managerial turnover.

Methodology:

The analysis is based on data comprising all firms listed on the Shanghai and Shenzen Stock Exchanges for the period 1995 to 2000. Turnover data is sourced from the China Corporate Governance Research Database. The sample for the study included 731 companies that experienced at least one CEO turnover event. The final sample, after miscellaneous deletions, consisted of 3,106 firm-year observations.

The authors initially regress the data to ascertain the sensitivities of turnovers to four different performance measures. A baseline model is created from the sample without accounting for any specific performance conditions. Thereafter, the sample was estimated according to loss or profit-making companies. The dependent variable was set as a dummy variable of order 1 if a forced turnover occurred during the period. Performance was measured using six constructs: Unadjusted ROA, industry adjusted ROA, annual change in ROA, industry adjusted annual change in ROA, the moving average of the ROA over the period, and the industry adjusted ROA moving average over the period.

Thus, an accounting performance is measured rather than a stock price performance. This due to the ‘noise’ of stock markets generally, but also the fact that state owned shares are not freely tradeable in China. In both instances, stock prices may not reflect the tenure and performance of the CEO. Control variables include the departing CEO’s age, years of service, and whether the CEO has a dual role as chairman. Firm size and capital structure (leverage) were also controlled. The shareholder structure was also controlled by a dummy representing whether the shareholder was a government agency or state-owned firms. Time series factors that considered years of turnover and the number of years for which the firm was listed were also controlled.

The authors note three estimation issues. Potential heteroskedasticity were considered using Huber-White estimates. Random effect modelling was used to capture all the observations. They also undertook Pearson correlation analysis to observe multicollinearity.

The authors also note that the corporate control is effective if shareholders identify a new CEO who improves firm performance. The examine this by analyzing whether ROA and IROA exhibit a statistically significant improvement following the turnover.

Conclusion:

The authors present empirical evidence of varying CEO performance-performance linkages depending on the financial performance of the firm. Shareholders seem to consider firm performance as critical and have a material incentive for disciplining CEO’s for poor performance. The authors also present evidence that shareholders attach different weights to poor performance depending on their objectives. The analysis funds that there is a significant negative relation between turnover and level of profitability when a firm is loss-making, and such a relationship is not prevalent for a profit-making firm. Moreover, there is a weak but significant relationship between turnover and profit change for profit making companies, but no such link with loss-making companies. Lastly, there is a material positive change in profitability after the managerial change for loss-making firms. In sum, there is a materially higher incentive for CEO turnover in loss-making firms.