

**Impacts of Aspiration Levels
and Managerial Power on Chief Executive Officer Turnover:
Evidence from Chinese Listed Companies**

**抱负水平和权力对公司高管变更的影响：
来自中国上市公司的经验分析**

—— LILI PI (皮莉莉 著)



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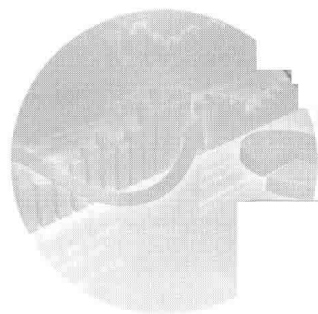
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ABSTRACT

A widely held view is that in the process of effective corporate governance, poor firm performance triggers CEO's removal. As a result, previous research has investigated the relationship between firm performance and CEO turnover. This study complements but significantly adds to this research by examining the impact of relative performance and the social and political processes accompanying this in the monitoring and removal of CEOs.

In this research, it is proposed that a board's perception of firm performance based on comparisons with its aspiration level affects its decision on CEO replacement. In addition, CEO turnover is also treated as a social and political process, involving power struggles and contests between the CEO and other organisational entities. This study focuses on the determinants of CEO turnover of listed companies in China, the largest transitional and developing economy in the world, where governance institutions and structures are evolving. Drawing on the strategic change, aspiration, and CEO power literature, a model of CEO turnover and a set of hypotheses have been constructed.

A panel data set of 325 Chinese listed companies for the period 1997—2006 was collected from published sources. Innovative econometric methodologies were used to model a range of relationships between CEO turnover and the board's aspiration level and CEO power. The statistical approach used in this study is Generalised Estimating Equations (GEE), which is a powerful tool for examining panel data where the independence of explanatory variables over time is not assumed. This approach is supported by the random effects method. The empirical results support the major hypotheses in this study. The board's aspiration level is found to be influential in its decision on CEO turnover; CEOs are more likely to be replaced involuntarily where firm performance is below the board's aspiration

level. CEO structural power affects the likelihood of both forced and voluntary CEO turnover, while CEOs' ownership power, prestige power, and tenure power influence the likelihood of forced CEO turnover, but not the likelihood of voluntary CEO turnover.

The study extends our understanding of the role of CEO in the strategy of organisation significantly, and has significant implications for governance, managerial capitalism and the theory of the firm.

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Chapter One Introduction

1.1 Research background

1.1.1 The escalation of CEO turnover in the world

The role of CEOs' leadership in strategy formation and organisational performance has been extensively addressed in the business and political press and in the research literature in strategic management. Stock markets react quickly to CEO changes (Huson, Malatesta, & Parrino, 2004); in the recent financial crisis, CEO performance has become a headline issue, and in the research literature, Waldman, Ramirez, House, and Puranam (2001) reiterate the assertion that CEOs are an important ingredient in the revitalisation of organisations. CEOs have a significant impact on strategy formation and organisational performance and CEO turnover is often a critical event with significant positive or negative implications for organisational performance and sometimes organisational survival (Carroll, 1984; Davidson, Worrell, & Cheng, 1990; White, Smith, & Barnett, 1997). Recent research suggests that organisations may adapt to major changes in their environment by choosing a new CEO with career experiences, educational background, and personal characteristics that better "fit"

the strategic contingencies faced by organisations (Hambrick & Mason, 1984; Henderson, Miller, & Hambrick, 2006; White et al., 1997). However, on the other hand, CEO turnover, especially forced CEO turnover, is a disruptive event for the development of any company (Kesner & Sebor, 1994). According to Booz Allen Hamilton's annual study of CEO succession for the 2500 largest companies in the world, the CEO turnover rate increased from 9% in 1995 to 15.3% in 2005, followed by a slight fall to 13.8% in 2007 (Karlsson, Neilson, & Weber, 2008) (see Figure A1.1 in the Appendix on page 396). This means that approximately one in seven of the largest companies in the world changed their CEOs in 2007.

The escalation of CEO turnover has aroused much public attention in recent years, and the CEOs themselves have become a topic of intense interest. Reports of corporate CEO turnover appear routinely in the popular press; for example, Booz Allen Hamilton has published an annual study of global CEO turnover since 2001 (Lucier, Kocourek, & Habbel, 2006). In academic research, attention to this topic has also increased. Indeed, a survey of articles on CEO turnover that have appeared in major management and strategy journals reveals a 250% increase in the number of publications from the 1970s to the 1990s (Kesner & Sebor, 1994). This is not only consistent with a managerial capitalism view of the world but also demonstrates the intense interest in this specific aspect.

1.1.2 The formation and development of the Chinese stock markets

Similar to the international trend, a large number of CEO turnover events have occurred in China since the Chinese stock markets were set up. Since it adopted an "open door" policy in 1978, China has undergone an extraordinary period of economic development as it moved from being a centrally planned economy to become a vibrant market economy. An important signal that China is building a "socialist market economy" is the establishment of stock markets (Qian & Wu, 2000). The Chinese government launched the Shanghai and

Shenzhen stock exchanges in December 1990 and April 1991 respectively. The Chinese government hoped to restructure ailing state-owned enterprises (SOEs) into corporations or “share holding companies” (Shi & Weisert, 2002), a new enterprise form in China’s recent history, with clear ownership structure, by listing them on stock markets. It was also hoped that households would put their savings into the stock market to finance listed SOEs (Shi & Weisert, 2002) in order to shift the weight of corporate financing from beleaguered banks to equity markets. Listing shares on the security exchanges is viewed as a convenient way to raise capital for restructuring and many SOEs have striven to go public. This phenomenon boosted the expansion of the stock markets and focused Chinese attention on the CEO in managerial capitalism.

In China, the number of listed companies increased from 10 in 1990 to 1 434 in 2006, and the total capital raised reached 1 911.93 billion RMB (i. e., the Chinese currency) in 2006-up from just 0.5 billion RMB in 1991 (see Figures A1.2 and A1.3 in the Appendix on page 396 and page 397). As the new enterprise form, listed companies have played a more and more important role in the development of the Chinese economy. The government accelerated SOE reform and installed internal and external monitoring mechanisms for SOEs by introducing a set of corporate governance guidelines into China. Over ten years, listed companies have become an example of the modern enterprise system in China (Peng, Zhao, Zhang, & Xu, 2001). At the end of 2001, the state-controlled listed companies produced a profit of 1 054.7 billion RMB, which was 63% of the total profit created by state-owned and state-controlled enterprises, although they comprised only 32% of the equity of state-owned and state-controlled enterprises (Xinhua Online, 2002). Listed companies also underpinned China’s economic rapid growth by raising substantial capital. More than 1 911.9 billion RMB was raised in the 16 years between 1991 and 2006. China GDP grew at an average rate of 9.3% between 1990 and 2004, which was dramatic and unmatched in the twentieth century. This strongly accelerated China industry structural adjustment by promoting the development of many new or high

technology industries, pillar industries, and leading industries (Peng et al., 2001). As announced by Qiu (2000), the Director of the National Statistical Bureau of China, the stock market has become a new source for Chinese economic growth. This is confirmed by Peng et al. (2001), who found that stock markets have contributed to Chinese GDP growth through the dramatic increase in its added value. According to their results, the added value of the China stock markets increased from 23.1 billion RMB to 83.7 billion RMB over the five-year period from 1996 to 2000. Correspondingly, its contribution to GDP growth rose from 1.9% in 1996 to 5.4% in 2000 (Peng et al., 2001).

With much industrial growth in China driven by listed companies, it is important to understand the development of their corporate governance processes in general and the drivers of CEO turnover in particular. China has a two tiered Board structure. This is similar to that of some western countries like Germany. However, the Chinese governance system lies somewhere between the German and Anglo Saxon models (Dahya, Karbhari, Xiao, & Yang, 2003). Changing CEO is one of the most important strategic decisions, for a company, and it affects the organisational economic and political climate within company (Kesner & Sebra, 1994). Decisions on hiring and dismissing the CEO are critical to the healthy development of companies. However, inappropriate CEO turnover decisions may be common, and thus understanding of the antecedents of CEO turnover is a significant issue (Haleblian & Rajagopalan, 2006; Wiersema, 2002).

1.1.3 CEO turnover literature

Along with the escalation of CEO turnover events in the world and China, a huge amount of literature has focused on the causes of CEO turnover. The topic of CEO turnover in Western, developed and market-based economies has been studied extensively since the 1960s. However, it still leaves many issues unresolved (Haleblian & Rajagopalan, 2006; Kesner & Sebra, 1994; Murphy &

Zimmerman, 1993; Pitcher, Chreim, & Kisfalvi, 2000; Weisbach, 1988).

Previous research on CEO turnover has applied several theoretical perspectives to identify potential determinants of why CEOs exit their positions. From the perspective of agency theory, firm performance is the signal of CEO's effectiveness and effort. Since boards of directors cannot directly observe all of CEO's actions, they must rely on various outcomes of corporate performance to assess CEOs (Hermalin & Weisbach, 2003). In terms of resource dependence theory, environments are the source of scarce resources and organisations are dependent on these finite resources for survival (White et al., 1997; Yokota & Mitsuhashi, 2008). Poor performance indicates that the existing way of operating is inappropriate and the organisation needs to change its leadership to adapt to the external environment (Hambrick & Mason, 1984). This view suggests that CEO succession serves as an organisational mechanism to overcome inertia (Friedman & Singh, 1989; Gordon, Stewart, Sweo, & Luker, 2000; Salancik & Pfeffer, 1980; Wiersema & Bantel, 1993) and adapt strategically to environmental change (Karaevli, 2007).

Although both agency theory (e.g., Huson, Parrino, & Starks, 2001; Warner, Watts, & Wruck, 1988) and resource dependence theory (e.g., Friedman & Singh, 1989; Pfeffer & Salancik, 1978; Yokota & Mitsuhashi, 2008) have predicted a negative relationship, empirical findings are mixed. A negative relationship between CEO turnover and firm performance can be found in many empirical studies, such as Denis and Denis (1995), Warner et al. (1988), and Goyal and Park (2002). However, some other researchers have found different results. For example, Fredrickson, Hambrick, and Baumrin (1988) and Furtado and Karan (1990) argue that firm performance explains less than one-half of the variance in CEO dismissal. Weisbach (1988) finds that the impact of poor firm performance on CEO turnover is small. Fizel, Louie, and Mentzer (1990) find no relationship between the variables.

In view of these inconsistent results, some researchers suggest investigating other potential factors influencing CEO turnover (Pitcher et al., 2000). Several

researchers have focused on CEO power and its impact on CEO turnover. An example is Ocasio (1994), who points out that CEO power may help explain the inconsistent results of the performance-turnover relationship, because powerful CEOs are able to use their power to maintain their position within corporations when firm performance is poor. However, relatively few empirical studies of the impact of CEO power on CEO turnover are available, although the impact of CEO power has been investigated in terms of firm performance (e.g., Allen & Panian, 1982; Combs, Ketchen, Perryman, & Donahue, 2007; Daily & Johnson, 1997), the selection of CEO successors (e.g., Boeker & Goodstein, 1993; Shen & Cannella, 2002a; Zajac & Westphal, 1996), and executive compensation (e.g., Barkema & Pennings, 1998; Bebchuk, 1999; Grabke-Rundell & Gomez-Mejia, 2002). In addition, the typology of executive-level power proposed by Finkelstein (1992), the first study to validate multi-dimensional and objective measures for executive power (Adams, 2004), has not been embraced by extant studies on the relationship between CEO power and CEO turnover. Prior studies on CEO power-turnover have commonly investigated determinants of CEO power that are related to corporate governance, such as the structure of the board of directors (e.g., board size, the proportion of outside directors, the proportion of directors appointed during the CEO's incumbency) and ownership structure (e.g., the proportion of shares held by the CEO, ownership concentration). These determinants can be measured by structural power and ownership power in the power typology proposed by Finkelstein (1992). However, some factors of CEO power which are determined by CEOs' personal characteristics, such as expertise and reputation, which are measured by expert power and prestige power in the power typology proposed by Finkelstein (1992), have been largely neglected.

Some other researchers have proposed that the mixed results between CEO turnover and poor performance found in previous research can be explained by the board's perception of firm performance (Fredrickson et al., 1988; Puffer & Weintrop, 1991). As Greve (1998) points out, the same performance level

may be evaluated differently in different organisations because they have different aspiration levels. Both the behavioural theory of the firm (Cyert & March, 1963) and prospect theory (Kahneman & Tversky, 1979) have explained how decision makers perceive firm performance and how their perception of performance affects their problemistic search and risk preference, which eventually influences their decision making. They argue that decision makers compare firm performance with their objectives or aspiration levels, which are determined by their historical performance (Levinthal & James, 1981) and the performance of similar others (Festinger, 1954; Greve, 1998). Performance below the aspiration level triggers a problemistic search and increases decision makers' willingness to take risks for the sake of perceived potential improvement. Conversely, decision makers are risk averse and prefer to maintain the status quo (Greve, 2003c). This view has been tested for various organisational decision-making activities and strongly supported in previous research, such as market entry (Greve, 2003c), innovation (Audia & Greve, 2006; Greve, 2003b), and factory expansion (Audia & Greve, 2006). However, CEO turnover, one of the most important organisational changes, has largely been neglected in previous research. Although the adaptive view of succession predicts an improvement in organisational performance following CEO turnover (Virany, Tushman, & Romanelli, 1992), CEO turnover is also a disruption for organisations (Beatty & Zajac, 1987; Carroll, 1984; Haveman, 1993) and may have a negative impact on future organisational performance and strategies (Grusky, 1963; Kesner & Dalton, 1994). Therefore, CEO turnover is a risky decision and should be explored from the perspective of the board's aspiration level.

In the Chinese context, very few studies of CEO turnover have been reported. So far, only a small number of studies on the turnover of the chairperson of the board of directors and CEOs in China have been published in international journals. The results of these reported studies between firm performance and turnover are mixed. Four studies have found that CEO turnover (i. e. , Fan, Lau, & Young, 2007; Kato & Long, 2006a), or the turnover of chairperson of the

board (i. e. , Firth, Fung, & Rui, 2006) , or top executive (defined as individuals holding the title of “ general manager ” or “ chairperson ”) turnover (Cheng, Li, & Tong, 2008) is significantly and negatively related to accounting performance. However, the results of Kato and Long (2006b) show that there is no significant relationship between CEO turnover and firm performance, although the negative relationship between firm performance and CEO turnover is stronger for firms with a majority shareholder. In addition, Chang and Wong (2009) found that the negative relationship between CEO turnover and firm performance only exists when firms are incurring financial losses, but no such relationship when they are making profits. All of these studies have investigated the antecedents of CEO turnover from the perspective of CEO corporate governance, especially internal corporate governance, such as independent directors, types of controlled shareholders, and the CEO’s duality. The reason for this is obvious; China is a transitional economy and companies listed on the Chinese stock markets have some unique features, such as the dominance of state ownership and control, highly concentrated ownership structures, and the lack of effective managerial labour markets (Fan et al. , 2007; Xu & Wang, 1999). CEO power and the board’s aspiration level for firm performance have not been explored in the Chinese context.

1.2 Research question

Traditionally, researchers see CEO turnover as the result of poor performance. This study moves beyond the conventional approach focusing on the relationship between performance and CEO turnover. It extends the existing literature by investigating the roles played by two factors in CEO turnover: the board’s aspiration level and CEO power. This leads to the research question of this study:

For a given level of firm performance, what is the impact of the board’s aspiration level and the CEO’s power on CEO turnover, including both voluntary and

involuntary departure, in Chinese listed companies?

1.3 Research objectives

This research has the following objectives:

- (1) To review relevant literature on CEO turnover, aspiration levels, and CEO power with a view to identifying factors that may influence CEO turnover;
- (2) To review the process of Chinese SOE reform in order to identify Chinese institutional factors that may affect CEO turnover in companies listed on the Chinese stock market;
- (3) To establish a multi-disciplinary theoretical framework incorporating the aspiration level and CEO power factors in order to examine the antecedents of CEO turnover in Chinese listed companies;
- (4) To design, on the basis of the theoretical framework, a research approach that recognises the nature of the data as it is arranged as a panel (cross sectional data over time), to develop the most appropriate models for CEO turnover, and to estimate the impact of the aspiration level and CEO power factors on CEO turnover;
- (5) To investigate the empirical evidence for the determinants of CEO turnover on the basis of the theoretical framework, particularly the impact of the aspiration level and CEO power.

1.4 The significance of this research

This study is important for at least three reasons. The first is that this research will extend existing CEO turnover research by exploring the issue of CEO turnover in China, the largest transitional economy in the world. Although CEO