

## **DETERMINANTS OF INTERNAL VS. EXTERNAL CEO SUCCESSIONS IN MALAYSIAN PUBLIC LISTED COMPANIES**

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### **ABSTRACT**

*Following a CEO turnover, a company may select an internal or external successor. The objective of this study is to determine if firm performance, board attributes, ownership structure and incumbent power influence the decision of whether to elect an internal or external candidate. Results from logistic regression analysis on 145 succession events over a four-year period (2002 to 2005) indicate that firms which are controlled by blockholders tend to select an outsider as the successor. Further, firms that are controlled by family members and position their former CEOs within the firms are more likely to select insiders as successors. However, firm performance, board composition, CEO duality and turnover type do not affect the selection choice. This study implies that poor firm performance does not necessarily lead to outside CEO selection choice. Further, boards of Malaysian PLCs are not effective in choosing outsiders as successors as both board composition and CEO duality do not necessarily select outsiders to become new CEOs. Another implication of this study is that former CEOs who continue their directorship in the same companies do have some power in naming new CEOs as the former tend to select insiders as successors.*

**Keyword:** CEO succession, corporate performance, corporate governance

### **INTRODUCTION**

The issue of who the successor will be in a Chief Executive Officer (CEO) turnover is always an important concern in organisational theory. This is because the choice of successor origin need to be carefully determined by the company as the impact of this selection will significantly influence firms' future strategies, policies and performance (Khurana, 1998). He adds that the decision to fire poorly performing CEO does not benefit the firms or shareholders unless the board of directors appoints a more capable successor.

The selection of the successor, either from inside or outside the company will be determined by the board of directors. The board may decide to limit its search to inside candidates or it may decide to broaden its search by considering outside candidates. The choice of a successor becomes a debate because the internal or external successor has his or her own strength. The proponents of insider succession highlight the importance of continuity and loyalty (Kotter, 1982; Lauterbach, Vu, & Weisberg, 1999). In contrast, an outsider succession may occur when there is organizational stress, such as poor performance, as outsider successions are generally prescribed as a remedy for firm difficulties (Parrino, 1997; Cannella & Lubatkin, 1993).

Despite the drop in the number of CEO succession events worldwide since 2003 until 2010 (Favaro, Karlsson, & Neilson, 2011), CEO succession is an important concern not only in developed countries, but also in Malaysia. However, little is known as to factors that lead to the decision of whether an insider or an outsider should become a successor. To the best of our knowledge, no studies have been conducted thus far in Malaysia to investigate the issue. Thus, the main objective of this study is to examine the selection choice of CEO successors, that is, either from an inside or outside source. In addition, this study investigates whether company performance, board attributes, ownership structure and incumbent CEO's power influence CEO selection choice in Malaysian public listed companies (PLCs). Malaysia is of interest not only because it is a developing country with an emerging capital market but also because of its unique corporate governance structure. While corporate governance, particularly the board structure, follows the Anglo-American model, the ownership structure is more towards the Franco-Germany model, whereby family ownership and state (or government) ownership is prevalent (Thillainathan, 1999). Similarly, Gibson (2003) argues that Malaysian companies are more often held by founding families and operate in an environment of relatively poor enforcement of shareholder's legal rights.

Results from the logistic regression analysis for the period of 2002–2005 reveal that firms that are controlled by block holders tend to select outsiders as successors. In contrast, firms that are governed by families and retain their former CEOs with other directorship post are more likely to name insiders as successors. Based on our results, it is hoped that this study will provide guidance to companies in their decisions that is whether to select inside or outside candidates as successors. Besides ownership structure, the power of CEO is amongst the factors that need to be considered by firms before they select their CEOs.

The rest of this paper is organised as follows. First, we discuss the literature review and theoretical development. Next, the methods employed are presented.

This is followed by a discussion of results. We end the paper with a conclusion section.

## **LITERATURE REVIEW AND THEORETICAL DEVELOPMENT**

The literature on CEO succession suggests several viewpoints related to the selection decision, i.e. the adaptive view, inertial view, scapegoating view and contingency view (Cannella & Lubatkin, 1993). Proponents of the adaptive view argue that organisations change or adapt in response to the environmental challenges and that CEO selection decisions represent an important adaptation mechanism. Accordingly, poor performance increases the likelihood of CEO turnover and when performance is poor, the board of directors will favour outside candidates as they believe outsiders are more capable of changing the mission, objectives and strategies of the firm than the insiders.

The second view of succession is the inertial view and proponents of this view argue that the selection process is relatively unadaptive because many people with vested interests are involved (Shen & Cannella, 2002). Proponents are of the view that environment continues to change but companies, particularly the large ones, often resist to change, even when faced with poor performance. These companies tend to select internal candidates if they decide to change the CEO.

The third view of succession is the scapegoating view. Boeker (1992) provides evidence that powerful CEOs of poorly performing firms will deflect the blame onto weaker subordinates. These weaker subordinates are subsequently dismissed while the CEO remains. The final view of succession is contingency view which is based on the sociopolitical approach to CEO succession. Advocates of this view suggest that several sociopolitical factors moderate the relationship between performance and the board of directors' decision making, causing the board of directors to react differently to a similar performance information (Cannella & Lubatkin, 1993).

### **Inside and Outside Succession**

The major concern of this study is the selection of new CEOs whether from internal or external sources. Pfeffer (1981) claims that a new CEO, whether an insider or an outsider, can either enhance or diminish the power of the organisation's board members. In addition, the choice of a successor has important consequences on the firm's future strategies and structure.

There are many arguments related to the issue of who the suitable candidates would be. For example, Kotter (1982) argue that, insiders are more

knowledgeable than outsiders about firms' specific products, competitors, markets, customers and employees. This knowledge will help managers understand a large, complex, and diverse set of activities and lead them to make appropriate decisions. Furthermore, internal successions also promote loyalty and establish social networks including superiors, subordinates, peers and others through which they gain information and support needed to perform their job (Lauterbach, Vu, & Weisberg, 1999). In other words, insiders provide smooth transition and stability since they are well acquainted and have participated in developing the existing corporate strategy.

In contrast, Zinkin (2010) comments that bringing in an outside successor is essential when drastic changes are required. The outside candidates are more promising as they are not bonded by the existing policies. In addition, they do not have vested interest in the past and no previous decisions of their own to defend or to undo. Besides that, outside succession can enrich the company with new perspectives, fresh ideas and decisive actions (Furtado & Karan, 1990; Zinkin, 2010).

Our definition of an insider (internal successor) and an outsider (external successor) follows the definition proposed by Dalton and Kesner (1985), who define an inside successor as a manager or employee promoted from within a firm and an outside successor as a newly appointed top management from outside a firm.

### **Corporate Performance and CEO Succession**

Boeker and Goodstein (1993) and Lauterbach et al. (1999) argue that poor past performance affects the origin of the new successor and their studies found that poor past performance leads to external selection choice. Alternatively, firms with good past performance tend to appoint an internal successor. External candidates who often have broader exposure and experience gained through their employment at other firms will introduce alternative ways to lead a poorly performing firm. In their study, Lauterbach et al. (1999) show that 60% of poor performers appoint outsiders as successors while 82% of top performers appoint insiders as successors. Their findings support the argument that firms with poor performance need to make some changes and external succession becomes more likely because an external successor is believed to conceive and implement fresh initiatives (Cannella & Lubatkin, 1993). Denis and Denis (1995) find that the ratio of operational income to total assets increases following the outside successor selection.

The above results support the adaptive view of succession that appointing new external CEOs by poorly performing firms may give good impression about the

companies. The shareholders may view the new outsider CEO more superior than the former CEO as the external successor might add value to the company. Therefore, it is reasonable to believe that the owner of poor performing firms will prefer an outsider as they perceive an outsider will bring some changes to their companies, including the improvement of their companies' performance (Cannella & Lubatkin, 1993; Boeker & Goodstein, 1993). Thus, based on the above arguments, we hypothesize that:

H1: Poorly performing firms are more likely to appoint outsiders as CEO successors.

### **Board of Directors' Attributes and CEO Succession**

Boeker and Goodstein (1993) and Cannella and Lubatkin (1993) suggest that besides prior performance, other factors such as board attributes and ownership concentration do influence the choice of successors. The main function of a board is to act as the representative of the shareholders and as the central body for decision making in a company. In order to become an effective board, Malaysian Code of Corporate Governance (MCCG) suggests that one third of the board should consist of outside members and different individuals should hold the post of a CEO and a chairman.

#### ***Board composition***

The composition of the board has an impact on the internal control system of a firm and it has been shown that a balanced board, including both inside and outside executives, will enhance the board's role as an internal control mechanism (Khurana, 1998). With respect to CEO succession decisions, agency theory predicts that inside directors tend to support insiders and oppose outside candidates. The rationale is that an internal candidate may add value to the firm since he or she is already involved in developing and implementing the firm's current policies (Khurana, 1998). Due to their knowledge and involvement, inside candidates are thus seen as the best candidates for CEOs.

Mizruichi (1983) argues that if a board is dominated by insiders, it will likely choose a CEO who poses a minimal threat of disruption and the most suitable person is typically someone from within the firm whom they already know. Hence, firms with insider-controlled boards tend to select insiders for their job and interest security as opposed to outsider-dominated boards. Likewise, agency theory also states that a board can potentially exercise control over managers and suggests that outsider-dominated boards act more independently in making CEO selection decisions. Therefore, we propose the following hypothesis.

- H2: Firms that have a high proportion of inside board members are less likely to appoint outsiders as CEOs.

### ***CEO duality***

Advocates of stewardship theory suggest that the combined functions of a CEO and a chairman (unitary leadership structure) provides unified firm leadership, and removes any internal or external ambiguity regarding who is responsible for firms, processes and outcomes. Haniffa and Cooke (2002) argue that efficiency in monitoring management can be enhanced through Chairman-CEO duality as less contracting is needed and information asymmetries is reduced. However, Pi and Timme (1993) claim that cost-efficiency and return on assets are lower when a CEO is also a Chairman. The argument is that the CEO-cum-Chairman will have concentrated power base which will allow the CEO to make decisions for his/her own-self interest at the expense of shareholders. Morck, Shleifer and Vishney (1988) suggest that the number of titles held by a single individual may indicate a power vested by that individual. Regarding the selection of the successor, Cannella and Lubatkin (1993) claim that a CEO who also holds the board's chairmanship will increase the power of the incumbent CEO. Due to the power that they have, they will intervene during the selection of a new successor. They tend to nominate a potential candidate who will maintain their status quo; they will choose an insider as the successor. Based on the above argument, we hypothesize the following:

- H3: Firms that exercise CEO/chairman duality are less likely to appoint outsiders as CEOs.

## **Ownership Structure and CEO Succession**

### ***Family ownership***

Family-controlled firms normally plan the succession of their CEOs by electing the heir apparent to be groomed up (Tsai, Hung, Kuo, & Kuo, 2006). This action is taken in order to ensure that their business empire will continue under the same family management. In the case of family controlled firms, profitability is not the only goal. According to Allen and Panian (1982), direct control by a family member, with all the power and privileges that this control confers on the other members of the family, may become a goal in itself. Indeed, controlling families may be willing to sacrifice some degree of corporate profitability in order to retain some degree of direct family control over the corporation. Family values like trust, altruism and paternalism can create an atmosphere of love for a business, and a sense of commitment is very important for family-owned companies (Chami, 1997). Therefore, due to their commitment and loyalty, even

in the case of poor performance, family-controlled firms will select one of their family members as the successor. Thus, the following hypothesis is proposed.

- H4: Firms that are controlled by families are less likely to appoint outside successors as CEOs.

### ***Blockholding***

Sufficiently large ownership by blockholders can support more active boards and reduce agency problems by reducing management entrenchment (Aggarwal, Erel, Ferreira, & Matos, 2009). Davidson III, Nemeč, Worrell and Lin (2002) claim that a successor in a blockholder-controlled organisation is expected to be an outsider as the board is not influenced by any controlling shareholders in making its decision. In the case of poor performing firms, an outside candidate is preferable as he or she is not responsible with the firm's ongoing strategy and policy. Thus, new changes and fresh ideas will be introduced by the outside successor in order to improve firm performance. Hence, we propose that:

- H5: Firms that are controlled by blockholders are more likely to appoint outside successors as CEOs.

### **Turnover Type and CEO Succession**

A CEO turnover can be classified either as a forced or voluntary turnover. Turnovers due to relay succession, normal retirement, early retirement and death or poor health condition are classified as voluntary turnovers (Friedman & Singh, 1989; Cannella & Lubatkin, 1993). On the other hand, a turnover event is categorised as forced if all officerships and directorships associated with the outgoing CEO were severed at the time of succession (Denis & Denis, 1995).

In a succession process, the type of turnover (forced or voluntary) may also influence the type of the successor (insider or outsider). Empirical evidence is not supportive of the adaptive view of succession which predicts that a forced turnover will lead to an outside succession. For example, Parrino (1997) documents that forced turnovers arising from poor performance are more likely to result in inside rather than outside successions. Similarly, Shen and Cannella (2002) find that 38 out of 65 dismissed CEOs (i.e. 58%) are succeeded by insiders. They claim that their result is not in line with the adaptive theory due to power dynamics within CEOs themselves. The power dynamics influence the selection process of the successor which, in turn, leads to an internal succession rather than an external succession. We thus test the following hypothesis:

- H6: Firms that experience forced turnover are less likely to appoint outsiders as CEO successors.

### **Predecessor Disposition and CEO Selection**

Cannella and Lubatkin (1993) claim that CEO disposition (the change from one position to another within a firm) signals that the incumbent knowledge and expertise are still needed by a firm. Friedman and Singh (1989) state that firms with a healthy financial performance tend to retain their incumbent top management, whereas poorly performing firms tend to dismiss their top management. This statement is supported by Lauterbach et al. (1999) as they claim that former CEOs are often retained on the board as the chairman of the executive committee to utilise the CEO's valuable knowledge on the company and business. The retention of former CEOs may also reflect significant shareholdings by the CEO and his family.

The existence of a predecessor on the board may also influence the selection of the successor, and it is reasonable to assume that firms that retain their former CEOs signal their preferences for some continuity (Lauterbach et al. 1999). Thus, an inside successor is preferable to an outside successor when the predecessor CEO is still holding an official position in the company. The reason is that an insider will continue with the existing policies and strategies established by the firm. In other words, the selection of an inside successor will secure both predecessor CEO job and other board members' directorships (Boeker, 1992). Hence, we state the hypothesis as follows:

- H7: Firms that retain their predecessor CEOs are less likely to appoint outsiders as successors.

## **METHODS**

### **Data**

This study focuses on CEO succession for a four-year period from 2002 to 2005 inclusive. Year 2002 is selected as a starting year to control for the influence and consequences of the 1997/98 financial crisis. In addition, the MCCG was already in place during the period. A large number of companies suffered financial distress during the 1997–1998 period and were expected to reorganise their financial and operation policy in order to expand their businesses. The ending period of year 2005 is chosen due to the introduction of the new Financial Reporting Standards (FRS) in 2006 that replace the standards established by the

Malaysian Accounting Standard Board (MASB). The new standards would have some impacts on the calculation of the accounting ratios used in this study<sup>1</sup>.

This study employs a logistic regression analysis to determine the relationship between performance, board composition, firm ownership, type of turnover, predecessor disposition and CEO selection choice<sup>2</sup>. The unit analysis of this study is CEO succession in Malaysian PLCs. The population comprises of companies that are traded and listed on Bursa Malaysia. There were 258 cases of CEO succession during the period 2002 to 2005. However, after omitting MESDAQ companies (4), delisted companies (28), financial institutions (6), companies with incomplete financial data (26), companies whose annual reports are inaccessible (12), companies whose CEO change more than once (33), companies with joint CEOs (2) and companies experiencing mergers and takeovers (2), we finally have 145 succession events in our sample<sup>3</sup>.

### **Variable Measurement**

**CEO origin (*Outsider*)**. The dependent variable is the CEO selection choice (i.e. insider or outsider). Successor origin is coded as "0" if the successor is from inside the firm, and "1" if from outside.

**Average ROA (*AVROA*)**. Return on Assets (ROA) is the measure of firm performance. The ROA is measured as the ratio of accounting earnings before interest and taxes to the book value of assets. This study uses a two-year average performance because a firm usually does not immediately react to poor performance by replacing its CEO in the year the poor performance occurs (Boeker & Goodstein, 1993).

**Board composition (*BCOMP*)**. Board composition is measured as the proportion of non-executive directors (NEDs) to the total number of directors on the board of the company. This method is used, among others, by Borokhovich, Brunarski, Donahue and Harman (2006).

**CEO duality (*DUALITY*)**. The variable is coded as "1" if the outgoing CEO is also a chairman and "0", otherwise. This measurement is used, for example, by Cannella and Lubatkin (1993).

**Family ownership (*FAMILY*)**. Family ownership is defined as the proportion of ordinary shares owned by family directors group to the total shares outstanding (Haniffa & Cooke, 2002).

**Blockholding (BLOCK).** Blockholding is measured as a percentage of shares owned by individuals who hold 5% or more of the total shares outstanding (The Companies Act 1965, 1993, Para 69D).

**Turnover type (TURNTYPE).** Turnover type is classified as either voluntary or forced turnover. Succession theory suggests that there are at least four voluntary scenarios, namely relay succession, normal retirement, early retirement and death or poor health (Friedman & Singh, 1989; Cannella & Lubatkin, 1993). With respect to forced turnover, Dahya, McConnell and Travlos (2002) and Huson, Malatesta and Parrino (2004) identify forced turnover by examining the report released by the press including the Financial Times and the Wall Street Journal. They labeled a turnover as a forced turnover when the news articles state that a CEO is "fired" or "resigned" and in both cases the CEO must be less than 55 years old. In addition, if an announcement does not provide any reason for the departure, such as death, poor health, or the acceptance of other position elsewhere or within the firm stated, the departure is also classified as forced turnover. Further, removal is also considered as forced turnover since top management are removed before the expiration of their three-year term (Kang, 2002). This study adopts the above guidelines by Friedman & Singh (1989), Cannella & Lubatkin (1993), Dahya et al. (2002) and Huson et al. (2004) in determining if a turnover is forced or voluntary, upon reading the announcements found on the Bursa Malaysia website. A score "1" is given for a forced turnover and a "0", otherwise.

**Predecessor disposition (DISP).** The variable is coded as "1" if the CEO stays in the company with a new position, and "0" if the CEO leaves the firm (see for example, Friedman & Singh, 1989).

**Control variables:** The control variables in this study are firm size, leverage and diversity. It is argued that large firms and those with many business segments (diversified) tend to select insiders due to the firms' complex structure and policy, while firms with high leverage prefer outsiders as they believe outsiders can better turn around firm performance and decrease the leverage level of the firms (Dalton & Kesner, 1983; Parrino, 1997; Haniffa & Cooke, 2002; Renneboog, 2000, Berry, Bizjak, Lemmon, & Naveen, 2006). Firm size (FSIZE) is measured as the natural log of total assets, and firm leverage (LEV) as the proportion of total debt to total assets. For firm diversification (DIVERS), "1" is given for firms that have more than one business segment, and "0", otherwise (Berry et al., 2006).

## RESULTS AND DISCUSSION

Table 1 shows the descriptive statistics of the characteristics of sampled firms. Out of the 145 succession firms, 74 (51%) firms tend to select insiders as successors while 71 (49%) firms select outsiders as successors. The mean ROA shows that inside selection has a lower mean than outside selection and both ROA means have positive values which indicate that on average the sample firms are not having financial difficulties. On average, 62% of the board members are non-executive directors with a mean of 0.648 for outside selection and 0.614 for the inside selection. Interestingly, both ownership structures (family and block holders) significantly influence CEO selection choice as both independent *t*-test and Mann Whitney U test display a statistically significant difference for the above-mentioned variables. Firms that are controlled by families are more likely to select insiders as successors as the mean for family-controlled firms is much higher in the inside selection sample as compared to outside selection sample. In contrast, the mean of blockholders for outside selection (53.206) is higher than that of blockholders in the inside selection (42.132). This result indicates that when firms are controlled by blockholders, they are more likely to select outsiders as successors. In relation to firm characteristics, the size of firms in the outside selection sample are larger than firms in the inside selection sample. The mean of total assets in outside selection is RM2976 million compared to RM949 million in the inside selection. Firms in the outside selection sample also have a higher leverage (29.180) than firms in the inside selection sample (25.361).

Table 1  
Descriptive statistics for continuous variables

Variables	Full Sample (n = 145 companies)				Outside succession (n = 71)		Inside Succession (n = 74)		Outside vs. Inside Succession			
	Mean	Min	Max	Std. Dev.	Mean	Std. Dev	Mean	Std. Dev	Independent T-test		Mann Whitney U Test	
									<i>t</i> -stat	<i>p</i> -value	<i>z</i> -stat	<i>p</i> -value
AVROA	0.028	-	1.020	0.154	0.036	0.183	0.022	0.119	-0.547	0.585	-0.433	0.665
BCOMP	0.623	0.000	1.000	0.190	0.648	0.213	0.614	0.186	-1.026	0.307	-1.638	0.101
FAMILY	10.677	0.000	88.92	20.819	5.033	16.658	16.093	22.983	3.328	0.001***	-4.003	0.000***
BLOCK	47.685	0.000	88.76	21.739	52.076	22.847	43.471	19.872	-2.416	0.017**	-2.545	0.003***
FSIZE (million)	1942	371	63495	6567	2976	9123	949	1790	-1.839	0.070*	-1.485	0.137
LEV	27.231	0.000	81.76	28.933	29.180	35.522	25.361	20.836	-0.785	0.434	-0.010	0.992

\*\*\* Significant at 1 % level (2-tailed test) \*\* 5 % level, \* 10 % level

Table 2 reports the descriptive statistics for the dichotomous variables. Regarding CEO/Chairman duality, 95.9% of the firms separate the role of CEO and Chairman. For CEO disposition, only 56 (39%) predecessors remain in the

company with other directorships while 89 (61%) of them leave the company. From 145 turnover cases, 83 cases are classified as forced turnover and 62 cases are determined as voluntary turnover. For firm diversification, 100 of 145 firms have more than one business segment as compared to 45 firms that are classified as focused firms.

Table 2  
Descriptive statistics for dichotomous variables

Variables	All sample (n = 145)	Outsider (n = 71)	Insider (n = 74)
DUALITY			
"1" CEO = Chairman	6 (4.1%)	2 (2.8%)	4 (5.4%)
'0" CEO ≠ Chairman	139 (95.9%)	69 (97.2%)	70 (94.6%)
DIVERS			
"1" Firm with > 1 business segments	100 (69.0%)	45 (63.4%)	55 (74.3%)
"0" Firm without business segment	45 (31.0%)	26 (36.6%)	19 (25.7%)
DISP			
"1" Former CEO holding other post	56 (38.7%)	15 (21.1%)	41 (55.4%)
"0" CEO out from company	89 (61.3%)	56 (78.9%)	33 (44.6%)
TURNTYPE			
"1" Forced turnover	83 (37.2%)	52 (73.2%)	31 (41.9%)
"0" Voluntary turnover	62 (62.8%)	19 (26.8%)	43 (58.1%)

Table 3 summarises the correlation between all variables involved in this study. Among the independent variables, a significant correlation (correlation coefficient of  $-0.59$ ) is found between turnover type and predecessor disposition. This indicates that firms which experience CEO forced turnover are less likely to retain their predecessor CEO as a member of their board or management team. Based on Hair et al. (2006), multicollinearity is not a severe problem here because the correlation coefficients are less than 0.7.

Table 3  
Correlation of variables (N = 145)

Variables	1	2	3	4	5	6	7	8	9	10
1. Outsider	1									
2. AVROA	0.46	1								
3. BCOMP	0.12	0.06	1							
4. DUALITY	-0.06	-0.27**	0.13	1						
5. FAMILY	-0.27**	0.25**	-0.06	0.05	1					
6. BLOCK	0.25**	0.24**	0.35**	-0.13	0.06	1				
7. TURNTYPE	0.24**	-0.34**	0.03	-0.02	-0.17*	0.03	1			
8. DISP	-0.34**	-0.12	-0.15	0.06	0.14	-0.18*	-0.59**	1		
9. FSIZE	0.15	0.02	0.16	0.06	-0.25**	0.21*	-0.05	-0.07	1	
10. LEV	0.07	-0.10	-0.03	-0.03	-0.12	-0.22*	0.13	-0.07	-0.01	1
11. DIVERS	-0.12	-0.16	-0.02	0.06	-0.18*	-0.17*	0.02	0.08	0.17*	0.19*

\*Significant at 0.05 level    \*\*Significant at 0.001 level

Table 4 shows the relationship between firm performance, board attributes, ownership structures, predecessor power and outside CEO selection choice, using logistic regression analysis. The model reports a significant chi-square statistics at a 1% level, suggesting a good fit of the model. The overall classification accuracy is 71.0% and the model is able to correctly classify 69.3 % of firms that select outsiders as successors and 72.8% of firms that select insiders as successors. The Hosmer-Lemeshow goodness-of-fit is more than 5%, which indicates that the model estimates fit the data at an acceptable level. The Nagelkerke  $R^2$  is 30.4%, suggesting considerable explanation between dependent and independent variables.

Results shown in Table 4 reveal that there is no significant relationship between each of performance, board composition, CEO duality, and turnover type, and outside CEO selection choice. Thus, the findings do not support Hypotheses 1, 2, 3 and 6. The findings thus indicate that performance, board composition, CEO duality and turnover type do not influence the decision of whether to appoint an insider or an outsider as a successor. These findings fail to support the adaptive view of succession as far as firm performance is concerned. Rather, it supports the contingency view which suggests that board of directors react differently to similar performance information. The relationship between performance and CEO selection choice is not significant because several socio-political factors may moderate the relationship between firm performance and CEO selection choice (Cannella & Lubatkin, 1993). However, it is not the objective of this study to examine the moderating effect of the factors on the said relationship.

Table 4  
*Logistic regression analysis: Outside CEO selection choice*

Independent variables	Expected sign	B	SE	Wald Ratio	P-value	Exp (B)
AVROA	-	-0.170	1.314	0.017	0.449	0.844
BCOMP	+	-0.216	1.073	0.041	0.420	0.806
DUALITY	-	-0.005	0.967	0.000	0.500	0.995
FAMILY	-	-0.028	0.010	7.067	0.004***	0.972
BLOCK	+	0.023	0.010	5.017	0.013**	1.023
TURNTYPE	-	0.347	0.483	0.516	0.237	0.461
DISP	-	-1.061	0.501	4.478	0.017**	0.346
FSIZE	-	0.263	0.325	0.657	0.209	1.301
LEV	+	0.008	0.007	1.042	0.154	1.008
DIVERS	-	-0.775	0.454	2.914	0.044**	0.461
CONSTANT	+/-	-1.610	2.148	0.562	0.227	0.200
Ch-square $\chi$				37.468***		
Degree of freedom				10		
Hosmer and Lemeshaw				62.6%		
Cox and Snell $R^2$				22.8%		
Nagelkerke $R^2$				30.4%		
Mc Fadden Pseudo- $R^2$				18.5%		
Classification Accuracy: Overall						
- Outsider Selection				71.0%		
- Insider Selection				69.3%		
Sample Size				72.8%		
- Outside Selection				145		
- Inside Selection				71		
				74		

Findings of this study also support the statement by Gibson (2003) that the power of board reduces when the ownership is concentrated in one hand of individuals. Due to their limited power, their nomination of CEO new successor may not be agreed by concentrated shareholders, which in turn will select their preferred CEOs from their families or colleagues. Further, forced turnover also do not lead to CEO inside selection.

As far as family ownership is concerned, the result supports H4. This study provides evidence that outsiders are not preferred in family-owned firms. An internal successor is appointed in family-owned firms in order to maintain family status quo, control and job security. Conversely, firms that are controlled by blockholders are more likely to choose an outsider as a successor, lending

support to H5. As board of directors in blockholders-controlled companies are not influenced by shareholders in making its decision, the outsiders will be selected as successors.

H7 predicts that firms that retain their predecessor CEOs are more likely to appoint insiders as successors, and our result supports the hypothesis. This implies that the existence of a predecessor on the board may also influence the selection of the successor because it is reasonable to assume that firms that retain the former manager in their organizations signal their preferences for some continuity (Lauterbach et al., 1999). Thus, an inside succession is preferable than an outside succession when the predecessor CEO is still a director.

## **CONCLUSION**

The main objective of this paper is to examine whether firm performance, board attributes, ownership structure, turnover type and predecessor disposition influence the selection of CEO successors, i.e. whether they are selected from inside or outside a company. This study fails to find a significant relationship between performance and CEO selection choice. In addition, this study finds that board attributes (i.e. the proportion of outside members on board and CEO/Chairman duality), are not significant in determining CEO selection choice. However, our evidence suggests that firms tend to select an outsider as a successor when they are controlled by blockholders. Further, firms that are owned by families and retain their incumbent CEOs are more likely to choose an insider as a successor.

The major implication of this study is that poor prior performance does not necessarily lead to an outside successor, a finding which is different from those of most previous studies (see Lauterbach et al., 1999; Cannella & Lubatkin, 1993; Denis & Denis, 1995). The notion of the adaptive view in that outside succession will attract investors' attention that may increase firm future performance is not applicable in the Malaysian environment. Rather, the contingency view which suggests that directors react differently to similar performance information is likely to be applicable.

This study also has important implications for corporate governance and ownership structure of organisations which consequently will help companies and policy makers in strategizing CEO successions. Boards of the Malaysian PLCs should be more effective in choosing outsiders as successors, as this study finds that both board composition and CEO duality do not necessarily lead to CEO outside selection. This condition may be due to concentrated ownership in Malaysian PLCs which reduces the power of the board in making their decisions

regarding CEO successions. Firms that are controlled by block holders are more likely to select an outsider as a successor. This finding reveals that block holders will have more information and communicate extensively with outsiders. As a result, they are able to find a suitable outside candidate to fill the vacant post. Firms that are controlled by families are more likely to choose an insider as a successor for continuity of policies, structure, control and security. These firms believe that an insider will provide a smooth transition and stability since he or she is well acquainted and have participated in developing existing corporate strategies.

Other implication of this study is that the power of predecessor CEO influences the choice of the successor. Firms that retain their former CEOs tend to select an insider as a successor for the sake of the former CEOs' security as well as other board members' security.

Finally, this study provides a basis for future research on CEO succession which can be extended in many ways. First, in order to increase the sample size of CEO change events, future studies need to include a longer time period so that the results can be generalized. Further, as this study focuses on the direct relationship between corporate performance and CEO change, future studies may include moderating variables that may intervene this relationship such as ownership structure and incumbent CEO power.

## **NOTES**

1. The main difference between FRS and MASB is in the presentation of the income statement which affects the determination of firms' ROA.
2. Hair, Black, Babin, Anderson and Tatham (2006) explain that both logistic regression and discriminant analysis are appropriate statistical techniques when the dependent variable is categorical (nominal or nonmetric) and the independent variables are metric variables. However, logistic regression is preferable because it is less affected when the basic assumptions, particularly normality of the variables and equal variances are not fulfilled. Therefore, results produced by logistic regression are more robust than discriminant analysis when these assumptions are not met.
3. The omission of MESDAQ companies is due to its newly established market in 2005 and the exclusion of financial institution is because of the different method used in presenting their financial statement which affects the calculation of accounting ratio. Companies whose CEOs change more than once are also excluded since at least two year performance is needed prior to and after turnover events. Companies with joint CEOs are omitted to avoid split turnover. Companies experiencing take-overs and mergers and are also excluded as both takeovers mergers are considered termination of one company or the new

company was established from the combination of two companies. These activities may involve top management change including termination of the CEO and the selection of new CEO.

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