

An Analysis Of Market Reaction To CEO Turnover Announcement: The Case In Indonesia

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ABSTRACT

This paper investigates market reaction analysis to CEO turnover announcement in Indonesia. We are considering the succession factors: (1) the origin of successor (inside/outside firm) and (2) the process of succession (routine/non-routine). This paper aims to examine the market reaction of CEO turnover announcements. The samples consist of 59 firms from 1992 to 2003 and there was a t-test use to examining information content of CEO turnover announcements. The results show that market reacts positively to all CEO turnover announcements. The examination of the effects of succession process shows that market react positively to routine change, but do not react to non-routine change. Market also reacts positively to succession that leads inside candidate become a CEO, but the market give a mixed reaction when the successor come from outside firm. When the author combines the succession factors, we find the interesting result that market reacts favorably (positive) to routine change that leads the candidate from inside firm become a CEO. But market reacts unfavorably (negative) to routine change that leads candidate from outside become CEO. That's mean the Indonesian investor prefer the smooth process in the succession, and they can reduce the uncertainty. Therefore we conclude that CEO turnover announcements have information content.

Keywords: CEO turnover, inside and outside CEO, routine and non-routine turnover.

INTRODUCTION

A Chief Executive Officer (CEO) is an important man/woman which defines the firm's strategy in order to compete with other firm in a market. If CEOs turnover it will have an impact on the firm's strategy. The incoming CEO changes firm structures (Agrawal, Knoeber & Tsoulouhas 2000), fixes unprofitable investment decision previous CEO did (Weisbach, 1995), and increases internal control (Denis & Denis, 1995). Thus, the incoming CEO uses his/her power to increase firm value.

A CEO turnover is a signal from the firm that they will make a change in company's management. They want to apply a new rules and procedures under the incoming CEO. This change in management styles is expected to improve the performance and value of the firm. Many research investigated market reactions of CEO turnover announcements, but the results are mixed. In US, Weisbach (1988), Denis and Denis (1995), and Huson, Malatesta and Parrino (2003) found positive market reaction to CEO turnover announcements. On the other hand, Reinganum (1985), and Warner, Watts and Wruck (1988) did not find market reaction for the US. In UK researcher find as well mixed results. Dahyaa and McConnel (2003) show that there is evidence that market react favorable to CEO turnover announcement and find positive abnormal returns around CEO turnover announcements. But, on the other hand Dedmen and Lin (2002) find negative abnormal returns around CEO turnovers and they claim that markets react negatively to CEO turnover announcements. Richard, Sing and Barr (2001) confirm the result found by Dedmen and Lin (2002) using Australian data. Investors in Australia perceived CEO turnover as bad news, therefore they react negatively to these announcements. Research about market reaction to CEO turnover in Asia, i.e. in Japan conducted by Kang and Shivdasani (1996) shows positive abnormal returns. This means that market perceives CEO succession as an improvement of a firm's firm performance, or good news, and therefore they react positively.

The different results of analyses of market reaction to CEO turnover announcements may be due to differences in information about the specific successions: (1) process of CEO change: routine and non-routine; and (2) the origin of incoming CEO: inside or outside firm. Friedman and Singh (1989) argue that market reaction to CEO turnover announcement affected by organization context and organization content of succession. Warner, Watts and Wruck (1988), Denis and Denis (1995), Kang and Shivdasani (1996), and Dherment-Ferre and Reneboog (2000) found positive market reaction to non-routine CEO change. On the other hand, Dedmen and Lin (2002) shows negative market reaction to non-routine CEO change. Other research by Hermalin and Weisbach (1988), and Agrawal, Knoeber and Tsoulouhas (2000), as well as Dherment-Ferere and Reneboog (2000) argue that the outgoing CEO will improve firm value, and therefore market reacts positively (Worrel, Davidson III & Glascock, 1993; Dahyaa & McConnell, 2003; Huson, Malatesta & Parrino, 2003).

This paper investigates market reaction analysis to CEO turnover announcement in Indonesia. It is the first research investigating market reaction to CEO turnover in Indonesia, thus contributing to the understanding of how the market reacts to CEO turnover in Indonesia.

REVIEW PREVIOUS RESEARCH AND HYPOTHESIS DEVELOPMENT

Market Reaction To CEO Turnover

Research about market reaction based on abnormal return surrounding CEO turnover announcement, shows inconsistent results. Warner, Watts and Wruck (1988) investigate market reaction to CEO turnover in USA period 1962-1978. Their samples consist of 269 firms listed at NYSE and 567 CEO turnover announcements. Warner, Watts and Wruck (1988) detect positive abnormal return but not significant. They confirm the result of Reinganum (1985) that does not find market reaction to CEO turnover, too.

On the other hand, Weisbach (1988), Denis and Denis (1995), and Huson, Malatesta and Parrino (2003) find significant abnormal return around a CEO turnover in the US. Weisbach (1988) investigate the relationship between CEO turnover and Board of Directors composition. The samples of his research enclose the period of 1974 to 1983 and there were 367 CEO turnovers during this period. The result shows that the market reacts positively to a CEO turnover announcement. The market reacts even stronger if independent directors dominate the composition of the board. The market does not react if inside directors are dominating board composition.

Bonnier and Brunner (1989) confirm the results found by Weisbach (1988). They find that market reacts positively to CEO turnover announcements over the period of 1969 to 1983. The result indicates that a CEO turnover announcement is useful information for investors in order to make investment decisions. Denis and Denis (1995) also show positive abnormal return (0.63%) for window periods for CEO change announcements. They show that a firm's performance increases after a CEO turnover, too. This confirms the market reaction that a CEO turnover as good news; they perceive that an incoming CEO will make a significant contribution to the firm's performance.

Huson, Malatesta and Parrino (2003) investigate market reaction to CEO change announcements in US over the period of 1971 to 1995. The source of the CEO change is "Forbes" magazine, while the exact announcement date is derived from "Wall Street Journal". Their sample consist of 1200 CEO turnover announcements. Their results show that over a two days observation (t-1 and t0) market reacts positively (CAR 0,354%) to CEO turnover announcements. Huson, Malatesta and Parrino (2003) confirm the results of Weisbach (1988), Bonnier and Brunner (1993), and Denis and Denis (1995), but they are not consistent to Warner, Watts and Wruck (1988). The research of market reaction to CEO turnover in US shows inconsistent results. The next section reviews the research about market reaction to CEO change announcement outside US.

The results of the research conducted about market reaction to CEO turnover in UK shows mixed results, too. Dedmen and Lin (2001) find evidence that UK investor perceive CEO turnover as bad news. The market reacts negatively to CEO turnover announcements. Investor worry that new CEO would not improve firm's performance. On the other hand, the results of Dahyaa and McConnel (2003) are inconsistent to those found by Dedmen and Lin

(2001). Dahyaa and McConnel (2003) investigate on market reaction of 523 CEO turnover announcements, for the period 1988 to 1999. Their results show that there is evidence that UK investors perceive CEO turnover as good news. The market reacts positively and they find an abnormal return of 0.39% (significant at 1% level), at these announcements.

Suchard, Singh and Barr (2001) investigate market reaction to CEO turnover in Australia over the period 1989 to 1995. Their sample consists of 59 CEO turnover announcements. The results show that investor earn a negative abnormal return surrounding the announcements date. Therefore, Australian investor perceived that CEO turnover are bad news. This is consistent to the result found by Dedmen and Lin (2000).

Kang and Shivdasani (1996) investigate investor reaction to CEO succession announcements in Japan. Their sample consists of 432 CEO turnover announcements of the period 1985 to 1990. The results of their research show that market reacts positively to these announcements. Japanese investor perceived that this news is good news; they hope that a new CEO brings new insight into leading the company. Based on the literature review, the hypothesis to test for this research is:

H₀₁ : The Market does not react to CEO turnover announcements

Market Reaction To Routine And Non-Routine Turnover

CEO succession could be a routine or non-routine process. Denis and Denis (1995) investigate the effect of routine and non-routine process on CEO turnover. They identify 69 non-routine and normal processes at CEO turnover. The results show that investors react positively to both processes: non-routine and routine CEO changes of 2.5% and 0.61% abnormal return respectively. They also find that investor reaction to non-routine change is bigger than to normal change.

Neumann and Voetmann (1999) investigate on market reaction to CEO turnover announcements in Denmark. Their sample consists of 39 non-routine change and 42 voluntarily change for the period 1994-1998. The results of their research show that the market reacts positively to non-routine change, but negatively to routine changes. Denmark investors prefer non-routine changes more than routine changes. Dherment-Ferere and Reneboog (2000) confirm the results found by Neumann and Voetmann (1999) using data of France companies.

Dedmen and Lin (2002) investigate the effect of CEO turnover processes on market reaction in UK. Their sample consists of 24 fired turnover process, 28 voluntarily signed off, 22 normal turnover processes, and 10 moved to another firm. They show evidence that market reacts negatively to the processes: fired, voluntarily sign off, and move to another firm. The results of Dedmen and Lin (2002) imply that UK investors perceive a CEO turnover as bad news. Based on literature review, the hypothesis to test for routine and non-routine CEO turnover is:

H₀₂: The market does not react to routine (non-routine) CEO turnover announcements.

Market Reaction To Inside And Outside CEO Turnover

One important factor that affects investor reaction of a CEO turnover announcement is the origin of the successor: inside or outside the firm. Dherment-Ferere and Reneboog (2000) argue that the advantages of incoming CEO from an inside the firm are: firstly, she/he has a better vision and more understanding about the firm's internal condition, product, market, competition with the rival, and relationship with the clients. Secondly, he/she has a better social network, thus he/she will get specific information. They also argue that incoming CEO's from outside the firm can maintain their image, especially when the firm is facing monetary problems or poor performance. Board of directors tends to choose successor candidates from outside, if the firm has a poor performance (Farrel & Whidbee, 2003). If boards still prefer to choose internal candidates when firm suffers of poor performance, it make the firm's image even more negative because the candidate will be responsible for the poor performance. Another advantage from an outside CEO is he/she will bring a new vision to the firm, new passion to reach a better position on the market.

Worrel, Davidson III and Glascock (1993) provide evidence that outside CEOs increase stockholder wealth, but inside CEOs do not have any impact. On the other hand, the research conducted by Dahyaa and McConnell (2003) shows evidence that investors react positively to both types of origin of the successor: inside and outside. Kang and Shivdasani (1996) using Japan data confirm Dahyaa and McConnell (2002) that market reacts positively to both origin of successor: inside and outside. They compare the magnitude of market reaction to inside and outside CEO, and their result shows that the market reacts more favorably to outside CEO than inside CEO (Kang & Shivdasani, 1996, Dahyaa & McConnell, 2002).

Dherment-Ferere and Reneboog (2000) are investigating on market reaction to inside and outside CEO. They do not find significant evidence of market reaction to both origins of successor. Even when firms suffer from poor performance and trying to hire an outside CEO, the market does not react. When the firm enjoys good performance and hire an inside CEO to maintain the firm's stability, investor do not appreciate this. Dherment-Ferere and Reneboog (2000) provide evidence that the market perceives a CEO turnover as not having any content of information.

Based on the literature review that shows an inconsistent result about market reaction to CEO turnover announcement from inside and outside firm (Worrel, Davidson III & Glascock, 1993; Kang & Shivdasani, 1996; Dherment-Ferere & Reneboog, 2000; Dahyaa & McConnell, 2003), the next hypothesis is:

H₀₃: The market does not react to inside (outside) CEO turnover announcements.

Market Reaction To Routine (Non-Routine)/ Inside (Outside) CEO Turnover Announcement

The analysis of market reaction to CEO turnover announcements in this paper consider the combination of organizational factors, too: routine change with inside incoming CEO, routine change with outside incoming CEO, non-routine change with inside incoming CEO, and non-routine change with outside incoming CEO. Kang and Shivdasani (1996) investigate the effect of combination of organizational factors on the market reaction to CEO turnovers in Japan. They find interesting results. The market reacts to CEO turnover announcements when the process is non-routine and firm promotes an outside candidate. Japanese investor perceive that non-routine processes need a new style and leadership that differs from the previous CEO, and therefore the more suitable candidate comes from outside. Kang and Shivdasani (1996) find a positive abnormal return around non-routine outside CEO changes. But, the market does not react when inside candidates handle CEO positions if the process is non-routine. Inside candidates should be responsible for poor performance, and he/she will still use similar approaches like previous CEO to lead the firm. Investors also appreciate inside candidate if the process is non-routine; than the market reacts positively to routine inside CEO changes. Inside candidates will ensure that the firm will use the similar strategy to maintain the position on the market. Clayton, Hartzell and Rosenberg (2002) argue that inside CEOs know firm conditions well enough, thus he/she can lead the firm with similar strategies. They also provide evidence that market does not react to outside candidates if the process is routine.

Based on literature review, the hypotheses are:

H₀₄: The market does not react to routine inside (outside) CEO turnover announcements

H₀₅: The market does not react to non-routine inside (outside) CEO turnover announcements

RESEARCH METHODOLOGY

This research is an event study. The objective of an event study is to test the performance of share prices for window periods for specific events. In this paper the specific event is the CEO turnover announcements. The window period is 11 days around the CEO turnover announcement: 5 days before the announcement date, the announcement date, and 5 days after the announcement date. The hypotheses are tested by using t-test. This paper uses market model to measure abnormal return using. The Jakarta Stock Exchange (JSX) is an emerging stock market, and one of characteristic of an emerging market is that they are thin market. Thin market cause bias in beta

measurements. To minimize the bias in beta measurements the author use Fowler and Rorke (1983) methods 4 lead and 4 lag, as suggested by Hartono and Surianto (2000).

The data of this research are taken from newspapers: “Neraca”, “Kompas” and “Business News” in order to find out the CEO turnover announcement date. The author also tried to contact the firm in order to know the announcement date. The return data were taken from the Accounting Development Center (PPA) at the Faculty of Economics, Universitas Gadjah Mada.

Variable Identification

This section explains how to identify the variables. The Chief Executive Officer is top position of the firm, also known in Bahasa Indonesia (Indonesian language) as Direktur Utama and Presiden Direktur. CEO turnover process can be identified as: routine and non-routine. Routine change is well planned and well structured process, while nonroutine process is an unstructured process. This research looks for related articles about CEO turnovers on newspapers, like: “Neraca”, “Kompas”, and “Business News” newspaper in order to identify the CEO change process as routine or non-routine. If related articles can not be found, the author referred to Kang and Shivdasani (1996) in order to identify the succession process. If outgoing CEOs hold a member or chief Board of Commissioners¹, the succession process is non-routine, but if outgoing CEO does not hold a member or chief Board of Commissioner, the succession process is non-routine. The origin of CEO is divided to inside and outside of the firm. Inside CEO person are defined as a person who is at least 3 years working inside the firm as an employee or the person has a family relation to outgoing CEO. If the incoming CEO does not have family relationship to outgoing CEO and he comes from outside firm we define as outside CEO.

ANALYSIS

Descriptive Statistics

The author found 107 CEO turnover announcements of listed firms from 1992 to 2003 period. By eliminating the confounding effects and incomplete stock prices from the sample list, the final sample consists of 59 turnover announcements. The next step is analyzing the turnover process: there were 22 routine processes and 37 non-routines process and identify 31 inside CEO and 28 outside CEO changes identified. Further analysis shows that routine outside turnover and routine inside turnover are 7 and 15 events, respectively. While non-routine outside and non-routine inside turnover are 21 and 16 events, respectively.

This study considers the Jakarta Stock Exchange as an emerging market. One characteristic of emerging market characteristic is to be thin market, thus the beta have to be adjusted. The author uses the method introduced by Fowler and Rorke (1983) with 4 lead and 4 lag in order to adjust beta as suggested by Hartono and Surianto (2000). The average beta before adjustment is 0.272, and after adjustment 1.09.

Market Reaction To CEO Turnover Announcements

Table 1 shows the market reaction to CEO turnover announcement.

¹ The Indonesian Corporate Law of 1995 requires the two-tier of board systems: board of commissioner and board of directors. Board of commissioner responsible for supervise Board of Directors, while Board of Director function is to manage firm.

Table 1
Market Reaction To CEO Turnover Announcements

Day	CEO		Routine CEO		Non-routine CEO		Inside CEO		Outside CEO		Routine Inside CEO		Routine Outside CEO		Non-routine Inside CEO		Non-routine Outside CEO	
	AAR	t-value	AAR	t-value	AAR	t-value	AAR	t-value	AAR	t-value	AAR	t-value	AAR	t-value	AAR	t-value	AAR	t-value
t-5	0.010	1.921*	0.032	1.678	-0.003	1.153	0.007	0.891	0.014	1.875*	0.029	1.321	0.040	-0.006	-0.017	-0.125	0.005	1.565
t-4	-0.007	-0.691	-0.016	-1.0390	-0.002	-0.078	0.005	0.599	-0.020	-1.641	-0.008	-0.855	-0.032	-0.590	0.017	1.622	-0.017	-1.555
t-3	0.051	1.757*	0.020	2.504**	0.069	0.307	-0.026	-0.547	0.136	3.147***	0.028	2.383**	0.001	0.950	-0.062	-2.350**	0.180	3.086***
t-2	-0.012	-1.536	-0.014	-0.579	-0.011	-1.510	-0.003	-0.218	-0.022	-2.020*	-0.012	-0.279	-0.017	-0.619	0.010	0.128	-0.023	-1.976**
t-1	0.007	0.777	0.005	0.589	0.008	0.535	0.009	0.472	0.005	0.641	0.013	0.818	-0.012	-0.154	0.002	-0.305	0.010	0.829
t-0	-0.008	0.344	-0.000	-0.494	-0.012	0.819	-0.023	-0.976	0.009	1.530	0.005	0.036	-0.012	-0.929	-0.054	-1.462	0.016	2.303**
t+1	0.011	0.855	-0.012	-0.173	0.024	1.223	0.048	2.203**	-0.030	-1.066	0.012	0.582	-0.062	-1.160	0.083	2.332**	-0.020	-0.561
t+2	-0.011	-0.377	-0.021	-0.733	-0.004	0.085	-0.007	-0.072	-0.014	-0.476	-0.014	-0.776	-0.037	-0.163	-0.001	0.662	-0.006	-0.455
t+3	0.020	2.236**	0.033	1.982*	0.013	1.320	0.036	2.513**	0.003	0.629	0.021	1.646	0.057	1.104	0.056	2.017*	-0.015	0.090
t+4	-0.011	-1.060	-0.002	-0.503	-0.016	-0.962	-0.014	-0.825	-0.007	-0.684	-0.010	-1.064	0.016	0.666	-0.019	-0.124	-0.015	-1.174
t+5	0.004	-0.029	0.007	0.644	0.002	-0.533	0.037	2.447**	-0.033	-2.617**	0.032	2.358**	-0.047	-2.310*	0.034	0.764	-0.028	-1.688

* significant 10%, ** significant 5%, *** significant 1%

During the window periods (11 days of observation), the market reacts significant positively at t-5, t-3, and t+3 with an *abnormal return* of 1.006%, 5.07%, and 2.036%. On the other days, the market does not react. The market reacts before the CEO turnover announcements and this suggest that market knew the relevant information in advance. The market reacts in the long term, 3 days after CEO turnover, too. Thus, based on this analysis the CEO turnover announcements have information content.

A CEO turnover is useful information for investors, so they use this information in order to make investment decisions. The market reacts significant which means that the market perceives CEO turnover announcements as good news. Investors perceive that a CEO succession is an effort of the firm to become better. Investors also earn positive abnormal return in window periods. These results confirm Weisbach (1988), Denis and Denis(1995), Kang and Shivdasani (1996), Neumann and Voetmann (1999), Dahyaa and McConnell (2003), and Huson, Malatesta and Parrino (2003) that show CEO turnover are good news. On the other hand this research inconsistent with Reinganum (1985), Warner, Watts and Wruck (1988), Dedmen and Lin (2001), and also Suchard, Sing and Barr (2001).

Market Reaction To CEO Turnover Routine And Nonroutine

Results of testing routine changes show that the market reacts significant positively to CEO turnover announcements at t-3 and t+3. Abnormal return at t-3 is 1.952% (significant at 5% level) and abnormal return at t+3 is 3.259% (significant at 10% level). The market reacts slowly to routine CEO turnover announcements, so investor can earn positive abnormal return at 3 days before and 3 days after CEO turnover announcements.

The market perceives routine CEO turnover announcement as good news and therefore investor reacts positively. Investors believe that a routine turnover does not cause radical changes at firm's management and the new CEO knows well about the firm and he/she can adapt quickly. Based on these results, routine CEO turnover announcements have information content.

The market reaction to non-routine changes in table 1 show different patterns to the market reactions to routine change. During a window period, the market does not react to this information. The market perceives that non-routine CEO turnover does not have any information content. This result is inconsistent to Denis and Denis (1995), Neumann and Voetmann (1999), Dherment-Ferere and Reneboog (2000), and also Dedman and Lin (2002). It is really interesting to analyze the different patterns between market reaction to routine and non-routine CEO changes. Based on this result, Indonesian investors prefer to routine changes to non-routine changes because there will be consistency in the firm's management.

Market Reaction To Inside/Outside CEO Turnover Announcements

Market reaction to inside CEOs show positive reaction at t-3 (1.952%) and t+3 (3.529%). The market perceives that inside CEOs will follow the strategy of the previous CEO did. Investors believe that inside CEOs will have a positive impact to firm performance. The author finds an interesting result when analyzing market reaction to outside CEO. The author finds mixed results: positive and negative reactions at window periods. The market believes that outside CEO turnovers contain good and bad news. Warner, Watts and Wruck (1988) argue that a CEO turnover announcement is a less clear signal. CEO turnover announcement contain complex things: investors believes that the CEO turnover are bad news because they know that firms had a bad performance, and at the same time they believes that CEO turnover are good news because there will be a change in firm management. CEO turnovers contain two things: good news and bad news (Warner, Watts & Wruck, 1988). So, the market reaction to CEO turnover at windows periods can be positive and negative.

Market Reaction To Routine (Non-Routine) Inside (Outside) CEO Turnover

Table 1 show that market reactions to routine CEO turnovers for both inside and outside CEO. But, they have a different direction. The market reacts positively to routine inside, while it reacts negatively to routine outside. This is an interesting fact that the market reacts suitable to process and origin of successor. The market reacts

significant positively to routine inside, because investors believe that new CEO following an existing strategy and therefore there is less uncertainty. But, the market perceives that routine changes with the origin of successor from outside are bad news, because they make a greater uncertainty than inside new CEOs.

Non-routine changes make investor confuse. The market reacts positive and negative at window periods. Non-routine changes with inside CEOs show negative reactions at t-3. Investors bear negative abnormal return of 6.19% (significant 5% level). But investors earn positive abnormal return at the day after the announcements date and t+3 are 8.32% and 5.60%, respectively. Non-routine changes with outside COS also show mixed reactions. The market reacts positively at t-3 (3.79%), but negatively at the next day. At the announcement day, market reacts positively to CEO turnover announcement.

CONCLUSIONS

This paper shows that the market reacts to CEO turnover announcements. CEO turnovers have information content for investor. CEO turnover announcements are good news, so market reacts positively to these announcements. But, when we analyze contextual factors of CEO turnovers, the author finds interesting result. The market prefers routine process and inside new CEOs. Investors believe that these smooth successions lead firm to unradical changes in firm management. Investor can reduce uncertainty factor from CEO turnover processes. But when routine change turnover and new CEO comes from outside, market does not like it and react negatively.

Non-routine CEO changes are mixed signal for investor. They are unsure about the way the new CEO manages the firm. This is reflected by mixed result at window periods, both for non-routine inside and non-routine outside changes. This results confirms Warner, Watts and Wruck (1988) argue that CEO turnover contain mixed signals to investors.

ACKNOWLEDGEMENTS

The researcher got a grant from TPSDP Batch III Accounting Study Program, Faculty of Economics, Universitas Sebelas Maret at Surakarta, Indonesia. He would to thank Santoso Tri Hananto (Universitas Sebelas Maret), Salamah Wahyuni (Universitas Sebelas Maret), Payamta (Universitas Sebelas Maret), Prof Sunardi (Universitas Sebelas Maret), Siswandari (Universitas Sebelas Maret), and Marion Pircher (University of Vienna) for their suggestion to improve this research; and to the research assistances: Wahyanti, Niken Perwitasari, Rully Legha Hariwibowo and Wati Rochayani for their invaluable work.
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NOTES