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CEO Turnover and Market Reaction in Indonesia

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This research examines Chief Executive Officer (CEO) turnover and market reaction in Indonesia. The sample of this research consists of 213 CEO turnover announcements for Indonesia Stock Exchange during 2000–2010 period. T-tests were used to investigate the effect of CEO turnover announcement on abnormal stock return during the event windows periods. The results of this research show that there is positive reaction on the CEO turnover announcements. This research considers both routine and non routine CEO turnover processes. This research finds that both turnover processes have information content to investor. This research also finds positive reaction on the announcements of outsider incoming CEO, while investors do not react on the announcement of insider incoming CEO. Thus, this research provides evidence that CEO turnover announcement have information content.

Keywords: *CEO turnover, stock price, turnover process, the origin of incoming CEO*

Introduction

This research aims at examining the information content of Chief Executive Officer (CEO) turnover in Indonesia. CEO is the person who holds the highest position in a company. CEO is a very important person as CEO is regarded as the icon and the role model of his company (Dierickx and Veneziano, 2008). CEO holds strategic functions such as formulating and implementing the vision and mission of the company, developing firm strategy to achieve short-term and long-term objectives, as well as making strategic investment decisions (Canals, 2010). Miller et al. (2011) and Zhang and Rajagopalan (2010) found that CEO has significant effect on the choice of firm strategy. Mackey (2008) found evidence that CEO has significant influence on firm performance. Kodrat and Gunawan (2008) argued that succession of CEO is the most important agenda for a company because it has significant effect on the firm future sustainability. A survey by Chua et al. (2003) on family firm in Canada found that CEO succession issue is regarded as the top priority issue by most companies. Therefore, CEO turnover is an important event for companies.

Since CEO turnover is an important event for companies, investors are expected to react to the announcement of such news. This

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implies that CEO turnover announcement has information content. Previous research on the market reaction to CEO turnover announcement provided inconclusive results. Studies conducted by Bonnier and Bruner (1989), Huson et al. (2004) in the United States, Dahya and McConnell (2005) in the United Kingdom, and Kang and Shivdasani (1996) in Japan present evidence on positive reaction to the CEO turnover announcements. On the other hand, there is evidence on negative reaction to the announcement of CEO turnover in Australia as reported by Suchard et al. (2001) and the United Kingdom as documented by Dedman and Lin (2002) and Hillier et al. (2006). In addition, Warner et al. (1988) report insignificant effect of CEO turnover in the United States.

Reinganum (1985) argued that the origin of CEO and the succession process should be taken into consideration in analyzing the effect of CEO turnover on stock market. The origin of incoming CEO can be divided into inside and outside incoming CEO. Empirical evidence on the market reaction to the CEO turnover announcement based on origin of incoming CEO found that investors prefer outsider than insider (Kang and Shivdasani, 1996; Worrel et al., 1993). There are two succession processes: routine and non routine CEO turnover process. Previous empirical research show investors reacted positively to non routine turnover (Cools and van Praag, 2007). However, there is evidence that investors react positively to routine CEO turnover announcements (Shen and Cannella, 2003).

Previous research on market reaction to CEO turnover in Indonesia was conducted by Setiawan (2008). His research period is 1992 to 2003 and he found positive reaction around CEO turnover. This research extends Setiawan (2008) research using newer data which covers CEO turnover events during 2000-2010. The objectives of this research are: (1) to examine market reaction to the announcements of CEO turnover in Indonesia; (2) to examine market reaction to the announcements of CEO turnover in Indonesia, based on the succession process that is routine and non routine succession process; and (3) to examine market reaction to the announcement of CEO turnover in Indonesia, based on the origin of CEO that is inside and outside CEO.

Literature Review

Information content of CEO turnover announcement

Indonesia adopts the two-tier board system which comprises of the board of directors and the board of commissioners. The board of directors manages the operations of the companies, while board of commissioners is responsible for monitoring and giving advice to the board of directors. Both board of directors and board of commissioners are appointed and dismissed by the Annual General Meeting of Shareholders. The board of commissioners does not have the full authorithy to dismiss the board of directors. Instead, they are only given the authority to temporary dismiss the board of directors. The final decision is only made in the Annual General Meeting of Shareholders. The CEO, or *Presiden Direktur* or *direktur utama* in Indonesian language is the coordinator. The CEO is responsible for the strategic function of the companies.

Foster (1986) stated that CEO turnover announcement is regarded as an important news whereby shareholders and investors are expected to react to the announcement. In other words, the CEO turnover announcement is one of the information used by investors to make investment decisions. This means CEO turnover announcement has information content to investors. Nevertheless, Warner et al. (1988) argued the information is ambiguous as it contains both good and bad news simultaneously. A CEO turnover event due to poor performance would be regarded as bad news and thus investors would react negatively to the news. At the same time, investors believe that the incoming CEO is capable to lead the company to achieve better performance and hence are pleased about the change. Therefore, investors are faced with two competing information: good news and bad news. The net effect of this information would be reflected by the investors' reaction. If good news (bad news) is perceived to be more dominant than the bad news (good news), there would be a positive (negative) reaction on the CEO turnover announcement. Salas (2010) found negative reaction on the announcement day and positive reaction on the subsequent day for the announcement of suddent executive death. This result supported Warner et al. (1988), who found that CEO turnover provides mixed signal. Cools and van Praag (2007) investigated market reaction on the CEO turnover in Netherland. They reported no significant effect of the CEO turnover announcement on the stock return. However, they did find significant trading volume activity around the turnover. They argued that the insignificant result of abnormal return around the CEO turnover announcement was due to competing information conveyed by the announcement. Hence, they concluded that CEO turnover has information content to investors.

Huson et al. (2004) investigated the effect of CEO turnover on firm's performance. They found positive effect of CEO turnover on firm performance. Incoming CEO is able to increase firm performance. This is in line with investors' expectation. There is a positive abnormal return around the CEO turnover announcement. Investors perceive CEO turnover announcement as good news because it contains positive information. Therefore, investors react positively. This result supported Bonnier and Bruner's (1989) findings. Their sample consisted of 87 senior management change on distressed companies for the periods of 1969 to 1983. The result of their research showed positive abnormal return around the announcement. Rhim et al. (2006) investigated the market reaction on 211 CEO turnover announcement during 1977-1994 in the United States. The result of their research showed significant positive abnormal return on the announcement date.

Kang and Shivdasani (1996) investigated the effect of CEO turnover on shareholders' wealth in Japan. Their sample consisted of 416 firms from 1985 to 1990. The result of their research showed positive abnormal return around the CEO turnover announcement. This suggested that Japanese's investors perceive CEO turnover announcement as a good news. Setiawan (2008) examined market reaction to CEO turnover in Indonesia during 1992–2003 using a sample of 59 turnover announcements. The result of this research showed positive reaction around CEO turnover in Indonesia.

On the other hand, Suchard et al. (2001) investigated market reaction to the announcement of CEO turnover in Australia. Their sample consisted of 59 CEO turnover during the 1989 to 1995 period. The result of their research showed negative abnormal return at one day after the announcement. This indicated that Australian investors perceive CEO turnover as bad news and thus reacted negatively. This result is supported by Dedman and Lin (2002) and Hillier et al. (2006), who examined the United Kingdom sample. Dedman and Lin (2002) found negative reaction during two days surrounding the announcement of 251 CEO turnover events during 1990–1995. Hillier et al. (2006) examined the market reaction on the CEO turnover announcement in United Kingdom during the 1993 to 2000 periods. Their sample consisted of 705 CEO turnover announcements. The result of their research showed that market reacted negatively to the announcement of CEO turnover. This suggested that investors in the United Kingdom perceive the CEO turnover as bad news and reacted negatively.

Warner et al. (1988) investigated the market reaction on the announcement of CEO turnover in the United States during 1963-1978. The result of their research did not find significant abnormal return around the succession. They argued that the insignificant result is due to competing information which offsetting each other. Therefore, the net effect is not significant. This result is in line with Reinganum (1985) who did not find significant reaction during the announcement of management change in the United States during 1978–1979 period.

Information content of CEO turnover announcement based on the origin of incoming CEO

There are two types of incoming CEO based on the origin: insider CEO and outsider CEO.

Insider CEO has advantages over the outsider as he has better knowledge and understanding about the companies environment and networks. Promoting an internal candidate as the CEO also creates healthy competition among potential internal candidates (Kato and Long, 2011). Such competition motivates internal candidates to work harder to show their capability in leading the companies which in turn may lead to better firm performance. Besides, such competition among candidates also produces a number of potential candidates to replace the CEO immediately if the present CEO leaves the company unexpectedly due to disagreement with board of directors or sudden death. Zhang and Rajagopalan (2010) found that insider CEO performed better than the outsider. On the other hand, if the companies need radical change in their strategy, outsider CEO performed better. Outsider CEO brings fresh blood and new ideas to the companies.

Charitou et al. (2010) examined the effect of appointment of outsider as the incoming CEO in the United States. Their sample consisted of 158 firms during 1993 to 2005. The result of their research showed that there is a positive market reaction on the day of announcement and the subsequent day. This indicated that investors perceive outsider incoming CEO as good news. This result is in line with Dahya and McConnell (2005) and Kang and Shivdasani (1996) who examined the United Kingdom and Japan samples, respectively.

Kang and Shivdasani (1996) also investigated the market reaction to the appointment of insider CEO. They reported positive market reaction. The market perceive internal incoming CEO as good news and thus reacted positively. On the other hand, Dahya and McConnell (2005) did not find significant reaction to the announcement of insider incoming CEO. Further, Dahya and McConnell (2005) and Kang and Shivdasani (1996) compared the market response to the the announcement of incoming CEO from outside and inside. They found market reaction to outside CEO is larger than the inside CEO. Therefore, their results suggested that the market prefers outside CEO as compared to inside CEO.

Information content of CEO turnover announcement based on the turnover process

There are two succession processes: routine and non routine CEO turnover process. Routine turnover process is a scheduled and planned process and non routine turnover process is an unexpected succession due to unexpected events such as: departing CEO is fired, departing CEO is resigned because disagreement between the CEO and the board of directors. Weisbach (1988) investigated the market reaction to the announcement of CEO resignation in the United States. His sample consisted of 376 firms during 1974 to 1983 period. The result of his research showed that the market reacted positively to the announcement of CEO turnover for non routine turnover. Investors perceive incoming CEO as good news because new CEO would bring new ideas to the company. Investors expect that incoming CEO will lead company to better performance. This result is in line with Denis and Denis (1995) findings. They found positive reaction to the announcement of CEO turnover under forced resignation process. The market reaction to the forced resignation is larger than the reaction to the mandatoty resignation. Rhim et al. (2006) also reported that investors reacted positively to the non routine turnover in the United States, but they did not react to routine turnover. These results showed non routine turnover has information content to the United States investor.

Cools and van Praag (2007) examined CEO turnover announcement in Netherland. The result of their research showed that Netherland investors perceive non routine turnover as good news. Therefore, investors reacted positively to the announcement of non routine CEO turnover. Neumann and Voetmann (2005) investigated market reaction to the announcement of CEO turnover, based on the turnover process in Denmark. The result of their research showed that Denmark investors perceive non routine turnover as good news. Thus, they reacted positively to the announcement. On the other hand, they perceive voluntary resignation as bad news. Therefore, they reacted negatively to the announcement of CEO turnover due to voluntary resignation. Neumann and Voetmann's (2005) finding is in line with Dherment-Ferere and Renneboog (2002) in the case of France.

On the other hand, Dedman and Lin (2002) presented evidence that the United Kingdom investors perceive non routine turnover due to dismissal and resignation as bad news and reacted negatively to the announcement of non routine turnover. Shen and Cannella (2003) examined the market reaction to the relay succession in the United States and found positive reaction on the promotion of the heir to the CEO position. This result shows promotion of heir as the CEO is a good news for the investors and investors reacted positively. However, Danisevska (2004) did not find significant market reaction on the announcement of CEO turnover for voluntary departure as well as forced departure in Netherland. Except for Danisevska (2004), the above results showed CEO turnover announcement with turnover process consideration has information content.

Information content of CEO turnover announcement based on the turnover process and the origin of incoming CEO

Kang and Shivdasani (1996) suggested to consider both turnover process and the origin of CEO in analyzing the market reaction to CEO turnover announcements. If the CEO was dismissed due to poor performance, it is considerd as a non routine turnover process, the company will need significant change to be introduced to its strategy and management. Therefore, outside incoming CEO would be more suitable candidate. Investors perceive external candidate as a signal of the firm to make significant effort for change. On the other hand, if the succession is a routine turnover, insider incoming CEO is more preferable. Kang and Shivdasani (1996) found evidence that the market reacted positively to routine turnover with insider incoming CEO and non routine turnover with outsider incoming CEO. However, they did not find significant reaction on the routine turnover with outsider incoming CEO and non routine turnover with inside incoming CEO. Dherment-Ferere and Renneboog (2002) investigated how market reacted to the origin of CEO with the conditionality of past performance. If past performance is poor (good), it is expected outsider (insider) will step up as the CEO. The result of their research showed that there is no significant reaction, except that there is negative reaction on the outsider appointment as CEO when the past performance is good. These results showed the importance of considering both turnover process and the origin of CEO in analyzing how market react to the announcement of CEO turnover.

Research Method

The sample of this research consisted of CEO turnover announcement by Indonesian Stock Exchange from January 1st 2000 to December 31st 2010. Then, we identified CEO change from the Indonesian Capital Market Directory. We compared the composition of the board of directors of year t with year t-1. If there is a change of CEO, it is identified as CEO turnover. In order to determine the announcement date, we traced the announcement from the Indonesian national newspaper: Kompas and Bisnis Indonesia. We find 340 CEO turnover announcements during the observation periods. However, 39 CEO turnover are not usable due to incomplete data. Out of 301 CEO turnover events, there are 88 CEO turnover announcement which published simultaneously with the company's other action events. Therefore, our non confounding CEO turnover events consist of 213 announcements.

Further, we classify internal incoming CEO as employee of the company or a person who is a member of the controlling family. Otherwise, we classify incoming CEO as outside incoming CEO. Thus, inside incoming CEO and outsider incoming CEO detected are 112 and 101 events respectively. Next, we classify turnover process as non routine turnover if departing CEO is not part of the board of commissioners. Otherwise, we classify it as routine turnover. This definition follows Kang and Shivdasani (1996) classification. Therefore, non routine turnover and routine turnover CEO turnover process are 89 and 124 events, respectively.

Table 1. CEO turnover and market reaction in Indonesia

Day	All samples	Routine CEO turnover	Non routine CEO turnover	Inside CEO	Outside CEO	Routine inside CEO turnover	Routine outside CEO turnover	Non routine inside CEO turnover	Non routine outside CEO turnover
-5	-0.2902	0.0735	0.0283	0.0335	-0.4731	-0.3782	0.4660	0.3106	-0.2605
	-0.5585	0.1071	0.0348	0.0464	-0.6075	-0.0261	0.4690	0.2760	-0.2144
-4	0.1290	0.5708	0.3656	-0.0580	0.3396	-0.9074	1.8450*	0.1092	0.7120
	0.2482	0.8319	0.4490	-0.0804	0.436	-0.0627	1.8560	0.0970	0.5860
-3	0.2365	1.0032	-0.0739	-0.1265	0.6528	0.7313	1.2480	-1.5620	1.3034
	0.4552	1.4622	-0.0907	-0.1754	0.8382	0.0500	1.2560	-1.3882	1.0727
-2	2.0144 ***	2.6636***	3.5770***	0.4048	3.6549***	0.6045	4.4110***	0.0486***	6.9450
	3.8772	3.8822	4.3925	0.5611	4.6928	0.0418	4.4370	0.0432	5.7160
-1	0.6851	0.7214	0.7163	0.2927	1.1257	1.1271	0.3490	-0.8133	2.1780
	1.3186	1.0514	0.8796	0.5611	1.4454	0.0418	0.3510	-0.7228	1.7926
0	0.3126	3.0587***	0.0119	-0.6626	1.3439	0.2231	5.4670***	-1.6022	1.8318
	0.6018	4.4580	0.0146	-0.9185	1.7255	0.0154	5.5000	-1.4239	1.5076
1	-0.0971	1.1077	-1.0079	-0.1136	-0.1004	0.6525	1.4540	-1.1685	-0.8466
	-0.1870	1.6145	-1.2376	-0.1574	-0.1289	0.0451	1.4630	-1.0385	-0.6968
2	0.3384	1.9903***	0.5079	0.6676	0.0272	0.5425	3.1540***	0.5443	0.4054
	0.6513	2.9008	0.6237	0.9253	0.0350	0.0375	3.1730	0.4838	0.3337
3	0.4398	0.5445	0.5029	0.3045	0.5990	0.0661	0.9730	0.7146	0.3120
	0.8465	0.7936	0.6175	0.4221	0.7691	0.0046	0.9790	0.6351	0.2568
4	0.2099	1.6960**	0.5945	0.5440	-0.0813	-0.3440	3.4290***	1.3438	-0.2558
	0.4040	2.4719	0.7301	0.7540	-0.1044	-0.0238	3.4500	1.1942	-0.2105
5	0.4156	1.4170**	-0.2976	0.3579	0.4288	0.7673	1.8950*	-0.3576	-0.2702
	0.8000	2.0653	-0.3654	0.4961	0.5506	0.0530	1.9070	-0.3178	-0.2224
	N = 213	N = 124	N = 89	N = 112	N = 101	N = 57	N = 67	N = 45	N = 44

***, **, * significant at 1%, 5%, and 10%

This research uses event study to investigate information content of CEO turnover in Indonesia. We use market model with 250 days estimation period and 11 days window period to measure abnormal return. Since Indonesian Stock Exchange is an emerging market, one of the characteristics of emerging markets is the thin market. Therefore, this study uses Fowler and Rorke 4 lead and 4 lag method (Hartono and Surianto, 2000) to adjust for beta. We use *t*-test to test the differences in the abnormal return around CEO turnover announcements.

Result and Discussion

This section discusses the results of the present study. As depicted in Table 1, abnormal return at *t*-5, *t*-4 and *t*-3 are not significant. However, two days before the CEO turnover announcement date for all sample, there is significant abnormal return (2.01%). This result is significant at 1%. On the announcement date, there is positive abnormal return. However, it is not significant. In the observation after CEO turnover announcement, there are no significant abnormal return. The significant reaction at *t*-2 shows that Indonesian investors perceive CEO turnover as good news. Investors expect that the change in CEO has significant impact to increase future firm performance. Thus, investors reacted positively to the CEO turnover announcement. This result is consistent with Bonnier and Bruner (1989), Huson et al. (2004), and Kang and Shivdasani (1996), who found market reacted positively to the announcement of CEO turnover.

This result shows that CEO turnover announcement has an impact on market reaction. Indonesian investors use this information to make investment decision. Indonesian investors perceive CEO turnover as good news because they expect this succession event has positive effect on the firm future performance. Investors expect incoming CEO to make strategic decision to lead the companies to achieve better performance. Therefore, investors reacted positively to the CEO turnover announcement.

The result on the market reaction to the CEO turnover announcement with insider incoming CEO showed that there is no significant abnormal return before the CEO announcement. The insignificant reaction also happened at

CEO turnover announcement date and after announcement date. There is no significant abnormal return during 11 days windows period. This result shows that Indonesian investor does not react on the announcement of insider incoming CEO. On the other hand, Indonesian investors perceive the announcement of insider incoming CEO does not have information content. Indonesian investors expect firm will make significant change on firm strategy to face market competition. Therefore, investors prefer outsider incoming CEO.

On the other hand, Indonesian investors react to the announcement of outside incoming CEO. There is a positive abnormal return (3.6549%), significant at 1%, at *t*-2. However, there is insignificant abnormal return on the announcement date. This reaction shows that Indonesian investors perceive outsider incoming CEO as good news. They expect outsider incoming CEO would bring new ideas to manage the company and to introduce better strategy to lead the company to achieve better future performance. This result is in line with Charitou et al. (2010), Dahya and McConnell (2005), and Kang and Shivdasani (1996).

The analysis of market reaction to the announcement of CEO turnover based on the origin of CEO shows that the market reacted positively to outside incoming CEO, but market does not react to the announcement of incoming CEO. This result shows that Indonesian investors prefer outside incoming CEO to insider. This result shows that Indonesian investors expect outsider incoming CEO bring different idea and strategy to lead the companies to achieve better performance.

From Table 1, the result of investigation on the market reaction to announcement of CEO turnover based on routine turnover shows that there is significant abnormal return at *t*+4. There is positive abnormal return 2.6636% at *t*-2. On the announcement date, market also reacts positively to the routine process. This result shows that Indonesian investors perceive routine turnover as a good news. Therefore, investors react positively. Further analysis shows investors react positively at *t*+2 (1.9903%), *t*+4 (1.6960%), and *t*+5 (1.4170%). Indonesian investors use information about routine turnover to make investment decision. Further, the result of market reaction to the non routine turnover shows positive reaction at *t*-2 (3.5770%). This positive reaction shows that Indonesian investors perceive non routine turnover as a good news. Thus, investors reacted positively. This result supported Rhim et al. (2006), Cools and van Praag (2007), Denis and Denis (1995), Neumann and Voetmann (2005), and Weisbach (1988), who found positive reaction on the non routine turnover.

This research showed that Indonesian investors use information about turnover process to make investment decisions. The analysis of market reaction to the announcement of CEO turnover based on the turnover process shows that the market reacted positively regardless of the turnover process. Indonesian investors perceived the announcement of CEO turnover with routine and non routine turnover as good news. Therefore, CEO turnover announcement by taking into account the turnover process has positive market reaction.

Further, this research investigates how Indonesian investors react to the routine turnover with inside incoming CEO (routine inside), routine turnover with outside incoming CEO, non routine turnover with inside incoming CEO (non routine inside), and non routine turnover with outside incoming CEO (non routine outside). The result of this research shows market does not react to the announcement of routine inside. This type of turnover (routine inside) is a signal that firm is satisfied with firm performance and strategy, therefore the succession is well planned and incoming CEO comes from insider. Incoming CEO tends to follow existing strategy. Indonesian investors expect that firms will make something new on their strategy, therefore investors do not react to routine inside turnover.

On the other hand, the result of market reaction to the announcement of routine outside shows that investor react positively. Before announcement date, there are positive reactions at *t*-4 (1.8445%) and *t*-2 (4.4105%). This research also finds positive reaction on announcement date (5.4673%). Further analysis after announcement date, it shows positive reactions at *t*+2 (3.1540%), *t*+4 (3.4280%) and *t*+5 (1.8950%). This result shows that Indonesian investors perceive routine outside turnover is a good news. Thus, investors react positively. Routine outside CEO turnover provides signal to the investor, that firms in a good condition and they want to make significant movement through recruiting outside incoming CEO. It is expected that outside incoming CEO brings new strategy and more fresh idea to develop firm performance.

From Table 1, we can see that market does not react to the announcement of non routine turnover. Indonesian investors perceive non routine turnover process with insider step up as firm CEO do not have information content. Therefore, investors do not make investment decision based on this information. However, Indonesian investors react positively to the announcement of non routine turnover when outside candidate becomes top manager. Investors expect that outside incoming CEO are able to lead the companies to achieve better performance.

The result of the market reaction on the announcement of CEO turnover with consideration of turnover process and the origin of CEO show Indonesian investors perceive both kinds of information is important. Indonesian investors perceive outside incoming CEO process as good news regardless the turnover process CEO. On the other hand, Indonesian investors do not react to the announcement of incoming CEO regardless turnover process.

Conclusion

This research found that the announcement of CEO turnover in Indonesia has information content. Indonesian investors perceive CEO turnover as good news. Thus, they reacted positively. Indonesian investors also perceive non routine turnover process and both inside and outside CEO have positive information content. However, Indonesia investors' reaction is mixed on the announcement of routine CEO turnover process. Further, we analyze the combination of turnover process and the origin of CEO. The result of this analysis shows that the market reacted positively to the announcement of outside incoming CEO for both routine and non routine process and inside incoming CEO for non routine process. However, we found mixed reaction on the inside routine CEO. These results show CEO turnover in Indonesia has important information content for investors.

The result of this research shows Indonesian investors prefer outside CEO as positive reaction, regardless of the turnover process. Indonesian investors expect outside CEO bring new idea and fresh blood to lead the company to achieve better future performance. However, as this study uses event study, we do not test the effect of CEO turnover on the firm performance. This will be an agenda for future research.

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