



American Finance Association

Performance Changes Following Top Management Dismissals

Author(s): David J. Denis and Diane K. Denis

Source: *The Journal of Finance*, Vol. 50, No. 4 (Sep., 1995), pp. 1029-1057

Published by: Blackwell Publishing for the American Finance Association

Stable URL: <http://www.jstor.org/stable/2329343>

Accessed: 25/11/2009 10:30

Your use of the JSTOR archive indicates your acceptance of JSTOR's Terms and Conditions of Use, available at <http://www.jstor.org/page/info/about/policies/terms.jsp>. JSTOR's Terms and Conditions of Use provides, in part, that unless you have obtained prior permission, you may not download an entire issue of a journal or multiple copies of articles, and you may use content in the JSTOR archive only for your personal, non-commercial use.

Please contact the publisher regarding any further use of this work. Publisher contact information may be obtained at <http://www.jstor.org/action/showPublisher?publisherCode=black>.

Each copy of any part of a JSTOR transmission must contain the same copyright notice that appears on the screen or printed page of such transmission.

JSTOR is a not-for-profit service that helps scholars, researchers, and students discover, use, and build upon a wide range of content in a trusted digital archive. We use information technology and tools to increase productivity and facilitate new forms of scholarship. For more information about JSTOR, please contact support@jstor.org.



Blackwell Publishing and American Finance Association are collaborating with JSTOR to digitize, preserve and extend access to *The Journal of Finance*.

<http://www.jstor.org>

Performance Changes Following Top Management Dismissals

DAVID J. DENIS AND DIANE K. DENIS*

ABSTRACT

We document that forced resignations of top managers are preceded by large and significant declines in operating performance and followed by large improvements in performance. However, forced resignations are rare and are due more often to external factors (e.g., blockholder pressure, takeover attempts, etc.) than to normal board monitoring. Following the management change, these firms significantly downsize their operations and are subject to a high rate of corporate control activity. Normal retirements are followed by small increases in operating income and are also subject to a slightly higher than normal incidence of postturnover corporate control activity.

INTERNAL MONITORING MECHANISMS HAVE recently received considerable attention in the wake of highly publicized Chief Executive Officer (CEO) dismissals at well-known firms such as General Motors, Kodak, IBM, and American Express.¹ In addition, the importance of internal control mechanisms has arguably increased following legal and regulatory developments that have curtailed activity in the external market for corporate control (see Jensen (1991)). However, there is surprisingly little evidence on the effectiveness of internal control devices in generating improvements in corporate performance.

If internal control mechanisms are effective, there should be i) a greater incidence of top management changes in poorly performing firms, and ii) improvements in firm performance following management changes. Consistent with i), Coughlan and Schmidt (1985) and Warner, Watts, and Wruck (1988) document that the rate of top management change is inversely related to prior stock price performance. Moreover, Weisbach (1988) finds that this relation is stronger for firms with a greater fraction of independent outsiders on the board of directors. These findings are consistent with boards of directors serving an important role in monitoring and disciplining poorly performing managers.

In this study, we examine whether management turnover leads to improved firm performance. While removing poorly performing managers is an important step toward maximizing shareholder wealth, a corporate board must also

* Krannert School of Management, Purdue University, West Lafayette, Indiana. We are grateful for helpful comments received from Linda DeAngelo, Rob Hansen, Greg Kadlec, Scott Lee, David Mayers, Dilip Shome, René Stulz (the editor), Michael Weisbach, Marc Zenner, two anonymous referees, and the workshop participants at North Carolina State University, Ohio State University, and Virginia Tech. This work has been partially supported by summer research grants from the Pamplin College of Business at Virginia Tech.

¹ For an account of several recent board-initiated top management changes at large firms see Stewart (1993).

be able to identify and attract superior replacement managers. Evidence on whether or not boards actually do so is necessary to address the effectiveness of internal monitoring. Moreover, although a negative relation between prior stock price performance and turnover is consistent with effective board monitoring, it is also consistent with two alternative interpretations. First, managers may voluntarily resign from poorly performing firms, perhaps to avoid shareholder lawsuits. Second, corporate boards may replace managers of poorly performing firms even if the managers are not responsible for the poor performance. (See, for example, Khanna and Poulsen (1994).) Under neither of these scenarios would a change in management necessarily be expected to generate performance improvements.

Our sample consists of 908 nontakeover-related top management changes announced in the *Wall Street Journal* over the period 1985 to 1988. Consistent with prior studies, our sample firms exhibit poor stock price performance prior to the management change. In addition, we find that announcements of management changes are associated with abnormal returns that are significantly positive (but economically small) for the 107 departures that we classify as forced resignations and are insignificant for the 110 departures that we classify as normal retirements. However, interpretation of these event-study results is difficult; a management change may signal that firm performance is worse than expected, that firm performance will improve as a result of the management change, or that the firm is "in play" as a takeover target. Moreover, top management changes are likely to be partially anticipated due to the poor preturnover firm performance.

Thus, in order to assess whether management turnover improves firm performance, we examine accounting data for the seven years centered on the year of the management change. We find that, on average, the ratio of operating income to total assets decreases in the three years prior to a management change and increases following the change. This overall result masks a considerable difference between forced resignations and normal retirements. Forced resignations exhibit large and significant decreases in operating performance prior to management changes and significant improvements following these changes. Normal retirements do not exhibit performance declines prior to the management change, but do exhibit small performance improvements following the change. In addition, both forced resignations and normal retirements exhibit a substantial amount of postturnover corporate restructuring—asset sales, layoffs, cost-cutting measures, etc.

Although performance improvements and corporate restructuring following forced resignations are consistent with effective board monitoring of top management, forced resignations are relatively rare. In addition, examination of the *Wall Street Journal Index* in the year prior to the forced top executive resignations reveals that 68 percent of these dismissals are preceded by active monitoring by parties other than the board of directors; e.g., large blockholders, other shareholders, creditors, and potential acquirers. Moreover, we find that 56 percent of the firms with a forced top executive change are the target of some form of corporate control activity (e.g., a block investment in the firm's

shares, a takeover of the firm, a leveraged buyout of the firm, or an unsuccessful takeover attempt for the firm) in the two years following the management turnover. Collectively, these findings provide little support for the hypothesis that boards of directors function effectively in isolation.

The remainder of the article is organized as follows. In Section I, we discuss our sample selection procedure and describe our samples of forced resignations and normal retirements. In Section II, we present event-study results documenting the preturndover stock price performance and announcement-period abnormal returns associated with our sample management changes. Section III documents accounting performance measures for the seven-year period centered on the year of the management change. Section IV provides details on the extent of postturnover restructuring and corporate control activity. Section V concludes.

I. Sample Selection and Description

A. Identifying and Describing Top Management Changes

Our sample is drawn from the 1,689 firms covered by the *Value Line Investment Survey (Value Line)* as of year-end 1984. For each firm, we identify top management turnover by following the composition of the top management team, defined as the CEO, chairperson of the board, and president, for a period of four years using Standard and Poor's *Register of Corporations, Directors, and Executives (Register)*. We define the top executive to be the CEO if there is one and the chairperson otherwise; any change in the identity of the top executive is defined to be turnover. We also include as turnover any change in the identity of the president or chairperson that results in a change in the composition of the top management team as a whole.

Of the 1,689 sample firms, 909 experience at least one instance of turnover. These 909 firms experience a total of 1,480 changes in top management over the 1985 to 1988 period, 581 of which involve a change in the top executive. Thus, the overall annual turnover rate is 21.9 percent, slightly higher than the 18.3 percent rate documented in Warner, Watts, and Wruck (1988).² The annual top executive turnover rate is 9.3 percent; Weisbach (1988) documents a 7.8 percent rate for CEO changes.³

² This rate is computed as the total number of management changes divided by the total number of firm-years (1,689 firms times four years) in the sample. The rate will understate the true turnover rate to the extent that some firms are delisted (e.g., mergers, liquidations, etc.) between 1985 and 1988.

³ Turnover rates conditional on other events related to corporate control or financial distress are much higher. Although not directly comparable due to differences in the definition of turnover and sampling periods, turnover rates are 42 percent following corporate takeovers (Martin and McConnell (1991)), 44 percent following unsuccessful acquisition attempts (Agrawal and Walkling (1994)), 33 percent following negotiated block trades (Barclay and Holderness (1991)), 51 percent following proxy contests (DeAngelo and DeAngelo (1989)), 40 percent following defensive share repurchases and special dividends (Denis (1990)), 40 percent following greenmail payments (Klein and Rosenfeld (1988)), and 52 percent following the onset of financial distress (Gilson (1989)).

We are unable to find a CUSIP number for 59 firms involving 92 turnovers. For each of the remaining 1,388 top management changes recorded from the *Register*, we search the *Wall Street Journal Index* and are able to identify announcement dates for 966 (70 percent) of them. For each of these, we read the entire *Wall Street Journal* article describing the change and record the following information: the reason given for the change (if any), the identity and previous employment of the new manager, the destination and age of the departing manager, and whether or not the management change was associated with a change in the control of the firm. Since we are interested in the performance effects associated with internal control mechanisms, we eliminate those 58 management changes directly associated with an acquisition of the firm.⁴ This leaves us with a final sample of 908 management changes.

Table I summarizes the reasons for turnover, the previous employment of the successor, and the destination of the departing manager for the 908 management changes. Throughout the paper, we report results separately for the sample of all management changes and for the subsample involving changes in the top executive. From Panel A, it is clear that retirement is the most common stated reason for a management change, accounting for 26 percent of all management changes and 29 percent of those changes involving the top executive. The next most common stated reason is forced resignation or conflict, which accounts for 7 percent of all management changes and 14 percent of those changes involving the top executive. No other stated reason accounts for more than 7 percent of the management changes in either subsample. We are unable to identify a stated reason for 309 (34 percent) of the 908 management changes.

In Panel B, we document the previous employment of the new managers. The new managers typically are employed by the firm prior to becoming a member of the top management team. This is true for 72 percent of all management changes and 65 percent of those changes involving the top executive. In 12 percent of all management changes, the new manager was not employed by the firm immediately prior to the change. This is true in 15 percent of the changes involving the top executive. The new manager was previously an outside director in 4 percent of all management changes and 7 percent of those changes involving the top executive.

In Panel C, we report the destination of the departing manager. The departing manager leaves the firm in 48 percent of all management changes and 58 percent of those changes involving the top executive. In 27 percent of all changes and 21 percent of those cases involving the top executive, the departing manager retains one of the top three management positions (usually chairperson of the board). In 20 percent of all changes and 17 percent of those changes involving the top executive, the departing manager retains a seat on the board of directors but is not chairperson.

⁴ See Martin and McConnell (1991) for a study of top management changes following corporate takeovers.

Table I
Description of Management Changes

Sample frequencies of reasons for management turnover, the previous employment of the new manager, and the destination of the departing manager for a sample of 908 management changes over the period 1985 to 1988. The sample is obtained by identifying any change in the set of individuals occupying the positions of Chief Executive Officer (CEO), chairperson of the board, and president for the 1,689 firms included in the *Value Line Investment Survey* as of year-end 1984. Management changes are identified from Standard and Poor's *Register of Corporations, Directors, and Executives* and confirmed in the *Wall Street Journal Index*. The top executive is defined to be the CEO if there is one, and the chairperson otherwise.

	All Management Changes		Top Executive Changes	
	Number	% of Sample	Number	% of Sample
Panel A: Reason for Turnover				
Forced resignation/conflict	66	7.3	48	13.6
Poor performance	22	2.4	16	4.5
Pursue other interests	63	7.0	23	6.5
Unexpected retirement	11	1.2	5	1.4
Retirement	240	26.4	101	28.6
Normal succession	24	2.6	11	3.1
Death/illness	32	3.5	15	4.3
Take position at other firm	28	3.1	16	4.5
No manager left firm	57	6.3	10	2.9
Other	56	6.2	19	5.4
No reason given	309	34.0	89	25.2
Panel B: Previous Employment of New Manager				
External appointment	113	12.4	54	15.3
Outside director	39	4.3	25	7.1
Current employee	652	71.8	228	64.6
Position not filled	69	7.6	31	8.8
Unknown	35	3.9	15	4.2
Panel C: Destination of Departing Manager				
Left firm	432	47.6	205	58.1
Remained in top 3 managers	245	27.0	74	21.0
Remained director	178	19.6	60	17.0
Remained other employee	8	0.9	4	1.1
Unknown	45	4.9	10	2.8

B. Identifying Forced Departures and Normal Retirements

To assess the effectiveness of internal control mechanisms, we are interested in comparing samples of top management changes that are forced departures with those that are normal retirements.⁵ Unfortunately, as noted in Warner, Watts, and Wruck (1988) and Weisbach (1988), identification of forced departures is difficult because press releases often do not describe them as such. Thus, for example, a stated retirement may really be a forced departure. However, if a press report does indicate that a management change is forced or that it is due to poor performance, we can be confident that the change is indeed forced.

We attempt to identify distinguishing characteristics of forced resignations so that we can classify management changes that share these characteristics as forced resignations, even if they are not explicitly stated as such. To do this, we compare management changes that we are confident are forced (i.e., those for which the stated reason is either forced resignation/conflict or poor performance) to those for which the stated reason for the change is either retirement or normal succession. We expect forced resignations to more frequently involve external appointments and result in the departing manager's leaving the firm, and to less frequently involve managers of normal retirement age. External appointments are those management changes in which the new manager was previously an outside director of the firm or was not previously employed by the firm.

The results in Panel A of Table II generally support these conjectures. Management changes involve external appointments in 52 percent of the changes that are forced resignations, but in only 8 percent of the changes that are stated retirements or normal successions. The difference between the forced and normal subsamples is significant at the 0.01 level. Similarly, departing managers leave the firm in 79 percent of the changes described as forced resignations and 69 percent of the changes listed as normal retirements. This difference is significant at the 0.10 level. Finally, management changes that are forced involve managers that are of normal retirement age (64–66) in only 3 percent of the cases, while retirements and normal successions involve managers that are of the normal retirement age in 48 percent of the cases. The difference is significant at the 0.01 level. Given that many firms have a mandatory retirement age of 65, these results are consistent with the conjectures of Warner, Watts, and Wruck (1988) and Weisbach (1988) that some retirements are not really normal retirements, and may actually be forced resignations.⁶ We find similar results if we limit the comparisons to those changes involving only the top executive.

⁵ The board may still play an important monitoring role in normal retirements. Since these typically involve the outgoing manager choosing his/her successor, the board must ensure that managers are choosing competent successors.

⁶ Consistent with a mandatory retirement age of 65, Weisbach (1988) finds that "a nontrivial number of resignations take effect on the CEO's sixty-fifth birthday." We include ages 64 to 66 as the normal retirement age to account for timing differences between management change announcement dates and the date upon which the manager leaves office.

Table II

Characteristics of Forced Resignations and Normal Retirements

Panel A reports characteristics of management changes for various subsamples formed on the basis of the stated reason for the change. Panel B reports the correlation between a management change being described as forced and various characteristics of the change (*p*-values in parentheses). The sample includes 908 top management changes over the period 1985 to 1988. New managers are labeled outsiders if they were not employed by the firm immediately prior to the change or previously an independent outside member of the firm's board of directors.

Panel A: Characteristics of Management Changes				
	All Changes		Top Executive Changes	
	Forced/ Poor Performance	Retirement/ Normal Succession	Forced/ Poor Performance	Retirement/ Normal Succession
Fraction of changes in which the new manager is an outsider	0.52	0.08	0.55	0.10
Fraction of changes in which the departing manager leaves the firm	0.79	0.69	0.78	0.71
Fraction of changes in which the departing manager's age is 64–66	0.03	0.48	0.04	0.59
Number of management changes	88	264	64	112

Panel B: Correlation Matrix				
	Forced/ Poor Performance	New Manager is Outsider	Departing Manager Leaves Firm	Departing Manager is Age 64–66
Forced/poor performance	1.00 (0.00)	0.21 (0.00)	0.19 (0.00)	–0.15 (0.00)
New manager is outsider		1.00 (0.00)	–0.07 (0.03)	–0.16 (0.00)
Departing manager leaves firm			1.00 (0.00)	0.03 (0.44)
Departing manager is age 64–66				1.00 (0.00)

In Panel B of Table II, we report the correlation between a management change being described in press reports as a forced resignation and whether the new manager is an external appointment, whether the departing manager leaves the firm, and whether the departing manager is between the ages of 64 and 66. The results indicate that forced resignations are significantly positively correlated with external appointments and with whether the departing manager leaves the firm, and negatively correlated with whether the departing manager is between the ages of 64 and 66. The results for the subsample of top executive changes (not reported in the table) are nearly identical.

In light of the results in Table II, we first classify a management change as a forced resignation if the stated reason is either forced resignation/conflict or poor performance. If neither of these two reasons is given for the change, we

classify a change as forced if it involves an external appointment *and* the departing manager leaves the firm *and* the departing manager is not between the ages of 64 and 66. This leaves us with a sample of 107 forced resignations, 73 of which involve the top executive of the firm. Of these, 88 (64 in the top executive subsample) are described as forced in press reports.

Firms typically do not provide many details of the process leading to a forced management change. Nevertheless, our examination of the forced top executive changes suggests that they are a result not only of board monitoring, but also of monitoring by large blockholders, other shareholders, creditors, and the external control market. Of the 73 forced top executive changes, an outside blockholder is present in 25 cases. Of these, there are 10 cases in which press reports indicate that the blockholder publicly calls for the manager to resign. In 20 cases, the firm has recently defaulted on debt payments, filed for Chapter 11, or restructured debt claims in order to avoid default; a blockholder is present in seven of these cases. In an additional seven cases, the top executive change occurs within one year following an unsuccessful takeover offer for the firm. Finally, in five cases the change is related to shareholder lawsuits alleging illegal behavior on the part of the top executive. Thus 50 of the 73 (68 percent) forced resignations are associated with factors other than normal board monitoring of managerial performance.

We classify a management change as a normal retirement if the stated reason for the change is retirement or normal succession *and* the departing manager is between the ages of 64 and 66. This leaves us with a sample of 110 normal retirements, 58 of which involve a change in the top executive of the firm.

Because we are interested in clearly distinguishing those management changes that are a result of internal disciplining efforts from those that are part of the normal succession process, our definitions of forced resignations and normal retirements are designed to minimize the probability of classifying a change as forced or normal retirement when it is really not. However, we recognize that these definitions may exclude some management changes that should be classified as forced or label some external appointments as forced when they are not. We examine the sensitivity of our results to our classification scheme in section III.D.

II. Event Study Results

We employ standard event-study methodology to measure the shareholder wealth effects of the sample management changes. Market model parameters are estimated over the 250-day period beginning two days following the management change announcement.⁷ We compute significance of abnormal re-

⁷ Use of a preevent estimation period would bias market model parameter estimates because the likelihood of management turnover is systematically related to firm performance (Coughlan and Schmidt (1985), Warner, Watts, and Wruck (1988), and Weisbach (1988)). We obtain similar results using simple market-adjusted returns.

turns using cross-sectional t -statistics to control for any event-induced increase in the variance of abnormal returns around the announcement of the management change.⁸ Abnormal returns are cumulated over two periods: i) the 250 days ending two days prior to the management change announcement, and ii) the two-day period including the day of and the day prior to the announcement of the change in the *Wall Street Journal*. The analysis is limited to those 853 management changes for which we have available stock return data on the Center for Research in Security Prices (CRSP) NYSE/AMEX and Nasdaq tapes. The results are reported in Panel A of Table III for all management changes, Panel B for those changes involving the top executive, and Panel C for those changes not involving the top executive.

Consistent with a negative relation between stock price performance and the likelihood of turnover, the sample firms exhibit significantly negative cumulative abnormal returns (CARs) over the 250 days preceding the turnover announcement. These CARs average -11.4% ($t = -6.2$) for the full sample, -14.3% ($t = -4.6$) for changes involving the top executive, and -9.5% ($t = -4.2$) for those changes not involving the top executive. These results are similar to those of Warner, Watts, and Wruck (1988) and Weisbach (1988). However, there is a considerable difference in the preturnover performance of those firms that experience forced resignations and those that experience normal retirements. Consistent with Warner, Watts, and Wruck (1988), forced resignation firms exhibit significant negative preturnover abnormal stock returns. CARs average -24.0% ($t = -3.1$) for the full sample of forced resignations; this is significantly different at the 0.02 level from the -4.2% ($t = -1.1$) preturnover CAR exhibited by the normal retirement firms. We find similar results in the subsamples of top and nontop management changes (Panels B and C). Thus, forced resignations are preceded by extremely large shareholder wealth losses, while normal retirements are not preceded by unusual performance.

Previous studies examining the wealth effects of a change in the top management team have produced mixed results. For example, Bonnier and Bruner (1989), Furtado and Rozeff (1987), and Weisbach (1988) find significant positive price effects, while Reinganum (1985) and Warner, Watts, and Wruck (1988) find insignificant price reactions. Table III reports two-day announcement period abnormal returns (ARs) associated with our sample management changes. To avoid confounding events, we limit our analysis of forced resignations and normal retirements to those management change announcements for which there is no other announcement on either the day of or the day prior to the date of the *Wall Street Journal* article describing the change. On average, the sample management changes are associated with a statistically insignificant abnormal return of 0.1% ($t = 0.6$). However, abnormal returns for forced resignations average 1.5 percent ($t = 2.3$), while those of normal retirements

⁸ Warner, Watts, and Wruck (1988) find a significant increase in the variance of abnormal stock returns around the announcement of management changes.

Table III
Stock Price Effects of Top Management Changes

Preannouncement and announcement-period abnormal returns associated with a sample of 853 top management changes of firms with stock returns data over the period 1985 to 1988. Preannouncement cumulative abnormal returns are computed over the 250 days ending two days prior to the announcement ($-251, -2$). Announcement period cumulative abnormal returns are computed over the two-day period including the day of and the day prior to the turnover announcement. Abnormal returns are computed using the standard market model procedure with parameters estimated over the 250-day period beginning two days after the turnover announcement. Management changes are designated forced if the reason given for the change is forced resignation or poor performance. If neither reason is given, a change is classified as forced if the departing manager leaves the firm *and* the new manager is not previously an employee of the firm *and* the departing manager is not between the ages of 64 and 66. A management change is classified as a normal retirement if the reason given for the change is retirement or normal succession *and* the departing manager is between the ages of 64 and 66.

	Preannouncement CARs ($-251, -2$)		Announcement-Period ARs ($-1, 0$)	
	Mean (<i>t</i> -Statistic)	Median (% Pos.)	Mean (<i>t</i> -Statistic)	Median (% Pos.)
Panel A: All Management Changes				
All changes ($N = 853$)	-11.35% (-6.18)	-6.04% (43.5)	0.09% (0.62)	-0.01% (49.9)
Forced resignations ($N = 85$) (clean announcements only)	-24.02% (-3.13)	-21.17% (37.6)	1.50% (2.26)	0.62% (57.6)
Normal retirements ($N = 88$) (clean announcements only)	-4.15% (-1.10)	-5.22% (45.5)	0.16% (0.45)	0.11% (54.5)
Panel B: Top Executive Changes				
All changes ($N = 328$)	-14.28% (-4.57)	-8.87% (40.9)	0.63% (2.18)	0.29% (54.5)
Forced resignations ($N = 69$) (clean announcements only)	-17.14% (-2.14)	-21.87% (37.9)	2.50% (2.88)	1.44% (65.5)
Normal retirements ($N = 43$) (clean announcements only)	-8.37% (-1.52)	-5.16% (46.5)	0.61% (1.62)	0.34% (62.8)
Panel C: Non-Top Management Changes				
All changes ($N = 525$)	-9.52% (-4.22)	-4.12% (45.1)	-0.24% (-1.43)	-0.20% (47.1)
Forced resignations ($N = 27$) (clean announcements only)	-38.81% (-2.30)	-19.81% (37.0)	-0.64% (-0.76)	-1.06% (40.7)
Normal retirements ($N = 45$) (clean announcements only)	-0.11% (-0.02)	-5.28% (44.4)	-0.27% (-0.44)	-0.10% (46.7)

CARs: Cumulative Abnormal Returns; ARs: Abnormal Returns.

average 0.2 percent ($t = 0.5$). The difference in abnormal returns is significant at the 0.07 level ($t = 1.8$).

In general, the abnormal returns surrounding top executive changes are much larger than those not involving the top executive. From Panel B, top executive changes are associated with significant average abnormal returns of 0.7 percent ($t = 2.2$). These abnormal returns are again larger for forced resignations (AR = 2.5 percent, $t = 2.9$) than for normal retirements (AR = 0.6 percent, $t = 1.6$). The difference is significant at the 0.05 level ($t = 2.0$). In contrast, management changes not involving the top executive (Panel C), are not associated with significant abnormal returns and do not differ significantly between the forced resignations and normal retirements. These findings suggest that management changes involving the top executive are more important events than those involving other members of the top management team.

It is noteworthy that, although statistically significant, the stock price reactions to top management changes are economically small, even for the Panel B changes involving the top executive. While this might be expected for normal retirements, one might expect a forced resignation to elicit a much stronger market reaction, particularly in light of the large shareholder wealth losses experienced by the firms in the year prior to the management change. As noted above, the small price reaction to the management change could be due to partial anticipation of the event or to confounding information concerning prior management performance and changes in expected future performance. Alternatively, the management change itself may be an economically unimportant event, perhaps because the board is unable to identify a replacement manager capable of reversing the pattern of poor corporate performance. In order to distinguish between these alternatives, it is necessary to examine whether real changes in managerial actions and profitability occur following management changes.

III. Changes in Performance Surrounding Management Turnover

A. Changes in Operating Income

We examine firm performance by measuring levels of and changes in operating income before depreciation in the years surrounding the sample management changes. Operating income before depreciation (COMPUSTAT data item 13) is equal to sales less cost of goods sold and selling, general, and administrative expenses, before deducting depreciation, depletion, and amortization. We scale operating income by the book value of total assets (COMPUSTAT data item 6) to control for differences in size across firms and for changes in asset base within firms across years. In addition, we compute industry-adjusted changes in performance to control for influences on operating income that are unrelated to the management change. We define an industry-adjusted change in operating income as the change in the ratio of operating income to total assets for the sample firm minus the same change for the median firm in the same two-digit Standard Industrial Classification (SIC) industry.

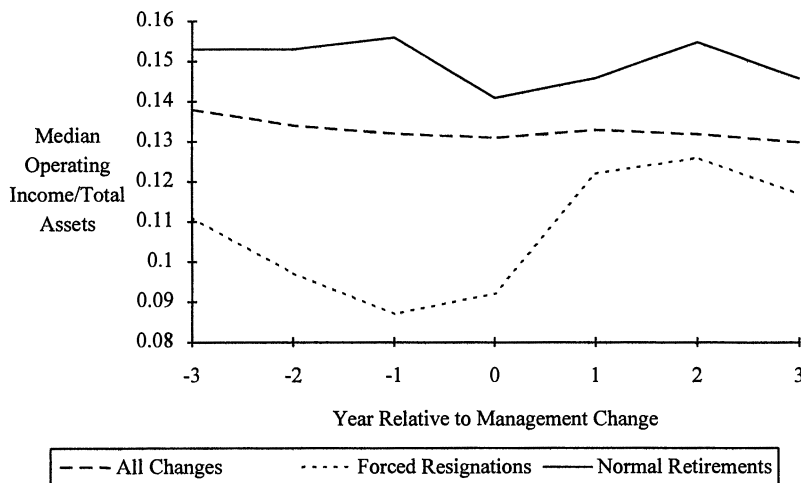


Figure 1. Median levels of operating income as a fraction of total assets for a sample of top management changes between 1985 and 1988. The sample includes 721 changes in the top management team for which a *Wall Street Journal Index* announcement date and COMPUSTAT data are available. The top management team is defined as the CEO, the chairperson of the board, and the president. Management changes are defined as forced if the stated reason is either forced resignation/conflict or poor performance. If neither of these two reasons is given, a change is classified as forced if it involves an external appointment *and* the departing manager leaves the firm *and* the departing manager is not between the ages of 64 and 66. A management change is classified as a normal retirement if the stated reason is retirement or normal succession *and* the manager is between the ages of 64 and 66.

In measuring accounting performance changes, we consolidate multiple events for a given firm in a given fiscal year. Thus, if a firm experiences two or more management changes in the same fiscal year, only one observation is recorded. In addition, we are restricted to measuring performance only for those firms for which COMPUSTAT data is available. These restrictions further reduce our sample to 721 observations, including 83 forced resignations and 99 normal retirements. Of these, 296 involve a top executive, of which 63 are forced departures and 58 are normal retirements.

Figure 1 depicts the median ratio of operating income before depreciation to total assets (OIBD/TA) in each of the seven years centered on the year of the sample management changes (year 0). In addition, Table IV reports median and mean changes in OIBD/TA over various time periods, measured as the difference between OIBD/TA at the end of the latter year and OIBD/TA at the end of the earlier year. We present both unadjusted and industry-adjusted changes in OIBD/TA, but focus our discussion primarily on industry-adjusted results. Median values are emphasized throughout to reduce the influence of outliers.

The results in Panel A of Table IV suggest that, overall, management changes are not preceded by unusual operating performance but are followed by small increases in performance. However, there is a considerable difference between the performance changes associated with forced resignations and

Table IV
Changes in Operating Income Surrounding
Top Management Changes

Operating income is measured as the ratio of operating income before depreciation to total assets (OIBD/TA). Panel A presents changes for 721 management changes between 1985 and 1988 for which a *Wall Street Journal Index* announcement date and COMPUSTAT data are available. Panels B and C present changes for the subsamples of top and non-top managers. The top executive is defined to be the CEO if the firm has one and the chairperson of the board otherwise. A change in manager is classified as nontop only if no top executive change occurred in the firm during the seven years centered on the year of the change. Medians are presented above means. Significance of median and mean changes are measured using a two-tailed Wilcoxon signed rank test and a standard two-tailed *t*-test, respectively.

Year	All Changes		Forced Resignations		Normal Retirements	
	Unadjusted	Industry-Adjusted	Unadjusted	Industry-Adjusted	Unadjusted	Industry-Adjusted
Panel A: All Management Changes						
	<i>N</i> = 721		<i>N</i> = 83		<i>N</i> = 99	
-3 to -1	-0.001** -0.008***	0.001 -0.003	-0.016** -0.034***	-0.005** -0.033***	0.001 0.004	0.005* 0.007*
-1 to +1	-0.003* -0.053	0.001* -0.045	0.003 -0.475	0.005 -0.458	-0.002 -0.001	0.003 0.005
-1 to +2	-0.003 -0.001	0.006*** 0.007*	0.011** 0.029**	0.018*** 0.041***	-0.007 0.004	0.009** 0.013**
-1 to +3	-0.005 -0.005	0.006*** 0.007*	0.011** 0.031**	0.026*** 0.046***	-0.002 0.003	0.006** 0.016***
Panel B: Top Executive Changes						
	<i>N</i> = 296		<i>N</i> = 63		<i>N</i> = 58	
-3 to -1	-0.001 -0.013**	0.000 -0.008*	-0.017** -0.041***	-0.012** -0.038***	0.003* 0.010	0.008** 0.013**
-1 to +1	-0.004 -0.130	0.002 -0.122	0.005 -0.639	0.011 -0.632	-0.005 -0.008	0.002 0.000
-1 to +2	-0.003 0.003	0.007** 0.011**	0.011* 0.026*	0.016** 0.035**	-0.007 0.005	0.007** 0.016***
-1 to +3	0.001 0.000	0.006*** 0.011	0.027** 0.034*	0.039*** 0.046**	-0.001 0.006	0.018** 0.019**
Panel C: Non-Top Management Changes						
	<i>N</i> = 295		<i>N</i> = 14		<i>N</i> = 28	
-3 to -1	-0.002 -0.005	0.003 0.002	-0.009 -0.014	0.002 -0.005	-0.004 -0.006	-0.001 -0.001
-1 to +1	-0.004 -0.000	0.001 0.005	0.002 0.031	0.003 0.039	-0.002 0.009	0.002 0.014
-1 to +2	-0.004 0.000	0.006* 0.007	0.021 0.045	0.034 0.052	-0.012 0.003	0.010 0.010
-1 to +3	-0.004 -0.004	0.008** 0.007	0.009 0.035	0.017 0.045	-0.010 -0.004	0.005 0.011

***, **, and * denote significance at the 0.01, 0.05, and 0.10 levels, respectively.

those associated with normal retirements. Firms with forced resignations exhibit a monotonic and statistically significant (at the 0.05 level) decrease in the level of OIBD/TA from year -3 to year -1 . Panel A of Table IV indicates that this ratio declines by an industry-adjusted median 0.005, approximately 4.5 percent of the median unadjusted year -3 level of OIBD/TA. Following the forced resignations, there is a statistically significant increase in OIBD/TA. By year $+1$, the median level of OIBD/TA has surpassed the year -3 level. The median 0.026 industry-adjusted increase in OIBD/TA from year -1 through year $+3$ represents an increase of 29.9 percent over the median year -1 level of 0.087.⁹ These results suggest that the positive announcement period abnormal returns documented in Table III for forced management turnover at least partially reflect expectations of real improvements in operating performance. Nevertheless, Figure 1 indicates that the level of OIBD/TA following forced resignations remains below that of the normal retirement firms.

To put the performance changes following forced departures into perspective, we compare them to performance changes following other organizational changes. Table IV indicates that the industry-adjusted change in OIBD/TA from year -1 to year $+2$ is 0.018, a 20.7 percent increase over the year -1 level of operating performance. By way of comparison, Kaplan (1989) documents a median 36.1 percent increase in industry-adjusted operating income over the two years following management buyouts, while Denis and Denis (1993) report a 17.7 percent increase in OIBD/TA over the two years following leveraged recapitalizations. Thus, forced changes in top management teams are followed by increases in operating income that are comparable to those observed following two of the more drastic (and value-increasing) organizational changes. The percentage change in operating performance also compares favorably with the 13.1 percent industry-adjusted increase in OIBD/TA through year $+2$ following proxy contests documented by Mulherin and Poulsen (1994).

In contrast to forced resignations, normal retirements are not preceded by declines in operating performance. Following normal retirements, there is evidence of an increase in operating performance, although these performance improvements are smaller than those following forced resignations through years $+2$ and $+3$. These differences are significant at the 0.10 and 0.05 levels, respectively. The median industry-adjusted change in OIBD/TA is significant at the 0.05 level over the $[-1, +2]$ and the $[-1, +3]$ windows. If, as Vancil (1987) argues, normal retirements are most often followed by the elevation of the outgoing manager's hand-picked and groomed successor, the postturnover increase in OIBD/TA following these events is somewhat surprising. However, this finding is consistent with the finding in Weisbach (1995) that both forced resignations and normal retirements are followed by a high rate of divestitures of acquisitions made by the outgoing manager. Weisbach suggests that his

⁹ The large negative mean change in OIBD/TA over the $[-1, +1]$ period is driven by a single outlier, Gibraltar Financial Corp. In the year following a change in the CEO, the firm incurred large losses and its primary subsidiary, Gibraltar Savings Association, was seized by federal regulators. Hence, by year-end, the firm's asset base had been dramatically reduced.

findings support the hypothesis that normal retirements provide an opportunity to correct the outgoing manager's mistakes.¹⁰

B. Top Executives Versus Non-top Managers

Panels B and C of Table IV reports changes in OIBD/TA for the subsamples of changes involving the top executive (Panel B) and those not involving the top executive (Panel C). In order to avoid confounding effects, we restrict the non-top management changes to those cases for which there is no top executive change within three years before or after the nontop management change. Consistent with the stock returns results, there is stronger evidence of performance changes following top executive turnover. From Panel B, forced top executive resignations follow significant decreases in industry-adjusted operating performance. The pret turnover performance of the forced resignation firms is significantly different (at the 0.01 level) from that of the normal retirement firms. Following a change in top executive, industry-adjusted operating performance increases significantly for the full sample and for the subsamples of forced resignations and normal retirements. The performance changes are larger in the forced resignation sample than in the normal retirement sample; the difference is significant at the 0.10 level over the -1 to $+3$ period.¹¹ In contrast, from Panel C, there is no evidence of significant declines in pret turnover operating performance and little evidence of increases in operating profitability following non-top management changes. Thus, the findings in Panels B and C of Table IV support the hypothesis that management changes involving top executives are more important economic events than those not involving the top executive.¹²

C. Performance Improvements: "Window Dressing" or Mean Reversion?

One possible explanation for our results is that new managers sell underperforming assets following forced resignations and the subsequent operating changes reflect these sales rather than operating improvements in the remaining assets. Of course, the sale of an underperforming asset will be valuable if the asset

¹⁰ Several recent studies suggest that net income is an important decision variable in the actions of boards of directors. (See, for example, DeAngelo, DeAngelo, and Skinner (1992), Jensen and Murphy (1990), and Kaplan (1994).) Consequently, we replicated our tests using net income rather than operating income as the performance measure. Because the results are qualitatively the same, we do not report the net income results.

¹¹ Because the sample firms may have more than one top management change over the seven years for which we measure operating performance, our samples do not necessarily contain independent observations. Hence, our tests of statistical significance may be biased. To adjust for this potential problem, we examine changes in performance for those firms experiencing only one change in top executive over the sampling period. The results for this sample are nearly identical to those reported in Table IV.

¹² It is interesting to note that our sample of forced resignations of non-top managers contains only 14 observations. This suggests that, not only are forced resignations rare in general, but it is extremely rare that a member of the top management team is forced out of office without the top executive also leaving his/her position around the same time.

Table V
Changes in Operating Income for Subsamples of Management Changes

Unadjusted and industry-adjusted changes in operating income as a fraction of total assets (OIBD/TA) from one year prior to three years following subsamples of changes in the top executive. Medians are reported above means. Significance of median and mean changes in operating performance are measured using the Wilcoxon signed rank test and the standard *t*-test. The sample includes top management changes announced in the *Wall Street Journal Index* between 1985 and 1988 for which COMPUSTAT data are available. Management changes are defined as forced if the stated reason is either forced resignation/conflict or poor performance. If neither of these two reasons is given, a management change is classified as forced if it involves an external appointment *and* the departing manager leaves the firm *and* the departing manager is not between the ages of 64 and 66. Warner, Watts, and Wruck (1988) classify a management change as forced if the stated reason is forced resignation/conflict, poor performance, to pursue other interests, to take a position at another firm, or if no reason is provided. External appointments are those management changes in which the new manager was previously an outside director of the firm or was not previously employed by the firm.

Sample	Sample Size	Unadjusted OIBD/TA (-1, +3)	Industry-Adjusted OIBD/TA (-1, +3)
1. Forced resignations	63	0.027** 0.034*	0.039*** 0.046**
2. Forced resignations with no announced asset sales	26	0.084** 0.104***	0.104*** 0.124***
3. Warner, Watts, and Wruck definition of forced resignations	161	-0.002 0.001	0.005 0.013
4. External appointments	62	0.005 -0.002	0.022 0.015
5. Resignations for which stated reason is forced departure or poor performance	48	0.044*** 0.051***	0.044*** 0.063***
6. Firms in bottom quartile of cumulative abnormal return over year preceding turnover	82	-0.007 0.004	0.022 0.019

***, **, and * denote significance at the 0.01, 0.05, and 0.10 levels, respectively.

is sold to a buyer who can put the asset to a higher valued use or if the sale eliminates value-reducing cross-subsidizations across divisions. However, it is also possible that the asset is sold to a buyer who cannot generate any additional value from the asset and therefore offers a low price. In such a case, operating changes following the asset sale could overstate real operating improvements.

To address this issue, we search the *Wall Street Journal Index* for the two years following each forced top executive change and identify 26 firms that do not announce any asset sales over this period. We report unadjusted and industry-adjusted changes in the ratio of operating income to total assets over the $[-1, +3]$ period for this subsample of forced resignations in item (2) of Table V. For ease of comparison, item (1) repeats the unadjusted and industry-adjusted operating performance results for the full sample of forced resignations of top executives. The results suggest that our earlier findings represent

real improvements in operating performance. The median industry-adjusted change in operating performance is a statistically significant (at the 0.01 level) 0.104 for the subsample of forced top executive resignations with no asset sales following the management change. These findings provide some assurance that the performance changes following forced resignations are not driven by firms that sell poorly performing assets at low prices.¹³

Another possible explanation for our forced resignations results is that they are due to a selection bias in that firms that perform poorly, but still survive, exhibit a rebound in performance. If so, our findings may be a result of this mean reversion, rather than performance improvements associated with the management change. To address this possibility, we examine the subsequent performance of a sample of poorly performing firms that do not have a change in top management. More specifically, from our original set of *Value Line* firms, we identify those firms that do not have a top management change over the 1985 to 1988 period. We then divide this set of firms into quartiles on the basis of the change in OIBD/TA over the 1982 to 1984 period. Finally, we measure changes in OIBD/TA over the 1984 to 1988 period. If our results are due to the mean reversion effect described above, firms in the bottom quartile of performance over the 1982 to 1984 period should exhibit an improvement in performance over the 1984 to 1988 period, even without a change in management. However, this is not the case. Although the median change in OIBD/TA over the 1982 to 1984 period is a statistically significant -0.092 for firms in the bottom quartile, these same firms exhibit a statistically insignificant 0.001 median change in OIBD/TA over the 1984 to 1988 period. Thus, our findings for forced resignations do not appear to be due to mean reversion in the performance of poorly performing firms.¹⁴

A third issue is whether our accounting performance measures are biased by managerial attempts to “manage” reported earnings through accounting accruals. For example, outgoing managers may have the incentive to increase reported earnings just prior to the management change in an attempt to save their jobs. Similarly, incoming managers may have the incentive to reduce reported earnings (take a “big bath”) immediately following taking office in order to blame poor performance on their predecessors and take credit for subsequent performance improvements.¹⁵ Our use of operating income rather

¹³ We also computed changes in OIBD/TA for the subset of firms that had a net increase in the book value of total assets over the three years following a forced top executive resignation and obtained similar results. In addition, we estimated regressions of the change in OIBD/TA (both unadjusted and industry-adjusted) over the $[-1, +3]$ period on the percentage change in total assets over the same period. There was no significant relation for any of the subsamples.

¹⁴ These findings are similar to those of Hotchkiss (1995), who finds that the continued involvement of prebankruptcy management during Chapter 11 is associated with poor postbankruptcy performance.

¹⁵ The evidence on this issue is mixed. Pourciau (1993) finds that incoming CEOs in nonroutine turnover situations often depress earnings in the year in which they take office. DeAngelo (1988) finds a similar tendency for successful dissidents in proxy contests to take an early earnings “bath.” She also finds that incumbents attempt to increase earnings during the proxy contest. Murphy and Zimmerman (1993), however, do not find any strong evidence of earnings management around management turnover.

than net income reduces the impact of these examples of earnings management. It does not necessarily eliminate them, however, as there is some potential to manage working capital accruals in a manner that would affect our operating income measure. Note, however, that increases in reported income by outgoing managers and reductions in reported earnings by incoming managers will bias us against finding performance improvements measured from year -1 . Despite this bias, we find significant performance improvements for forced resignations. Moreover, we examine changes in working capital accruals for the top executive forced resignation subsample and find no significant changes in net working capital accruals from pre- to postturnover. We thus conclude that managerial manipulation of accounting accruals is not responsible for the operating changes we document.¹⁶

D. Other Definitions of Forced Resignations

As noted earlier, our definition of forced resignations may exclude some management changes that should be classified as forced or, alternatively, label some external appointments as forced when they are not. We examine the sensitivity of our results to our classification scheme by computing unadjusted and industry-adjusted changes in operating performance for alternative definitions of forced resignations. The results are reported in items (3) to (6) in Table V.

In addition to management changes due to poor performance and firings, Warner, Watts, and Wruck (1988) include in their subsample of forced resignations those changes for which the reported reason is to pursue other interests, take a position outside the firm, policy differences, and those changes for which no reason is given. By employing a similar definition, we expand the number of forced top executive resignations with available data to 161. However, as shown in item (3) of Table V, we find no evidence of performance changes using this definition of forced resignations.

¹⁶ One common method for eliminating the influence of accounting accruals is to measure changes in operating cash flow rather than reported operating income, where operating cash flow equals operating income minus the change in working capital accounts. However, this measure is problematic because working capital accruals are endogenously related to firm performance. For example, firms that are performing poorly will tend to reduce inventories and accounts receivables and to increase accounts payable. These working capital changes represent rational economic responses to a decline in performance rather than discretionary accounting choices. (See DeAngelo, DeAngelo, and Skinner (1994) for further discussion and evidence on this issue.) Consequently, adjusting operating income for these accruals would produce misleading inferences regarding firm performance. Consistent with this, both Dechow (1994) and Holthausen and Larcker (1994) report that stock returns are more highly correlated with operating income than with operating cash flow. We find similar results using our sample firms. Consequently, we view operating income as a superior measure of firm performance. Nevertheless, we do examine changes in operating cash flow surrounding the sample management changes. Although these changes follow a similar pattern to the changes in operating income, the results are statistically less significant. For example, forced resignations are associated with significant (at the 0.05 level) increases in operating cash flow over the $[-1, +2]$ period but statistically insignificant increases over the $[-1, +3]$ period.

Another frequently employed classification scheme is to label all external appointments as forced resignations.¹⁷ The results in item (4) of Table V suggest that external appointments are not associated with significant changes in operating performance following management changes. The findings reported in items (3) and (4) are consistent with the joint hypothesis that: i) forced resignations are associated with performance improvements, and ii) our classification scheme more precisely identifies forced resignations than the classification schemes used in prior studies.

Our definition of forced resignations assumes that mandatory retirement takes place at age 65 and that managers not of retirement age that are replaced by outsiders are forced out. However, neither of these assumptions is necessarily correct. For example, some firms have mandatory retirement at age 70. In addition, some executives may voluntarily retire at some point beyond the age of 66. If these executives leave the firm and are replaced by outsiders, our classification scheme will incorrectly label them as forced resignations. Similarly, outside appointments may be made in those cases in which the firm changes its strategic direction in a manner such that the old manager lacks the required human capital. Such a management change would not necessarily be associated with poor performance on the part of the departing manager and therefore would not be "forced" in the same sense as our other forced resignations.

To examine the sensitivity of our results to these issues, we examine the subset of forced top executive resignations that are described as forced in the *Wall Street Journal* announcement of the management change. The results in item (5) of Table V suggest that our results are not sensitive to the exclusion of management changes that may not be forced. Forced resignations continue to be associated with significant (at the 0.01 level) postturnover changes in operating performance.

We document in Table III that stock returns performance prior to forced resignations is significantly more negative than prior to normal retirements. This raises the possibility of using poor performance as a screen by which to identify forced resignations. We address this by defining a management change as forced if the cumulative abnormal return (CAR) in the year preceding the announcement of the change is in the bottom quartile of our sample firms. These firms are clearly performing poorly prior to the management

¹⁷ The logic for doing so is based on the argument that external management candidates are at a disadvantage to internal candidates because: i) internal candidates may possess valuable firm-specific human capital, ii) information concerning internal candidates is less costly to obtain, and iii) firms may prefer internal promotions over external hires to strengthen the overall incentive system for junior executives (Furtado and Rozeff (1987)). Consequently, an external appointment will occur only when the expected benefits to such a change are particularly large. This is more likely to occur when managerial performance can be measured more precisely, managerial performance has been poor, and there has been a forced resignation. Consistent with this, Parrino (1993) reports that the likelihood of an external appointment is more sensitive to poor performance in homogeneous industries. However, as Warner, Watts, and Wruck (1988) point out, external appointments are also more likely to occur when the firm is expanding into new areas in which it does not possess specific human capital.

change; the median CAR is -72 percent. However, these firms do not exhibit performance improvements over the three years following the management change. From item (6) of Table V, the median industry-adjusted change in OIBD/TA is a statistically insignificant 0.022 . Interestingly, however, those 11 firms in the bottom quartile of CAR for which the management change is described in press reports as forced exhibit a significant (at the 0.01 level) 0.133 increase in median industry-adjusted OIBD/TA. These findings suggest that poor prior performance alone is not sufficient to elicit performance improvements following management changes.

E. Postturnover Stock Returns

Given that forced management changes are followed by substantial increases in operating profitability, it is puzzling that the announcement period abnormal returns associated with these management changes are so small. As noted previously, the small magnitude of the announcement effect may be due to the fact that the announcements are partially anticipated and/or that they contain confounding information concerning prior management performance. Note that under either of these explanations, the magnitude of the preannouncement negative abnormal returns would understate the reductions in value associated with the departing managers. Alternatively, the magnitude of the postturnover increase in profitability may have been unexpected. If so, we would expect postturnover stock returns to be significantly positive for the forced resignation sample.

Figure 2 depicts cumulative market-adjusted stock returns over the two years centered on the management change announcement.¹⁸ For forced resignations, stock returns are significantly negative prior to the management change, but insignificantly different from zero over the twelve months following the change. Over the first six months following the management change, however, market adjusted returns are actually a significant -6.1 percent ($t = -2.1$).¹⁹ These findings are inconsistent with the hypothesis that, on average, the performance improvements following forced resignations are larger than expected at the time of the announcement of the management change.²⁰ We thus conclude that the small announcement period abnormal returns associated with these changes are due to partial anticipation and/or to confounding negative information revealed by the fact that the departing manager is fired.

¹⁸ Specifically, market-adjusted returns are defined as the difference between the sample firm's return and that of the CRSP value-weighted index.

¹⁹ Warner, Watts, and Wruck (1988) document a similar negative drift in stock prices following forced top management changes. Like Warner, Watts, and Wruck, we have no explanation for this pattern.

²⁰ Note that this interpretation does not preclude a link between changes in operating performance and postturnover stock returns. Indeed, we find that market-adjusted returns in the year following forced resignations are significantly positively related to the change in OIBD/TA over the $[-1, +3]$ window. The results in Figure 2 suggest, however, that at the time of the announcement of the management change, the market makes an unbiased estimate of postturnover operating improvements for the forced resignation firms.

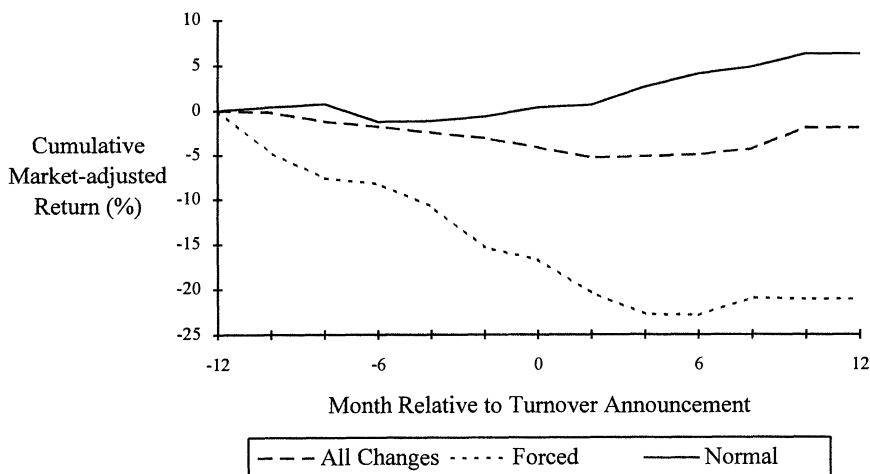


Figure 2. Cumulative market-adjusted returns for a sample of top management changes between 1985 and 1988. The sample includes 853 changes in the top management team for which a *Wall Street Journal Index* announcement date and stock returns data are available. The top management team is defined as the CEO, the chairperson of the board, and the president. Management changes are defined as forced if the stated reason is either forced resignation/conflict or poor performance. If neither of these two reasons is given, a change is classified as forced if it involves an external appointment *and* the departing manager leaves the firm *and* the departing manager is not between the ages of 64 and 66. A management change is classified as a normal retirement if the stated reason is retirement or normal succession *and* the manager is between the ages of 64 and 66.

Interestingly, postturnover stock returns average a significant 6.0 percent ($t = 2.5$) for normal retirements. This finding is surprising in light of the small performance improvements following these management changes. Upon further examination, we observe that these positive returns are driven by firms that are subsequently acquired. Postturnover stock returns average a statistically insignificant 3.1 percent for those normal retirement firms that are not acquired over the two years following the management change and a significant (at the 0.01 level) 23.3 percent for those firms that are taken over. Moreover, we document in Section IV.B that the normal retirement firms experience a slightly higher than normal rate of postturnover corporate control activity.

IV. Postturnover Restructuring and Corporate Control Activity

A. Corporate Downsizing

Previous studies have documented significant corporate downsizing following other organizational changes.²¹ In Table VI, we report median percentage

²¹ For changes in total assets, employment, and capital expenditures following large mergers, see Healy, Palepu, and Ruback (1992). For changes in employment following tender offers, see Bhagat, Shleifer, and Vishny (1990), Bhidé (1989), and Denis (1994). For changes following management buyouts, see Kaplan (1989) and Smith (1990). For changes following leveraged recapitalizations, see Denis and Denis (1993) and Palepu and Wruck (1992).

changes in total assets, number of employees, and capital expenditures for our samples of top executive changes. We also present industry-adjusted changes to address the extent to which any observed changes can be attributed to the firm-specific management change. Overall, we find mixed evidence of restructuring following management turnover. The book value of total assets increases significantly over all measurement periods. The median increase is 15.7 percent over the $[-1, +3]$ window; this change is significant at the 0.01 level. Employment levels are reduced significantly over the $[-1, +1]$, $[-1, +2]$, and $[-1, +3]$ windows. The median $[-1, +3]$ reduction is 8.6 percent, significant at the 0.01 level. Finally, capital expenditures are reduced in the short-run; 13.2 percent over the $[-1, +1]$ window, significant at the 0.01 level. However, capital expenditures increase by a significant (at the 0.01 level) 11.6 percent through year +3.

Again there is a substantial difference between forced resignations and normal retirements. Changes in the book value of the total assets of the forced resignation subsample are insignificantly negative through years +1 and +2 and insignificantly positive through year +3. Normal retirements are followed by significant increases in total assets through all three years. The median increase through year +3 is 25.3 percent, significant at the 0.01 level. The differences between the forced and normal subsamples are significant at the 0.01 level. Median employment levels are reduced by 24.2 percent (significant at the 0.05 level) through year +3 following forced resignations, while employment does not change significantly following normal retirements. The differences between forced and normal employment changes are significant at the 0.01 level over the $[-1, +1]$ and $[-1, +2]$ windows and at the 0.05 level over the $[-1, +3]$ window. Finally, capital expenditures are reduced by a significant 36.2 percent through year +1 following forced resignations; changes through years +2 and +3 do not differ significantly from zero. Capital expenditures by normal retirement firms increase significantly over the $[-1, +2]$ and $[-1, +3]$ windows. The differences between forced and normal retirements are significant at the 0.01 level over the $[-1, +1]$ and $[-1, +2]$ windows.

The industry-adjusted results indicate that the forced resignation firms downsize their operations significantly relative to industry peers. With the exception of capital expenditure changes over the $[-1, +3]$ window, industry-adjusted postturnover changes in total assets, employees, and capital expenditures are significantly negative in the forced resignation subsample. There is also weak evidence of downsizing relative to industry peers in the normal retirement subsample. Industry-adjusted postturnover changes in total assets and employees are significantly negative. However, industry-adjusted changes in capital expenditures do not differ significantly from zero.

In order to provide additional details on the extent of restructuring activity following top executive changes, we search the *Wall Street Journal Index* for the year of and the two years following each top executive change for any announcements of restructuring activity. These announcements include asset

Table VI
**Median Percentage Changes in the Book Value of Total Assets,
 Number of Employees, and Capital Expenditures**

The sample includes 296 changes in top executive between 1985 and 1988 with available COM-PUSTAT data. Significance of changes is measured using a two-tailed Wilcoxon signed rank test.

	Median Percentage Changes Between Years			
	-3 and -1	-1 and +1	-1 and +2	-1 and +3
Panel A: Book Value of Total Assets				
All Changes				
Unadjusted	9.28***	4.18**	9.07***	15.70***
Industry-adjusted	-5.21***	-10.90***	-13.53***	-11.62***
Forced Resignations				
Unadjusted	0.85	-9.64	-6.36	1.07
Industry-adjusted	-16.69***	-24.90***	-29.91***	-29.40***
Normal Retirements				
Unadjusted	14.24***	11.13***	17.06***	25.25***
Industry-adjusted	-3.90	-7.32	-9.02*	-6.01*
Panel B: Number of Employees				
All Changes				
Unadjusted	-1.04	-7.27***	-9.52***	-8.56***
Industry-adjusted	-5.24***	-11.22***	-14.59***	-14.16***
Forced Resignations				
Unadjusted	-5.87*	-15.87***	-26.80***	-24.26**
Industry-adjusted	-9.88***	-23.73**	-30.87***	-32.67***
Normal Retirements				
Unadjusted	0.93	-1.80	-2.86	-2.74
Industry-adjusted	-1.77*	-7.03***	-9.51***	-11.28***
Panel C: Capital Expenditures				
All Changes				
Unadjusted	-2.62	-13.21***	-7.47	11.63***
Industry-adjusted	-12.21**	-26.73***	-19.44***	-13.71*
Forced Resignations				
Unadjusted	-3.64	-36.16**	-19.70	-0.52
Industry-adjusted	-11.35	-35.48***	-36.71***	-30.94
Normal Retirements				
Unadjusted	20.75**	3.18	13.54**	35.35***
Industry-adjusted	-6.75	-4.38	0.00	10.78

***, **, and * denote significance at the 0.01, 0.05, and 0.10 levels, respectively.

sales, acquisitions, layoffs, wage cuts, plant closings, cost-cutting measures, other management restructurings, etc. Table VII reports the incidence of these restructuring announcements for our samples of forced resignations and normal retirements.

Table VII

Postturnover Restructuring and Corporate Control Activity

Incidence of restructuring and corporate control activity for the subsamples of forced resignations and normal retirements of top executives over the period 1985 to 1988. Restructuring and corporate control events are identified from a search of the *Wall Street Journal Index* for the year of and the two years following the announcement of the top executive change.

	Forced Resignations		Normal Retirements	
	Number	%	Number	%
Panel A: Restructuring Activity				
Asset sales	43	58.9	32	56.1
Other management restructuring	26	35.6	7	12.3
Acquisitions/joint ventures	23	31.5	43	75.4
Employee layoffs/wage cuts	22	30.1	11	19.3
Cost-cutting/efficiency measures	14	19.2	5	8.8
Discontinued operations/plant closings	13	17.8	7	12.3
Refocus business	5	6.8	3	5.3
Panel B: Corporate Control Activity				
Block investment in firm's shares	17	23.3	5	8.8
Firm taken over	13	17.8	3	5.3
Unsuccessful takeover attempt of firm	6	8.2	3	5.3
Leveraged buyout of firm	5	6.8	2	3.5
Firm adopted antitakeover measures	9	12.3	17	29.8

Interestingly, the rate of asset sales is approximately the same for forced resignations and normal retirements. About 59 percent of the forced resignation firms and 56 percent of the normal retirement firms announce asset sales. The similarity in the incidence of asset sale announcements is surprising in light of our findings in Table VI that forced resignation firms significantly reduce their asset base while normal retirement firms increase their asset base. The reason for this appears to be the fact that, in addition to a large number of asset sale announcements, the normal retirement firms also announce a large number of acquisitions and joint ventures. Over 75 percent of the normal retirement firms announce acquisitions or joint ventures while only 32 percent of the forced resignation firms make similar announcements. (The difference is significant at the 1 percent level.) Thus it appears that, while not downsizing on net, the normal retirement firms still engage in a substantial amount of asset restructuring.²² These findings are

²² There are three caveats associated with interpreting the data in Table VII. First, we have not compared the incidence of restructuring to a control period not associated with a management change. Hence, we cannot be sure that the rate of restructuring announcements is unusual in the two years following the sample management changes. Second, our comparisons of the incidence of certain announcements between the forced resignation and normal retirement firms may be biased because the forced resignation firms are, on average, smaller firms. To the extent that the *Wall Street Journal* biases its coverage towards larger firms, the incidence of announcements may be understated for the forced resignation firms. However, we are unsure as to the extent of this bias since, although smaller than the normal retirement firms, the forced resignation firms are still fairly

consistent with Weisbach's (1995) finding that incoming CEOs often reverse the policies of the previous CEO, even in those cases involving normal retirements.

The rates of change of other types of efficiency measures appear to be somewhat higher in the forced resignation sample. For example, 30 percent of the forced resignation firms announce employee layoffs or wage cuts, 19 percent announce cost-cutting programs, 18 percent announce plans to discontinue certain operations, and 7 percent announce plans to refocus the business. In the normal retirement sample, 19 percent announce employee layoffs or wage cuts, 9 percent announce cost-cutting programs, 12 percent discontinue operations, and 5 percent announce plans to refocus the business. Only the difference in the rate of cost-cutting programs is significant at the 10 percent level.

There is also a higher incidence of other management restructuring in the forced resignation sample. Nearly 36 percent of the forced resignation firms also announce broader plans to restructure the management of the firm's assets. These announcements do not necessarily involve management changes, but often include a reshuffling of the duties of the top officers of the firm. They frequently consist of consolidating different operations of the firm under a single group of managers. Only 12 percent of the normal retirement firms announce these types of other management restructurings. The difference between the forced resignation and normal retirement firms is significant at the 1 percent level.

B. Postturnover Corporate Control Activity

Table VII also reports the incidence of postturnover corporate control activity in the samples of forced resignations and normal retirements of top executives. There are several reasons why one might expect a higher incidence of control activity following management changes. First, Stulz (1988) demonstrates that managerial control of voting rights within the firm can entrench managers by decreasing the likelihood of successful takeovers. To the extent that new managers (particularly external appointments) control fewer shares, they will be less entrenched than the departing managers.²³ Second, Morck, Shleifer, and Vishny (1988) argue that other managerial characteristics, such

large firms, averaging over \$600 million in the book value of total assets. Finally, differences in the economic magnitude of the various actions are not reflected in the frequency of occurrence.

²³ Consistent with Stulz's (1988) model, Slovin and Sushka (1993) document an unusually high rate of takeover activity following the death of inside blockholders; they attribute this activity to the reduction in ownership concentration resulting from the disposition of the blockholder's shares. Similarly, Denis, Denis, and Sarin (1995) document a high rate of takeover activity following top management changes in which the departing CEO owns more than 1 percent of the firm's shares. In our sample, the median percentage ownership of the departing top manager is only 0.37 percent, while the new manager owns a median 0.21 percent following the management change. Hence, a reduction in entrenchment is unlikely to be the predominant explanation for control activity following our sample management changes. However, when the departing manager owns more than 1 percent of the firm's shares, we find a significant reduction in managerial ownership following the management change; median top executive ownership falls from 5.0 percent to 0.4 percent. Thus, a reduction in entrenchment is more likely for this subset of firms. Consistent with this, we find that six of the nine forced resignation firms in which the top executive's fractional ownership is reduced by more than 1 percent experience subsequent corporate control activity.

as status as founder, increased tenure and attachment to the firm, and lower employment of professional managers, can provide conditions conducive to entrenchment. If new managers are less likely to share these characteristics, there will be a higher incidence of takeover activity following top management changes. This should be particularly true in the subsample of forced resignations, given the fact that a greater fraction of forced resignations are external appointments. Moreover, given the magnitude of their poor performance prior to the management change, it would appear that these firms were at least partially insulated from the discipline of the market for corporate control. Finally, the high rate of pret turnover control activity present in the sample of forced top executive resignations suggests that the management change may be part of a broader change in the control of the firm.

The results in Table VII suggest that forced resignations are indeed followed by a high incidence of corporate control activity. Approximately 56 percent of the forced resignation firms are the target of some form of corporate control activity in the two years following the top management change. This activity comes in the form of a block investment in the firm's shares (23 percent of the firms), a takeover of the firm (18 percent), an unsuccessful takeover attempt for the firm (8 percent), or a leveraged buyout of the firm (7 percent). In contrast, only 23 percent of the normal retirement firms are the target of corporate control activity in the two years following their top management changes. The fraction of firms experiencing control activity in the forced resignation and normal retirement samples are significantly different at the 0.01 level.

To put the rate of corporate control activity into perspective, Mitchell and Lehn (1990) report that 48.2 percent of the firms covered by *Value Line* are targets of some type of corporate control transaction between 1980 and 1988. This works out to an annual rate of about 5.3 percent. Given that we search the *Wall Street Journal Index* over a period averaging 2.5 years, the average annual rate of corporate control activity is approximately 22 percent for our forced resignation firms and 9.2 percent for our normal retirement firms. Thus both our forced resignation and normal retirement samples experience higher rates of corporate control activity than do the firms studied in Mitchell and Lehn (1990).

Recall also from Section I.B that forced resignations often appear to be linked to the presence of a large block shareholder or an unsuccessful takeover attempt prior to the turnover. In fact, a striking 70 percent of the forced resignation firms experience some form of corporate control activity either in the year prior to or the two years following the top management change.²⁴ Of

²⁴ In order to ensure that the performance changes for forced resignations are not due to external corporate control transactions, we recompute changes in operating performance after excluding those firms that were taken over or had a large block investment in the firm's shares following the top management change. In general, those firms that were taken over or taken private following forced top management changes are already excluded from the results in Table IV because data is no longer available on COMPUSTAT following the takeover or buyout. We have data through year +1 for only four of the firms subsequently taken over or bought out and for none of these firms through year +2. Our results (not reported here) are not qualitatively affected. Operating performance still improves significantly following forced resignations.

these firms, 38 percent experience corporate control activity both prior to and following the management change, 24 percent have only preturndover control activity, and 38 percent have only postturnover activity. These findings suggest a strong link between forced resignations and the market for corporate control. Our reading of press reports suggests that top executive dismissals often appear to be a response to the threat of a control change or an intermediate step in the process of transferring control. In addition, postturnover control activity may be an indication that the board was not effective in choosing a successor to the dismissed executive.

V. Conclusion

We present evidence that forced top management changes are preceded by large and significant operating performance declines and followed by significant improvements in operating performance. These firms significantly downsize their operations following the management change, exhibiting large and significant declines in employment, capital expenditures, and total assets. Furthermore, the forced resignation subsample displays an unusually high incidence of postturnover external corporate control market activity.

In contrast, normal retirements are not preceded by significant changes in operating performance, but are followed by small increases in operating income. These firms also exhibit a slightly higher than normal incidence of corporate control activity following the management change.

Although forced resignations are associated with valuable operating improvements, several additional observations suggest that these improvements should not be credited to effective board monitoring. First, forced resignations are rare events; only about 13 percent of our sample management changes are classified as "forced." Second, over two-thirds of our forced resignations appear to be due to factors such as blockholder pressure, takeover attempts, financial distress, and shareholder lawsuits rather than to normal board monitoring. Finally, forced top management changes do not appear to be very timely; managers appear to be forced out only after an extended period of poor performance involving substantial shareholder losses.

An interesting avenue for future research involves studying the link between internal and external corporate control markets. Our findings suggest that the external control market has an important influence on the workings of the internal control market in disciplining poorly performing managers. While we are able to establish that postturnover external control activity is not driving the accounting performance improvements that we document, further work is necessary in order to understand the precise nature of the interaction between the internal and external control markets in improving firm performance in firms without a control change. Understanding this interaction is particularly important in light of recent regulatory developments that have curtailed corporate control activity. It is not clear from our results whether or not the internal control market functions effectively in isolation.

REFERENCES

- Agrawal, Anup, and Ralph A. Walkling, 1994, Executive careers and compensation surrounding takeover bids, *Journal of Finance* 49, 985–1014.
- Barclay, Michael J., and Clifford G. Holderness, 1991, Negotiated block trades and corporate control, *Journal of Finance* 46, 861–878.
- Berle, Adolph, and Gardiner Means, 1932, *The modern corporation and private property* (Macmillan, New York).
- Bhide, Amar, 1989, The causes and consequences of hostile takeovers, *Journal of Applied Corporate Finance* 2, 366–59.
- Bhagat, Sanjai, Andrei Shleifer, and Robert W. Vishny, 1990, Hostile takeovers in the 1980s: The return to corporate specialization, *Brookings Papers on Economic Activity, Economics*, 1–84.
- Bonnier, Karl-Adam, and Robert F. Bruner, 1989, An analysis of stock price reaction to management change in distressed firms, *Journal of Accounting and Economics* 11, 95–106.
- Coughlan, Anne T., and Ronald M. Schmidt, 1985, Executive compensation, management turnover, and firm performance: An empirical investigation, *Journal of Accounting and Economics* 7, 43–66.
- DeAngelo, Linda E., 1988, Managerial competition, information costs, and corporate governance: The use of accounting measures in proxy contests, *Journal of Accounting and Economics* 10, 3–36.
- DeAngelo, Harry, and Linda E. DeAngelo, 1989, Proxy contests and the governance of publicly-held corporations, *Journal of Financial Economics* 23, 29–60.
- DeAngelo, Harry, Linda E. DeAngelo, and Douglas Skinner, 1992, Dividends and losses, *Journal of Finance* 47, 1837–1864.
- DeAngelo, Harry, Linda E. DeAngelo, and Douglas Skinner, 1994, Accounting choice in troubled companies, *Journal of Accounting and Economics* 17, 113–144.
- Dechow, Patricia M., 1994, Accounting earnings and cash flows as measures of firm performance: The role of accounting accruals, *Journal of Accounting and Economics* 18, 3–44.
- Denis, David J., 1990, Defensive changes in corporate payout policy: Share repurchases and special dividends, *Journal of Finance* 45, 1433–1456.
- Denis, David J., and Diane K. Denis, 1993, Managerial discretion, organizational structure, and corporate performance: A study of leveraged recapitalizations, *Journal of Accounting and Economics* 16, 209–236.
- Denis, Diane, 1994, Evidence on the effects of hostile and friendly tender offers on employment, *Managerial and Decision Economics* 15, 341–358.
- Denis, David J., Diane K. Denis, and Atulya Sarin, 1995, Ownership structure and top management turnover, Working paper, Purdue University.
- Furtado, Eugene P., and Michael S. Rozeff, 1987, The wealth effects of company initiated management changes, *Journal of Financial Economics* 18, 147–160.
- Gilson, Stuart, 1989, Management turnover and financial distress, *Journal of Financial Economics* 25, 241–262.
- Healy, Paul M., Krishna G. Palepu, and Richard S. Ruback, 1992, Does corporate performance improve after mergers?, *Journal of Financial Economics* 31, 135–176.
- Holthausen, Robert W., and David F. Larcker, 1994, The financial performance of reverse leveraged buyouts, *Journal of Financial Economics*, forthcoming.
- Hotchkiss, Edith S., 1995, The post-bankruptcy performance of firms emerging from chapter 11, *Journal of Finance* 50, 3–21.
- Jensen, Michael C., 1991, Corporate control and the politics of finance, *Journal of Applied Corporate Finance* 4, 13–33.
- Jensen, Michael C., and Kevin J. Murphy, 1990, Performance pay and top-management incentives, *Journal of Political Economy* 98, 225–264.
- Kaplan, Steven, 1989, The effects of management buyouts on operations and value, *Journal of Financial Economics* 24, 217–254.
- Kaplan, Steven, 1994, Top executive rewards and firm performance: A comparison of Japan and the U.S., *Journal of Political Economy* 102, 510–546.

- Khanna, Naveen, and Annette B. Poulsen, 1994, Managers of financially distressed firms: Villains or scapegoats?, Working paper, University of Michigan.
- Klein, April, and James Rosenfeld, 1988, Targeted share repurchases and top management changes, *Journal of Financial Economics* 20, 493–506.
- Martin, Kenneth J., and John J. McConnell, 1991, Corporate performance, corporate takeovers, and management turnover, *Journal of Finance* 46, 671–688.
- Mitchell, Mark, and Kenneth Lehn, 1990, Do bad bidders become good targets?, *Journal of Political Economy* 98, 372–398.
- Morck, Randall, Andrei Shleifer, and Robert W. Vishny, 1988, Management ownership and market valuation: An empirical analysis, *Journal of Financial Economics* 20, 293–316.
- Mulherin, Harold, and Annette B. Poulsen, 1994, Proxy contests, shareholder wealth and operating performance: An analysis of the 1980s, *Journal of Financial Economics*, forthcoming.
- Murphy, Kevin J., and Jerold L. Zimmerman, 1993, Financial performance surrounding CEO turnover, *Journal of Accounting and Economics* 16, 273–316.
- Palepu, Krishna G., and Karen H. Wruck, 1992, Consequences of leveraged shareholder payouts: Defensive versus voluntary recapitalizations, Working paper, Harvard Business School.
- Parrino, Robert, 1993, CEO turnover and outside succession: A cross-sectional analysis, Working paper, University of Texas at Austin.
- Pourciau, Susan, 1993, Earnings management and nonroutine executive changes, *Journal of Accounting and Economics* 16, 317–336.
- Reinganum, Marc R., 1985, The effect of executive succession on stockholder wealth, *Administrative Science Quarterly* 30, 46–60.
- Slovin, Myron B., and Marie E. Sushka, 1993, Ownership concentration, corporate control activity, and firm value: Evidence from the death of inside blockholders, *Journal of Finance* 48, 1293–1322.
- Smith, Abbie, 1990, Corporate ownership structure and performance: The case of management buyouts, *Journal of Financial Economics* 27, 143–164.
- Stewart, Thomas A., 1993, The king is dead, *Fortune*, January 11.
- Stulz, René M., 1988, Managerial control of voting rights: Financing policies and the market for corporate control, *Journal of Financial Economics* 20, 25–54.
- Vancil, R. F., 1987, *Passing the Baton: Managing the Process of CEO Succession* (Harvard Business School Press, Cambridge, Mass.).
- Warner, Jerold B., Ross L. Watts, and Karen H. Wruck, 1988, Stock prices and top management changes, *Journal of Financial Economics* 20, 461–492.
- Weisbach, Michael S., 1988, Outside directors and CEO turnover, *Journal of Financial Economics* 20, 431–460.
- Weisbach, Michael S., 1995, The CEO and the firm's investment decisions, *Journal of Financial Economics* 37, 159–188.