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Corporate culture and CEO turnover

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ABSTRACT

We study the effect of corporate culture on the relationship between firm performance and CEO turnover. Utilising a measure of cultural dimension developed in organisation behaviour research, we quantify corporate culture by assessing official documents using a text analysis approach. We employ this quantification to examine the impact of culture on CEO turnover, especially in the case of poor firm-specific performance. First, we find strong evidence of a negative relationship between firm-specific performance and CEO turnover. Second, we demonstrate that the probability of a CEO change, on average, is positively influenced by the competition- and creation-oriented cultures. The negative relationship between firm-specific performance and CEO turnover is reinforced by the control-oriented culture and reduced by the creation-oriented culture. Finally, we study the CEO insider or outsider succession and observe that the creation-oriented culture has a negative relationship with the probability of hiring an outsider. Moreover, the creation-oriented culture weakens the negative relationship existing between the firm-specific performance under the incumbent CEO and the probability of hiring an outsider.

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1. Introduction

The threat of CEO change after poor performance is one of the main corporate governance instruments. It is widely believed that corporate culture plays an important moderating role in linking CEO turnover and past performance. Surprisingly, we are unaware of any large-sample empirical evidence indicating whether and how corporate culture influences the link between firm performance and the probability of CEO change. This lack of research is perhaps due to the somewhat nebulous nature of the notion of culture, which raises several measurement issues in empirical research (Guiso et al., 2006). Nonetheless, recent research has begun to explore the empirical link between culture and various economic phenomena using novel approaches to measuring culture (Bernhardt et al., 2006; Fang, 2001; Guiso et al., 2006, 2009; Luttmer and Singhal, 2011). However, this research has not addressed CEO turnover.

What role does corporate culture play in the decision to fire a CEO after poor performance? Is there a specific firm culture that increases (decreases) the probability of changing CEOs after poor performance? These questions are critical for assessing the credibility of the CEO change threat as a corporate governance instrument. The purpose of this paper is to empirically address these questions by focusing on a large sample of US listed companies between 1994 and 2011. Our approach involves obtaining a quantitative measurement of corporate culture by assessing corporate financial statements (e.g., 10-K reports). Text analysis has recently been used in various finance papers (e.g., Antweiler and Murray, 2004; Li, 2008; Loughran and McDonald, 2011; Tetlock, 2007; Tetlock et al., 2008). This method allows us to link the probability of a CEO change to the extent of various corporate culture orientations.

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Consistently with previous papers (e.g., Coughlan and Schmidt, 1985; Warner et al., 1988), we find a strong negative relationship between firm-specific performance and the probability of changing CEOs, indicating that the threat of turnover after poor performance is credible. Our main result is that corporate culture influences the probability of a CEO change and moderates the negative relationship with performance. Specifically, the probability of CEO change, on average, increases in the case of a corporate culture oriented toward competition (i.e., focusing on emphasising organisational effectiveness and fast response) or creation (i.e., focusing on generating future opportunities through innovation). Furthermore, the negative relationship with firm-specific performance is reinforced by a culture oriented toward control (i.e., focusing on internal improvements in efficiency through the implementation of better processes) and reduced by a culture oriented toward creation. Finally, when we disentangle CEO turnover into insider and outsider successions, we find that the creation-oriented culture plays an important role. First, it negatively impacts the probability of hiring an outsider. Second, it also weakens the negative relationship between the firm-specific performance under the incumbent CEO and the probability of hiring an outsider.

The rest of this paper is organised as follows. Section 2 provides a literature review, and Section 3 presents our definitions of corporate culture and formulates our research hypotheses. The investigated sample and the variables used in our empirical design are described in Section 4. Section 5 discusses the empirical results and robustness checks for CEO turnover. Section 6 focuses on the type of CEO succession (insider vs. outsider), while Section 7 presents our conclusions.

2. Related literature

To be considered a valuable corporate governance instrument, CEO change must be credible in the sense that the CEO turnover is negatively related to firm performance. Early papers (Coughlan and Schmidt, 1985; Warner et al., 1988) find a negative relationship between firm performance and CEO change.

The relationship between performance and CEO change is not simple and direct. Since the 1990s, various authors (e.g., Zajac, 1990) have noted that neither the strategic management nor the financial economic literature offers a unified theoretical or empirical framework for topics related to CEO succession. Furthermore, these studies have relied exclusively on archival data, with no attempt to collect or analyse primary data provided by the CEOs themselves. Consequently, the results are not always consistent, and past performance often explains only a very low portion of the turnover phenomenon (Pitcher et al., 2000). More recent papers (e.g., Wiersema and Zhang, 2011) recognise that research has advanced our knowledge of the firm performance — CEO turnover linkage, but the relationship continues to appear complex and somewhat ambiguous amid the existence of several variables that may play a moderating role (e.g., CEOs' influence on boards through direct ownership, as outlined in Easterwood et al., 2012; CEO's outside employment options, as outlined in Liu, 2014).

Although there appears to be convergent evidence that CEO change is credible, there are no studies assessing the reason for this link, and more research is needed to identify the roots of this relationship (Jenter and Kanaan, forthcoming).

The main contribution of our paper is that it is the first to provide empirical evidence (based on a large sample) that the relationship between performance and CEO turnover is strongly influenced by corporate culture. Although this finding is certainly logical and intuitive, there have been no studies documenting whether and how corporate culture influences the relationship between firm performance and the decision to fire the CEO. We build a unique dataset of all US listed companies between 1994 and 2011 and obtain a quantitative measurement (at the company level) of corporate culture by assessing financial statements. Our approach is based on text analysis (recently used in such finance papers as Antweiler and Murray, 2004; Li, 2008; Loughran and McDonald, 2011; Tetlock, 2007; Tetlock et al., 2008), which provides an objective assessment of corporate culture.

As suggested by Jenter and Kanaan (forthcoming), we assess the credibility of (the threat of) CEO change by measuring the sensitivity of CEO turnover to firm-specific performance. Jenter and Kanaan's (forthcoming) approach enables us to decompose firm performance into a systematic component (caused by peer group performance) and a firm-specific component that should reflect CEO ability.[1] This approach fits our research needs very well because it allows us to obtain a proxy of the (unobservable) CEO's ability and then investigate the role of corporate culture in the evaluation of his/her performance with the relative consequences in terms of turnover.

3. Theory and hypotheses

Culture is a broad concept and represents the implicit and explicit contracts that govern behaviour within an organisation (Bénabou and Tirole, 2002, 2011; Tabellini, 2008). Corporate culture is traditionally considered to have an important influence on an organisation's effectiveness (Deal and Kennedy, 1982; Peters and Waterman, 1982; Schein, 1992; Wilkins and Ouchi, 1983), and in a recent review of the literature, Sackmann (2010) suggests that some culture orientations have a positive effect on performance measures.

A first necessary step for our analysis is to define culture in a sufficiently narrow way within this framework so that it is possible to identify its influence on the relationship between CEO turnover and company performance change. We adopt the definition proposed by Cameron et al. (2006), who identify the following four types of corporate cultures (termed culture dimensions): control, competition, collaboration, and creation. We choose Cameron et al.'s (2006) framework because it draws on Quinn and Rohrbaugh

[1] In the financial and economic literature, it is a common belief that boards filter out exogenous industry and market shocks in assessing CEO performance. However, recent papers (e.g., Eisfeldt and Kuhnen, 2013; Jenter and Kanaan, forthcoming) show that the industry and market performances are also relevant in determining CEO turnover.

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