THE RELATIONSHIP BETWEEN ACCOUNTING PERFORMANCE AND CEO TURNOVER: EVIDENCE FROM INDONESIA

Lindrianasari, University of University of Gadjah Mada
Jogiyanto Hartono, University of Gadjah Mada Indonesia

ABSTRACT

This study provides empirical evidence regarding the usefulness of accounting information in the issue of CEO turnovers. Previous research shows inconclusive results about the relationship between accounting performance and CEO turnover. Moreover the topic of CEO turnover is still rarely examined in non-western countries, such as in Indonesia. This study used data on all companies that were identified as having undergone CEO, President Director for Indonesia, turnovers from 1998-2006. Other firms were included as a control sample. The sample used for testing included 140 companies, consisting of 81 companies with turnovers and 59 companies as a control. Final samples were determined after considering the availability of data and the confounding effects in the period observed. Hypotheses were tested using Logit regression because the dependent variable used is a binary variable, with the notation 1 for turnover and 0 for others. The results show that accounting performance had a statistically significant negative influence over the turnover decision. However, turnover did not affect accounting performance.

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KEYWORDS: CEO Turnover, Accounting Performance, Antecedent Factors, Concequences Factors, Routine and Non-Routine Turnover.

INTRODUCTION

Turnover decisions are generally made by leaders of a company to increase growth and encourage better corporate performance. This is shown in a Indonesia national bank that had a CEO turnover in the year 2004. Three years before the turnover (2002-2004), the company's revenues dropped by 34.67%, while the ratio of Total Debt to Total Assets amounted to 34.56%. A positive change occurred after the turnover was made. Corporate earnings continued to increase to 17.5% in 2008, while the ratio of Total Debt to Total Assets was 45.37% (an increase by almost 11%). This is an extraordinary achievement, in that at the time that global crisis hit the banking world, this corporation was actually able to increase its profit in comparison to previous years. This provided contextual proof that a company could succeed after a CEO change.

This study was conducted to demonstrate the significance of information contained in financial statements in relation to CEO turnovers. This study expects to provide findings that illustrate the significance of accounting variables as antecedents of a CEO turnover. Such a finding would support the findings of previous researchers (e.g. Engel, Hayes and Wang 2003). We hope the consistency of findings here with those of other researches will encourage stakeholders to become more focused on financial reports when making important decisions in the company. Studies in this field are rare in Indonesia. This is likely due to limited information regarding turnovers that occurred. However, this research is important, considering the significant contribution it could make to the corporate governance literature. Furthermore, this study also provides information to stakeholders on the appropriate treatment to give to the company's CEO using accounting information. This includes CEO's with good performance or otherwise. In order

to achieve these objectives, answer the question of whether accounting information can influence and affect CEO turnover.

The reminder of the paper is organized as follows: in the second section, we describe the previous literature on the relationship between accounting performance and CEO turnover. Hypothesis development is integrated with the literature review. Next, we describe the research methodology. Finally, the result and analysis are offered, and conclusions drawn.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The study on the relationship between accounting of a company CEO turnover was initiated by Coughlan and Schmidt, (1985). This study was followed by the work of Warner, Watts, and Wruck (1988) and Weisbach, (1988). These papers provide findings relevant to describing the link between CEO turnovers and the accounting market. Subsequently the literature grew. The overall findings of the literature were not conclusive through 2009. The following study by Engel et al. (2003) placed greater expectations on more informative accounting information on managerial performance. If accounting information proved to be more sensitive in explaining CEO turnovers, then the board would have more confidence in accounting returns than on other sources of information. They would consult accounting information when making decisions regarding the sustainability of employment.

Studies conducted by Kesner and Sebora (1994: 356) concluded that change is often treated as a dependent variable, and the findings show a consistent pattern of higher turnover rates occurring among firms with low performance. However, Finkelstein and Hambrick (1996) stated that performance prior to the turnover explains only a small percentage of the variation. This indicated that the relationships between variables following a turnover were still weak. Other weaknesses noted in previous research relate to differences between size and performance in the presence of other factors that tend to moderate the relationship between performance and replacement (see: Miller, 1991; Cannella and Lubatkin, 1993; Zajac and Westphal, 1996; Finkelstein and Hambrick, 1996).

Smith, Wright and Huo (2008) continued the previous line of research by using variables found to be statistically significant. It uses variables such as Total Assets, Total Debt, Book value of equity, Debt to Equity, Earnings retained; Current Ratio and Interest Coverage Ratio. Their study found significance in all samples, including the Total Assets, Total Debt, Book Value of Equity, Current Liabilities, Current Liabilities, and the interest coverage ratio for firms surviving only with the p-value smaller than 0.05. Besides the variable used by Smith et al. (2008), there are still other variables used in previous research. Return on Assets (ROA) is widely used in previous studies that analyzed accounting ratios (such as in the studies done by Virany, Tushman, and Romanelli, 1985; Harrison, Torres, and Kukalis, 1988, Shen 2000). ROA was found to have a negative relationship with turnovers where CEO replacement was recruited from outside the firm. The negative relationship found in the previous researches indicated that company performance could be reflected in the subsequent reduction of return on assets, which would then encourage a CEO turnover.

The study conducted by Beadles II (2002) found no relationships between functionality of sales and turnover (as a proxy of organizational performance) indicating a positive and significant relationship. Engel et al. (2003) and DeFond and Hung (2004) used the earnings variable in their research. The findings of this study strengthened the position of earnings as an antecedent factor of turnover. The purpose of the paper written by Engel et al. (2003) was to examine how the relationship between various measures of performance and CEO turnover is influenced by accounting system properties. Studies by Engel et al. (2003) specifically examined the cross-sectional variation for important points of accounting information in the CEO's decisions, and then connected these properties to performance measures. DeFond and Park (1999) stipulated that firms in less concentrated industries have a broader range of

comparing companies. Consequently, industry earnings provide the right signal as factors affecting the company in the industry. Engel et al. found that CEO turnovers are more common in less concentrated industries. This finding was consistent with research of DeFond and Park which stated that directors could learn more quickly about the ability of CEOs in this sort of industry. They mentioned that replacements to the poorly performing CEO could be made immediately. This result was found only sample firms experiencing a turnover. Both Engel et al. (2003), and DeFond and Park (1999) found a negative relationship between earnings and turnover. Therefore, our temporary assumption would be that accounting performance can affect CEO turnovers, as the first hypothesis of this study.

Gamson and Scotch (1964); and Boeker (1992) argued that turnovers really do not have an influence on performance. Turnovers symbolize the event of "a scape-goating" that would generally occur when the CEO was the founder (owner) of the company. And when faced with a decline in performance of the company, the CEO would experience no change but the CFO would be replaced. However, some research on the consequences of CEO turnovers indicate that a change could have positive effects on performance (Helmich, 1974; Davidson, Worrell and Dutia, 1993) if the CEO did not generate good performance. However, some studies also found negative effects of change (Grusky, 1964; Allen, Panian, and Lotz, 1979; Carroll, 1984; Beatty and Zajac, 1987; Haveman, 1993) resulting from a disturbance in the organization. Contingent factors that drove these diverse findings were usually caused by personality factors such the executive.

The consequences of CEO turnovers have become a topic of interest because it is driven by two types of problems that occur between principals and agents. These problems crop up due to deteriorating property rights and weak investor protections. A great amount of attention from among academics, practitioners and researchers have been garnered on resolving corporate governance issues. Kato and Long (2006) considered CEO change and its relationship with company performance provides an important measurement of how effectively a firm is able to resolve serious problems. First, to reconcile separate interests of top management and shareholders. Second, to bring together the interests of major and minor shareholders. The better the CEO's ability to reconcile these two major problems, the better the credibility of the CEO is, therefore reducing the probability of CEO turnover. And conversely, the failure of the CEO exacerbates organizational performance and ultimately the chances of a turnover are greater because of stakeholders' dissatisfaction with CEO performance.

Baron, Hannan and Button (2001) conducted a study on the consequences of following the directions from an executive turnover. There are several arguments suggesting the model associated with labor should resist change, which implies that attempting to recreate the blueprint will only cause disruptions. Attempts to modify the governance of employment will be more moderate when there is a change in organization. The research found that some types of organizational change (in strategy, top management, or other) have consequences on organizational performance and could jeopardize the organization's existence (see Barnett and Carroll 1995; and Carroll and Hannan 2000). Considering the above arguments, it is important that the study on the consequences of a change of direction be expanded.

Results from the analysis by Baron *et al.,* (2001) showed that the relationship between revenue and turnover has a statistically significant negative impact on the growth of income replacement, consistent with their first hypothesis. They hypothesized that the more frequent changes occur, the lower the growth rate. This situation caused the organization to face difficulties when leadership changes occur. Baron *et al.* were not able to obtain solid conclusions from in their studies because of restrictions in the gathering of data.

RESEARCH METHODS

The data used in this study consists of all CEO turnovers within the period of 1998 to 2006. Companies with turnovers that occurred during the period 2001-2003 followed by four consecutive years of no turnovers make up the sample population used in this study. We assumed that this new CEO would have brought changes to the company up to the year 2005. This data were obtained from a direct investigation of the financial statements of all companies listed on the Indonesia Stock Exchange during the eight years of observation. Consistent with previous studies, we will assign the title of CEO for the position of President Director of the company (in DeFond and Hung 2004) if the company does not explicitly use the term chief executive. The CEO turnover data were obtained by scanning through the reports and comparing the names of the companies' President Directors during the period of observation. In this way, we effectively obtain the necessary information through CEO names changes in a company used to measure CEO turnover in a particular company in a given year. The research takes into account changes in CEO names in Indonesia in three years from 2001 until 2003.

This period was then designated as the t_0. Next, we trace the data for three years before and after. For market data, we used the data from three years before and three years after the turnover year. Previous research generally use a three to five-year period before and after the turnover. However, because the sample size shrinks if we extend the period of observation, we chose to use a period of three years before and after the turnover. During the period 1998-2005 there were about 246 CEO turnovers in public companies in Indonesia. But those that met the criteria for our study sample, having a three-year financial data before the turnover and market data three years after the turnover and did not have confounding effects such as restructuring and stock management, included 81 companies. These statistics are presented in Table 1.

Table 1: Sample Selection

Describes	Total
Companies investigated: period 1998-2006	3200
Total identified turnovers: period 1998-2006	264
Turnovers without changes for four consecutive years in the period 2001-2003	97
Final sample for analysis of accounting data	140*

81 samples and 59 samples of control sample **The control sample consist of companies that during the observed years 1998-2005 experienced no changes in their CEO. The companies are expected to have a relatively stable performance. Accounting and market data that we use for analysis is an average of over a five year period from 2001 to 2005.*

The testing of antecedent variables uses the logit analysis as in equation (1) is commonly used in research that use binary variables as the dependent variable (the turnover denoted 1 and 0 for others) as well as for cross sectional data. This research model has been used in previous researches in the field of Accounting and Management. Zhou, Xiong and Garguli (2009) used the binary model when they conducted accounting studies using adoption of IFRS as the dependent variable. They symbolized Adopt as (1.0). They used logit analysis to test possible relationships between independent and dependent variables. The logit model of our study for testing our first hypothesis is:

$$TURNOVER\ (1,0) = \alpha_0 + \alpha_1 ln\text{-}TAssets_{it} + \alpha_2 CurRatt_{it} + \alpha_3 ln\text{-}TSales_{it} + \alpha_4 ROA_{it} + \alpha_5 ROI_{it} + \alpha_6 Earnings_{it} + \varepsilon_{it} \quad (1)$$

We used the paired sample test to test the second hypothesis.

Variables used in this study are variables that have been used in previous studies (such as Smith, Wright and Huo 2008) and have been found to be statistically significant. The variables we use here are:

Total assets (ln-TAsset), as a proxy for company size, and is used to control the natural log from highly non-linear data. This variable is believed to have a negative relationship with turnovers because increase in total assets reflects the positive growth of the company.

Current ratio (CurRat), formulation of current assets / current liabilities, and serves as a proxy for short-term financial shortage. Research in cases of bankruptcy in Smith et al had previously shown that this variable had a negative relationship with the probability of turnover (Flagg and Giroux, 1991; and Zmijewski, 1984).

Total sales (ln-TSales), which is used to measure the company's management of operational performance with the natural-log to control data. ln-TSales is expected to be negatively related with turnover, which means that high ln-TSales will not encourage CEO change.

Return on Assets (ROA), is a measure of performance obtained from the ratio of earnings to total asset. The better the ROA, the less likely it is for turnovers to occur.

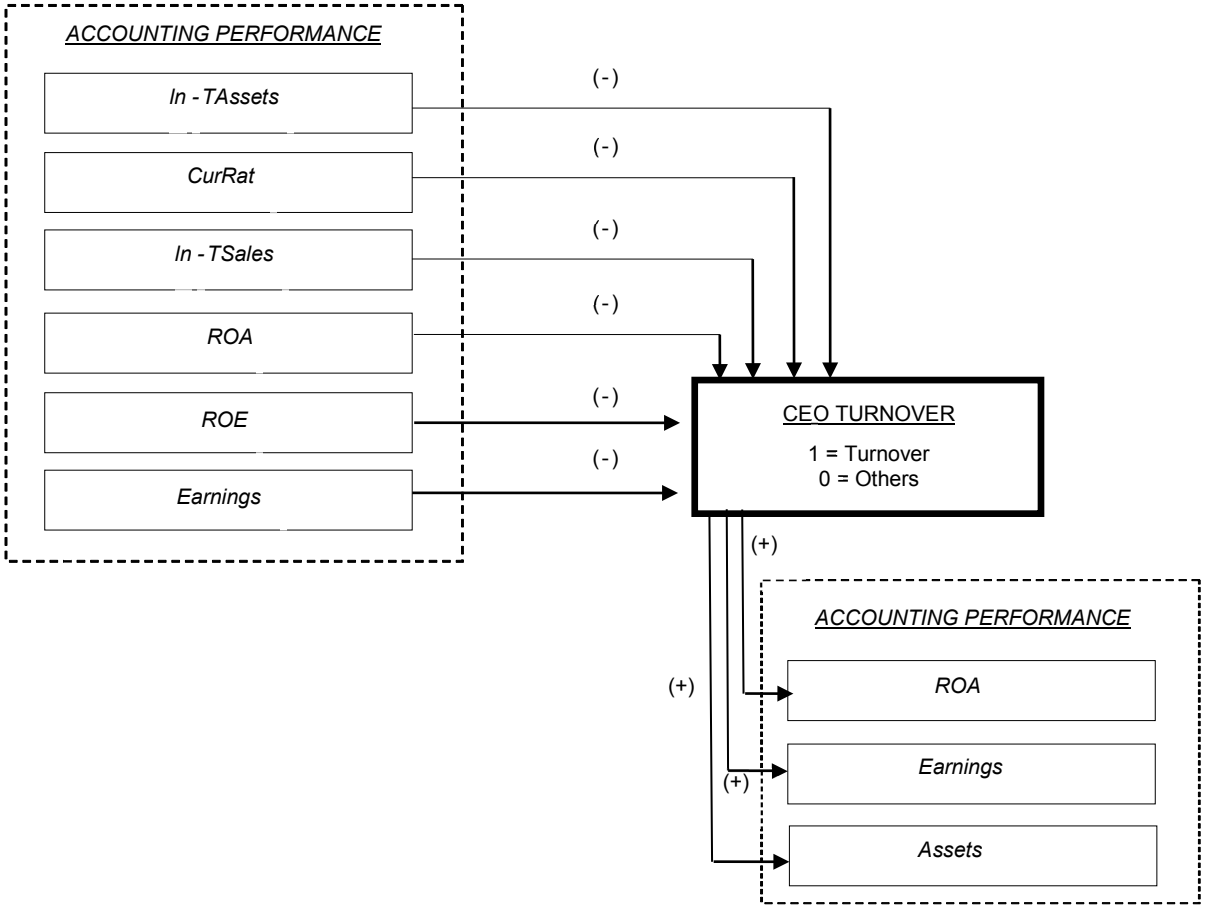
Return on Equity (ROE), as an alternative assessment for the company's success in its equity restoration management. ROE values are obtained from the equation of earnings divided by total equity. This variable is believed to have a negative relationship with turnovers, in that the failure in the return of capital would contribute as one reason for a turnover in the company.

Earnings. This measurement was used in Engel et al. (2003), DeFond and Hung (2004) and showed a negative relationship with turnovers. This measurement is very common and is often used to evaluate management of performance. In this research, we use net income to represent earnings.

We apply three variables of accounting performance as a consequence of turnover, Return on Assets (ROA), Earnings, and Assets. ROA measures performance obtained from the ratio of earnings to total asset. We predict that turnover will improve accounting performance, as well as ROA, as Kato and Long (2006) found that ROA improves after the change occurs. Earnings, measures management performance, and is used in this study as consequences factors of turnover. Previous research using this variable include Baron *et al.,* (2001) and Murphy and Zimmerman (1993). Assets (ln-TAsset), is a proxy for company size, and is used to control the natural log from highly non-linear data. This variable is believed to have a positive affected by turnovers.

Figure 1 presents the research model that we tested in this study. Figure 1 shows the six variables of accounting performance that we use as factors that led to turnover, and three variables of accounting performance as factors affected by CEO turnover. We can see in the figure that there are negative signs between antecedent variables related to turnover, while a positive signs on the relationship of consequences variables of CEO turnover.

Figure 1: Research Model where Accounting Variable as an Antecedent



RESULTS AND ANALYSIS

Before we operate logit analysis on accounting data, we first performed a classic test for both sources of data used. Our classic test tested for multi-collinearity and heteroscedasticity. From the classical assumption on the data, we concluded that the data used was not problematic in these areas.

Our study tested accounting data as a factor significant in the issue of CEO turnovers in Indonesia. Overall, the logit test results for the accounting show a percentage predictive value of 91.4% correct. This signifies that the values of the variables used in the model were appropriate. Individually, 5 of 6 accounting variables showed significance at the level of $p \leq 0.05$. This value is supported by a chi-square omnibus test which illustrates the influence of antecedent models in accounting and a very strong market significance, respectively ($p = 0.000$). The chi-square omnibus test values of model coefficients were less than $p = 0.05$ indicating that the null hypothesis, stating the independent variables had no influence over dependent variables, is rejected. Furthermore, Nagelkerke's R square, which is a modification of the coefficient cox, and Snell R square are used to determine the varieties of the relationships that each independent variable would have with its dependent variables. The influences of independent variables are collectively indicated by Nagelkerke's R square value of 0.66, and the partial value of Nagelkerke's R square is described using Wald, which also shows the significance of each variable. We explain the overall results of the analysis in Table 2. The characteristics and results of the tests conducted in this study, including the samples we used are also explained in the table. Table 2 Panel

A shows the results from the testing of effects of CEOs turnover from a sample of 140 companies consisting of 59 companies without turnovers in the period of our observations, together with 81 companies with turnovers.

This study is consistent with the results of the study by Smith et al. (2008) and other researches, such as Engel *et al.* (2003). As the first hypothesis is supported, we are able to state that the results of this study are in line with expectations from previous researchers (e.g. Engel *et al.,* 2003), suggesting that accounting information should be considered when making important decisions at the company. Tests on the variable ROA show it has a significant relationship with turnovers. This is consistent with the findings of Shen (2000) who discovered the significance of ROA and the turnover. This finding shows accounting performance is an important factor to be considered when making important decisions.

The test results accounting performance measures influenced by CEO turnover are presented in Table 2 : Panel B.

Table 2: Summary Statistics Data and Results of Tests

	Variables	t-statistic	Wald (R^2)	Coefficient	Sign.
Panel A	In TAssets	-2.2899$^{**)}$	5.239	-0.9787	0.02
	CurRatio	-0.1706	0	-0.0004	0.99
	InTSales	-1.9191$^{**)}$	3.683	0.6994	0.05
	ROA	-4.4301$^{***)}$	19.719	1.2698	0
	ROE	-2.1563$^{**)}$	4.566	-0.0206	0.03
	Earnings	-1.9137$^{**)}$	4.212	-0.0032	0.04
Panel B	ROA	-1.873$^{*)}$	2.8	-0.168	0.06
	Earnings	1.973$^{**)}$	3.1	0.177	0.05
	InTAssets	1.988$^{**)}$	3.2	0.178	0.05
			Mean		**Sign.**
Panel C		**t-statistic**	**Before**	**After**	
Pair 1	ROABefore-ROAAfter	0.457	2.54	0.05	0.649
Pair 2	EarnBefore-EarnAfter	-1.013	246.1213	245.2733	0.315
Pair 3	AssetBefore-AssetAfter	-1.709$^{*)}$	2673.371	7801.558	0.092

Note: $^{***)}$, $^{**)}$, and $^{*)}$ indicate significance at the 1, 5, and 10 percent levels respectively

Table 2 Panel A shows the results of the regression analysis that out of six accounting variables that were used on the antecedent models of turnover: $TURNOVER\ (1,0) = \alpha_0 + \alpha_1 ln\text{-}TAssets_{it} + \alpha_2 CurRat_{it} + \alpha_3 ln\text{-}TSales_{it} + \alpha_4 ROA_{it} + \alpha_5 ROI_{it} + \alpha_6 Earnings_{it} + \varepsilon_{it}$. Panel A Shows variables that are significant with a turnover. Total Sales is significant at the 0.05 level, while Total Assets, ROE and Earnings are significant at the level ≤ 0.05, while ROA shows the strongest significance at the level of ≤ 0.000. However, we do not find any significance for the variable Current Ratio. Using these statistical results, our study supports the first hypothesis that the performance of accounting research has a significant influence on CEO turnover.

Table 2 Panel B shows the result of regression analysis of the consequences of turnover on accounting performance. Statistical result showed that all the accounting performance tested in this study show companies that make the change perform significantly better than companies that do not. In Panel C Table 2 we see the average value of Earnings and Assets are better after the turnover, although Assets are significant at the level of 10%. Nevertheless, we conclude that accounting performance is affected by CEO change in Indonesia, although the study did not have strong enough support to accept the second hypothesis.

We perform tests on firms that had routine and non-routine turnovers as an additional test in order to provide a more detailed explanation on the issue of turnovers. A Paired Samples Test is used on both types of turnovers. We find there is a striking difference in the mean of the five accounting variables

between routine and non-routine turnovers, (Total Assets, Total Sales, ROA, ROE, and Earnings) although the difference in mean is not consistent in Current Ratio. Table 3 shows the results of the difference test performed on accounting for both routine and non-routine turnovers. In this study, we try to define the turnover process very carefully. By our definition, a non-routine turnover is a turnover that results in the replaced CEO not transferring to any other position (the board of commissioners or members of top management team) in the original company or those companies belonging to the same owners. Setiawan (2008) followed the directions by Kang and Shivdasani (1996) in identifying the process of non-routine and routine turnovers. If the replaced CEO was eventually recruited to be a member of the board of commissioners, then the turnover would be considered a routine turnover, and if not, then it would be considered non-routine. In addition to CEOs becoming members of the board of commissioners, this research also takes into account CEO turnovers in firms with the same ownership and also cases where the CEOs were recruited into the top management team. We then found significant differences in the accounting variables used in this study.

Table 3: Results of Difference Test in Accounting Performance for Routine and Non-Routine Turnovers

	Pairs	Mean	Sig.
Result of T-Test Paired Sample, N= 59	1 TAsset(R)	6.082	. 245
	TAsset(N)	6.542	
	2 CurRat(R)	1.721	.328
	CurRat(N)	1.265	
	3 TSales(R)	5.214	.120
	TSales(N)	5.761	
	4 ROA(R)	-2.532	.737
	ROA(N)	1.544	
	5 ROE(R)	-50.135	.188
	ROE(N)	-21.023	
	6 Earnings(R)	-529.934	.314
	Earnings(N)	668.008	

Note: (R): Routine (N): Non-Routine

The test on different types of turnovers shows that accounting performance of non-routine turnovers is generally lower (except for Current Ratio). This indicates that non-routine turnovers generally occur when corporate performance is in decline. In other words, the findings are, in concept, consistent with the reasons causing CEO change and are in line with the opinions of previous research findings that financial performance as the antecedent of turnover. We therefore concluded that non-routine turnovers are encouraged by worsening conditions of the organizational performance

CONCLUSIONS, IMPLICATIONS AND LIMITATIONS

This study has provided findings regarding the contribution made by accounting information to CEO turnovers in Indonesia. Antecedent factors of turnovers in our analysis are the main contribution of this research. All the samples used are made up of companies with a turnover in a given year and with abundant accounting data and market data. Of the six accounting variables used as antecedent, the variables Total Assets, Total Sales, ROA, ROE and Earnings is found to be consistent and unbiased with turnovers. The findings provide important information which describes the usefulness of accounting information. This benefits the entire accounting community, because accounting data is considered an important source of information for making company decisions.

We cannot argue that the decision of the turnover is easy for the organization to make, since changes in top leadership mean that the model of organization would change and might be weakened especially in companies that are highly dependent on the figure of a leader and not on the information systems. Finally, we conclude the decision to turnover a CEO would take into account significant accounting information and impacts accounting performance.

Although this research has been conducted meticulously, we know that improvements are always possible. Limitations of this study include that it did not consider broader reasons that would encourage turnovers, such as retirement, death, or forced or voluntary turnovers, all of which have shown considerable influence in previous research in this field. Also, in accordance with previous studies, further researches need to consider the characteristics of CEO personalities who were replaced and who were brought in. By considering these factors, better findings may be obtained in the issue of CEO turnovers, which would then be better able to provide a comprehensive explanation regarding issues of turnovers in Indonesia.

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BIOGRAPHY

Lindrianasari is a Lecturer at University of Lampung – Indonesia and PhD. Student of the Accounting Program of University of Gadjah Mada. Lidrianasari can be contacted at: sari_170870@yahoo.com.

Yogiyanto Hartono is Professor of Financial Accounting and Senior Lecturer at University of Gadjah Mada Indonesia. Yogiyanto can be reached at: jogiyantohm@gmail.com