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**SUCCESSION EVENTS: AN EMPIRICAL STUDY OF SUCCESSION AND
LEADERSHIP EFFECTS ON SHAREHOLDERS EXPECTATIONS OF FUTURE
EARNINGS MODERATED BY THE CONTEXT AND CONTENT OF THE EVENT**

Nada Farah

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Of
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ABSTRACT

Succession Events: An Empirical Study of Succession and Leadership Effects on Shareholders Expectations of Future Earnings Moderated by the Context and Content of the Event.

Nada Farah

Succession and leadership effects are two important elements to the understanding of the impact of CEO succession on the performance of the organization as measured by shareholders' expectations of future earnings. This relationship is moderated by the presuccession performance - a context variable -, successor origin, departure type and CEO compensation – three content variables. This study also investigates whether presuccession performance is an antecedent to origin. The findings in past research have been conflicting but basically supported either one of three theories of succession that the event has either positive, negative or no effect on the organization. This study uses the event study methodology, which allows the measurement of abnormal returns for the stock of companies around the announcement date. A sample of 156 large business organizations that had announced the succession event in the Wall Street Journal for the years 1986-1995 is used, and the compensation data are extracted from the yearly compensation scoreboard of the Business Week. The results show that both effect are important in the full understanding of succession impact, and some of the moderators are also very influential while others less so.

Dedication

To My family

Especial thanks for my husband and young sweet daughter who supported and loved me throughout this whole year. For my two sisters, Jeanine and Lina, who believed I could do it, and to Mom and Dad who taught me to always go for what I want. You are all a constant source of love and support. For my two brothers, John and Gaby, you always make life interesting and challenging. Last but not least, to my newborn baby boy whose birth on July 3, 1998, is the highlight of this year.

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Introduction

The topic of executive succession and its impact on organizational performance has been the center of attention for the last four decades; however, the research has been sparse with conflicting results. Researchers have been pondering the question of whether leadership change impacts firm performance positively, negatively, or not at all, with very little consensus in their findings. Nevertheless, the literature indicates that in order to understand the ripples that are caused by an event such as leadership succession, it is vital to recognize the dynamics of the succession event, which progressively unfolds into two related but separate folds: succession effect and leadership effect.

The first fold is the 'succession effect'; it deals with the impact of the turnover itself on the organizational performance. In other words, what is the reaction of the interested parties, such as stockholders, the market, investors and employees, to the change? The second fold, labeled 'leadership effect', takes place after the initial impact of turnover and involves observing the repercussions of the strategic changes that the new leader implements on firm performance. In this second phase, it is the actions of the new leader that are assessed and reacted to, and this usually takes place after a certain time has lapsed following the announcement. In fact, there seems to be a set of factors and conditions involving the event of executive replacement, that seem to impact the leader's ability to influence the

organizational performance. Several studies have portrayed new CEOs as facilitators of change (Fredrickson, Hambrick and Baumrin, 1988; Hambrick and Finkelstein, 1987; Miller, 1990; 1993), and linked them to a set of transformations that modify the structure, strategy and direction of the organization (Miller, 1993). Miller's study (1993) found that succession events were followed by a certain 'diffusion of authority', and an increase in 'organizational information processing', he concluded that:

“Succession is associated with change, regardless of direction, in a wide variety of organizational dimension. Increases and decreases in power dispersion, information processing, and competitive aggressiveness all appear to be especially likely after the appointment of a new CEO.” (Miller 1993, p. 656)

In fact, the change in leadership can be interpreted as either continuity in the organizational life cycle or a disruption of the existing status quo. Depending on the conditions surrounding the event, the investors and the market might receive either one of the above messages. Therefore, it becomes important to determine the factors that seem to influence the relationship between succession and leadership effects on firm performance.

The literature classifies the conditions surrounding the succession event as either context or content factors. The context factors are the performance of the

organization prior to the succession event and the size of the firm. The content factors are more varied. The most consistent amongst the studies are the origin of the successor and the type of removal of the predecessor. One factor to look at is the mandate to implement change, which might affect the ability of the successor to influence organizational performance. Is the new CEO empowered by the board of directors to modify the strategies and decision making of the organization? It is the aim of this research to determine whether or not the boards of directors give the successor a certain mandate to strategically change the organization's direction. In other word, using the compensation package offered to the new CEO, this study tries to determine the message that is detected by the shareholders on whether the new leader will conserve the continuity of the organization or strategically implement change that will disrupt the current situation.

Compensation packages serve a variety of functions. For instance, since CEOs are considered a valued asset to the organization, compensation packages became a means to attract and keep new CEOs (Zajac, 1990). Another role of executive remuneration is to align CEO interest with that of shareholders by using long-term compensation to tie CEO wealth with that of the shareholders. Especially using long term compensation as a means to ensure that executives do not favor short-term improvement over long-term strategic decisions (Zajac and Westphal, 1995). Compensation is a very hot issue, today. Researchers are trying to define the impact of pay on firm performance, as well as determining the role that the board of

directors play in determining what is an adequate compensation package (Grossman and Hoskisson, 1998).

However, up to date, very little attention was paid to the intentions of the board of directors in designing the compensation package. There seems to be a consensus that the components of the pay plan are used to control executives. It is this study's own assumption that since the pay influences the way the executives run the organization, then the ratio of the components of the package become an implicit message to shareholders, investors, employees and other concerned parties as to what is expected of the new leader. The two determinants of the compensation plan are distinguished as short-term or salary and bonus, and long-term or stock-options.

The percentage of each of the above two components with total compensation then signals the interested parties as to what is expected of the new CEO. When short-term compensation is a substantially large part of the total compensation, it might send the message that a focus on short-term strategy is expected and therefore short-term improvement is expected, an almost support to the continuity of the firm. On the other hand, a larger long-term option is a signal that the new CEO is expected to implement changes that will have long-term improvement not just short-term. This might be one of the factors influencing the impact of CEO succession on firm performance.

There are three theories concerning the impact of succession on organizational performance. The first is labeled the 'common sense' theory, which basically says that succession will positively affect performance (Guest, 1962). In other words, the new leader will have a positive impact on the performance of the organization. The second theory, the 'vicious cycle' theory, states that the event is viewed as so disruptive that it will negatively affect the performance (Grusky, 1963). Although the change ought to bring positive effects to the organization, the disruption or discontinuity that is created by the event is such that the negativity outweighs the expected positive results. The third theory labeled the 'scapegoating' theory, supports that the new leader will have no effect on performance (Gameson and Scotch, 1964). That final theory claims that a change in leadership is nothing but a way the board of directors tries to appease the unsatisfied shareholders by sacrificing the previous CEO. However this theory can be debated either way, the shareholders unhappy with the results of the previous leadership will welcome the change Or if the old CEO is seen as unfairly removed then the morale of the employees might be negatively affected which in turn negatively impacts the performance of the organization. That last theory has not received wide support from recent studies.

Allen, Panian and Lotz (1979), is one of the initial studies that emphasized the distinction between the two effect but it was not until Carson, Smith and Alexander (1984) that the two effects are investigated within the same research. It

is not enough to determine one or the other but a full understanding of the succession of leadership requires an investigation of both effects together.

This study revisits the succession issue, and attempts to differentiate between the change effect and leadership effect in order to assess the factors that explain some of the variance in performance surrounding the announcement day and the period after it. In addition, it also investigates an important facet of this event that seems to have been ignored so far, and that is the mandate given to the new CEO by the board of directors. As was noted earlier, the degree to which a mandate for change is proposed by the board of directors who selects the new CEO, and offers them a certain compensation package depends on the proportion of the long-term compensation ratio. Using a sample of 156 companies who publicly announced CEO successions between 1986 and 1995 in the Wall Street Journal, this study will address the following issues:

- (1) What is the impact of leadership change on the organizational performance?
 - 1.1 What is the impact of succession announcement on the market?
 - 1.2 What is the impact of leadership effect on the performance post-succession?

- (2) What are the conditions pertinent to executive succession that explain how the succession affects the performance of the organization?
- 2.1 How does successor origin- insider vs. outsider- moderate succession effect? Leadership effect?
- 2.2 How pre-succession performance (or the organizational context) clarify the deviation if any in performance at the announcement? During the leadership period?
- 2.3 Is pre-succession performance an antecedent of successor origin?
- 2.4 Does the method of departure of the predecessor- voluntary vs. involuntary moderate the relation between performance and succession effect? Leadership effect?
- (3) Finally, does the board with the compensation package it offers the new CEO gives him/her the mandate to implement change within the firm?

In addition, it is the contention of this study that studying succession effect only during the announcement window is insufficient. Beatty & Zajac (1987), Lubatkin et al. (1989) advocated the use of several time periods to investigate the conditions surrounding succession events.

This thesis will be organized as follow: part one will look at previous work that has been done in the field of succession, and review the findings of the studies. Part two will determine the methodology and data collection. Part three will summarize the results followed by a discussion section, and finally part four will be the conclusion.

1. Literature Review

1. Succession Theories

The issue of succession is heavily debated with no consensus in its results. The literature show that there are three streams of thoughts on the issue and each has its proponents. One theory postulates that succession is bound to improve the performance; the second claims that leadership change will disrupt the organization and cause a decline in performance; the third theory argues that no change to performance, whether positive or negative is to be gained. In addition, the research on succession has had two separate momentums, which were a separate study of each of the effects of succession. One deals with the effect of succession per se, or 'succession effect', which focuses on the impact that the turnover has on performance. The second momentum or fold deals with the 'leadership effect', in other words, it tries to determine whether or not the new leader can influence the performance of the organization.

The earliest research focused mainly on the impact of the change itself. The outcomes of the earliest efforts in investigating succession effect are three theories: the 'common sense' (Guest, 1962) theory or positive effect on performance, the 'vicious cycle' (Grusky, 1963) or negative impact on performance and the 'scapegoating theory' (Gameson and Scotch, 1964), the no impact theory. Although

these studies have paved the way for succession research, they are limited in their focus on sports.

Then, a second wave of research dealt with the “leadership effect” trying to determine whether one leader can make a difference. Although two of the earliest studies by Lieberman & O’Connor (1972) and Pfeffer & Salancik (1977) denied the new leadership any impact on performance; later studies showed that if the effectiveness or experience of the new leaders is taken in consideration leadership did explain some of the overall variance in performance. In other words, there seems to be some factors that are specific to the new leaders that seem to affect the organizational performance.

Both these two effects seem to give an important insight into the change event; however, to fully understand the consequences of succession, it is vital to study both these effects together and not separately. Unfortunately, very few studies combined the two effects. Two of the earliest studies, Pfeffer and Davis-Blake (1986) focused on the experience of coaches in NBA teams and its impact on performance while Smith, Carson and Alexander (1984) studied the efficiency of church ministers and its link to church performance as measured by the attendance to mass. Beatty and Zajac’s (1987) and Lubatkin et al. (1989) seem to be two of the few studies about business organizations, which studied both effects together.

The study of both effects within the same study is the third stage in the succession research, which is to ultimately understand that the investigation into succession consequences is not complete until both effects are determined and explained. Therefore, it is not sufficient anymore to find how succession impacts performance-- i.e. positive, negative or no effect, but to ascertain which factors explain some of the variance in performance. The succession event does not occur in a vacuum, and the circumstances surrounding it seem to provide some information as to which way is the succession going to influence performance.

Several papers have emphasized the importance of studying the context of the change as well as the content of succession events (Beatty and Zajac, 1987; Friedman and Singh, 1989; Kesner and Dalton, 1983; Lubatkin et. al., 1989; Reinganum, 1985; Davidson, Worrell and Cheng, 90). Several variables appear to be particularly significant in furthering the understanding of the change event. These variables can be classified as follow: the context variables are pre-succession performance and the size of the enterprise; and the content variable is the origin of the successor (insider to the firm or outsider). These are the variables that seem to be constant amongst most succession studies. Additional variables such as the stability of the environmental context (Tushman and Rosenkopf, 1996), successors experience (Pfeffer and Davis-Blake, 1986), successor effectiveness (Smith, Carson and Alexander, 1984), the initiating forces of change (Friedman and Singh, 1989) and the firm's systematic risk as a measure of top management strategic decisions (Beatty

and Zajac, 1987) have been investigated. These variables are the specific angles the researchers chose to reflect upon in the quest to explain the shifts in performance. The first set of variables common to the majority of the studies have been found to explain some, significantly or none at all of the variance of either the succession effect or the leadership effect.

The next section will examine the evidence uncovered concerning both the leadership and succession effects. It will look at the moderators that seem to influence the link between the two separate effects and the performance of the organization.

1.1 Succession Effect

The initial study of Smith, Carson and Alexander (1984) and Salancik and Pfeffer (1987) found that the succession per se had no effect on performance. However, these two studies have a major setback and that is the first is focused on ministers while the second on NBA coaches, therefore hardly generalizable to the business community. However, their results on the leadership effect are interesting and should be addressed in the following section on leadership. Later studies examined business organizations with an increasing usage of event methodology to assess market reaction to the announcement of change. The event methodology

allows the use of abnormal returns on stock prices as a measure of market reaction. This measure seems to be favored in recent studies on succession as a better indicator of firm performance. Accounting measures are weak because they do not permit the actual measure of how the firm is doing at the announcement date¹.

The findings of the latest studies on this specific effect seem to suggest that the market is not indifferent to succession announcement. In fact, some of the studies indicate that the market seems to negatively react to the change within a two-day window of the announcement (Beatty and Zajac, 1987; Friedman and Singh, 1989). Lubatkin et al. (1989) found that there was no reaction at the two-window but the three different time periods they use around the announcement indicate that the reaction is negative. There seems to be a significant support to Grusky's (1964) claims that the succession event is initially viewed as a disruptive change that will disturb the organization and adversely affect its performance. These assessments are surprising since most studies seem to sustain the fact that poor prior-performance seems to be the rule prior to succession but they add even more support to the disruption theory. Other studies have found that succession announcement are positively viewed by the shareholders (Davidson, Worrell and Cheng, 1990; Furtado and Rozeff, 1987; Weisback, 1988), and this supports Guest (1962) contention that when the organization performs badly a change in leadership will positively impact the firm.

¹ Beatty and Zajac (1987) advocates the use of stock prices over accounting measures.

(a) Context of succession effect

Since there seems to be no agreement on the 'succession effect', it is imperative then to look at the factors that might explain some of the variance in performance, as well as shed the light on the lack of consensus on the impact of 'succession effect'. The variables that has been most discussed in the literature are prior-performance, origin of the successor (insider vs. outsider to the firm), and type of removal (firing, customary, voluntary departure, death...). In addition, the interaction between prior-performance and successor origin will be discussed briefly, since a few studies tried to assess whether prior-performance is an antecedent of successor choice.

(i) Presuccession performance

Researchers seem to agree that poor performance is one of the causes of executive replacement (Dalton and Kesner, 1985, Lubatkin et al., 1989; Beatty and Zajac, 1987; Friedman and Singh, 1989). In fact, Bonnier and Bruner (1989) compared, in their study, the reaction of the market to succession taking place in companies experiencing performance difficulties and other ones quite healthy. They concluded that the market was more positively in favor of CEO change in the poorly performing organization than the healthy one. Their results were supported by Friedman and Singh (1989) whose findings prove that the lower the presuccession

performance the more positive stockholders reaction. On the other hand, Lubatkin et al. (1989) found that during the 51 days prior to succession the market reacted positively and significantly when the firm performed well prior to succession. However, in both opposing results the significance was not strong enough ($p < 0.1$) in Friedman and Singh study while Lubatkin et al., 1989 had that moderator significant at $p < 0.05$ in only one of the four succession effect windows. Therefore, there is still no strong evidence as to the importance of presuccession performance as a strong contextual factor.

As for presuccession performance being the antecedent of successor origin (Dalton and Kesner, 1985), the findings were insignificant, i.e. presuccession performance was not found to be a predictor of successor origin. These findings were also upheld by Friedman and Singh, (1989) who also found that presuccession performance did not moderate the relationship between successor origin and firm performance. In contrast, Lubatkin et al. (1989) found that during 50 days post-succession and the 101 cumulative days (51 days prior to succession and 50 days after) a good prior performance was linked to positive attitude by stockholders toward outsiders. However, in general pre-succession performance was found to be an insignificant predictor of origin. This now leads to successor origin as a predictor of market reaction.

(b) Content of Succession

(i) Origin of Successor

Does the origin of the successor have an influence on the relation between succession effect and performance? There seems to be some preconceptions linked to either type of successor. An insider is viewed as less disruptive, and the one that will protect the present strategy and direction of the organization. On the other hand, the outsider is linked with a desire to escape a certain status quo or inertia; s/he is the instigator of change and maybe the savior of a failing organization. Therefore it is tempting to say that poor prior performance inherently leads to an outsider in hopes to improve the performance. However, as was mentioned earlier, this is not the case. There does not seem to be a link between poor prior performance and choice of successor.

Beatty and Zajac (1987) found no relation between origin and performance. Furtado and Rozeff (1987) found that insiders had a more positive and significant ($p < 0.05$) abnormal returns than outsiders. Lubatkin et al. (1989) reached the opposite conclusion, outsiders had a more positive and significant impact on the performance measure. Although Friedman and Singh concluded the same in their discussion section, their results were unfortunately not significant. The first two studies unfortunately do not use a continuous data set but split the sample in two between insiders and outsiders and since outsiders are around 15% versus insiders

85% their results can be questioned due to unequal sample sizes. Lubatkin et al. (1989) study indicates that origin is an important moderator.

It is very difficult to determine why is there so little consensus in the results. All these studies have used event study methodology, i.e. stock prices as a measure of firm performance. They all have decent sample sizes and most used regression analysis except Beatty and Zajac (1987) who employed the Ancova test. The reason could be that the issue is so complex that the research has barely scratched the surface. There are so many factors that have not been investigated yet that could explain the variance in performance. In addition, very few studies combined all the factors together.

(ii) Initiating forces

Initiating forces determines how the incumbent CEO is removed. There is almost no empirical data on this specific factor in a succession process. One of the few papers that deals with it is Friedman and Singh (1989). They seem to have found four different initiating forces: customary retirement, board initiation, CEO initiated and death or health related departure. They found that the only factor that was significant and positively affected earnings was the board-initiated removal. The customary retirement, which was 75% of total cases, showed no significant impact. Worrell and Davidson (1987) found that following the death of predecessor

internal succession was favored by shareholders, whereas external appointment had no effect on abnormal returns. Finally, Johnson et al. (1985) in an analysis of stock price reaction to sudden executive death found no impact.

In conclusion, the findings presented in the above overview of the research on succession effect seems to suggest that additional research is required in this area to try to demystify the impact of succession events. This study will try to reassess the impact of succession effect on the market and will try to identify some of the predictors that might explain the performance variance if any. It will also try to assess the impact of leadership effect on the organization and explain it too.

1.2 Leadership Effect

This is the second fold of the succession event. It is an assessment of how the new leader impacts the organization after the market had time to adjust to the change in executives, and had taken in the initial modifications the new CEO is implementing to the organization. The literature is not abundant on the 'leadership effect' in the context of succession event. The earliest work of Smith, Carson and Alexander (1984) and Pfeffer and Davis-Blake (1986) concluded that effectiveness and experience, respectively, positively impacted the performance of an organization. These two are amongst the first studies to introduce the notion of leadership ability to influence the organizational performance. Beatty and Zajac (1987) do not use

abnormal returns to determine the impact of the new leader on the organization. Instead, they measure the influence the new CEOs have on production and investment decision of their companies as measured by the risk factor. Lubatkin et al, (1989) found that the abnormal returns had a negative and significant impact on the shareholders ($p < 0.01$); however, one study is not enough to conclude that 'leadership effect' matters, more research is needed.

(a) Context of Leadership effect

(i) Presuccession Performance

Presuccession performance is not only a determinant of succession effect but also a contextual factor of the leadership effect. It seems common sense that a leader who is coming into an organization with poor performance will have more leeway to implement change since they are expected to make transformation that will improve the company's performance. Whereas the new CEO of a thriving enterprise might not be as free to implement change as his counterpart in a poorly performing firm, especially if the shareholders are satisfied with the earnings of the company.

Unfortunately, very little empirical work has been done in this specific area. One of the few studies that investigated pre-succession performance in a leadership effect perspective is Lubatkin et al. (1989). They found that context had a somewhat

weak influence ($p < 0.1$) on shareholders' expectations in the 200-days window following the event. The predictor was negatively related to the abnormal returns, which meant that the lower the performance prior to succession the better the investors reacted to changes implemented by the new CEO during the 200 days window post succession. Their findings are not significant enough to solidly conclude that pre-succession performance is a valid moderator of the relation between leadership effect and organization performance after succession.

(b) Content of Leadership effect

(i) Origin of Successor

Again, the dearth of the empirical work done in this area of leadership effect is quite puzzling. It would have been of interest to study whether an insider has a different impact on post-succession period than an outsider. Especially, that an outsider would be expected to upset the status quo while an insider would maintain it. For instance, although Beatty and Zajac (1987) found no significant difference between insider/outsider successor on the firm risk. Lubatkin et al. (1989) found that outsiders have a certain positive ($p < 0.1$) influence on the earnings of the enterprise, which was contrary to their hypothesis. Since they hypothesized that outsiders will be less capable than insiders to maintain a high performance in a firm. Again, the weakness of the findings might suggest that more research is needed.

(ii) Leadership factor

Smith, Carson and Alexander have published one of the first studies to introduce the notion of leaders ability within the context of succession in 1984. Ministers were considered effective if they were paid one standard deviation above the mean while church performance was measured by the attendance to masses. Even if they found that leaders' effectiveness did explain some of the variance in performance, their study is hardly generalizable since it focuses on churches whose purpose do not resemble business objectives. However, it is noteworthy to mention that they were the first to use salary as a measure of leadership effectiveness.

Beatty and Zajac's (1987) research was geared toward business firms and tested for leadership effect by measuring how the new CEOs influenced production and investment decision. They found that the change in leadership was linked to a change in company risk for both insiders and outsiders. They then concluded that CEOs do influence the production and investment decision as measured by a change in the firm systematic risk after the succession event. These are the few studies that looked at leadership effect.

This study will look at leadership from a different angle. It will try to assess leadership effect not by how the new leader affects the performance of the organization but by looking at the content of the succession event itself. It is not a study of whether the new leader can make a difference or whether leadership matters.

This has been already proven as was mentioned in the introduction. This study will try to assess whether the new CEO is mandated by the board of directors to implement change.

The board of directors has the responsibility to select, hire and compensate the executive (Zajac, 1990). They are important because they seem to play the police between the shareholders and the top managers of the firm; they make sure that the executives' decisions are aligned with shareholders wealth. Therefore whomever they hire becomes important not only to the continuity of the company but to the shareholders. Within the selection process there seems to be two factors that play a role into who is hired: the successor origin and whether the incumbent CEO has someone in mind.

Zajac (1990) suggest that the difference between the two successor types lies not in what they can or cannot do but on the agent -principal relationship. The difference is that the board has a better knowledge of the insider successor than the outsider one, and therefore is inclined to chose from within. Therefore, according to Zajac(1990) the agency relationship between the board of directors and the new CEO is explained in the fact that the information asymmetry between board of director and insider is less severe than the agency relationship between the board and outsiders. Therefore, the board will prefer hiring an insider over an outsider thinking that they

will be have a better control on the insider than the outsider. There will be fewer surprises in the long run.

Another reason that might explain the low level of outsiders in the boards' unwillingness to bring in someone from the outside is survival. Since a lot of the directors are actually top executive at the firm, an outsider might oust them in a swiping strategy for change (Goddstein and Boeker, 1991).

The other factor in the selection process is whether the incumbent CEO has someone in mind, and Zajac (1990) found that if that was the case the firm performed better in the long run than companies with no successor in mind. The first issue seems to justify why insiders are preferred over outsiders.

The other responsibility of the board is to compensate the executives adequately in order to attract them to the organization, and make sure that the performance of the organization improves. It is the contention of this paper that the board of directors who selects the CEO and offers him/her a certain compensation package is actually providing the new leader with the authorization to implement change. This mandate will be measured by the ratio of long-term compensation (stock options) over total compensation. In addition, this paper will look at the way the incumbent CEO was removed from his post, i.e. whether voluntarily vs. involuntarily.

In order, to investigate both effects together this study will look at different time intervals preceding, following and coinciding with the announcement date. Traditionally, finance and economic studies focus on the two-day window to investigate the effect of the leadership change on the performance using stock prices as an indicator of performance. There is a demand in management studies to look at several time windows to better understand 'succession effect'. The reasons being that sometimes the market might not fully incorporate the factors involved in the turnover within those two days. A look at a pre-succession window might indicate if any leakage of information has occurred. Another look at a post-succession period might indicate that after the initial reaction to the change, the market takes a better look at the conditions surrounding the event. Combining the impact of the three different time intervals will give a better understanding of succession effect. In addition, to determine whether the new leader's modifications to the organization have an impact on the performance of the firm, another time interval should be observed following succession. This effect is investigated after a certain time have lapsed following the announcement of succession in order to allow the market to take in the changes that the new leader has implemented. These intervals will be the traditional two-day interval, 50 days before the announcement of succession, 50 days after the announcement, a 102 cumulative days of the first three; these will give an adequate measurement of succession effect. Leadership effect will be investigated following one hundred days after announcement and the excess returns will be

accumulated for 200 days. These intervals will be discussed more thoroughly in the methodology section.

2. Research Model and Hypothesis Development

The above overview of the literature suggests that whether the market reacts or not to the leadership change is contingent on several factors, that can explain some of the deviation from the expected returns that might take place due to the event. In addition, the two venues of research, succession effect and leadership effect, suggest that a full understanding of succession impact on organizational performance comes with studying both effect together within the same study. Therefore, more research needs to be involved in demystifying some of the ambiguity that still exists in this area of succession.

As was mentioned, earlier this research is focused on investigating an area of leadership effect that has not been handled previously, and that is the mandate that the board of directors give to the new CEO in implementing change within the organization. Moreover, it will try to combine within one study several of the research that has been done in the past, improving on some of them while correcting for weaknesses that affect studies that have been previously done.

The research model is represented below. The initial step would be to assess the effect of both succession effect and leadership on the performance, and the second phase would be to investigate the factors that seem to explain those effects.

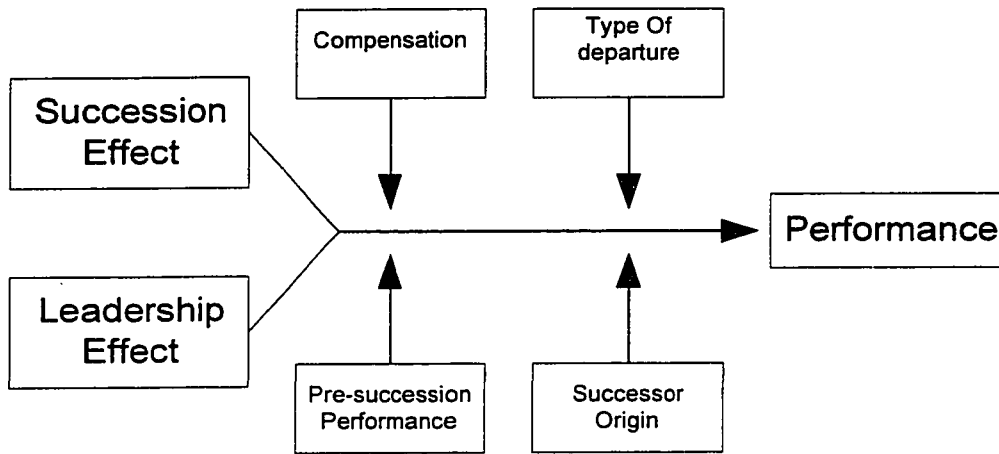


Figure 1: The Research Model

There is a second minor model that describes the possible moderation of the relationship between successor origin and organizational performance by the presuccession performance. This model is shown below in figure 2

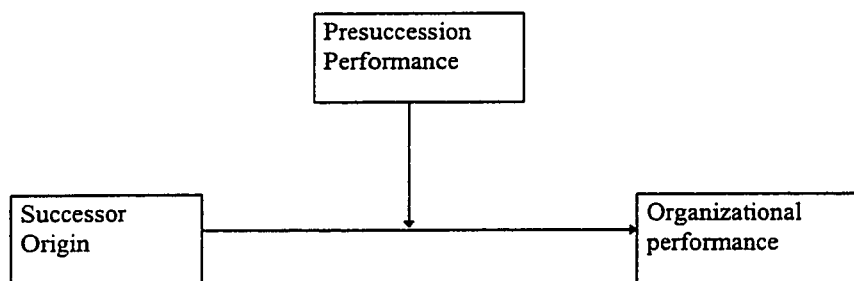


Figure 2: Presuccession Performance the Moderator of Origin and Performance

2.1 Succession Effect and Organizational Performance

The first question that is addressed in this study is whether succession has an impact on the performance. As was mentioned before, this issue has been addressed by numerous researcher with quite conflicting results. The earliest work of Guest (1962), Grusky (1963), and Gameson and Scotch (1964) each emitted a different theory on the effect of succession per se on performance, which is either positive, negative or no effect, respectively. Subsequently, researchers in this area supported either one or the other of these theories. There was very little consensus on the effect even amongst empirical studies.

Beatty and Zajac (1987), Lubatkin et al. (1989) and Reinganum (1985) supported Grusky's initial theory that the disruption that is the result of leadership change is large enough to offset any positive consequences expected from it. In each of their studies they found that shareholders seem to lower their expectations of the companies future earnings.

“Investors appear skeptical about the alleged positive intentions that motivate succession decisions” (Lubatkin et al., 1989 p. 58)

However there are several weaknesses in either study. Beatty and Zajac does not give the overall result of his entire sample instead, they split the sample in half

between outsiders and insiders because of that it is very difficult to assess the effect of the succession on the overall sample. In other words, they do not cumulate their abnormal returns for all their firms but instead give the cumulative abnormal returns for the firms with outside and inside successors separately. Lubatkin et al.(1989) found no impact on the two-day interval but significant negative results for the three other intervals.

On the other hand, Rozeff and Furtado (1987) and Friedman and Singh (1989) are in full support of Guest's (1962) work which found that succession actually was positively greeted by the investors and they concluded that although the disruption seems to be expected it does not take place. However, both studies looked at the two-day period only, which might not be enough to conclude that succession has a positive impact on the shareholders. In summary, since the above two studies have significant results in the two-day interval and Lubatkin (1989) found negative results afterwards, it would be interesting to revisit the issues by looking at the four intervals as an adequate measurement of succession effect impact. Therefore because of the weaknesses of the first studies this study will lean towards the positive impact of succession.

Hypothesis 1: Succession effect measuring the impact of succession announcement on organizational performance is expected to be positive at event window (t= -1, 0).

In other words, the abnormal cumulative returns will be significantly positive indicating that the actual returns on the stock prices are higher than expected. And since confounding effects will be eliminated within this specific time period any abnormal returns should be due to the actual event of succession.

2.2 Leadership effect and its impact on performance

There is the earliest study by Lieberman & O'Connor (1972) that focused on determining whether one leader is any different from another. They concluded that leaders do not make a difference, and that environmental factors as well as organizational context explained more of the variance than did leadership. However, both Beatty & Zajac (1987) and Weiner & Mahoney (1981) later criticized Lieberman and O'Connor's for their choice of performance measure and methodology, respectively. One of the few empirical studies, which focused on business organizations, is Lubatkin et al. (1989) who concluded that the leadership impact has negative consequences on the performance of the organization post succession.

The following studies seem to view leadership effect as having a positive impact on the performance of the organization. Wiener and Mahoney (1981), found that leadership had a definitely positive impact on performance as did Smith Carson

and Alexander (1984) who were amongst the first to study succession effect and leadership effect separately within the same study, unfortunately his target sample was churches.

Finally, Beatty and Zajac hypothesized that the succession event was not related to systematic company risk. The risk in this case is a direct measure of the new CEOs strategic decisions' in production and investment. Their findings rejected their hypothesis, and concluded that leadership did matter but they do not explain how it impacts risk.

Due to the mixed results of previous studies and considering that the new leader is expected to improve the organizational performance of the organization, this study will hypothesize that the new leader will be able to positively impact the firm's performance.

Hypothesis 2: New leaders will have a positive impact on the performance of the organization at the window $t \in [+100,+300]$.

In this interval the market will be reacting to the changes that the new leader has implemented on the organization after the succession and during the first 100 days of his/her reign.

It is not enough to determine the impact and its sign but an understanding of what affects the deviation from expected returns is a must. There seems to be a

consensus in the literature that investigating the conditions of succession are a vital part of better understanding the succession event and its impacts.

2.3 Moderating Factors

(i) Pre-succession Performance

Most researchers in this field seem to agree that poor organizational performance seems to be a major instigator of succession (Allen, Panian and Lotz, 1979; Brown, 1982; Brady and Helmich, 1984; Coughlan and Schmidt, 1985; Dalton and Kesner, 1985; Pfeffer and Davis-Blake, 1986; Lubatkin et al. (1989). In addition, Davidson & al.(1993), in their study of succession in bankrupt firm found that the market reaction to the announcement of CEO replacement was both positive and significant, especially when the change was initiated after bankruptcy.

Performance is a means of determining whether an organization has efficiently used its resources. Therefore when an organization is not performing as good as it is expected the market and shareholders react accordingly, and change becomes obviously needed to turn the company around. One way to do that is to replace the CEO. Hence, we can assume that when performance is poor the shareholders will positively react to CEO announcement.

It was found that the stockholders react most positively to key executive succession announcement when pre-succession performance has been poor (Bonnier and Bruner, 1989; Friedman and Singh, 1989, Davidson, Worrell and Dutia, 1993). These results were also found to indicate that the organizations [with poor performance] were finally doing something to correct their misdirection.

Friedman and Singh (1989) findings' supported their hypothesis that the lower the presuccession performance the more positive the impact on the shareholders reaction towards the announcement of leadership change. However, Lubatkin et al. (1989) whose hypothesis stated that context affected the ability of a new CEO to influence change in the future. Their hypothesis is very vague and could be interpreted either way. During the 51-day period prior to the succession, they found that the better the presuccession performance the more positive was the shareholders reaction. Whereas during the leadership period, the lower the presuccession performance the higher was the reaction of shareholders implying that maybe new leaders with low-context companies have more leeway to implement change. The results for announcement date and post succession was not significant. To sum up, context seems to have a definite impact on the effect of succession and some on the leadership effect. However, the research so far has produced mixed results.

Hypothesis 3a: The presuccession performance will moderate the relationship between the succession effect and the market reaction.

Although it has been agreed that poor performance seems to trigger the succession event, the research has been very scarce concerning pre-succession performance and its impact during the leadership period post-succession. In fact, Lubatkin and al. (1989) found that the better the performance prior to succession, the better the new CEO was able to affect positively the future performance of the organization. However, one study is not enough to conclude that CEO who inherit high performing organizations have a better chance at succeeding whereas poor performers will inhibit the ability of the new CEO. Friedman and Singh (1989) concluded that succession that followed poor performance has been viewed as a conversion where new CEO were permitted more latitude in their decisions to make strategic changes. (Fredrickson, Hambrick and Baumrin, 1986; Griner and Bhambri, 1989; Miller 1991). In other word, as Miller (1993, p. 645) puts it “CEOs are a catalysts for change”. It is easy to then deduce a good performance prior to the change will give an easier task to the new leader; however, it could also be difficult to meet the challenge of keeping the same kind of performance that is expected from a high performing firm. (Fredrickson, Hambrick and Baumrin, 1986). However, a poorer performer will be a bigger challenge where a CEO will be able to make his mark. Due to the scarcity of the research in this specific area the following hypothesis will be tested:

Hypothesis 3b: Presuccession performance will moderate the relationship between leadership effect and shareholders reaction.

(ii) Origin of the Successor

Does successor's origin moderate the relation between both effects and firm performance? The successor that is promoted from within is viewed as maintaining a certain continuity and stability to the organization. Whereas the outsider is considered as the disturber, the one that will wreak havoc on the organization but also the one that has the ability to break away from inertia and bring the company back into a healthy financial future.

However, which one can and will improve the future earnings of the organization is still to be proven. The issue has been investigated numerous times with opposing results. In fact, outsiders create more disruption than insiders and the magnitude of which seems to offset the positive results that could have been the result of a succession event (Allen, Panian and Lotz, 1979; Lubatkin et. al., 1986; Pfeffer and Davis-Blake, 1986).

As was mentioned before the results of previous studies that included origin as a predictor of future performance are quite mixed. Friedman and Singh (1987)

found that outside appointment yielded more positive abnormal returns. Furtado and Rozeff (1987) found the opposite, i.e. insiders had higher and more significant results than the outsiders to the firm. Beatty and Zajac (1987) found no distinction and Reinganum (1985) found positive abnormal returns only for outsiders in small size organization. Besides Reinganum(1985) none of the above studies accounted for size.

The two studies that investigated both effects have also mixed results. Beatty and Zajac (1987) found no distinction between either origin and concluded that the importance of insider/outsider distinction is highly overstated. Whereas, in Lubatkin and al (1989) supported Frideman and Singh (1989) results of positive impact with outsiders. The outside appointments had a varying significance in their five different time frames but all showed shareholders to favor outside successors over insiders. The only period that had no significance was the 51-day presuccession period. Outside succession was found to be positively and significantly affecting investors' expectations for both the succession as well as the leadership effect. Although the results are conflicting there seems to be a more favorable outcome to outsiders than insiders.

Hypothesis 4a: Successor origin will moderate the relation between the succession effect and the organizational performance, in that the relationship between succession effect and firm performance will be stronger for outsiders than it is for insiders

At the announcement of the leadership change, Shareholders will be more favorable to outsiders than insiders.

Since outsiders are synonymous with change the market reaction to an outside succession will be more significant and positive than that of an insider who will be viewed at maintaining an undesirable status quo.

The same goes for the leadership effect. An Outsider will be expected to perform better than an insider does and this will be indicated through a more favorable reaction by the shareholders during the leadership period after the announcement date. Especially that outsiders are viewed as catalyst for change (Miller, 1993).

Hypothesis 4b: Successor origin will moderate the relation between leadership effect and firm performance and those outsiders will have a more positive impact than insiders.

Shareholders will expect outsiders to influence the organizational performance post-succession more positively than the insiders.

Although outside succession seems to be favored, in reality it takes place less often than expected. Inside succession is much more frequent than outside succession and on average most samples have 82-85% insiders and 15-18%

outsiders. Again this could be due to the fact that most are large organization and seem to favor grooming in a successor.

Dalton and Kesner (1985) found that only mid range performer chose outside succession. Bonnier and Brunner (1989) found that pre-succession performance is an antecedent of succession and therefore strongly influences the succession events; their results were further supported by the work of Friedman and Singh (1989), as well as Pfeffer and Davis-Blake (1986) and Dalton and Kesner (1994).

It is important that one major constraint to outside successions is the scarcity of available candidate that can takeover the task or are even willing to do so, especially for low performer. This could also explain the large salaries that are being offered lately to attract outside candidates. Especially when the organization is performing poorly and becomes a risky endeavor; the new CEO is offered a large compensation to offset the risk of undertaking such a task.

(iii) Performance as an Antecedent of Origin

The main hypothesis tested in this subject is the following. Do poorly performing organization have a higher rate of outside succession, and will that affect the ability of the successor to impact the organization whether insider or outsider.

Reviewing the literature, it seems that the above hypothesis is often rejected. Dalton and Kesner, (1985) found that outside succession did not necessarily take place in poorly performing firm but in companies with midrange performance. Their results where the same for both of their presuccession measures, ROE over three years and end-of the month closing stock prices. Friedman and Singh (1989), whose measure of presuccession performance was ROE for the year prior to succession, found that outsiders where chosen in only small firms, and presuccession performance was not a significant predictor of successor origin.

Lubatkin et al. (1989) investigated the interaction term in five different time period. There results were as follow: for the announcement date, leadership period and the 51 days prior to succession the interaction term was not significant; and significant for the 50-days post succession, as well as the 101-cumulative days (t-50, t+50). After performing a contingency matrix they found that in low performing firm shareholders where indifferent to the origin of the successor, whereas for high performing firm insiders have a positive impact on shareholders expectations. That last finding supported their hypothesis that insiders will be able to better influence a healthy organization.

Hypothesis 5: Presuccession performance will moderate the effect of the origin of the successor on organizational performance.

Outsiders will have a more favorable impact on future earnings of a poorly performing organization.

Insiders will have a more favorable impact on the earnings of a highly performing organization.

This hypothesis is testing whether presuccession performance is an antecedent of origin. In other word, 'successor origin' relation with firm performance is moderated by the presuccession performance.

(iv) Voluntary vs. Involuntary Departure

This is a variable that has not been really investigated in the literature of CEO succession as is. Friedman and Singh (1989) investigated whether or not the different initiating forces of leadership explain the variance in organizational performance. They described four possible initiating forces as follow: (1) customary retirement; (2) Board initiated change or firing of the previous CEO; (3) CEO initiated departure or early retirement and (4) death or health related departure that strikes without any previous warning. In their study, they investigated the pre-succession performance as a possible antecedent to type of removal. They hypothesized that the lower the performance prior to succession the higher the incident of board removal and shareholders will react more positively to CEO initiated departure and board removal. Also, death will be negatively associated to earnings. They found that only board removal was associated with a positive market

reaction, and lower performance definitely increased board removal incidents. The other hypotheses are rejected. In addition, they found that customary initiation had no impact on stockholders' reactions. This result can be easily understood since change in leadership could have been already discounted way before succession was announced.

However, this study will not look at it as forces of initiation but whether the departure was voluntary or involuntary. Considering board removal as involuntary and customary or CEO initiated as voluntary. Succession due to a sudden death will be removed since it is difficult to determine whether it is voluntary or involuntary. Since death is considered a disrupting event that will have a negative impact on the organization whereas involuntary removal will have a positive effect on succession.

Since most studies agree that poor performance seems to be the instigator of change, the following will be hypothesized,

Hypothesis 6a: Involuntary departure will be positively viewed by the shareholders, whereas voluntary, which is mostly customary, will have no significant impact on the shareholders.

Involuntary departure will signify that the board is doing something to rectify a poor performance, and therefore positive abnormal returns will mirror this approval by the shareholders.

Hypothesis 6b: Type of departure will not be a significant predictor at the leadership level since this factor will be fully discounted by that time.

Obviously, the market would have already adjusted to this information by the time the new leader starts implementing change, and the origin of the successor becomes more relevant to determine whether s/he are able to positively influence the performance of the organization.

(v) Compensation

It is obvious from those studies that it is very difficult to find a measure that assesses leadership effect on performance, a fact that has been most emphatically emphasized by Pfeffer and Davis-Black (1987). However, this study is not trying to determine whether leadership matter since this issue has been well documented in the last decade and leadership has been proven to have an impact. What this study will investigate is whether the new leader is given a mandate to implement change and that will be measured by the compensation packages, which in turn will determine the impact a new leader has on performance.

While most research has been focused on how much organizational performance influences CEO pay this study will look at executive compensation as a

tool that board of directors' use not only to hire CEOs but also as a mandate for the new leader to implement change. Salaries per se have almost never been used in succession studies to assess the ability of the new CEO to implement change. Carroll, Smith and Alexander (1984) used it as a measure of CEO performance in their study on church ministers.

However, it has not been used to measure the mandate the board of directors give the new leader. Lately, the literature has paid close attention to the compensation package offered to CEOs. The mix of the several components of the compensation seems to have a link between CEO strategies and shareholders interests. Pay is becoming more of monitoring tool to keep CEO in-line with maximizing shareholders wealth. Especially, when the package seems to link the CEO's future with that of the investors.

Since the board, who represent shareholders' interest, is responsible for creating the pay package, then the pay becomes a mean to not only to control CEOs but also to give them a projection of what is expected of them. The one component in this study that is of interest is the ratio of long-term compensation to total compensation, and it is the number of stock options offered to the CEO which link the CEO's pay to the long-term performance of the firm.

Stock options signal the new leader that shareholders want their wealth to be maximized not only in the present but also in the future. It is a message that change might be needed and if performance does not improve then so CEO salary might suffer. The message is 'we want change and this is the permission to influence change'. What is of interest to this paper is to see which would be a predictor of future shareholders expectations performance?

Although many studies have linked the level of compensation to the performance of the organization, none look at whether compensation can be a determinant of performance. Although a cyclical relation might exist such as when performance is improved compensation increases which in turn encourages the CEO to be even more productive. This paper hypothesizes that long-term performance seems to have an influence on the companies long term improvement of performance, long-term compensation will have a positive impact on performance.

Hypothesis 7: Long-term compensation will moderate the relationship between succession effect and the market reaction.

The larger the long term compensation the more positive the market reaction would be to the new leader.

(vi) Size of the organization

The size of the organization should be controlled for because it is a variable that affects not only the compensation since larger firms have the ability to pay larger salaries. But also, larger firms are more immune to market shifts and therefore CEOs are more protected than in smaller firms. Finally, larger firms tend to choose successors from within. Many previous researches seem to hint to the fact that size does matter and therefore should be controlled for; however, none of the research has been able to determine any relationship between size and outside/inside succession (Lubatkin et al., 1989). It is also important to mention that most studies focus on large organization.

It also seems as large organizations are able to insulate themselves and top management from outside pressures such as market pressures; therefore, are more inclined to choose an insider (Dalton and Kesner, 1983, Furtado and Rozeff, 1987). In addition, they are able to control the influence of a new leader that might affect corporate performance. (Hall, 1987, Freeman and Hannan, 1977) Therefore it is important to control for size.

Although, large organization seem to choose insiders, large failing firm where more inclined to go for an external CEO than did smaller ones (Schewarts and Menon, 1985). Dalton and Kesner (1985), on the other hand, found no difference but

in mid range performing organization which tend to go external. Lubatkin et al. (1989) found that size was not a significant variable. Also, compensation seems to have an impact on compensation and therefore need to be controlled for (Gomez-Mejia and Balkin, 1992).

2. Research Design

1. Event Study Methodology

The use of event study in management research has been increasingly used to determine the impact of CEO succession on the market (Beatty and Zajac, 1987; Friedman and Singh, 1989; Furtado and Rozeff, 1987; Lubatkin et al. 1989). Using a market-based measure of performance called “abnormal” return, the researcher has the ability to measure the impact of the succession while bypassing the usage of accounting measures. Stock prices facilitate measuring the impact of CEO succession on the market by incorporating relevant information and “reflecting the discounted value of all future cash flows.” (McWilliams and Siegel, 1997)

The event studies methodology was developed in order to gauge the impact of an ‘*Unanticipated*’ event, such as executive succession, on the stock prices. It basically entails estimating a market model for every firm in the sample and then calculating the abnormal results. It is these abnormal returns that are assumed to mirror the effect the announcement of succession had on the market. In short, any deviation from the expected return on one stock can be linked back to the release of new information. Especially that the market is expected to incorporate new information almost immediately (Fama, 1980).

For estimating returns for each firm the model is as follow:

$$R_{it} = A_i + B_i * R_{mt} + \varepsilon$$

R_{it} = It is the expected rate of return on stock i. at day t.

A_i = Is the intercept of firm i.

B_i = It is the systematic risk of stock i. Or in other word the regression coefficient of firm i.

R_{mt} = It is the rate of return on a market portfolio of stocks as measured by CRSP on day t.

ε = This is the error term, which is usually equal to zero.

The parameters estimates, a_i and b_i for the intercept (A_i) and systematic risk (B_i) of the above model are derived by regressing the daily returns (R_{it}) on the daily market returns (R_{mt}) over an estimation period of time, $T = 200$ days which preceded the succession event. In this study, it was necessary to have an event window, which was (t-500; t-301) days prior to the succession announcement to also calculate the pre-succession performance, which was (t-300; t-1-100); t is the announcement date of the succession of CEO.

Then the above estimated equation for each stock will provide estimates for daily returns for each stock, which are, then deducted from the actual daily returns of

those stocks respectively to obtain what is called abnormal returns (AR_{it}), the equation is as follow:

$$AR_{it} = R_{it} - (A_i + B_i * R_{mt})$$

Any significant deviation from the actual return is an abnormal return (McWilliams and Siegel, 1997).

Then the abnormal return is standardized by its standard deviation, called standardized abnormal returns (SAR_{it}). The standardized abnormal returns are cumulated for the event windows to obtain a cumulative abnormal returns for each firm (CAR_i), which is then divided by its standard deviation $[(T-2)*(T-4)]$. This is done in order to fulfill a standard assumption that all CARs are independent and identically distributed. Dodd and Warner (1983) initially developed the above procedure, and many researchers after that emulated the process, which is the following:

$$SAR_{it} = AR_{it} / SD_{it},$$

$$SD_{it} = \{S_i^2 * [1 + 1/T * (R_{mt} - R_m)^2 / \sum_{t=1}^T (R_{mt} - R_m)^2]\}^{0.5},$$

S_i^2 is the residual variance of the market model for firm i.,

R_m is the mean return on market portfolio for the estimation period,

T is the estimation period of 200 days for this study,

k. is the number of day s in the event window, and there are five different event window in this study as will be explained later.

Then,

$$CAR_i = (1/k^{0.5}) / \sum_{k=1}^k (R_{mt} - R_m)^2 \}^{0.5},$$

$$ACAR_i = 1/n * 1/[(T-2)*(T-4)]^{0.5} \sum_{i=1}^n CAR_{it}.$$

Finally, the test statistics used is the following where n is the number of firms:

$$Z = ACAR_t * n^{0.5}.$$

For the event study to be reliable it is important that three assumptions are met. These assumptions are the (1) market efficiency, (2) unanticipated events, and (3) no confounding effect. (McWilliams and Siegel, 1997).

1.1 Critical Issues

Besides the above three assumptions, in their article on event studies for management research, McWilliams & Siegel (1997) set up five criteria that should be met when implementing an event study. These criteria are as follow: (1) sample size, (2) the length of the event window and justification of the length of that window, (3) no confounding effects, (4) nonparametric tests to identify outliers, (5) explanation of the abnormal returns.

In this study, four of these five criteria are met as follow:

- (1) Sample size: In order for the assumption of normality to be functional the sample size has to be adequately large. In this case a sample size of 156 companies is large enough since it indicate that the results are generalizable to the overall population of large firms. In addition, the skewness index is presented in table 1. This index tests for normality; the larger the index the less normal the variables. The results in table 1 prove that normality is satisfactory.
- (2) Nonparametric test for outliers: this test is again very important for smaller samples since one significantly large outlier can drastically influence the data. However, since the sample in this study is large enough no test were done, but two companies whose abnormal returns were -3.25 and 3.75 of the standard deviation are excluded and the statistical results where significantly improved.
- (3) The length of the event window: although finance and economic studies try to limit the event window to 2 or three days, most management studies rely on much larger windows. This becomes an issue because it is then very difficult to make inferences that are directly related to the event window itself. Especially, if confounding effects are not controlled for, which is dealt with the next point. Also, researchers have to make sure that they justify the length of the windows. The use of lengthy windows is justified in the time frame selection section of data collection.

- (4) Confounding effects: if confounding factors are present within a certain window, the conclusion becomes erroneous. Therefore, this study controlled for confounding events such as mergers, dividend announcement, major acquisitions or takeovers and large unexpected lawsuit settlements.
- (5) Explanation of Abnormal returns: it is important to explain the significance in the abnormal returns by determining if those returns fit a certain theory. This study uses regression analysis to determine if several moderating factors explain the impact of the succession event on the performance of the organization.

2. Data collection

The event study methodology will help determine whether the succession announcement had a significant impact on the stock price of the firm announcing succession. However, if the abnormal returns are significant then explaining that deviation between expected and actual returns becomes the second step to understanding the actual effect of succession on an organization. This abnormal return- if no confounding event occurred- is then due to the additional information passed on to the market through the succession announcement. The content of the news becomes important to the explanation of the variance. It is these information

that this study is interested in, and to which the market reacts by being either favorable or not to the change in leadership.

The factors that are of importance to this research are the following: (1) pre-succession performance, (2) successor origin (insider vs. outsider), (3) voluntary vs. involuntary departure of predecessor, (4) ratio of long term compensation to total compensation, and (5) size as a controlling variable.

2.1 Data sources

This study is focused on firms that had undergone executive succession for a ten-year period spanning from 1986-1995. The public announcement had to be in the Walls Street Journal, and the firms had to be on the NYSE, which meant that the sample of firms is skewed toward largeness. However, the choice is deliberate since it did allow to also gather compensation figures from the Business Weeks' annual 'Executive Compensation scoreboard' which publishes compensation data for the 500 highest paid executives in the United States. In addition, daily returns were collected for these firms from the Chicago Center for Research on Security Prices (CRSP) tapes. For each of these firms daily returns were gathered for 801 days ($t - 500$; $t + 300$).

Each announcement was coded for origin of successor and whether the departure was voluntary or involuntary. Additional investigation was done in the Wall Street Index to gather more information in the cases where origin and type of departure were ambiguous in the announcement. In addition, the search for any confounding effect such as merger and dividend announcement, acquisitions, takeover threats and major court losses was initially done for the event window surrounding the succession announcement to eliminate any companies with dubious events. Then, a second search was done for the year prior to the succession and another following it. In consequence, a total of 16 companies were taken out because of confounding effect, 17 had either no data on CRSP or missed data during one of the event windows, 15 did not have compensation data, one was eliminated because of sudden death, and finally two were removed because of multiple succession in less than one year. This brought the sample from a total of 207 companies down to 156.

The final sample of firms that was used in this study is 156 large organizations 25 of which had an outside successor while the other 131 were inside successions. These findings of 16%-84% for outsider vs. insider succession fall right into the range of the rest of the studies published. Dalton and Kesner (1985) found the ratio to be 18:82, Beatty and Zajac (1987) 12:88, Friedman and Singh (1989) 15:85 and Lubatkin et al. (1989) 11:89, outside to inside succession.

In addition, two cases were removed because they were extreme outliers beyond -3 and $+3$ standard deviations. Their removal had a definite impact on the findings, which slightly improved. Especially, for the two-day announcement window where the voluntary/involuntary departure and successor origin became significant. Also, although a slight upward heteroscedasticity was uncovered, it was not corrected for since most results were fairly significant, and the statistical tests are usually quite robust to that weakness.

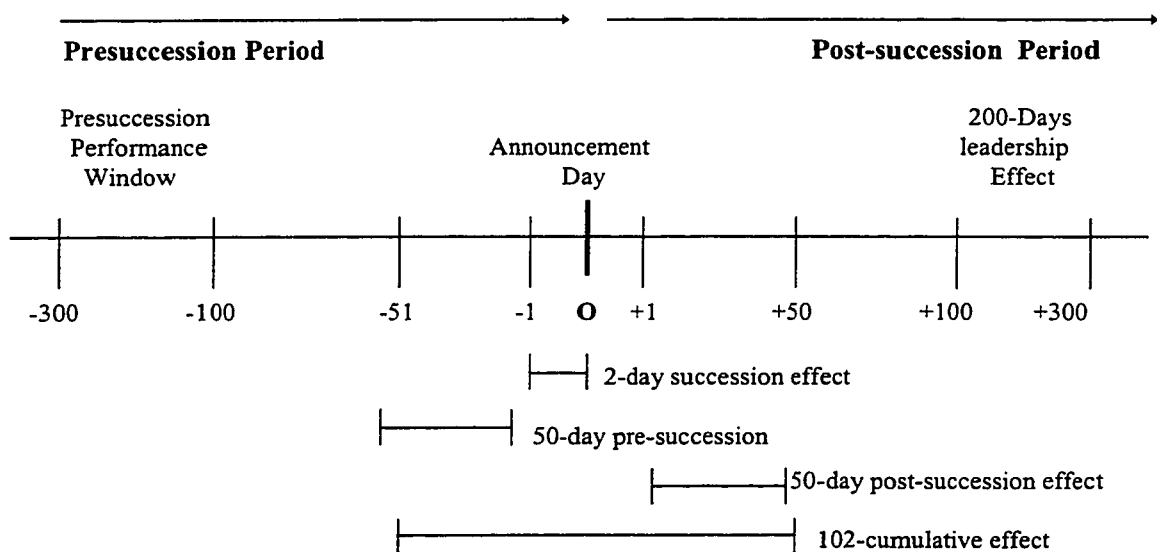
The size of the organization in sales varied from \$99.3 million to \$123,276 million. Finally, the average cumulative abnormal returns for the pre-succession performance was significant at $p < 0.1$, which is weak, but significant enough to indicate that on average poor performance is a precursor of succession. In addition, the compensation packages taken from the 'Annual Executive Scoreboard' of the Business Week, which publishes the pay of the 500 highest paid executives in the USA, is also another criterion of large organization.

According to Lubatkin et al. (1989), the conditions of poor pre-succession performance, low occurrence of outside successions and the tendency toward largeness indicate that the sample in this study is representative of large organizations. Add to these factors the large compensation criterion mentioned above, it is permissible to conclude that the results in this study can be generalized to the total population of large firms.

3. Time Frames Selections

The selection of event windows is an important process especially in the management field where the length of the time frames chosen are much longer than in the finance and economic studies. Therefore, it is important to justify the use of a time window that is much longer than two or three days since the dangers of confound effect grows with the length of the event window (McWilliams and Siegel, 1997).

Figure 3: Windows of Study



Since this study will be using the time frames used by Lubatkin et al. (1989, p.56) which is depicted in figure 3 above, it is vital to reevaluate, in this section, their choices and verify whether their justifications are in concordance with their findings. However, it is important to mention that Lubatkin's study does meet three of the four criteria set by McWilliams and Siegel (1997) who examined management research using event studies. The criteria met were the justification of the length of the window and the explanation of the excess return. The left out criteria was verification for confounding effect, which this study tries to correct for.

3.1 Evaluation of Time Frames

Most finance event studies limit the event window to either 2-day window ($t-1, t=0$) or three days ($t-1, t+1$). However, some management researchers believe that this window is not enough, that sometimes information does leak into the market prior to the event. In consequence, they control for a leak by looking at the period of time preceding the announcement date (Beatty and Zajac, 1987; Freidman and Singh, 1989; Lubatkin et al., 1989; Reinganum, 1985). This already defies the basis of event methodology, which states clearly that the event has to be unanticipated if the method is to be effective in measuring the impact on the market. However by justifying using a longer period of time prior to the event, Lubatkin et al. (1989) are trying to correct for the possibility that information might have been absorbed by the

market prior to succession announcement. Especially, that it is not only the reaction of the market that is of interest but the reasons behind it.

- (1) The first time horizon is the 2-day announcement ($t-1, t=0$) day that is mostly used in finance journals and literature. This period should detect the reactions to the succession itself not the effect of that the new leader might have on the organization, and in fact Lubatkin et al. (1989) found that the market negatively reacted to the announcement of leadership change. Beatty & Zajac (1987) supported their findings.
- (2) The second event window of 50 days ($t-51, t-2$). Lubatkin used ($t-50, t=0$), which includes the announcement date and the date before. For clarification purposes, this paper has chosen to look only at the 50 days prior to the event excluding those two days. This time period should be enough, according to lubatkin et al. (1989), to capture whether the market has anticipated the leadership change and reacted accordingly. They also concede that although the exact date of when the market awareness of possible leadership change is impossible to determine the 50 days is long enough period to detect any perception of change and yet short enough to limit confounding effect. There suspicion of leakage of information might have been right since the results support that the market does adjust downwardly its expected returns by 1%. Beatty and Zajac (1987), who only scanned the 10-days window and split their sample between anticipated and

unanticipated (although it is not clear how he was able to do that), found that the market did react differently for the unanticipated group by having a more dramatic decline in prices on the day of the event and the previous one. While the anticipated group had the decline prior to those two days.

- (3) The third 50-days event window ($t+1, t+50$) will allow the measurement of any latent reactions of investors to a CEO change. According to Lubatkin et al. (1989) this also allow the depiction of changes in investors perceptions due to new set of factors that where not revealed at the announcement or especially if the new leader was not anticipated for. Again their expectation proved accurate since the market had an even more dramatic decrease of 3.5% in their returns during that period. Similar results with Beatty and Zajac (1987) for 10-days after the succession.
- (4) The fourth cumulative period of 101-days ($t-50, t+50$) sums up the reaction for that period of time and the reaction was of course negative again.
- (5) Horizon five ($t+100, t+300$) the leadership period which will allow the detection of changes due to leadership effect and not succession/announcement effect. It is also the period of time where the leader starts making strategic changes. Surprising enough the shareholders kept downgrading their expectations of the organization performance.

In general, their justifications are clear and their results seem to back up their expectations. Therefore, it is pretty safe to use their different time horizons, keeping in mind that length of event windows is still very arbitrary.

4. Measurement of Variables.

The research model identified one dependent variable (cumulative excess returns) and two independent variables (compensation and voluntary/involuntary retirement) and two moderators (pre-succession performance and origin of successor[internal/external]). This paper's aim is to determine how much variance is explained by succession effect and leadership effect separately and the variable affecting each effect contribute to explaining this variance.

4.1 Dependent variable: Cumulative Abnormal Returns

Abnormal returns are used as an efficient measure of performance because they overcome the limitation of accounting measures which is the inability to effectively isolate the impact that a certain event has on the performance of the organization. Abnormal returns can be instrumental in that they represent the future performance of firm's common stock by investors' expectations. In other word, a positive abnormal return implies that the stock has over-performed and negative

returns signify under-performance. It is a measure that has been used by several researchers as a mean to determine the effect of succession of performance (Beatty and Zajac, 1987; Lubatkin et al. 1989; Worrell and Davidson, 1987; Maggee, Nagarajan and Newman, 1985). This measure will be represented as CAR in the tables followed by each of the intervals used.

4.2 Independent Moderating Variables

- a) Context: Pre-succession performance: This variable will be measured by the abnormal returns cumulated over 300 hundred days preceding succession by one hundred days. It is represented in the tables as context.
- b) Origin of Successor: This variable will indicate whether the successor is an insider to the firm or an outsider, and it is a dummy variable that is 0 for insiders and 1 for outsiders. It is represented in the table as origin.
- c) Type of Departure: This measure will determine whether the departure of the previous CEO was voluntary vs. involuntary. It will be a dummy variable where 0 is involuntary and 1 voluntary departure.
 - (1) Voluntary succession will be determined as follows: 1. a succession initiated by the CEO himself; 2. an announcement of voluntary CEO retirement. 3. The CEO has found employment in another organization
 - (2) Involuntary succession: 1. announcement of dismissal, or removal by the board, 2. references of disagreement.

This construct is unfortunately highly subjected to the researcher's own bias and judgment; this weakness is corrected for by calculating an inter-rater reliability. Therefore a second person was asked to code two variables voluntary/involuntary departure and successor origin. Concerning the successor origin there was a 100% agreement as to the origin of the successor. For the voluntary/involuntary variable there was disagreement on only one of the cases. In that case the CEO was the president of the organization two years before when left because he was passed over for a promotion. He was brought back after his predecessor left for another opportunity. The second coder coded him as an outsider because he was brought in from another organization. However, since his 17 years experience with the organization makes him very knowledgeable about it the researcher felt that he should be considered an insider. The second coder agreed.

d) Compensation

Compensation will measure the leadership effect, and therefore will be constructed as follow:

- (1) Ratio of long-term compensation: this is the proportion of long-term compensation calculated by the dollar value of stock options divided by the total compensation in dollar value of salary, bonus and stock options.

4.3 Moderator of the Moderators

a) Pre-succession performance × Successor origin

This measure will be calculated by multiplying the abnormal returns cumulated for the 200 trading days starting three hundred days prior to succession announcement publicly by the successor origin (Lubatkin et al., 1989). It is represented in the tables as interaction term.

4.4 Control Variable: Size

Although several studies found that size does not have a significant impact on the organization it seems important to control for it. It will be measured as a continuous independent variable calculated through the dollar value of the sales for each firm in the sample.

3. Statistical analysis and Discussion

1. Statistical Analysis

1.1 Descriptive Analysis and Pearson Correlation Matrix

The first table will provide the means, standard deviation, the skewness index, and N (the sample size for each variable).

Variables	Means	Std. Deviation	Skewness	N
Origin	0.147	0.356	2.008	156
Context	-0.151	1.323	-0.071	156
Departure type	0.929	0.257	-2.39	156
Compensation	0.245	0.245	0.759	156
Size	9340	14947	4.858	156
Interaction term	-0.021	0.648	-1.667	156
CAR (-1, 0)	0.194	1.432	0.970	156
CAR (-51, -2)	-0.026	1.207	0.353	156
CAR (+1, 50)	-0.033	1.046	0.077	156
CAR (-50, +50)	-0.043	1.174	0.494	156
CAR (+101, 300)	-0.125	1.340	0.017	156

The skewness index indicates the normality for each of the above variables. The closer the index is to the zero the better the normality. The negative and positive numbers indicate whether the variable is skewed accordingly. The index for size seems to be large enough that it might require a logarithmic transformation; however when this was performed on the variable, size, and the results were found to be not significantly different from the none transformed variable. For that reason, this variable was left as is.

The next table provides the correlation between each of the variables used in this study.

Table 2: The Pearson Correlation Matrix

Variables	1	2	3	4	5	6	7	8	9	10
1. Compensation	1									
2. Departure type	.072	1								
3. Origin	.125	-.061	1							
4. Context	.144	.013	-.025	1						
5. Interaction Term	.083	-.001	-.129	.472**	1					
6. Size	.149	.060	-.030	.036	.163*	1				
7. CAR (-1,0)	.202*	-.075*	.133	.027	-.017	-.011	1			
8. CAR (-51, -2)	.032	.009	.045	.262**	.233**	.082	.302	1		
9. CAR (+1,50)	.199*	.116	.221**	.247**	-.047	-.020	.175*	.052	1	
10. CAR (-50,+50)	.150	.080	.173*	.352**	.125	.046	.338	.749**	.685**	1
11. CAR (+101,200)	.058	.072	.176*	.365**	.070	-.052	.208	.326**	.323**	.452**

- p<0.05
- p<0.01

The above table provides the Pearson Correlation, which will demonstrate whether any inter-correlation exists between the variables that are being investigated. The table indicates that correlation is not a threat to the variables used in the regression analysis.

1.2 Cumulative Abnormal Returns Calculation

Using the event methodology described in the previous section, cumulative abnormal returns were calculated for each of the different event windows. Then a

Z-statistics was derived to gauge how significant are the deviations from the expected returns, the results are listed in table 3.

Table 3: Cumulative Abnormal Returns Statistics

<i>Cumulative Abnormal Returns</i>	<i>ACAR</i>	<i>Z-Statistics</i>	<i>Significance</i>
CAR (-1, 0)	0.1930586	2.411	P < 0.01
CAR (-51, -2)	-0.04228	-0.5281	Not significant
CAR (+1, 50)	-0.04614	-0.57632	Not significant
CAR (-51, +50)	-0.06432	-0.80331	Not Significant
CAR (+101, 300)_	-0.139657	-1.744319	P < 0.1

Table three presents the ACAR and their Z values as well as the significance level. From this table, it is obvious that the Z-statistic for the average cumulative abnormal returns (ACAR) for the two-days period on the succession effect period is very significant with $p < 0.01$, less significant for the leadership effect with a $p < 0.1$. This suggests that the leadership change definitely did not go unnoticed by the shareholders who adjusted their expectations of the earnings of the organization accordingly.

In fact, at the announcement of the succession ($t-1, t=0$) the market has a very significant and positive reaction to the change; the actual returns are 19.3% higher than expected. On the other hand, during the leadership period ($t+101, t+300$) the market seems to downgrade their expectations by 13.97%. Almost signifying that the decisions of the new leader are either not enough or not what they were expecting.

The results for the other time frames (t-51, t-2), (t+1, t+50) and (t-51, t+50) are – 4.2%, -4.6% and –6.4% respectively, and although they are not significant they should not be discounted, especially that they are all negative CARS unlike the two-days window. More clarifications will be deduced from the regression analysis on the CARs.

The results in table 3 indicate that the succession event does not go unnoticed; therefore the no effect theory can be already disregarded. This leaves the other two succession theories to contend with, the positive effect and the disruptive or negative effect theory. First of all, at the announcement window of two days the ACAR were 19.3%. This positive very significant excess return indicates that shareholders are very favorable to the change in leadership. In addition, the fact that all the other windows have negative excess returns while the 2-day window has a positive one also indicates that the shareholders approve, initially, of the change. Since, the actual returns are 19.3% higher than what is expected by the market model. This already supports Guest's theory that the succession event seems to have a positive impact on the organizational performance. Therefore **hypothesis 1 is accepted** and 'succession effect' has a positive effect.

In addition, the excess returns are not significant for the period of fifty days prior to the event, which provide no evidence of leakage. Although, anticipation can be expected to be strong in the cases of planned succession or mandatory retirement

age, this is not the case in this study. In fact the negative, insignificant excess returns can indicate that shareholders might still be holding-off until the announcement date when several determinants in the form of additional information clears up some of the uncertainty of the succession event. The additional information would who the successor is, what type of departure it was, how is the new CEO compensated. In addition, a negative excess return might indicate a certain uncertainty existing in the period prior to the announcement.

The other three cumulative abnormal returns after the announcement date might indicate that the disruption from the change event is strong enough to offset the positive influence expected from the change in leadership, especially that pre-succession performance was negative and significant at $p < 0.1$. This can be a direct support of Grusky's theory that the disruption caused by succession may neutralize the positive results expected from the new leader.

This is even more prominent in the leadership period where the results are significant at $p < 0.1$. During that period, the shareholders seem to correct their expectations downwardly by 14%. In other word, the actual results are 14% lower than the expected ones from the estimated market model. In this period what the leaders are reacting to are now any actions taken by the new leader that affect their perception of the future earnings of the firm. This negative result seems to be in support of Grusky's claim, which **rejects Hypothesis 2** that the new leader does not

positively influence the organizational performance. Instead, the results suggest that whatever action the new leader undertook has been negatively reviewed by the shareholders.

The opposing results between succession effect and leadership effect seem to suggest the following. First of all, even though a leadership change is perceived by shareholders as a sign of change and positively viewed as a possible improvement of the performance, which is negative prior to the change in this case, investors seem to negatively adjust their position after the first 100 days. This indicates that Grusky's claim of disruption should not be dispelled but carefully assessed. Also, the 'leadership effect' is impacted by conditions surrounding the event, as well, as after the event. In addition, these opposite results viewed together and not separately support the need to study several windows, as advocated by management studies, for the full understanding of succession events.

Now that the cumulative abnormal returns have been shown to be significant indicating that succession is not an inconsequential event, explaining this significance is the next step. This introduces the next section where some of the conditions surrounding the succession event are investigated to determine whether they moderate the relation between 'succession effect' and organizational performance and 'leadership effect' and organizational performance.

Now, that the excess returns are found to be significant for **'succession effect'**, and less so for **'leadership effect'** and McWilliams and Siegel's (1997) criteria are fulfilled, explaining these abnormal returns becomes the next step which is investigated in the next section, regression analysis.

1.3 Regression Analysis

In order to further the understanding of the succession impact on organizational performance and test the rest of the hypotheses an ordinary-least-square regression analysis was performed on the cumulative abnormal returns (CAR) for all the firms at each of the five different time frames. There are two important regression models. The first incorporates all the moderators of the relation between the two effects of the succession event and the organizational performance as measured by CAR. The second model will include the moderation of the origin by the pre-succession performance, which is the interaction term between the two variables. There is a third model that is not very important and it incorporates the control variable, size. The two meaningful models are based on the following functions:

CAR = f (pre-succession performance, Successor origin, Type of predecessor departure, ratio of long-term compensation over total compensation, Successor origin \times pre-succession performance, company size and an error term).

Table 4: The results of Multiple Regression on the Five Windows of succession

		2-day Succession Window (t \in [-1,0])	50-day Post- succession Window (t \in [1,50])	50-day Pre- succession Window (t \in [-51,-2])	102-day Cumulative Window (t \in [-52,50])	200-day Leadership Window (t \in [101,300])
Model 1	Constant	-0.913 (-2.021)**	-0.508 (-1.419)	-0.117 (-0.274)	-0.519 (-1.353)	-0.489 (-1.081)
	Size	-3.123E-06 (-0.460)	-1.739E-06 (-0.323)	7.036E-06 (1.085)	2.298E-06 (0.398)	-2.925E-06 (-0.435)
Model 2	Context	0.00171 (0.201)	0.256 (3.796)***	0.210 (2.763)***	0.317 (4.387)***	0.432 (5.112)***
	Departure type ^e	0.835 (1.952)**	0.304 (0.897)	2.829E-02 (0.066)	0.363 (0.998)	0.384 (-.906)
	Compensatio	1.11 (2.597)***	0.605 (1.785)*	-8.247E-02 (-0.200)	0.286 (0.789)	-0.231 (-0.546)
	Origin ^f	0.559 (1.813)*	0.522 (2.706)***	0.218 (0.792)	0.557 (2.125)**	0.686 (2.358)**
Model 3	Interaction term	-0.122 (-0.671)	-0.372 (-2.081)**	0.277 (1.563)	-5752E-02 (-0.371)	-0.251 (-1.387)
	F	2.785***	4.207***	2.002*	4.986***	5.540***
	†R ² (Model 1)	-0.07	-0.06	-0.06	-0.04	-0.04
	R ² (Model 2)	0.041	0.092	0.052	0.14	0.146
	R ² (Model 3)	0.038	0.112	0.057	0.135	0.151

^a INSOUT is a dummy variable with 0 = inside succession, 1 = outside succession

^b VOLINV is a dummy variable with 0 = involuntary departure, 1 = voluntary departure

* p < .1

** p < .05

*** p < .01

† Note that all the R-squared used in this table are the adjusted R-square. Also, model 1 represent the regression with just the control variable, model 2 includes the 4 moderators (successor origin, type of departure, pre-succession performance and percentage of long-term compensation), model 3 includes all the above plus the interaction term between successor origin and pre-succession performance.

The variables were entered in a stepwise procedure. First, the control variable, size, was entered. Then, the four moderators, percent long-term compensation, type of departure, pre-succession performance and successor origin, are entered. The third step includes the interaction term between pre-succession performance and origin. The results of the five regression analyses are reported above in table 4 above, as well as the adjusted R-square for each of the models and the F-statistic. The findings in this table will be discussed in the next section.

Findings and Discussion of the Regression Results

The first step in this study was to determine whether the succession event has an impact on organizational performance, and after determining that, understanding the significance of the abnormal returns becomes the second step in investigating the effect of leadership change on the organization. Towards this end five different regressions were performed to analyze and understand the significance of abnormal returns. The dependent variable, cumulative abnormal returns, was regressed first on the control variable, then the moderators and finally the interaction term representing the moderation of the successor origin by the pre-succession performance. Each of the five regression equations is presented in table 4.

In addition, the significance of each of the predictors is indicated by a t-statistic in bracket under each of the regression coefficients for these predictors.

Asterisks to indicate the level of significance whether it is 0.1, 0.05 or 0.01 will also mark the t-statistic. Also, each model will have an F-statistic, which will signify whether at least one of the predictors is significant or different from zero, and the adjusted R²-statistics for each of the models in a stepwise procedure show much of the variance is explained by the predictors.

The F-statistics

The F-statistics are very significant at $p < 0.01$ for all time frames except for the fifty-day pre-succession where the significance is at $p < 0.05$. This indicates that the regression models used explain a good amount of the variance in the cumulative abnormal returns, and that at least one of the variables used is significant. In other words, one of the moderators has an important role in influencing the link between the change event and the performance of the organization. This is further determined by looking at the t-statistics in brackets for each of the moderators, where in each time period at least one of the determinants is significant at $p < 0.05$. In the next few paragraphs, the results will be examined in order to establish whether the hypothesis stated in the second section of this study are accepted or rejected. First, a closer look at the adjusted R² will help determine how much of the variance is explained by the moderators.

The Adjusted R²

The stepwise procedure has three steps or models. The first step, model 1, is the regression on the control variable in this case the size of the organization. As is obvious by looking at the adjusted R² of model 1, the size is not a significant variable since the value of the R² varies between -0.04 to -0.07, which is actually zero, i.e. size doesn't explain any of the variance. The interesting part starts when the four moderators are included into the regression in step 2, which will be model 2. Here the R² increases in value and become more important. In fact, it is interesting to notice that the value of this statistics, like the F-statistics, increases as the time-lapse from the announcement period increases. This may suggest that when the uncertainty of the announcement clears up certain moderators impact becomes clearer to the shareholders and therefore more pertinent to the organizational performance and the ability of the new leader to implement change. The results for the R² for the 2-days window, 50-days pre-succession, 50-days post succession, 102-days cumulative and the 200-days leadership window are 4.1%, 5.2%, 9.2%, 14% and 14.6%, respectively for model 2. For model 3, they are 3.8%, 5.7%, 11.2%, 13.5% and 15.1%, respectively.

These are significant except for the 2-days announcement window and the 50- days pre-succession window. The tremendous increase in the R² when the moderators are entered indicates that on average some of these predictors in those

models explain between 9.2% for post-succession period and 14.6% for the leadership period, of the variance in the abnormal returns. The two variables that seem to be significant in four of the five different regressions are successor origin and presuccession performance. The findings actually indicate that presuccession performance is a very significant contextual variable that should always be considered when evaluating succession event, the same conclusion applies for origin. Departure type is significant only at the 2-day window while compensation is significant at the 2-day window and the 50-day post succession. These variables will be discussed more thoroughly in the next sections.

The R^2 of model 3, where the interaction term is introduced, do not differ significantly from those of model 2, except for the 50-day post succession period, where this term is significant. In that period the interaction term explains an additional 2% in the variance of the abnormal returns, and it is in this period that the pre-succession performance is found to moderate the relation between successor origin and performance.

The above F and R^2 statistics seem to provide support to Lubatkin et al (1989) and Beatty and Zajac (1987)'s contention that more valuable knowledge is exposed by studying several time windows than just the traditional two or three days windows.

The significant F-statistic and R²-statistic suggest that the at least one of moderators used is crucial to understanding the impact the change in leadership has on the organization performance, which is measured here by excess returns. These are the moderators that will help explain the relationship between succession effect and leadership effects with the organizational performance. The next paragraphs will look at each of these moderators and determine their importance in the research model.

Presuccession Performance

The presuccession performance is positively and significantly ($p < 0.01$) related to shareholders' expectations at the four of the five different time-periods, except at the 2-day window. This strong show of pre-succession performance's impact on abnormal returns indicates first of all, that context is definitely an important moderator that should not be ignored in the process of understanding succession events. Hypothesis 3a is already partially supported since pre-succession performance is definitely an important coefficient in understanding the variance in abnormal returns.

That this variable is not significant in the 2-days window does not indicate that it has no influence on '*succession effect*'. In fact, the strong results in the 50-days pre-succession period, the 50-days post-succession and the 101-cumulative

period indicate that the performance of the organization prior to the change of leadership influences the relation between succession effect and organizational performance. In fact the results indicate that the market reaction is directly linked to the presuccession performance. In other words, the market reaction is proportional to presuccession performance, i.e. the lower the presuccession performance the more negative the market reaction and the better the performance the greater the market reaction. Therefore, **hypothesis 3a is supported**. This might infer that shareholders perceive a good prior performer as providing a stronger disposition to have changes implemented than a weaker organization financially. The new person will be better able to improve performance in a strong organization since s/he will be build on the strength of the organization.

These results seem to be also supported in the leadership period. Presuccession performance is still very significant although shareholders seem to be less confident in the new leader since the actual returns are significantly lower than the estimated returns from the estimated market model. In this period, shareholders seem to believe that the new leader's will be able to implement change better in a strong performer versus a weaker one; **hypothesis 3b is also supported**. Presuccession performance is a strong moderator of '*leadership effect*' and performance. In short, one might conclude that, although, poor prior performance seems to be the precursor of succession a good pre-succession performance gives a better head-start to the organization in the event of succession.

Successor Origin

Origin was proven to be significant in 4 of the 5 time frames. At 50-day presuccession windows origin is not a significant predictor of performance; however, a weak 2-days result ($p < 0.1$), a strong 50-days post-succession coefficient ($p < 0.01$) and less so at the cumulative period ($p < 0.05$) suggest that this variable is also a very strong moderator of the relationship between '*succession effect*' and performance. Who succeeds is apparently very important to shareholders who adjust their perception of future performance accordingly. This seems to reject Beatty and Zajac's contentions that at the succession announcement there is no distinction between insiders and outsiders. In fact, this demonstrates successor origin is a solid moderator of the relation between '*succession effect*' and performance. The findings seem to suggest that outsiders seem to be favored by the shareholders over insiders. Therefore, we can deduce that **hypothesis 4a is supported**. The results of Lubatkin et al. (1989) and Friedman & Singh (1989) receive support that outsiders seem to be favored and have a better chance at improving the performance. The same applies for the leadership period where successor origin is also found to be significant ($p < 0.05$). Outsiders are expected to have a better chance at improving the performance of the organization than insiders, **hypothesis 4b is also supported**.

Performance as an Antecedent to Origin

The contingent relationship seems to receive not much support, hypothesis 5 seems to be rejected for all time periods but one, the 50-day post succession ($p < 0.01$). The significant interaction term between origin and succession in the 50-day post succession window is investigated in a contingency matrix whose results are shown in table 5. That significant term in the regression analysis on the CARS of the above mentioned time frame [fourth column in table 4] denotes that presuccession performance might be a moderator of the relationship between successor origin and organizational performance. In order to acquire additional information as to the significance of the interaction term, the sample of abnormal returns for that time frame is split in half, and then sorted by the presuccession performance from lowest to highest. Then the sample is split even further between insiders and outsiders.

Table 5: Contingency Matrix: Abnormal Returns by Origin and Context

Origin	Presuccession Performance	
	High	Low
Insiders	- 0.444931918 (0.39533) 64	- 0.453225 (1.1597) 66
Outsiders	0.4713793 (0.7269) 13	- 0.210835(1.63) 11
T stat	2.27551**	-0.458

** $p < 0.05$

Each cell has a mean abnormal return, the standard deviation of that mean (in parentheses), and the number of observation per cell underneath.

The findings in table 5 indicate that outsiders in high performing firms are able positively impact organizational performance much more than insiders. On the other hand, for low performing firms the results show that there is no significant difference between insiders and outsiders. In other words, the market is indifferent to the origin of the successor for low performing firms but value outsiders in high performing firms.

This is contrary to what was hypothesized. Since outsiders are viewed as the instigators of change and the ones capable of disrupting the status quo of a failing firm it was hypothesized that they would be favored over insiders who are considered as the enforcer of the continuity of previous styles of management. Moreover, the shareholders of good performers should favor insiders who will maintain previously successful decision making styles. However, in both instances this was not found to be so. In addition, since the interaction term was found to be insignificant in all but one period, it is safe to say that presuccession performance does not moderate the relation between origin and organizational performance. Therefore **hypothesis 5 is rejected**. These results might indicate that good performing firm are less subjected to the disruption due to the replacement of the CEO than low performing firms. It is as if the shareholders do not believe anyone can make a difference in a low performer. The surprise is the results in favor of outsiders in good performers as if the market is signaling the need for change. This seems to reflect today's fast changing market and the need for firms to stay flexible and in constant mutation in

order to catch up to the turbulence of the environment in which businesses perform. Additional information might have been deduced from the type of industries in which the firms in this study competed.

Voluntary vs. Involuntary Departure

The coefficients for this moderator were very weak in all the periods except for the 2-day announcement window, and this can be due to the fact that 11 of the 154 successions were involuntary (7%). Since this was a dummy variable where 0 = involuntary departure and 1 = voluntary departure, the significant result ($p < 0.05$) at the announcement window shows that voluntary departure seems to be favored by shareholders. A voluntary departure seems to improve the expectation of the shareholders in the organizational performance. This is a surprising result, which might indicate that the shareholders might have received new information concerning the voluntary departure that was not incorporated earlier **hypothesis 6a is rejected**. **Hypothesis 6b seems to be supported** since this moderator does not seem to be significant at the leadership period. The significant result on the announcement day might also imply that even though succession is a very usual event, one that is often planned, its impact on the organization is significant and therefore needs to be investigated.

Successor Origin	presuccession Performance
0	-0.94890
0	-0.03330
0	-0.03311
0	0.39789
0	0.93399
1	-2.26443
1	-0.37777
1	-0.16911
1	0.16353
1	0.38920
1	1.44273

The above table shows that there isn't a clear, distinctive pattern that separates outsiders from insiders for involuntary departure at to the presuccession performance.

Compensation

This variable was found to be significant in the 2-days window ($p < 0.01$) and less so in the 50-days post succession period ($p < 0.05$). The positive coefficient suggests that the larger the long-term compensation percentage the more favorable the shareholders seem to the leadership change. There seems to be a positive significant link between succession effect and the cumulative abnormal returns. The significant positive coefficient might also indicate that shareholders believe it is time for the change. This might imply that the larger the long-term compensation is to total compensation the more the shareholders are looking for change, which supports hypothesis 7 partially.

Unfortunately, this variable is found insubstantial in the leadership period. This is quite disappointing since this study hypothesized that the long-term compensation might indicate the mandate a leader is given to implement change. This determinant should not be discounted since the lack of significance could be due to several factors. Maybe the period of 200 hundred days is not enough to assess whether long term compensation can be linked to performance. Also, stock prices might not be at this point an accurate measure of performance. Other measures of performance should be considered to assess the leader's abilities such as ROA or ROE. Therefore, there is **partial support for hypothesis 7**.

As was mentioned earlier, this is a first attempt at looking at directors' intentions when hiring new CEOs. Although the results were not very significant further research is needed in the link between the board, the compensation offered and the new executive. The results indicate that the shareholders are prone towards compensation packages whose largest component is long term compensation or stock options further suggesting that change in direction and strategy may be implicit to a change in leaders.

Size

Size is an insignificant predictor, which is expected since most of the organizations studied here are quite large.

3. Summary of Results

The use of event methodology to testing whether leadership change has an impact on organizational performance has contributed two significant results. First of all, the 'succession effect' or the impact of the succession itself was found to be positive and very significant. In other word, the cumulative abnormal returns for the 2-days announcement were positive which meant that the actual returns were much larger than the expected returns from the market estimation model. This finding supports previous research as well as the 'common sense' theory, which states that succession will have a positive effect on the performance. This means that the shareholders approve of the change in leadership. The second result concerns the 'leadership effect' or the impact of the new leader on the organizational performance. During the 200-days post-succession the result was opposite to the one for the 'succession effect'. The cumulative abnormal returns were negatively significant, which indicated that the shareholders aren't appreciating the way the organization is run by the new leader. This finding supports the 'vicious cycle' theory, which states that the disruption from the change is so strong that it outweighs the good that might have resulted from it or that the initial perception the shareholders have on the new action of the leader is disproving. Although, we hypothesized that the new leader should be able to implement positive improvement to the organization this was not found to be so. Hypothesis 1 is supported while hypothesis 2 is rejected. Also no anticipation was found in the results.

In testing the impact of presuccession performance on succession effect we predicted that the lower the performance the larger the approval of the shareholders to the change in leadership. Also, good presuccession performance was expected to positively influence the ability of the new CEO to improve organizational performance. Presuccession performance was found to be a very significant moderator between succession effect and performance, and leadership effect and performance. However, the result where such that the better the presuccession performance the better the shareholders reaction to the change for the succession effect as well as the leadership effect. In other words, the better the presuccession performance the better the new leader's chances to improve organizational performance. Hypothesis 3a and 3b are fully supported. This indicates that the context is an important variable to be included in the study of the succession event.

The impact of successor origin was also found to be very significant for both the succession effect on performance and the leadership effect on performance. Outsiders seem to be favored by the shareholders over the insiders. This is the same as what was predicted in our hypothesis 4. It seems that shareholders seem to perceive outsiders as having a better chance at improving the organizational performance. Again this is a very strong moderator that should never be discounted. Hypothesis 4a and 4b are accepted.

Presuccession performance was not found to be a strong moderator of the relationship between origin and performance. Only in one of the time periods was the interaction significant. We predicted that a poor prior performance would increase the chances that an outsider will implement changes that will improve organizational performance. While good prior performance will enhance the ability of an insider. The results reject that hypothesis. First, for low performers shareholders seemed to be indifferent to whom succeeds whereas for high performer outsiders are favored. Hypothesis 5 is rejected.

In testing for the impact of type of departure on the performance, we predicted that involuntary departure would be welcomed by shareholders whereas voluntary will have no impact on the performance. Also, voluntary departure will be discounted in the period preceding the announcement. In addition, we predicted that type of departure would be insignificant for the leadership period. The findings partially supported these predictions. However, surprising enough it was voluntary departure that was favored by shareholders, and not involuntary, especially that most involuntary departure where board removal due to unsatisfactory performance. Hypothesis 6 is partially supported.

In testing for the impact of compensation, it was predicted that the larger the long-term compensation percentage the more favorable the shareholders would be. In other word, the larger the long-term compensation performance which measures the

extent to which the board gives the new executive a mandate to implement change, the higher the performance expectation of shareholders. A positive coefficient was found which indicates that the larger the long-term compensation percentage the higher the expectations of the shareholders in organizational performance. This is valid for the succession effect, i.e. for the period surrounding the succession announcement. For the leadership period this moderator was found to be insubstantial. Hypothesis 7 receives partial support. However, further research is needed.

4. Conclusion and Future Research

This study had two goals. The first was to determine what impact leadership change had on organizational performance, if any. The second goal was to investigate whether presuccession performance (context variable), successor origin, type of departure, and the boards' mandate to the new CEO measured by compensation (content variables) moderated the relationship between both succession and leadership effects with organizational performance. Furthermore, this research is an initial step in determining whether boards of directors, through careful use of compensation packages provide the new CEO a mandate for change. This section will summarize the findings and offer suggestions for future research.

This study's purpose was to examine the succession event in its entirety and not in parts like previous research; i.e. investigating succession effect and leadership effect within the same context. In order to reach our goal, the succession effect, which is the impact of the succession, per se on the organization, is examined in four different time windows: 50-days prior to the announcement, 2-days announcement window, 50-days post-succession and 102-days cumulative. Then, a 200-day window post-succession examined leadership effect, which studied the impact of the new leader on the organization after a certain period of time has lapsed following the announcement of CEO succession. Afterwards, the several context and content moderators were investigated to explain the variance in performance. The results of

these two effects provide very interesting insights into the impact of succession on the organization.

The findings indicate that understanding the succession event and the dynamics involved with it, one needs to look at both succession and leadership effect together. In fact, the results suggest that the impact of CEO succession is not a simple matter of whether it is negative or positive, as previous studies implied, but a look at the short term as well as the long term performance provide significant insights into the intricacies of the event. In general, the models tested in the literature involved a study of one of the above effects separately. This study tries to correct for this weakness by investigating both effects together.

First, the results indicate that the impact on performance is not static as was previously thought. This study showed that to say that the impact of succession is just positive, negative or neutral would be too simplistic. In fact, examining the effects on a longer time span indicates that the perception of the impact seems to evolve and change with time. This study suggests that initially shareholders welcome CEO replacement as a sign of change in the organization; a change that might implement positive consequences in the organizational performance. However, as time goes on and the disruption that is caused by the change in leadership is amplified the shareholders revise downwardly their perceptions of the firm's future earnings. In addition, the positive results that are expected from the

changes the new leader implements on the organization are offset by the succession's disruption. Therefore, it is possible to say that although the executive succession seems to be a welcomed change by shareholders, its longer span disruption seems to have a powerful negative effect. In other words, the findings in this study seem to support Grusky's claim that successions are disruptive and have a negative impact on organizational performance. However, more research is needed with a longer time span in the future that might provide us with more information as to the long-run impact of the new CEO on firm performance, i.e. a longitudinal study.

Moreover several moderators were found to improve our knowledge of the impact of the succession event. Presuccession performance, as expected, is found to be a strong determinant of how the succession events impact the organization. This moderator is found to have a positive and direct impact on the relationship between succession and leadership effects with organizational performance. In other words, the more negative the presuccession performance the more negative the shareholders' reaction to the change, and the more positive the presuccession performance the more positive shareholders reaction. The better the performance of the firm prior to the event the more positive the market's reaction to the change. The strong results for this moderator in four of the five time windows suggest that presuccession performance or context is a strong factor that brings us closer to understanding the event by looking at the conditions surrounding the change.

The same goes for successor origin, as hypothesized, outsiders are favored by shareholders throughout the length of the time studied. The results are strong enough to support the theory that although insiders are synonymous with continuity and less disruption to the organization, outsiders are considered as facilitators of change. In other words, since outsiders are equivalent to change and are favored by shareholders then the market may be sending the signal to the organization and the CEO that change is welcomed even when the organization is performing well prior to the succession announcement.

The question of whether the board does provide the CEO with a mandate to implement changes onto the organization is not fully answered. The results show that long-term compensation seems to be favored by the shareholders. As was mentioned earlier a strong support of long term compensation might indicate that it is not the short term improvement in performance that are expected but the long term changes. This study has offered only an initial step in determining whether or not the board does provide the new leader with certain guidelines for their decision-making processes. More research might provide additional information as to how the boards of directors intend to steer the CEO through compensation packages.

One interpretation of the above findings is that change is the goal to CEO succession. All the above findings seem to point that it is 'change' that is required when the CEO of an organization is replaced. The replacement of the top executive

of an organization seems to be viewed as a means to implement changes in the organization even for good performer. In addition, this is further indicated by the positive results for outsiders and the positive response to larger long-term compensation ratios. This also supports our contention that the board might be giving the new executive a ticket to implement strategic changes to the organization.

However, low R-squared results also indicate that there are several moderators that are not accounted for; therefore, more research is needed. In addition, the data that was used taints our results with forward bias since the exact long-term compensation is not given per say, but the stock options are. This variable was found to moderate the relationship between succession effect and organizational performance but not the leadership effect. Again, more research is needed.

Limitations and Suggestions for Future Research

There are several limitations to this study. First of all, the sample used in this study is limited to fairly large organizations, which excludes the results pertinent to smaller organizations. It would be interesting to see whether size is an important determinant. Unfortunately, the availability of the data makes it very hard to implement it. Second, the use of the actual compensation figure from the business

study taints the results with a forward bias since at the time of the succession only the number of stock options given is known to shareholders not the actual profit. Third, limiting the presuccession performance to 200 days prior to the succession is also another limiting factor the use of another variable such as ROE for a longer period of time would be another interesting alternative.

Suggestions for future research:

- (1) This study uses cumulative abnormal returns for 200 days prior to the succession event. A more accurate study needs to also look at another indicator of presuccession performance such as return-on-equity (ROE). This will also shed the light on whether there are differences between the measures of performance used. Also a longer time period could be used such as three years prior to succession. In addition, a longitudinal study following the event may also shed some light on the long term impact of the new CEO on the performance of the firms.

- (2) The new leader's influence on performance can be better assessed by the use of another measure of performance than stock prices. Another measure of leadership impact such as ROA or ROE or any other profitability indicator might be used over a longer period of time to determine the impact. In fact, in their most recent study on pay design Grossman and Hoskisson (1998) suggested that accounting measures are better suited for firms pursuing cost leadership and

unrelated diversification strategies as well as in highly leveraged firms or firm with low-cycles. Low cycles meaning firms well protected from competitive pressures. Stock prices on the other hand are suited for differentiation, related diversification and restructuring strategies as well as fast-cycle firms such as firm which are heavily based on technological change and innovations and high growth industries. Their paper offers a way of designing compensation packages that suit the strategy of the firm and matches the adequate measure of performance to the pay.

- (3) Also, this study looks at the four moderators, presuccession performance, successor origin, type of departure and compensation, as well as the presuccession performance as antecedent of origin. Other moderators might be used, such as the tenure of the predecessor, the reaction to the departure of the predecessor. The latter is a very interesting prospect since it has not been investigated yet. Especially, that it seems that some of the reaction to the succession might be due to the departure of the previous CEO, specifically after a long tenure, where shareholders might believe it is time for change. In addition, another moderator that can be investigated is whether the incumbent CEO has a successor in mind. Zajac (1990) found that a company with a successor in mind has a better performance than one with no successor aligned.

(4) Also, this study used only one value of compensation, which is the percentage of the actual dollar figure of long-term compensation, which gives a forward bias to our results. Another compensation measure such as the number of stock options offered to the new CEO divided by the total shares outstanding would have been a better alternative. In addition, short-term incentives should also be included to determine whether they might explain some of the performance variance. Coughlan and Schmidt (1985) found that salary and bonus was related to abnormal returns. Finkelstein and Boyd (1998) seem to suggest that managerial discretion seems to influence executive compensation. Managerial discretion being the extent of freedom they are given to run the organization. They also link compensation with the context of the organization, i.e. whether a low or high performer seems to influence the compensation, which might indicate that maybe prior performance does influence compensation. They indicate that more research is needed to understand “how discretion and CEO compensation are related” (p. 195), as well as, how the board signal CEO as to the extent of their managerial discretion.

(5) This study also tried to look at one part of the selection process, which is the compensation package offered to executives. A need to look at the whole selection process might give a better idea at the criteria that board members look at when choosing a successor, especially that this study has shown that it is change that seems to be sought after when a CEO is replaced. One of the

hypotheses Zajac (1990) offers is that companies with a specific successor in mind has a better performance than the ones with no orderly succession. In other word, companies might be choosing some CEOs for their background, their experience, their strategies, their styles of management, etc. The type of successor according to the above specification might also indicate whether change is wanted or not. . This study attempted to use LT comp as a measure of the mandate for change. Other measures would include looking at the president letter and code it as to whether he perceived CEO replacement as a mean for a change from the status quo. Also, analyzing newspaper articles, that appear around the announcement date, and determine whether the change is seen as a mean for change.

- (6) In addition, the sample that is used in this study is definitely skewed towards largeness, which might limit the variance. Especially, that compensation might vary between smaller organizations which is why size was found insignificant. A sample with more diverse firm size wise would be interesting provided that the data is accessible which is hardly the case for smaller firms.
- (7) Also, it would be interesting to determine if there are differences in the pay packages proposed to outsiders and whether that affects the firms' performance. Are outsiders paid more than insiders?

The earliest research had conflicting results not only concerning the impact of the succession event on organizational performance but also to the significance of the moderators on the relationship between the event and the performance. This study by using several windows of investigation managed to shed some light on the issue. It suggests that succession impact is not a one time event like most finance and economic journal indicate but a long term effect that needs to be assessed if an overall understanding of the leadership change is to be understood. The significance of the long-term compensation in the two-day period might indicate that executives are asked to act in a certain way. However, the lack of significance in the leadership period indicates that more research is needed. Most importantly, this study indicates that leadership succession might be viewed by shareholders as a way for disrupting the company's status quo, even when the company is not showing a need for change. Yet, in order to be competitive in today's forever evolving market change is prescribed.

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