RESEARCH BRIEF

Center for Executive Succession

INVESTOR RESPONSE TO CEO SUCCESSION AFTER FINANCIAL WRONGDOING

Following financial misconduct, firms often choose to replace their CEO as a strategic response, with the replacement equally likely to include an inside successor, outside successor, or temporary leader. Less known, however, is the effectiveness of replacing the CEO following such misconduct and under which conditions investors, as a key stakeholder group, will respond positively. Forthcoming research in the *Journal of Management* illustrates that replacing a departing CEO with an outside successor results in a positive investor response, while utilizing an interim CEO or remaining silent with regard to a successor results in a negative response.

Key Takeaways:

- Following financial wrongdoing, firms who replace CEOs with an outside successor receive a positive investor result of 3.85 percent.
- Investors respond most negatively when firms hire an interim CEO or fail to name a successor following a CEO succession after material financial misstatement.
- Boards must be wary of acting symbolically to remove a CEO following financial misconduct without a readymade successor to condition investor response.

Researchers identified 104 CEO successions following a material financial restatement in firms from 1992-2010 and examined changes in stock prices following the succession announcement. The replacement of a CEO with an outside hire increased a firm's share price by 3.85 percent. At the same time, naming an interim CEO reduced firms' stock price by 2.09 percent, while failing to name a successor reduced share prices by 3.49 percent. For firms with a $1 billion market capitalization, hiring an outsider increases market capitalization by approximately $38.5 million, while using an interim CEO or failing to name a successor costs companies $20.9 and $34.9 million, respectively, in market cap. Comparatively, the researchers found that naming an interim CEO was worse than naming either an insider or outsider as a replacement, while failing to name a successor at all resulted in the lowest investor response. The authors suggest that signaling change through hiring an outsider or scapegoating a departing executive by hiring an insider are optimal firm strategies.

In summary, how investors respond to a succession event as a strategic response to firm financial misconduct is predicated on the successor identified. Importantly, boards should be wary of CEO dismissal following financial wrongdoing without an appropriately identified successor. The authors suggest that investors may perceive the problem associated with the financial misconduct as pervasive rather than the result of the actions of a lone bad apple.

Source: Gangloff, K. A., Connelly, B. L., & Shook, C. L. (2015). Of Scapegoats and Signals: Investor Reactions to CEO Succession in the Aftermath of Wrongdoing. *Journal of Management*, In Press.

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