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# Outsider vs insider: Does firm governance matter?

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**Abstract:** As CEO turnover occurs, the company may select an insider or outsider as a successor. This study attempts to ascertain whether firm performance, female directors, board religiosity and blockholder ownership influence the decision to appoint an internal or external candidate. Results from logistic regression analysis on 72 succession events over a five-year period (2011 to 2015) reveal that firms which are controlled by blockholders and those with females on their boards tend to select an outsider as the successor. Meanwhile, firms that have Muslims on their boards are more likely to select insiders as successors. This study implies that poor firm performance does not necessarily lead to outside CEO selection choice. On the overall, the findings indicate that blockholder ownership and gender diversity in the boardroom matter in the Nigerian corporate landscape.

**JEL Classifications:** M41, M42, M48, G34, G38

**Keywords:** Blockholder, CEO selection, performance, gender diversity, religiosity

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## 1. Introduction

The Chief Executive Officers (CEOs) have significant influence on the corporations. Any changes in the CEOs' position will have a significant effect on investors' perceptions, which will in turn affect the price fluctuation in the firms' stock prices in the immediate term, and in the long term affect the firms' profitability (Ishak & Abdul Latif, 2013). Therefore, selecting and replacing of the CEO is one of the major responsibilities of a company's board of directors (Jenter & Lewellen, 2010); and whatever choice of a successor the boards make, it has significant consequences on the company's future direction, strategies and structure (Ishak, Ku Ismail, & Abdullah, 2012).

In recent times, approximately between 10 to 15 percent of the companies globally change their CEOs (Larcker, Miles & Tayan, 2014). Similar phenomenon is also observed in Nigeria as reported in a CEO success study conducted by Booz Company - a subsidiary of PricewaterhouseCoopers (PwC) in 2015. The study reports that CEO turnover in Nigeria rose from 15.90% in 2010 to 16.30% in 2012. It further increased to 16.70% in 2015. However, due to the inherent advantages and disadvantages of either internal or external successor, the debate on which is better preferred by the board and shareholders remains topical and unabated among the academics and professionals.

Although several scholars have examined the determinants of appointing an external or internal CEO, yet there is no consensus opinion on the main determinants of CEO selection choice. For example, scholars like Fatima, Goergen, & Mira (2014) and

Rachpradit et al. (2012) argue that external successor is usually appointed when the change was due to poor performance, while an internal CEO will be appointed following good performance. On the contrary, Boeker & Goodstein (1993) assert that the successor is always appointed from within the firm or/and within the family regardless poor firm performance. Similarly, Ishak et al. (2012) based on their study on the determinants of external versus internal succession in Malaysia concluded that poor firm performance will not necessarily result to external CEO selection choice. They suggest that some other factors such as board composition, firm ownership and sociopolitical factors could be moderating the relationship between poor firm performance and external succession. Although, a few studies have considered CEO selection in the emerging markets, no studies to the best of the researchers' knowledge have been carried out in Nigeria and the entire Africa as a continent. Hence, this study attempts to investigate the factors that influence the choice of CEO selection in Nigerian Public listed companies (PLCs).

This study is organized as follows. Section 2 reviews prior studies and develops the hypotheses. Section 3 discusses the research method, and Section 4 presents the results and discussions. Section 5 provides the conclusion of the study.

## 2. Literature review

In response to the corporations' failure and collapse across the globe both from developed economies and the emerging markets, such as Barings Bank, Enron, Arthur Andersen and the Mirror Group, the corporate governance role became a central issue and given a serious attention. In the United State of America (USA), with the collapse of Enron Corporation, the 7<sup>th</sup> largest company in America, in the year 2001, it responded with the enactment of the public company accounting reform and investor protection Act No. 404 in 2002 popularly called the Sarbanes-Oxley (SOX) act. Similarly, in Australia the Corporate Law and Economic Reform Programme (CLERP 9), also known as Audit Reform and Corporate Disclosure Act 2004, was enacted because of the Enron, HIH and One Tel failures. In Nigeria, the government established the Committee on Corporate Governance of Public Companies (CCGPCN) in 2003. This was followed by the corporate governance code 2011, issued by the Securities and Exchange Commission (SEC) also adjudged as the most comprehensive and detailed corporate governance regulation currently operational in Nigeria. It deepens corporate governance practices and addressed the inadequacies inherent in the 2003 code while at the same time entrenches the code of best practices on corporate governance in the country. This is not surprising because, Nigeria is the largest market in Africa with a significant influx of foreign investment. The importance of corporate governance cannot be taken lightly, because poor corporate governance as asserted by Erah, Samuel, & Izedonmi (2012), results in poor performance and imminent failure and collapse of corporations.

Agency theory is the most adopted theoretical framework in most of the previous academic literature in the field of corporate governance, because it tends to dominate the recommendations on board best practices in the various codes of corporate governance (Mallin, Melis, & Gaia, 2014). The modeling of the relationship between the owners and the managers to such that exists between the principal and the agent is a key feature of Jensen & Meckling (1976). Human capital theory is also very relevant in the CEO selection research; it is used as a supporting theory. It underscores the importance and value of human capital in the existence, survival and wellbeing of the firms and the employees (Nafukho, Hairston, & Brooks, 2004).

## 2.1. Firm performance and CEO turnover

CEO selection as suggested by Ishak, Ku Ismail, & Abdullah (2013) provide means for assessing the efficacy of a leader in shaping a firm's fortunes. Custódio, Ferreira, & Matos (2011) classified CEO selection into insider and outsider succession. The selections are made by the directors who most of the time rely on public information in their assessment of the CEOs and subsequently selecting external candidates for the CEO's job. They rely specifically on current performance of the CEO candidates. Scholars have suggested that poor firm performance affects the origin of the successor or the new CEO. While some researchers suggest that in the event of turnover following poor performance, the board of directors are likely to hire an outsider as a replacement in order to turn around the strategies and improve the firm's performance (Bereskin & Hsu, 2011; Ishak et al., 2012; and Ishak et al., 2013). In contrast, some studies like Gangloff et al. (2014) and Ishak et al. (2012) suggest that in the event of poor performance, internal successor is more preferred to replace the ousted CEO, especially in large corporations due to the size and structure as well as the difficulties in altering the strategies of the companies and strong influence of some vested interest. Maharjan (2015) argues that the firms are more likely to recruit or engage an outsider CEO as a successor or replacement following poor firm performance. Therefore, in line with the preceding arguments, the study hypothesizes that:

**HI selection:** *Firms are more likely to choose external candidates as new CEOs in the event of poor performance.*

## 2.2. Board structure and CEO selection

The board of directors are elected representatives of the shareholders (Boivie, Bednar, Aguilera, & Andrus, 2016). Some of the most important decisions usually taken by the board of directors are decisions relating to hiring or dismissal and replacement of the CEO (Boivie et al., 2016; Fisman, Khurana, Rhodes-Kropf, & Yim, 2014).

### Female directors

Female directors' presence on the board of directors of firms plays a significant role in the effective performance of the board. As such, it is expected to influence the CEO succession of the firm. Recent studies suggest that gender diversity can strengthen the monitoring function and other important board functions such as selecting a successor CEO (Alves et al., 2015; Boivie et al., 2016; Ku Ismail & Abdul-Manaf, 2016). Female directors appear to have superior monitoring ability and are also able to think more independently; and they are not influenced by the usual old-boys' club syndrome common with the men (Abdullah, 2014; Alves, Couto, & Francisco, 2015; Nguyen, Locke, & Reddy, 2014). Furthermore, a more gender diversified board increases the independence and efficiency of the monitoring role, as such more likely to hire an external replacement (Alves et al., 2015).

Resource dependence theory opines that the security of companies' crucial resources and the linkage between the firms and its external environment could be enhanced by increasing the diversity. Impliedly, firms with more diverse boards can have advantages in acquiring and maintaining their vital resources, such as the human capital of the boards like knowledge, talent, and skills (Liu, Wei, & Xie, 2014). Therefore, in the event of

turnover, the board with female directors will be inclined to select an outside candidate because the availability of external potential candidates. Thus, this study hypothesizes that:

**H2 selection:** *Firms with female board members are more likely to select external candidates as their new CEOs.*

### **Board religiosity**

Researchers have argued that corporate decision making is affected by religiosity of the individual director or decision maker (Grullon, Kanatas, & Weston, 2009; McGuire, Newton, Omer, & Sharp, 2012). This opinion was also strengthened by Kennedy & Lawton (1998); in societies, where religions play a greater role, there is higher likelihood of religions affecting the choices and decisions of corporate managers. Thus, it is expected that greater participation and involvement in religious activities of board members increases the amount and quality of monitoring, control and supervision within the firm and consequently less likely to hire the new CEO from outside the firm.

Similarly, Kim & Daniel (2016) find that social norms specifically religions, have strong influence on corporate governance practices. This is similar to the findings of Volonte (2015) who studies the influence of culture on corporate governance and suggests that religious groups have certain values in common which to a great extent determine the type of corporate governance mechanisms that firms adopt. Therefore, in the event of selecting a successor, it is expected that, consistent with social network theory, religious membership will create bond and connection between the board members, hence more likely to appoint an insider. Thus, this study hypothesizes that:

**H3 selection:** *Firms with higher number of Muslim directors on the board are less likely to appoint outsiders as their new CEOs.*

### **2.3. Ownership structure**

Ownership structure to a great extent influences the sensitivity of CEO selection choice. Several types of ownership structure exist as an internal monitoring mechanism; and each of them is expected to have its own unique way of affecting the CEO selection. Prior studies have established how ownership structure affects CEO succession, and these effects tend to vary considerably across the economies. This is essentially due to the differences in the markets and the contexts in which the studies were conducted; for example, developed economies have strong capital markets and developing or emerging markets have weak corporate governance mechanisms (Ishak, Ku Ismail, & Abdullah, 2013; Rachpradit, Tang, & Ba Khang, 2012; Ishak, 2010). This study considers blockholder ownership which is very relevant to the context of this study; Nigerian corporate market is dominated with blockholder ownership.

#### **Block holder ownership**

Blockholder ownership is defined as owning 5 percent or more of the total shares (Acero & Alcalde, 2014; Goyal & Park, 2002; Masulis, Wang, & Xie, 2012). Blockholder ownership has the capacity to neutralize the entrenchment or reduce management entrenchment. Blockholder controlled firms are more likely to select an outsider candidate

as successor. Vafeas & Vlittis (2014) argue that ownership structure is a very important determinant of appointing an outside CEO. This is because of the need for policy and strategy changes for improved performance, especially as the new CEOs are not parts of the existing policies and strategies and therefore, will be in better position to introduce new changes to improve the fortune of the corporation (Ishak et al., 2012).

Blockholder ownership increases the independence of the board which in turn enhances the monitoring effectiveness of the firm thereby leading to high probability of selecting an outside successor (Acero & Alcalde, 2014; Bekiris, 2013). Ishak et al. (2012) study CEO 145 succession events in Malaysian listed companies from the period of 2002 to 2005. They report that blockholders are inclined to selecting an outside successor. This is the case because the blockholders are independent and are not influenced by the management. While Thanh & Heaney (2013) believe that blockholders have the needed resources to remove the CEOs who are not meeting the objective of creating wealth for the shareholders and subsequently hire an external candidate who can meet the demand of the shareholders. Hence this study hypothesizes the following:

**H4 selection:** *Firms with blockholders are more likely to select outside candidates as their new CEOs.*

### 3. Methodology

This study is based on secondary data mainly sourced from the audited annual reports of the public listed companies in Nigeria and corporate announcements from the website of the Nigerian Stock Exchange (NSE).

The study covers the public listed companies on NSE in Nigeria. It covers the period of five years, from 2011 to 2015, focusing on those companies that have changed their CEOs within the period. The listed companies on NSE are broadly categorized into two main sectors - financial sector and non-financial sectors.

This study focuses on the non-financial sector only; the financial sector was excluded from the population due to available specific regulations. Over all, the final sample of this study included 72 CEO selections that performed in the public listed companies on the NSE in the period from 2011 to 2015. Further, in line with Conyon & He (2012), Lindrianasari & Hartono (2012), Rachpradit et al. (2012), the logistic regression was used in this study to analyse the CEO selection choice. This is consistent with the opinion of Pallant (2007) who observed that logistic regression is the most appropriate tool used to simultaneously investigate the effects of several independent variables on a single dependent variable.

In addition, the dependent variable in this study is binary and Ishak (2010) asserted that when the dependent variable is nominal, logistic regression is most appropriate statistical technique as it gives a more robust results. The regression model is expressed as:

$$SELECTION = \beta_0 + \beta_1 ROA_{it} + \beta_2 BGNDR_{it} + \beta_3 BRLGN_{it} + \beta_4 BHOWN_{it} + \beta_5 LFSIZE_{it} + \beta_6 LEVRGE_{it} + \beta_7 DVRSTY_{it}$$

The measurement of variables is explained in Table 1.

TABLE 1. THE VARIABLES' OPERATIONAL MEASURES

VARIABLES	OPERATIONAL MEASURES
<i>SELECTION</i>	1- Outside CEO, 0 - Inside CEO
<i>ROA</i>	The ratio of earnings before interest and taxes to the book value total assets.
<i>BHOWN</i>	Individuals or institutions with more than 5% shares in the company
<i>BGNDR</i>	Proportion of female directors on board
<i>BRLGN</i>	Proportion of Muslim directors on board
<i>LFSIZE</i>	Natural log of total assets
<i>LEVRGE</i>	Total debt/ total assets
<i>DVRSTY</i>	1 - more than one business segment, 0 - one business segment focused firm

#### 4. Results and discussions

Table 2 explains the descriptive statistics of the companies. On average the sample companies have low corporate performance as the mean of ROA is 0.004 with a minimum of -0.933. Meanwhile, the mean of women directors on the boards is 8.3%, indicating a low representation of women directors on the boards. As a matter of fact, some companies do not have any woman director on their boards as the minimum score is zero percent. Similarly, the mean of board member religiosity is 20.2% which explains that the proportion of Muslim directors on the corporate boards of Nigerian public listed companies is quite low and there are some firms that do not have any Muslim on their boards as the minimum score is zero. This finding also shows that more than half of the ownership structure (55%) is made up of blockholder ownership, which reveals that Nigerian firms are characterized with concentrated ownership by blockholders.

TABLE 2. DESCRIPTIVE STATISTICS

VARIABLES	MEAN	MIN	MAX	STD. DEV
ROA	0.004	-0.933	0.207	0.151
BGNDR	0.083	0.000	0.333	0.100
BRLGN	0.202	0.000	0.667	0.190
BHOWN	54.946	0.000	94.890	26.283
LFSIZE	16.537	11.450	20.828	1.881
LEVRGE	0.797	0.022	13.451	1.533
DVRSTY	0.542	0.000	1.000	0.502

Table 3 displays the correlation between all the variables contained in this study. The result shows that CEO selection is positively associated with female directors. This association explains that external CEOs were more likely to be appointed in firms with female directors on their boards. Large firms tend to have better performance, more female and Muslim directors on their boards; they have more blockholder ownership. Meanwhile, highly leveraged firms have unhealthy performance and they are not large. While firms with multiple business segments have more female directors on their boards, more blockholder ownership and they

are usually large in size. All the correlation coefficients are within the threshold, as such there is no multicollinearity issue among the variables of this study.

TABLE 3. CORRELATION MATRIX

S/N	VARIABLES	1	2	3	4	5	6	7	8
1	SELECTION	1.000							
2	ROA	-0.013	1.000						
3	BGNDR	0.271**	0.048	1.000					
4	BRLGN	-0.129	0.186	-0.052	1.000				
5	BHOWN	0.187	0.065	0.024	0.080	1.000			
6	LFSIZE	0.182	0.457***	0.297**	0.286**	0.270**	1.000		
7	LEVRGE	0.074	-0.781***	-0.088	-0.134	-0.015	-0.322***	1.000	
8	DVRSTY	-0.002	0.107	0.362***	-0.065	0.384***	0.434***	-0.085	1.000

On the other hand, collinearity diagnostic test was conducted to determine the existence of intercorrelation between the independent variables. According to the opinion of Pallant (2007) multicollinearity is deemed to exist if the tolerance level is less than 0.01 and the variance inflation factor is greater than 10. Table 4 reveals that there is no multicollinearity existing among the variables in this study. This is so because all the tolerance values are respectively greater than 0.01 and VIF less than 10.

TABLE 4. MULTICOLLINEARITY TEST

VARIABLES	COLLINEARITY STATISTICS	
	TOLERANCE VALUE	VARIANCE INFLATION FACTOR
ROA	0.344	2.99
BGNDR	0.806	1.24
BRLGN	0.861	1.16
BHOWN	0.812	1.23
LFSIZE	0.547	1.83
LEVRGE	0.384	2.60
DVRSTY	0.638	1.57

The regression results in Table 5 reveal that firm performance proxied by ROA is not statistically significant with CEO selection choice. This finding indicates that firm performance is not important in determining the origin of the CEO to be selected as replacement. This finding does not support the hypothesis of the study which states that firms are likely to select an outside successor in the event of poor performance. This finding contracts the previous findings by scholars like Bereskin & Hsu (2011) and Maharjan (2015), but the finding aligns with Gangloff et al. (2014) and Ishak et al. (2012) which suggest that in the event of poor performance, internal successors are more preferred to replace the ousted CEO especially in large corporations due to the size and structure as well as the difficulties in altering the strategies of the companies and strong influence of some vested interest.



Hypothesis on female directors on boards predicts a positive significant relationship between proportion of female directors on board and outside CEO selection. The regression result indicates that board members' gender is significant at 5% level with a positive coefficient, implying that the more female directors on the board of a firm the more the probability of selecting an outsider CEO. This finding supports the hypothesis. The result of this study is consistent with the previous empirical findings arguing that a more gender diversified board increases the independence and efficiency of the monitoring role, as such more likely to hire an external replacement (Alves et al., 2015). It equally agrees with resource dependence theory as explained by Yu Liu, Wei, & Xie (2014). Therefore, the board will be inclined to select an outside candidate because of the availability of external potential candidates who are eager to join the firms to benefit from the good performance and growth of the firm.

This study predicts a negative and significant relationship between the proportion of the Muslims on the board of directors of the company and external CEO selection. The regression result reveals that board members' religiosity is significant at 10% level with a negative coefficient, implying that board religiosity does play a significant role in the choice of the origin of the CEOs, and that the more Muslims on the boards of the companies the less the likelihood of selecting an outsider as a CEO.

TABLE 5. REGRESSION RESULTS FOR THE STUDY

VARIABLES	COEFFICIENT	Z SCORE	STD. ERROR	P- VALUE
<i>ROA</i>	1.103	0.36	3.089	0.721
<i>BGNDR</i>	7.950	2.39	3.320	0.017**
<i>BRLGN</i>	-3.182	-1.90	1.671	0.057*
<i>BHOWN</i>	0.025	2.06	0.012	0.040**
<i>LFSIZE</i>	0.373	1.80	0.207	0.072*
<i>LEVRGE</i>	0.301	0.99	0.303	0.321
<i>DVRSTY</i>	-1.725	-2.32	0.742	0.020**
<i>Constant</i>	-6.810	-2.13	3.193	0.033**
Prob > chi2			0.012	
Pseudo R2			0.180	
Overall classification			65.28%	

Note: \*\* Significant at 5%, \* Significant at 10%.

The study postulates that firms with blockholders ownership are more likely to appoint an outsider as their CEOs. The result as displayed in Table 5 shows that blockholders ownership is significant at 5% level with a positive coefficient and p- value of 0.040, which implies that, the more the percentage of blockholders ownership in the company, the higher the probability of selecting an outside CEO. This finding supports the hypothesis and it agrees with the previous empirical results obtained particularly by Vafeas & Vlittis (2014), Ishak et al. (2012), and Thanh & Heaney (2013) that firms dominated with blockholders are more independent and are inclined to select external candidates as CEOs.

## 5. Conclusion

Given the scanty nature of research with regards to CEO selection in developing economies and Nigeria in particular, this study provides evidence on the factors

determining CEO selection choice in the Nigerian PLCs. This is the first study to consider influence of gender diversity on CEO selection choice in Nigeria. The study finds that firms tend to select an outsider as a successor when they are controlled by blockholders and the presence of female directors on the board does increase the probability of selecting outsider as CEO. Furthermore, when there are Muslims directors on the board, the firm tends to select an insider as a successor. In addition, firm performance measured by ROA does not influence the choice of the successor.

Findings from this study may be useful to the government and the regulatory agencies in formulating and enforcing reforms that would entrench good corporate practices which will in turn, boost the investors' confidence in Nigeria's business landscape. This study provides an insight to the companies and shareholders who are responsible for hiring and firing CEOs as the selection of a successor may have a significant impact on firm's future strategies, policies and performance. In conclusion, there are some factors that might pose as limitation to the level of usefulness of the findings of this study. Firstly, this study utilized only data on the non-financial sector of the NSE, hence, the results might not be generalized to all the registered companies in Nigeria. In addition, the period of the study is limited to five years (2011 to 2015). Moreover, the findings of this study may not necessarily be applicable to the developed economies with strong corporate governance regulations and dispersed ownership structures.

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