



Board independence, CEO succession and the scope of strategic change

Empirical research on the effectiveness of independent directors

Effectiveness of independent directors

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Abstract

Purpose – This paper aims to examine the effectiveness of independent directors based on the perspective of strategic control.

Design/methodology/approach – This is an empirical study carried out between 2007 and 2012 based on a sample of Chinese A-share-listed companies.

Findings – The results indicate that the departure of a CEO provides conditions for the new CEO to become empowered to carry out strategic change. The behavior of a new CEO results in the phenomenon of “a new broom sweeps clean” and increases the scope of strategic change. In addition, the results indicate that the board's independence negatively moderates the relationship between the CEO's succession and the scope of strategic change, and that independent directors are effective in supervising risk-taking behavior on the part of the CEO which ultimately results in damaging company performance.

Practical implications – The corporate internal and external supervisory mechanisms should be improved during the process of succession of a new CEO, and the effectiveness of the supervision of board directors should also be strengthened during the implementation of the strategic process of a new CEO.

Originality/value – Previous research on the effectiveness of independent directors mostly focuses on financial control, with a single leap from independent directors to corporate performance, which neglects the strategic control of independent directors. From the micro perspective of the strategic

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control process as a means of discussing the independent directors' watchdog role, this paper extends and enriches the research on "the effectiveness of independent directors".

Keywords China, CEO succession, Corporate governance, Strategic change, Board's independence, Effective independent directors

Paper type Research paper

1. Introduction

Rapid economic growth and the relative scarcity of resources, are placing new strategic demands on companies around the world. Strategic change is an important method used by organizations to cope with uncertainty factors (Kraatz and Zajac, 2001), and the issue of strategic change is attracting widespread attention from both domestic and international scholars. A CEO who participates in a company's decision-making plays a critical role in dealing with paroxysmal events and promoting strategic change (Boeker, 1997a). Because of the significant role of the CEO, CEO turnover significantly affects the action mechanism of the CEO on strategic change around the CEO-turnover event. Lant *et al.* (1992) and Weng and Lin (2012) suggest that CEO turnover easily causes strategic change, as the new CEO is responsible for the practice of strategy and brings a different ability, knowledge and experience to the company. Goodstein and Boeker (1991) suggest that the CEO-turnover event creates an opportunity for the redistribution of existing power within the company, thus helping break organizational inertia to drive strategic change. The above studies suggest that the CEO-turnover event easily induces strategic change and provides evidence for the hypothesis that a new CEO tends to promote strategic change. However, once the new CEO gets the power to implement strategic change, he will attempt to extend his company using his blind desire alone. And when the action of strategic change is beyond the normal firm or industrial level in which the company operates, the scope of strategic change is excessive or inappropriate. Therefore, the effectiveness of the board's independence is challenged (Boyd, 1994).

Although the effectiveness of the independent director system is considered by domestic and overseas scholars as an important mechanism in solving the principal-agent problems between shareholders and managers, it remains the subject of much dispute. Scholars have studied the relationship between a board's independence and company performance in broad terms in that independent directors perform supervisory duties through the means of financial oversight. However, many of them have drawn discordant conclusions[1]. That domestic and international research presents inconsistent results also raises doubts around the effectiveness of the independent director system as a method of company management. Most of the previous studies focusing on the effectiveness of board independence from the perspective of financial oversight make a big logical leap in ignoring the process of strategic oversight (Pettigrew, 1992). And yet, in terms of the board of directors' influence on corporate performance, the logical premise is that the board has the ability to influence company decisions in strategic areas, that is, controlling the company's strategy through effective oversight.

In view of this analysis, this paper will examine the effectiveness of independent directors in Chinese-listed companies and assess whether independent directors are competent as "Watchdogs". The CEO-turnover event provides an opportunity for a new CEO to become empowered to drive strategic change, so we take it as our brief to explore

the effects of a new CEO on the scope of strategic change and to verify the proposition that “a new CEO sweeps clean”. Further, on this basis, this paper will also test the effectiveness of independent directors in supervising a new CEO and their role in restricting the behavior of the new CEO, and thus the phenomenon of “a new broom sweeps clean”. Through the above research, it is expected that this paper can provide a theoretical basis and empirical evidence for effectively operating and making improvements to the independent director system.

2. Literature review and hypotheses

2.1 Strategic change and the scope of strategic change

Early research into strategic change can be divided into two schools: the content school and the process school. Study of “the content school” is confined to the analysis of the driving force for strategic change, and lacks any explanation of the differences in performance of that strategic change (Rajagopalan and Spreitzer, 1997; Wang *et al.*, 2011). Conversely, the study of “the process school” focuses on the process of implementing strategic change, exploring the relationship between strategic change and corporate performance from the perspective of process. The process of implementing strategic change involves a series of changes in strategy (e.g. company’s mission and the makeup of product markets) and organization (e.g. organizational system, organization structure organizational culture and organization personnel). Thus, in emphasizing the process of strategic change, the definition of strategic change by Van de Ven and Poole has been more and more widely recognized by academics (Ge *et al.*, 2003). They point out that strategic change refers to the change of form, feature and situation when the organization modifies its alignment with the external condition of organization over time (Van de Ven and Poole, 1995). Meanwhile, a growing number of scholars are beginning to pay attention to the characteristic course taken by strategic change, such as its speed and scope. In rapidly changing global competitive environments, the important role of the speed of strategic change in helping companies to gain the competitive advantage is becoming more protrusive, and the scope of strategic change is relevant to company performance.

The scope of strategic change refers to a certain degree of change in the content of strategy in depth, breadth and size and that is the magnitude of changes in the mode of resource allocation of products, services and target markets offered by enterprises (Ge *et al.*, 2007). Therefore, the scope of strategic change reflects the intensity with which managers adjust corporate strategy to environmental change. However, as an innovative behavior, strategic change has the features of incompleteness of information and uncertainty of returns, etc. Therefore, the greater the scope of strategic change, the longer the time required to achieve it, and the higher the risk taken by the company (Zhao and Li, 2004). Some scholars have explored or analyzed the relationship between the scope of strategic change, company risks and company performance. Lnes (2004) and Naranjo-Gil *et al.* (2008) point out that strategic change leads to a dip in corporate performance and reduces a company’s ability to survive. In their study, Haynes and Hillman (2010) claim that because the broad scope of strategic change presents a major risk to companies and general managers, company performance after the implementation of strategic change is unpredictable. And Stensaker *et al.* (2001) point out in their study that the excess scope of strategic change would bring about reduced company performance and eventually threaten its survival and development.

2.2 The influence of CEO succession on the scope of strategic change

CEO succession creates conditions for a new CEO to break organizational inertia and become empowered to carry out strategic change. Organizational inertia is described by scholars of strategic management and organization as the behavior to maintain the organizational status quo (Wang and Feng, 2009). Breaking the organizational framework means reconfiguring organizational resources and organizational power. Therefore, to maintain their own vested interests, existing organization members tend to preserve the stability of the organization's structure, resulting in organizational inertia. When an organization's current situation is favorable for the development of the company, a stable organizational structure has certain advantages in fully utilizing its long-term accumulation of resources and promoting long-term development of the company. However, when company production is threatened with changes in environment or needs to be improved, maintaining the *status quo* will produce unsatisfactory consequences for shareholders and managers. Therefore, when a company modifies its alignment with conditions that are external to the company itself, breaking organizational inertia and implementing strategic change is necessary if it is to develop. And because of the existence of organizational inertia, corporate past behaviors, activities and practices limit the behavior of the current CEO, so that the current CEO's management model becomes rigid and the CEO tends to follow the existing strategy of the company. In conclusion, the CEO will stick to the original strategy to keep their present positions, vested interests of themselves and stakeholders in the company where a CEO-succession event has not occurred. Even if strategic change is implemented in the company, there is only a slight adjustment to the scope of the existing strategy.

CEO succession brings the company a manager with new skills and new ideas, who will review the company's conventions and procedures and try to correct them, before breaking organizational integration and re-organizing resources to become empowered to promote strategic change. The new CEO's timely implementation of strategic change serves the interests of company development. However, in gaining the power to carry out strategic change, the new CEO sends out a warning signal at the same time. Because the new successor expects to make more outstanding achievements than the former, he will make different strategic decisions from the former or show more active behaviors; as the Chinese saying goes, "a new broom sweeps clean". To quickly establish his authority throughout the company, the new CEO will deny the ineffective strategic decisions made by the former CEO and in so doing emphasize the benefits and advantages he brings to the company (Sonenshein, 2010). On this basis, the new successor will sweep away resistance to organization inertia, as being under the influence of the former CEO. He will then aggressively implement strategic change. Therefore, the process of strategic change by the successor is more a reflection of personal will than of the strategic status of the company and industries of the company, resulting in strategic change with a broader scope. Accordingly, we propose the *H1* as follows:

H1. There is a positive correlation between CEO succession and the scope of strategic change.

2.3 Board independence, CEO succession and the scope of strategic change

In their study, Johnson and Daily (1996) point out that the board of directors affects the company's output by exercising the function of supervision, allocation of resources and strategic roles. Brick and Chidambaran (2007) also find that the board's oversight activities can increase the firm's value. And this is because board members can effectively identify managers' opportunistic behavior by monitoring to ensure that organizational behaviors comply with the interests of stakeholders across the company.

We have reached the following conclusion in the analysis of the above: CEO succession provides conditions for the new CEO to become empowered to implement strategic change. To establish authority, the new CEO often carries out intensive reform. Therefore, they are more flexible in the process of implementing strategic change and a tendency toward opportunism may exist. The CEO's opportunistic behavior means that the magnitude of strategic change is beyond the company's existing capacity, leading to excessive or inappropriate action, which will bring significant potential risks to shareholders' interests and even to the company's survival and development. The introduction of independent directors, who account for a significant proportion in boards, increases the board's independence and objectivity *vis-à-vis* managers, enhancing the effectiveness of the board's participation in the strategic management of the company (Li and Xue, 2011). This helps the board to play a supervisory role and enhances the effectiveness of board governance. On the one hand, the independent directors' supervision reflects their interests and needs. Compared with inside directors, independent directors can better represent the interests of shareholders (Fama and Jensen, 1983). However, the close relationship between inside directors and the CEO will significantly reduce the supervisory effects (Lynall *et al.*, 2003). On the other hand, independent directors have the ability to supervise CEO's adventurism. Due to high cognitive abilities and the rational agent characteristic, during their tenure, independent directors will carefully consider the risks that certain major issues may bring to the company. Faced with potential risks that may affect company performance, they will take a rigid stance on the board (Tang and Luo, 2006).

In conclusion, the board of directors' supervision may restrict the CEO's tendency toward opportunistic risk in the process of strategic change, guarding against "a new CEO sweeps clean"-type behavior. And if the board is more independent, it is able to ensure its supervisory role more effectively. Accordingly, we propose the following *H2*:

H2. Board independence negatively moderates the relationship between CEO succession and the scope of strategic change.

3. Data and methodology

3.1 Data and sample

This paper chooses Chinese A-share-listed companies between 2007 and 2012 as the initial sample. We exclude ST and *ST companies, companies with missing data, companies founded after December 31, 2007 and companies having a CEO-succession event merely for the purpose of corporate control transfers, respectively. The final sample includes 1,329 observations. The continuous variables are winsorized at 1 per cent. The process information used to measure the scope of strategic change is obtained from the Wind database, CEO succession data are collected from the CSMAR database and the Chinese-listed companies' annual reports, the data of independent directors are obtained from the China Center for Economic Research (CCER) database and was

adjusted against the Chinese-listed companies' annual reports. Other data are sourced from the CCER database.

3.2 Model specification and variable explanation

We use Model (1) to test the influence of Chief Executive Officer (CEO) succession on the scope of strategic change:

$$ssc = a_0 + a_1 succession + a_2 duality + a_3 state + a_4 dr_{10} + a_5 roa + a_6 growth + a_7 lev + a_8 size + a_9 age + a_{10} \sum ind + a_{11} \sum year + \varepsilon \quad (1)$$

The explained variable *ssc* stands for the scope of strategic change. In line with previous studies (Boeker, 1997b; Liu *et al.*, 2009), we adopt the abstract percentage change of annual change in degree of diversification across year_{t+1} to year_{t-1} to measure the scope of strategic change in year_t. We employ entropy to measure the degree of diversification. And then:

$$Entropy = \sum_{i=1}^n p_i \ln(1/p_i)$$

p_i stands for the percentage of the main business revenue in the i_{th} business unit (industry).

The explanatory variable *succession* stands for CEO succession. The variable, *succession*, is coded "1", if CEO turnover occurs and "0" otherwise, based on the turnover information in the China Stock Market & Accounting Research (CSMAR) database. Because of the time lag of strategic change, the scope of strategic change corresponded to the CEO succession of the previous year. We exclude companies where the tenure of the new CEO is under one year to ensure that the new CEO is actually working on the process of strategic change.

We follow previous research (Zhang, 2006; Barron *et al.*, 2011) and include controls for *duality*, *state*, dr_1 , etc. The variable, *duality*, is coded "1", if the CEO is concurrently the President and "0" otherwise. The variable, *state*, is coded "1", if the CEO is of a company which is state-owned and "0" otherwise. We measure dr_{10} as the proportion of the sum of share ratios from second to tenth shareholders to share ratios of the largest shareholders. We also control for *roa*, *growth* (the growth rate of primary operating revenues), *lev* (debt/assets), *size* (natural logarithm value of total assets), *age* (company age), industry dummy variables and time dummy variables. In accordance with the China Securities Regulatory Commission (CSRC)'s classification of industries, we code manufacturing based on the second-level classification and other industries based on the first-level classification.

We use Model (2) to test the moderating effect of the board's independence on the relationship between the CEO succession and the scope of strategic change:

$$ssc = a_0 + a_1 succession + a_2 id + a_3 id \times succession + a_4 duality + a_5 state + a_6 dr_{10} + a_7 roa + a_8 growth + a_9 lev + a_{10} size + a_{11} age + a_{12} \sum ind + a_{13} \sum year + \varepsilon \quad (2)$$

The easiest way to ensure the board maintains its independence is for independent directors to hold a majority on the board (Tan, 2003). Therefore, following previous research, we adopt the proportion of independent directors (*id*) to measure board independence. Further, $id \times succession$ is a cross term for the proportion of independent directors and CEO succession. Meanings of other variables are consistent with variables in Model (1). According to *H2*, we expect a significant negative coefficient of $id \times succession$.

3.3 Descriptive statistics

Table I sets out the distribution of CEO succession samples. During our sample period, the CEO succession rate is 15.0 per cent. It also indicates that stated-owned companies have higher CEO succession rates than non-stated-owned companies (8.1 per cent vs. 6.9 per cent). Of the three years, the highest rate of CEO succession was in 2007 (6.5 per cent).

Table II provides summary statistics for the sample. In the sample as a whole: the average scope of strategic change is 0.121; the average proportion of independent directors is 36.7 per cent, which exceeds ratios of three to one[2]; the mean (SD) values of *growth* are 0.256 and 1.364, respectively, which indicates that the growth rate of primary operating revenues differ among Chinese-listed companies. And the scope of strategic change is significantly higher in CEO succession companies than in firms overall (0.173 vs 0.121), which shows that CEO succession does influence the scope of strategic change.

Table III shows cross-sectional correlations for the variables. CEO succession is positively correlated with the scope of strategic change, which indicates that CEO-succession companies have a higher scope of strategic change than non-CEO-succession companies. Table III also shows that *growth*, *lev* and *age* are all positively correlated with the scope of strategic change, with both *roa* and *size* correlated with the scope of strategic change.

4. Empirical analysis

4.1 OLS regression estimates

Table IV presents the results of Ordinary least square (OLS) regressions, and we use White (1980) robust standard errors to account for potential heteroskedasticity. As column (1) indicates, the coefficient on *succession* is positive (with a value of 0.0546) and statistically significant at 1 per cent. The results suggest that, after taking over, the scope of strategic change introduced by a new CEO will be large, which then offers evidence for *H1*. Additionally, consistent with Zhang (2006) and Weng and Lin (2012),

Year	All companies		State-owned companies		Non-state-owned companies	
	Succession companies	(%)	Succession companies	(%)	Succession companies	(%)
2007	86	0.065	45	0.034	41	0.031
2008	58	0.044	32	0.024	26	0.020
2009	55	0.041	30	0.023	25	0.019
Total	199	0.150	107	0.081	92	0.069

Table I.
Distribution of CEO succession samples

Table II.
Descriptive statistics

Variables	Observation	Maximum	Minimum	Mean	SD
<i>All companies</i>					
<i>ssc</i>	1,329	1.144	0.000	0.121	0.182
<i>sgm</i>	1,329	1.000	0.000	0.150	0.357
<i>id</i>	1,329	0.667	0.182	0.367	0.052
<i>duality</i>	1,329	1.000	0.000	0.053	0.223
<i>state</i>	1,329	1.000	0.000	0.560	0.497
<i>dr₁₀</i>	1,329	5.551	0.015	0.738	0.705
<i>roa</i>	1,329	2.317	-1.135	0.057	0.111
<i>growth</i>	1,329	43.607	-0.901	0.256	1.364
<i>lev</i>	1,329	7.144	0.009	0.492	0.331
<i>size</i>	1,329	25.991	18.827	21.554	1.193
<i>age</i>	1,329	51.000	1.000	11.755	4.958
<i>Succession companies</i>					
<i>ssc</i>	199	1.144	0.000	0.173	0.220
<i>id</i>	199	0.571	0.200	0.377	0.055
<i>duality</i>	199	1.000	0.000	0.055	0.216
<i>state</i>	199	1.000	0.000	0.538	0.500
<i>dr₁₀</i>	199	5.499	0.030	0.708	0.745
<i>roa</i>	199	2.317	-1.135	0.047	0.199
<i>growth</i>	199	11.836	-0.882	0.240	0.928
<i>lev</i>	199	7.144	0.009	0.532	0.520
<i>size</i>	199	25.827	18.827	21.502	1.230
<i>age</i>	199	29.000	2.000	12.302	4.766

we find that *roa* has a significant negative correlation with the scope of strategic change. We find *size* is negatively correlated with the scope of strategic change, which coincides with the research of Zhang (2006). We also found that company age is negatively correlated with the scope of strategic change, which coincides with the theoretical research of Boeker (1997a). The growth rate of primary operating revenues has a significant negative correlation with the scope of strategic change, which might be because companies with larger growth rates have richer resources to ensure the implementation of strategic change.

As column (2) indicates, the interaction between *succession* and *id* is negative and significant (-0.776 , t -statistic = -2.70), and the coefficient on *succession* is positive (with a value of 0.0629) and statistically significant at 1 per cent. The results suggest that the board's independence negatively moderates the relationship between CEO succession and the scope of strategic change, which is consistent with *H2*, that independent directors effectively restrict risk-taking behavior on the part of the new CEO during the process of strategic change.

4.2 Robustness tests

The robustness tests are shown in Table V.

4.2.1 Relative measure of scope of strategic change after controlling for industry. Companies in different industries may be at different periods of strategic transformation, so industry differences may affect the scope of strategic change among companies. Therefore, to examine the robustness of our results according to this

Variables	ssc	succession	duality	state	dr ₁₀	roa	growth	lev	size	age
ssc	1									
succession	0.119***	1								
duality	0.024	0.005	1							
state	0.015	-0.019	-0.110***	1						
dr ₁₀	-0.026	-0.027	0.054**	-0.312***	1					
roa	-0.123***	-0.084***	0.066**	-0.133***	0.164***	1				
growth	0.082***	-0.007	0.006	-0.031	0.013	-0.026	1			
lev	0.069**	0.038*	-0.057**	0.067**	-0.040	-0.339***	0.129***	1		
size	-0.065**	-0.018	-0.049*	0.283***	-0.139***	-0.010	0.016	0.359***	1	
age	0.121***	0.054**	-0.021	0.135***	-0.035	-0.192***	-0.021	0.183***	0.093***	1
id	-0.016	0.089***	0.023	-0.046*	0.005	0.050*	0.073***	-0.065**	-0.044	0.009

Note: Significant at: *0.1; **0.05 and ***0.01

Table III. Descriptive statistics

Variables	Model (1)	<i>t</i> -statistic	Model (2)	<i>t</i> -statistic
<i>constant</i>	0.396***	(3.95)	0.400***	(4.02)
<i>succession</i>	0.0546***	(3.62)	0.0629***	(4.00)
<i>id</i>			0.0177	(0.17)
<i>id</i> × <i>succession</i>			-0.776**	(-2.70)
<i>duality</i>	0.0272	(1.14)	0.0282	(1.18)
<i>state</i>	0.0102	(0.92)	0.0124	(1.12)
<i>dr</i> ₁₀	-0.00219	(-0.30)	-0.00162	(-0.23)
<i>roa</i>	-0.218*	(-2.05)	-0.196	(-1.87)
<i>growth</i>	0.0406*	(2.29)	0.0405*	(2.26)
<i>lev</i>	0.0446	(1.33)	0.0463	(1.38)
<i>size</i>	-0.0142**	(-3.07)	-0.0144**	(-3.13)
<i>age</i>	0.00305*	(2.53)	0.00294*	(2.47)
<i>ind/year</i>		Yes		Yes
<i>N</i>	1329		1329	
<i>R</i> ²	0.0822		0.0897	
<i>F</i>	3.39***		3.41***	

Table IV.
OLS regression results
and models

Notes: Significant at: *0.1, **0.05 and ***0.01; OLS estimates are White (1980) robust

alternative definition of scope of strategic change, we recompute the scope of strategic change measures so that the industry-adjusted scope of strategic change (*ssc_adjust*) is calculated as the scope of strategic change minus the median value of the corresponding CSRC industry. As Model (1) indicates, the coefficient on *succession* is positive and statistically significant at 1 per cent. As Model (2) indicates, the interaction between *succession* and *id* is negative and significant (-0.776, *t*-statistic = -2.68), and the coefficient on *succession* is positive (with a value of 0.0637) and statistically significant at 1 per cent. Both findings indicate that our results are robust according to this alternative definition of scope of strategic change.

4.2.2 *Measure of scope of strategic change by method of resource reallocation.* Following the resource reallocation method used by Quigley and Hambrick (2012), first, we settle two items[3]: marketing intensity (sales expenses/sales) and administrative intensity (administration expenses/sales). For each of these items, we measure the absolute change from the year prior to succession (year_{t-1}) to the year following succession (year_{t+1}). Then, we recomputed the scope of strategic change measures so that “*ssc*” is calculated as the average values of the sum of both absolute changes. As Table V indicates, we also obtain similar results when we measure the scope of strategic change using the resource reallocation method.

4.2.3 *Excluding firms in which the proportion of independent directors is less than one-third.* As previously stated, the CSRC once ordered that the proportion of independent directors on the board should be no less than one-third. Therefore, if the proportion of independent directors on the board of a Chinese-listed company is less than one-third, it is illegal and also affects the efficiency of independent directors. To ensure that our results are not being driven by these factors, we omit 52 companies where the proportion of independent directors is under one-third. As Table V indicates, we find that our results are also robust when these companies are excluded.

Variables	ssc_adjust'(Robustness test1)		ssc'(Robustness test2)		ssc'(Robustness test3)	
	Model (1)	t-statistic	Model (2)	t-statistic	Model (1)	t-statistic
<i>constant</i>	0.211*	(2.11)	0.215*	(2.16)	1.881***	(7.42)
<i>succession</i>	0.0553***	(3.63)	0.0637***	(4.01)	0.0920*	(2.30)
<i>id</i>			0.0134	(0.13)		
<i>id × succession</i>			-0.776**	(-2.68)		
<i>duality</i>	0.0264	(1.11)	0.0275	(1.16)	-0.0736	(-1.84)
<i>state</i>	0.0102	(0.91)	0.0124	(1.11)	-0.0251	(-0.86)
<i>dr₁₀</i>	-0.00206	(-0.28)	-0.00150	(-0.21)	0.0264	(1.38)
<i>roa</i>	-0.215*	(-2.02)	-0.193	(-1.84)	-0.978***	(-3.87)
<i>growth</i>	0.0415*	(2.31)	0.0415*	(2.29)	0.244***	(4.06)
<i>lev</i>	0.0451	(1.35)	0.0467	(1.40)	-0.0161	(-0.17)
<i>size</i>	-0.0143**	(-3.09)	-0.0146**	(-3.16)	-0.0817***	(-6.01)
<i>age</i>	0.00302*	(2.53)	0.00292*	(2.46)	0.0127***	(4.46)
<i>ind/year</i>	Yes		Yes		Yes	
<i>N</i>	1329		1329		1170	
<i>R²</i>	0.0491		0.0568		0.2097	
<i>F</i>	1.90***		1.95***		5.15	
					Yes	
					1277	
					0.2134	
					4.90	
					0.0877	
					3.47***	

Notes: Significant at: *0.1, **0.05 and ***0.01; OLS estimates are White (1980) robust

Table V. Robustness analysis

5. Additional analyses of the effectiveness of independent directors

When the scope of strategic change goes beyond the capacity of the company, it will produce a big wave of strategy, which will have negative consequences for the company (Chen *et al.*, 2012). The empirical evidence from Naranjo-Gil *et al.* (2008) also supports the finding that strategic change is negatively related to corporate operating performance. We confirm that a new CEO's "a new broom sweeps clean"-type behavior drives the increased scope of strategic change and a board's independence effectively restrains a new CEO's risk-taking behavior. Therefore, does a new CEO's "a new broom sweeps clean"-type behavior have a negative influence on corporate performance? Do independent directors restrain any aggressive behavior on the part of the new CEO, a reflection of the effectiveness of supervision by independent directors?

In view of the above questions, we chose a CEO succession sample to test further using models (3) and (4):

$$roe = a_0 + a_1ssc + a_2state + a_3dr_{10} + a_4growth + a_5lev + a_6size + a_7age + a_8 \sum ind + a_9 \sum year + \varepsilon \quad (3)$$

$$roe = a_0 + a_1ssc + a_2id + a_3ssc \times id + a_4state + a_5dr_{10} + a_6growth + a_7lev + a_8size + a_9age + a_{10} \sum ind + a_{11} \sum year + \varepsilon \quad (4)$$

roa is the ratio of the company's total profit and equity, and it gives an accurate representation of company performance (Chen *et al.*, 2012; Su *et al.*, 2009). The variable *id* in Model (4) stands for the effectiveness of independent directors, which is measured by the initiative of establishing independent directors. The variable, *id*, is coded "1" if the proportion of independent directors on a board is over one-third and "0" otherwise. Meanings of other variables are consistent with variables in Models (1) and (2).

Table VI presents the results of additional analysis of the effectiveness of independent directors. As Model (3) indicates, the coefficient on *ssc* is negative (with a

Variables	Model (3)	t-statistic	Model (4)	t-statistic
<i>constant</i>	0.4608	(1.26)	0.4473	(1.22)
<i>ssc</i>	-0.3580***	(-3.98)	-0.4414***	(-4.38)
<i>id</i>			0.0340	(0.90)
<i>ssc × id</i>			0.4451*	(1.89)
<i>state</i>	-0.0266	(-0.72)	-0.0292	(-0.79)
<i>dr₁₀</i>	0.0222	(0.94)	0.0206	(0.88)
<i>growth</i>	0.1046***	(2.84)	0.1109***	(3.02)
<i>lev</i>	0.0471	(0.64)	0.0037	(0.05)
<i>size</i>	-0.0201	(-6.01)	-0.0202	(-1.27)
<i>age</i>	-0.0037***	(-0.96)	-0.0032	(-0.82)
<i>ind/year</i>		Yes		Yes
<i>N</i>	183		183	
<i>R²</i>	0.2543		0.2729	
<i>F</i>	1.88***		1.90***	

Table VI.
Results of additional
analysis

Notes: Significant at: *0.1, **0.05 and ***0.01

value of -0.3580) and statistically significant at 1 per cent, suggesting that the large scope of strategic change brought by new a CEO has a negative influence on company performance. As Model (4) indicates, the coefficient of *ssc* is negative (with a value of -0.4414) and statistically significant at 1 per cent, and the positive interaction between *ssc* and *id* is positive (0.4451 , t -statistic = 1.89). The results suggest that independent directors are effective in restraining the negative influence of the behavior of a new CEO (“a new broom sweeps clean”) on corporate performance.

6. Conclusions and insights

6.1 Research conclusions

Based on the sample of Chinese-listed companies between 2007 and 2012, we examine the influence of CEO succession on strategic change and the moderating effect of board independence on the relationship between CEO succession and the scope of strategic change. The research results show, first, that CEO succession provides the conditions for a new CEO to become empowered to initiate strategic change, and that the tendency of a new CEO to sweep clean will increase the scope of strategic change and, second, that board independence negatively moderates the relationship between CEO succession and the scope of strategic change and board independence can effectively inhibit the aggressive behavior of a new CEO, in some cases reducing company performance. This shows that supervision by independent directors can be an effective means of exercising strategic control.

The main theoretical contributions of this paper are outlined below. First, we enrich research on the relationship between CEO turnover and strategic change. Previously, most research has considered the CEO turnover event as a natural phenomenon and has taken the perspective that a CEO turnover promotes the implementation of strategic change simply because it is beneficial to break organizational inertia. According to this theory, CEO succession empowers the new CEO to initiate strategic change. This paper breaks with former patterns and focuses on opportunistic behavior during the process of strategic change. This study interprets “a new broom sweeps clean”-type behavior during the process of a new CEO’s implementation of strategic change. Second, we build on research into the effectiveness of supervision by independent directors. At present, there is some debate among domestic and international scholars about the effectiveness of the system of independent directors. Most previous studies are based on the perspective that independent directors exercise supervisory duties through the means of financial oversight and discuss the effectiveness of independent directors by examining the relationship between board independence and company performance. However, this paper builds a bridge with previous research. The logical premise in terms of the influence of independent directors on company performance is that they have the ability to influence the company’s strategic decisions, that is, to control the company’s strategy through effective oversight. Based on this thesis, we discuss the effectiveness of independent directors by analyzing the restrictions imposed by the supervision of independent directors on the behavior of a new CEO’s and any damage to performance resulting from aggressiveness during the process of strategic change.

6.2 Research implications

In view of the above conclusions, we derived the following implications for research:

6.2.1 *Although CEO turnover can induce strategic change, the CEO succession event sends a warning signal about the execution of strategic change.* CEO turnover brings the transfer of power in terms of business management while breaking organizational inertia. A new CEO takes over the management powers of the former, which means he can reallocate company resources according to his will, including by controlling the scope of strategic change through investment, mergers and other behaviors. The irrational tendency of the new CEO may present a huge risk for the company's operations, existence and development. As a result, internal and external corporate governance needs to be more scientific and perfect when a new CEO succession occurs. On the one hand, the company should operate the board's internal governance mechanism efficiently to scientifically select a successor CEO by conducting a comprehensive evaluation of the candidates' knowledge, background, work experience, leadership style and other aspects. On the other hand, the government should cultivate and improve the market of professional managers to ensure fairness, the transparency of managers' personal information and train high-quality management teams.

6.2.2 *A new CEO empowered to carry out the behavior of strategic change challenges the effectiveness of board supervision.* The core of corporate governance is "checks and balances and scientific decision-making" (Li, 2001). The power struggle between the board and CEO always exists. In controlling the scope of strategic change, the CEO shows a tendency to be adventurous, which may damage the company's operating performance, and threaten the reputation of independent directors. Therefore, independent directors will inhibit risky behavior on the part of the CEO through constructive suggestions. It is particularly important to strengthen the effectiveness of supervision by the board in the process of strategic implementation. Our study finds that the proportion of independent directors in Chinese-listed companies increases year-on-year, and that they now account for over one-third of the boards of most companies in our research samples. However, in some listed companies, the proportion of independent directors is much lower than one-third. As described by Liang *et al.* (2009), according to the one person-one vote rule and the minority being subordinate to the majority, if there are not enough independent directors, they would not have a significant impact on board decisions. Therefore, to ensure that independent directors play an effective supervisory role, listed companies are required to comply strictly with the regulations of the CSRC, and increase the proportion of independent directors according to company characteristics. In addition, listed companies are required to make the process of selecting and appointing independent director candidates more restrictive and improve mechanisms to motivate and constrain independent directors, thus ensuring the independent directors' qualitative and quantitative effectiveness.

Notes

1. For example, Rosenstein and Wyatt (1997) and Wang *et al.* (2006) argue that board independence is positively correlated with company performance; Bhagat and Black (1999) find that there is a negative correlation between board independence and company performance; Li and Zhang (2007) argue that the relations between board independence and corporate performance is a "U"-type dynamic curve; Hermalin and Weisbach (1991) and

- Bhagat and Black (2002) find that board independence has no effect in terms of promoting corporate performance.
2. In August 2001, the China Securities Regulatory Commission issued guidance on establishing the independent director system in listed companies, which contained the following specific provisions. Prior to June 30, 2002, members of the board of directors of the listed company must include at least two independent directors; on June 30, 2003, the proportion of independent directors in the board of directors of listed company shall not be less than one-third.
 3. Quigley and Hambrick (2012) choose three resources configuration indexes to measure strategic change: advertising intensity (advertising/sales), research and development (R&D) intensity (R&D/sales) and selling, general and administrative (SG&A) intensity (SGA/sales). The 2010 regulation of accounting standards for enterprises states that “advertising expenses should be included in the cost of sales; For internal research and development projects (including ongoing research and development projects which have been confirmed as intangible company assets), spending in the research phase should be included in profit and loss after the collection period (administrative expenses); spending in the development stage can be confirmed as intangible assets when meeting certain conditions, namely capitalization”. Therefore, we select two enterprise resource configuration indexes – marketing intensity (sales expenses/sales) and administrative intensity (administration expenses/sales) – to measure strategic change.

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Further reading

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