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The Impact of Routine and Non-Routine CEO Turnover on Earnings Management

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Abstract

Purpose: This study aims at examining the practice of earnings management by focusing on the routine and the non-routine CEO turnover.

Design/methodology/approach: The sample in the study consists of all non-financial companies that are listed in the Indonesia stock exchange from 2004 to 2014. We utilize the multiple regression analysis both to test the hypothesis and additional analysis.

Findings: The findings reveal that the successor CEO will aggressively manage earnings during the non-routine turnover, while we do not find that the predecessor CEO engage in earnings management during the routine turnover.

Research limitations/implications: We classify the routine and the non-routine CEO turnover by browsing relevant articles and the official newspaper from the Internet. If we cannot identify, we follow the methods of Kang and Shivdasani (1995) who classify that routine turnover is when the predecessor CEOs still serve the board of commissioners and non-routine turnover is when the predecessor CEOs do not serve the board of commissioners.

Practical implications: The results of this study provide insight for investors and boards of commissioners in order to assess the performance of the CEO in the first year of their service.

Originality/value: This research provides evidence on the importance to differ the routine and non-routine CEO turnover because they have a distinct effect in earnings management.

Keywords: Routine and Non-routine Turnover, Predecessor and Successor CEO, and Earnings Management

i. INTRODUCTION

The existing studies investigating the association of the routine and non-routine turnover and earnings management have been taken place in the setting of the advanced countries. In the context of Indonesia, such studies are relatively scarce as the researchers have difficulty in obtaining the data on the CEO turnover (Lindrianasari & Hartono, 2012). For example, Herawaty and Solihah (2019) and Fontanella (2017) examine the event of CEO turnover only in manufacturing companies during 2012-2016 and 2010-2012, respectively. In addition, Setyawan and Anggraita (2018) investigate that of CEO turnover in all non-financial firms, although their research periods are focused from 2012 to 2014. However, none of them scrutinize routine and non-routine CEO turnover in Indonesia. Unlike previous studies, we extend the period of research until ten years to obtain comprehensive results. Therefore, we aim at examining the impact of routine and non-routine CEO turnover on earnings management.

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Using the sample of non-financial firms listed in Indonesia Stock Exchange between 2005 and 2014, we find that the successor CEOs will aggressively understate earnings during the non-routine turnover. However, we cannot empirically prove that CEOs will aggressively overstate earnings during the routine turnover. Also, we find that non-routine turnover is more than routine turnover at 113 and 85, respectively. Of 113, there are 2 CEOs fired, 2 CEOs stumbled by corruption in the Commission of Corruption Eradication (*Komisi Pemberantasan Korupsi*), 3 CEOs passing away, 13 CEOs resigning without the clear reason, and 93 CEOs not serving the board of commissioners after they do not serve as a CEO. For routine turnover, we find that 2 CEOs are in charge of the parent company, 8 CEOs have served as long as two periods, 12 CEOs experience the slight decrease of their position becoming only directors, not president directors, and 63 CEOs resign in order to serve the board of commissioners.

This study contributes to the accounting literature. Firstly, this research fills the gap in the literature, particularly in routine and non-routine CEO turnover because many researchers have difficulty in collecting the data of routine and non-routine CEO turnover in Indonesian contexts. Secondly, results of this research provide insight to investors and boards of commissioners in order to assess the performance of CEOs in the first year of their service.

ii. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Non-Routine and Routine Turnover

CEO turnover is an action taken by the boards of commissioners for both the survival and the improvement of the company. Previous studies have classified into two categories, namely the routine and non-routine CEO turnover (Kang & Shivdasani, 1995; Lindrianasari & Hartono, 2012; Murhpy & Zimmerman, 1993; Pourciau, 1993; Setiawan et al., 2017; Wells, 2002). However, other studies still use the term of forced and peaceful turnover (Choi et al., 2014), and also that of the forced and voluntary turnover (Hazarika et al., 2012). Nevertheless, we still implement the term of the routine and non-routine turnover since we adopt the method developed by Kang and Shivdasani (1995) for classifying the routine and non-routine turnover.

The routine turnover is the CEO turnover process that has been structured and well planned, while the non-routine turnover is vice versa (Pourciau, 1993). The former is caused by the fact that the CEO approach retirement (Wells, 2002). On the contrary, the latter is motivated to improve the performance of the company as the CEOs assessed by the boards of commissioners or shareholders do not have the capability (Pourciau, 1993). Lindrianasari and Hartono (2012) document that if CEO cannot increase the financial performance, they will be fired in the following years.

Both routine and non-routine turnover may trigger the practice of earnings management. On the one hand, during the routine turnover, the outgoing CEOs know when his or her office period will end. As a result, they could plan to overstate earnings in order to increase the amount of compensation at the end of the office period (Murphy & Zimmerman, 1993). In the United States of America, CEOs approaching the retirement period (routine turnover) will manage earnings in order to pump the profit so that the amount of the pension will increase (Kalyta, 2009). On the other hand, during the non-routine turnover, the incoming CEOs have the incentive to understate earnings during the transition period for improving future earnings (Bornemann et al., 2015; Murphy & Zimmerman, 1993). This happens because they have a chance to blame the outgoing CEO regarding the earnings decrease.

Non-Routine Turnover and Successor CEO

Non-routine turnover is the CEO turnover in which the company does not have sufficient time to prepare and establish linkage between the successor and the predecessor CEO (Pourciau, 1993). The non-routine CEO turnover takes place because the shareholders are not satisfied with the performance of the CEO. Previous research of Lindrianasari and Hartono (2012) finds that financial performance is a determinant factor for the CEO turnover. Thus, CEO will pay attention to the earnings and does not report high earnings in the first year of his or her service so that in the following years, he or she does not have difficulty in meeting or beating the prior earnings.

Non-routine turnover might trigger the successor CEO to manage earnings. When the predecessor CEO has been fired from the position due to the poor performance, the successor CEO has a chance to understate earnings in order to increase the future earnings and blames the predecessor CEO relating the earnings decrease, known as the earnings bath (Murhpy & Zimmerman, 1993). When a new CEO has been appointed, the board of commissioners and the shareholders do not expect quick improvement on the company performance (Wilson & Wang, 2010). Thus, they have the chance to understate earnings in the first year of their service period. Previous studies of Bornemann et al. (2015); J. S. Choi et al. (2014); Wells (2002) find that the successor CEOs engage in income-decreasing earnings management during the transition period. Based on the argument and the previous results, we propose the first hypothesis as follows:

H_1: During the non-routine turnover, the successor CEO will be more aggressive in income-decreasing earnings management.

Routine Turnover and Predecessor CEO

A horizon problem might lead to earnings management, fraud, and other consequence that will deteriorate the company value (Kalyta, 2009). It takes place as the outgoing CEOs attempt to choose the investments of short-term rather than those of long-term, which will be more beneficial (Dechow & Sloan, 1991). During the routine turnover, horizon problem might trigger the earnings management conducted by predecessor CEOs as they can identify when their office period will end; therefore, they are motivated to plan for managing earnings in order to boost the amount of compensation at the end of their office period (Murhpy & Zimmerman, 1993).

By using the U.S. data with the observation period from 1997 until 2006, Kalyta (2009) find that the outgoing CEOs approaching the retirement (routine turnover) will overstate earnings to improve the amount of the pension at their final office period. Similarly, Reitenga and Tearney (2003) find that the CEOs engage in income-increasing earnings management in order to increase the chance of serving as the board of commissioners. Based on the argument and the prior results, we propose the second hypothesis as follows:

H_2: During the routine CEO turnover, the predecessor CEO will be more aggressive in income-increasing earnings management.

iii. RESEARCH METHODOLOGY

Sample and Data Gathering Technique

The sample in the study consists of all non-financial companies that are listed in the Indonesian Stock Exchange from 2004 until 2014. The data are attained from the BVD Osiris about the financial data, the financial report relating to the cut-off period of the CEO's service, and official news on the Internet regarding the reasons behind the CEO turnover. We utilize national newspaper (Bisnis Tempo, Okezone Economy, Detikfinance) on the Internet to obtain such information. Keywords implemented on the Internet are "*Alasan pergantian direktur utama/presiden direktur/CEO"* followed by the name of the CEO or the firm. We obtain information concerning CEO turnover in the Internet at 62 news of 198 CEO turnover. The sample is presented in Table 1.

Table 1: Sample by Firm and CEO Turnover

Panel A: Sample by Firm				**Panel B: Sample by CEO Turnover**			
Sampling Criteria	**Firm**	**Distribution Based on Industry**	**Firm**	**Non-Routine Turnover**	**CEO**	**Routine Turnover**	**CEO**
Companies that do not experience CEO turnover from		Agriculture	5	Fired	2	Being in charge of the parent company	2
		Mining	13	Stumbled by corruption in the Commission of Corruption Eradication		End of the CEO	
		Basic industry and chemicals	23				

2005 until 2014		Miscellaneous industry	18	Pass away		office period	8
Companies that	204	Consumer goods industry		Resign without the	2	Not Serving as a	
are not supported		Property, real estate and	15	reason	3	CEO and only the	
with the		construction		No information on the		director	12
complete data		Infrastructure, utilities and	25	Internet and not serving	13	Resign in order to	
		transportation		the board of		serve the board of	
	41	Trade, services and	16	commissioners		commissioners	
Number of		investment					63
Firms			48	**Number of CEOs**	93		
	163		**163**		**113**		**85**

Variable and Measurement

We implement the discretionary accruals with the modified Jones model in order to estimate the accrual earnings management. The formula for estimating the discretionary accruals through the modified Jones model is as follows:

$TAC_{it}/TA_{it-1} = \beta_0 (1/TA_{it-1}) + \beta_1 (\Delta REV_{it}/TA_{it-1}) + \beta_2 (PPE_{it}/TA_{it-1}) + \varepsilon_{it}$.....(1)

TAC is the total accruals on the year t for the company *i* obtained from the earnings before extraordinary items minus cash flow from the operation. The direct calculation of total accruals is performed by deducting the earnings with the operating cash flow in order to avoid the estimation error (Hribar & Collins, 2002). TA_{it-1} is the total asset of the company *i* in the previous year (*t-1*). ΔREV_{it} is the income of the company *i* in the year *t* minus the income on the year *t-1*. PPE_{it} is the fixed assets for the company *i* on the year *t*. β_0, β_1, and β_2 are the specific parameters of the estimated company.

The equation model (1) is intended to obtain the specific parameters of the company and the total accruals which were estimated. Furthermore, the equation model (2) is to acquire the non-discretionary accruals:

$NDA = \beta_0 (1/TA_{it-1}) + \beta_1 [(\Delta REV_{it} - \Delta REC_{it}/TA_{it-1})] + \beta_2 (PPE_{it}/TA_{it-1})$..... (2)

ΔREC_{it} is the accounts receivable for the company *i* on the year *t* minus the accounts receivable on the year *t-1*. NDA is the discretionary accruals and other items equal to the previous definition. The discretionary accruals are obtained by subtracting between the total accruals and the non-discretionary accruals:

DA= TAC-NDA.....(3)

The routine and the non-routine CEO turnover are classified by finding out the relevant articles and the official newspapers from the Internet. The technique of searching the official newspapers on the Internet implemented by Setiawan et al. (2017), who investigate the relationship between CEO turnover and the company performance.

We classify routine CEO turnover if the CEO has approached the retirement, has served for two periods, has been promoted to the board of commissioners, has served the position in the parent company, and has served only as a director, not as a CEO. On the other hand, the non-routine CEO is classified if the CEO has been dismissed, has been arrested by the law enforcers, and has passed away. If we cannot find the relevant articles or the official news for the CEO turnover, then we will employ the method of Kang and Shivdasani (1995), who classify routine turnover if outgoing CEOs still serves the board of commissioners, and non-routine turnover if otherwise.

We measure the successor CEO by using the dummy variable that equals one if the successor CEO in the non-routine turnover and zero if otherwise (Choi et al., 2014; Wilson & Wang, 2010). Furthermore, the predecessor CEO equals one if the predecessor CEO during the routine turnover, and zero if otherwise (Kalyta, 2009).

Statistical Test

In order to test the hypothesis, we utilize the multiple regression analysis. Before conducting the multiple regression analysis, we perform the classical assumption tests, which are consisted of normality, heteroscedasticity, multicollinearity, and autocorrelation test. Then, the regression model is as follow:

$$DA = \beta 0 + \beta 1\ NSCEO + \beta 2\ RPCEO + \beta 3\ LEV + \beta 4\ SIZE + \beta 5\ LOSS + \beta 6\ ROA + \varepsilon \quad (4)$$

DA is discretionary accruals obtained from the equation model (3). NSCEO is the non-routine successor CEO that equals one if the successor CEO serves during non-routine turnover, and zero otherwise (Setiawan et al., 2017). RPCEO is the routine predecessor CEO that equals one if the predecessor CEO serves during the non-routine turnover, and zero otherwise (Wilson & Wang, 2010).

Other independent variables in the equation (4) are the control variables. Cohen and Zarowin (2010) argue that the proxy of earnings management is possible to involve measurement errors that might be associated with the company characteristics.

LEV is the leverage measured from the total debt divided by the total asset (Klein, 2002). In this study, we predict that the leverage has a positive association with earnings management. This can be explained by the hypothesis of debt covenant describing that the firm is motivated to implement the earnings management in order to avoid the violation of debt covenant (DeFond & Jiambalvo, 1994). LOSS equals one if the company reports the loss after tax and zero if otherwise. The negative association between LOSS and earnings management is expected, indicating that the company engage in earnings management in order to avoid the loss (Zhou & Elder, 2004).

SIZE is the company size measured by the total asset (Francis et al., 2008). The negative association was expected between the SIZE and earnings management. The bigger the company size, the better the internal control system, so there would be more analysts and more qualified audit committees monitoring the company; as a result, earnings management might be low in the big-size companies (Bassiouny, 2016). ROA is the return on the asset acquired from the net profit divided by total assets (Cohen & Zarowin, 2010). ROA and earnings management are expected to have a positive association because the profitable company would get strong pressure to meet or beat the targeted profit (Barton & Simko, 2002; Barua et al., 2006).

iv. FINDINGS

1.1 Descriptive Statistic

The general description of all variables is presented in Table 2. As shown in Table 2, the discretionary accruals (DA) have the same score for mean and median of -0.07, suggesting that the many firms engage in income-decreasing earnings management than those engage in income-increasing earnings management. Concerning return on asset (ROA), the mean score of 0.04 and the median score of 0.04 indicate that many profitable companies dominate in this research sample. This also is supported by LOSS, illustrating that the vast majority are those companies at 79 per cent. Furthermore, the leverage (LEV) has the mean and median score of 0.55 and 0.51, respectively. This shows that half of the companies' asset is financed by debts. In addition, SIZE has a mean score of 510 billion and the median score of 141 billion, the maximum score of 11.4 trillion, and the minimum score of 340 million, showing that the samples represent both small and big firms.

Table 2: Descriptive Statistic

Continuous Variable	N	Mean	Median	Max.	Min.	Std. Dev.
DA	1391	-0.072	-0.072	0.340	-0.530	0.115
ROA	1391	0.044	0.036	2.628	-0.866	0.138
LEV	1391	0.549	0.506	3.398	0.004	0.403
SIZE	1391	510,808	141,040	11,415,994	340	1039103

Dummy Variable	N	1	0
NSCEO	1391	79 (5.7%)	1312 (94.3%)
RPCEO	1391	65 (4.7%)	1326 (95.3%)
LOSS	1391	281 (20.2%)	1110 (79.8%)

DA is discretionary accruals estimated from the equation model (3). **ROA** is the return on the asset acquired from the net profit divided by total assets. **LEV** is the leverage obtained from the total debt divided by the total asset. **SIZE** is the company size measured by the total asset. **NSCEO** is the non-routine successor CEO that equals one if the successor CEO serves during non-routine turnover, and zero otherwise. **RPCEO** is the routine predecessor CEO that equals one if the predecessor CEO serves during the non-routine turnover, and zero otherwise. **LOSS** equals one if the company reports the loss after tax and zero otherwise.

1.2 Pearson Correlation

The correlation matrix, as presented in Table 3, shows that the discretionary accruals (DA) have a negative association (–0.086) and at 1% significant level on the successor CEO during the non-routine turnover (NSCEO). This indicates that the successor CEO understate earnings during the non-routine turnover.

Table 3: Pearson Correlation

Variable	DA	NSCEO	RPCEO	LEV	SIZE	LOSS	ROA
DA	1						
NSCEO	-0.086***	1					
RPCEO	0.014	-0.054**	1				
LEV	0.005	-0.012	-0.004	1			
SIZE	-0.030	-0.038	0.022	-0.080***	1		
LOSS	-0.242***	0.016	-0.010	0.242***	-0.218***	1	
ROA	0.163***	-0.043	0.007	-0.215***	0.221***	-0.529***	1

***, ** and * indicate significance at the 0.01, 0.05, and 0.10 levels, respectively. **DA** is discretionary accruals estimated from the equation model (3). **NSCEO** is the non-routine successor CEO that equals one if the successor CEO serves during non-routine turnover, and zero otherwise. **RPCEO** is the routine predecessor CEO that equals one if the predecessor CEO serves during the non-routine turnover, and zero otherwise. **LEV** is the leverage obtained from the total debt divided by the total asset. **SIZE** is the company size measured by the total asset. **LOSS** equals one if the company reports the loss after tax and zero otherwise. **ROA** is the return on the asset acquired from the net profit divided by total assets.

1.3 Hypothesis Test

We use the multiple regression analysis in order to test the hypotheses. Before testing the hypotheses, we test the classical assumption, namely the normality, heteroscedasticity, autocorrelation, and multicollinearity assumption. In order to meet the requirement of normality assumption test, we delete the extreme values of discretionary accruals at the 5th and 95th percentiles. Then, to deal with heteroscedasticity assumption, we perform the Huber-White procedures. The summary of the hypothesis test result is presented in Table 4.

Table 4: Results of Hypothesis Test

Variable	Expected Sign	Dependent Variable: Discretionary Accruals	
		Coefficient	t-Statistic
Constant		0.000	0.023

NSCEO	-	-0.045***	-3.434
RPCEO	+	0.005	0.381
LEV	+	0.020**	2.252
SIZE	-	-0.006***	-3.482
LOSS	-	-0.069***	-7.663
ROA	+	0.056*	1.768
F Test	20.019***		
Adj. R-Square	0.076		
N	1391		

***, **, and * indicate significance at the 0.01, 0.05, and 0.10 levels, respectively. **DA** is discretionary accruals estimated from the equation model (3). **NSCEO** is the non-routine successor CEO that equals one if the successor CEO serves during non-routine turnover, and zero otherwise. **RPCEO** is the routine predecessor CEO that equals one if the predecessor CEO serves during the non-routine turnover, and zero otherwise. **LEV** is the leverage obtained from the total debt divided by the total asset. **SIZE** is the company size measured by the total asset. **LOSS** equals one if the company reports the loss after tax and zero otherwise. **ROA** is the return on the asset acquired from the net profit divided by total assets.

The results of the regression in Table 4 show that the variable successor CEO during the non-routine turnover (NSCEO) has a negative and significant coefficient, -0.045 (t-statistic= -3.434), suggesting that the successor CEO during the non-routine turnover engage in income-decreasing earnings management. Therefore, the first hypothesis is supported. Moreover, this result supports the results of Bornemann et al. (2015); Choi et al. (2014); Wells (2002) and is also consistent with the notion that when the outgoing CEO has been dismissed due to the poor performance, the incoming CEO will have a chance to understate earnings in order to improve the future earnings and blames the outgoing CEO because of the earnings decrease (Murhpy & Zimmerman, 1993).

At the same time, the results of the regression analysis in Table 4 show that the predecessor CEO during the routine turnover (RPCEO) has a positive and insignificant coefficient, 0.005 (t-statistic=0.381). Hence, these results do not support the second hypothesis and are consistent with the results of the study by Butler and Newman (1989); Murphy and Zimmerman (1993).

A possible explanation regarding the failure to support the second hypothesis is that the predecessor CEOs could be concerned about the potential impacts of earnings management practices on the share price if these practices are detected by the market participants when they serve the board of commissioners. Moreover, they who plan to pursue a career as the board of commissioners are less likely to perform earnings management because the earnings management will be reversed in the future (Davidson et al., 2007). Hazarika et al. (2012) present the evidence that earnings management increase the likelihood of CEO getting fired in the subsequent year.

Additional Analysis

The additional analysis is intended to examine whether the successor CEO has an influence on earnings management during the routine turnover. The results in Table 5 column (1) show that the successor CEO during the routine turnover (RSCEO) has a negative and insignificant coefficient, -0.007 (t-statistic= -0.523). This finding supports the earnings bath hypothesis, namely earnings management only taking place in the event of non-routine CEO turnover.

Table 5 column (2) aims at investigating whether the successor CEO affects earnings management without considering the routine and non-routine turnover. The successor CEO (SCEO) has a negative and significant coefficient, -0.025 (t-statistic= -2.715). This finding suggests that the successor CEO has an effect on income-decreasing earnings management. Moreover, this suggests that the classification between the routine and non-routine CEO turnover on the

earnings management is important since the result in Table 5 column (1) illustrates that only during the non-routine turnover, the successor CEOs engage in earnings management and do not manage earnings during the routine turnover.

Table 5: Additional Analysis

Variable	Expected Sign	Dependent Variable: Discretionary Accruals			
		(1)		(2)	
		Coefficient	t-Statistic	Coefficient	t-Statistic
Constant		0.000	0.011	-0.002	-0.110
NSCEO	-	-0.041***	-3.456		
RSCEO	-	-0.007	-0.523		
RPCEO	+	0.005	0.351	0.005	0.347
SCEO	-			-0.025***	-2.715
LEV	+	0.020**	2.255	0.020**	2.294
SIZE	-	-0.006***	-3.443	-0.006***	-3.343
LOSS	-	-0.069***	-7.673	-0.070***	-7.715
ROA	+	0.056*	1.775	0.058*	1.847
F Test		17.188***		19.459***	
Adj. R-Square		0.075		0.078	
N		1391		1391	

*****, **** and ***** indicate significance at the 0.01, 0.05, and 0.10 levels, respectively. **DA** is discretionary accruals estimated from the equation model (3). **NSCEO** is the non-routine successor CEO that equals one if the successor CEO serves during non-routine turnover, and zero otherwise. **RSCEO** is the routine successor CEO that equals one if the successor CEO serves during the routine turnover, and zero otherwise. **RPCEO** is the routine predecessor CEO that equals one if the predecessor CEO serves during the non-routine turnover, and zero otherwise. **SCEO** is the successor CEO that equals one if the successor CEO serves, and zero otherwise. **LEV** is the leverage obtained from the total debt divided by the total asset. **SIZE** is the company size measured by the total asset. **LOSS** equals one if the company reports the loss after tax and zero otherwise. **ROA** is the return on the asset acquired from the net profit divided by total assets.

v. CONCLUSION

We aim at examining the practice of earnings management by focusing on the routine and the non-routine CEO turnover. We expect that the predecessor CEO in the routine turnover and the successor CEO in the non-routine turnover will engage in earnings management. We find that the CEO will aggressively manage earnings during the non-routine turnover. However, we do not find that the predecessor CEO engage in earnings management.

This study contributes to the accounting literature. Firstly, this research fills the gap in the literature, particularly in routine and non-routine CEO turnover because many researchers have difficulty in collecting the data of routine and non-routine CEO turnover in Indonesian contexts. Secondly, the results of this study provide insight to investors and boards of commissioners in order to assess the performance of CEOs in the first year of their service.

The possible limitation in this study is related to the classification between the routine and the non-routine CEO turnover. We classify the routine and the non-routine CEO turnover by browsing relevant articles and the official newspaper from the Internet. If we cannot identify, then we follow the methods of Kang and Shivdasani (1995) who classify that routine turnover is when the predecessor CEOs still serve the board of commissioners and non-routine turnover is when the predecessor CEOs do not serve the board of commissioners. Therefore, future studies are expected to be able to classify the routine and the non-routine CEO turnover based on the information from the minutes of

meeting in the General Meeting of Shareholders so that researchers can identify the clear reasons why CEO turnover occurs.

vi. REFERENCES

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