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EXECUTIVE SUCCESSION AND STRATEGIC CHANGE IN JAPAN

MOTOHIRO NAKAUCHI[1] and MARGARETHE F. WIERSEMA[2]*
[1] *Faculty of Business Administration, Toyo University, Tokyo, Japan*
[2] *The Paul Merage School of Business, University of California, Irvine, Irvine, California, U.S.A.*

Scholars studying upper echelons have found that executive succession can serve as an important adaptation mechanism. The bulk of these findings, however, derive from market-based governance settings, which raises an issue of contextual robustness. This study examines this issue by investigating the link between executive succession and strategic change in Japan, a context noted for relatively weak market-based corporate governance and lack of board independence. We find a greater likelihood of strategic change after non-routine executive succession, with the extent of change unaffected by firm performance. Routine succession in the case of a powerful prior president leads to less post-succession strategic change. Copyright © 2014 John Wiley & Sons, Ltd.

INTRODUCTION

The upper echelons perspective asserts that an organization's leadership is of primary strategic importance, with the chief executive acting as a critical bridge between the organization and its environment, providing the strategic direction that enables the company to better position itself in relation to external change (Child, 1972; Schwenk, 1988). Of particular interest to this perspective has been how executive succession can induce organizational change, under the hypothesis that differences in an incoming chief executive's cognitive perspective, knowledge, skills, experience, and demographic background may enable an organization to strategically adapt to its environment (Barr, Stimpert, and Huff, 1992; Helmich and Brown, 1972; Tushman, Virany, and Romanelli, 1985; Vancil, 1987). Prior research has, for instance, found that newly appointed CEOs are more likely to precipitate major strategic change in their organizations than incumbents (Bigley and Wiersema, 2002; Westphal and Fredrickson, 2001). Researchers have also highlighted the importance of corporate governance as a source of contextual conditions that may influence the ability and willingness of the CEO to enact change (Arthaud-Day *et al.*, 2006; Denis, Denis, and Sarin, 1997; Denis and Serano, 1996).

Although such research has been extensive, our understanding of executive succession and strategic change remains limited by a focus on U.S. firms. The U.S. context is characterized by public listing requirements that promote board independence, and by the capital market and its constituents (e.g., investment analysts, institutional investors), as well as the market for corporate control, all playing a significant external monitoring role (Jensen, 1986; Morck, Shleifer, and Vishny, 1989; Walsh and Kosnik, 1993). External and internal monitors of management can influence whether the board will retain or fire the CEO and may affect the likelihood of post-succession strategic change. The governance of publicly listed companies in other

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*Correspondence to: Margarethe F. Wiersema, Paul Merage School of Business, University of California Irvine, Irvine, California 92717, U.S.A. E-mail: mfwierse@uci.edu

countries, however, varies considerably and often does not rely as heavily as the United States on these market-based mechanisms (Aguilera and Jackson, 2003; Doidge, Karolyi, and Stulz, 2007). As a result, we know little about whether our understanding of the linkage between executive succession and strategic change holds in a non-U.S. context.

This paper examines the issue of executive succession and strategic change in Japan, a context noted for relatively weak market-based governance. Japanese firms are regarded as having weak investor protection, as significant and stable shareholdings by financial institutions and corporate affiliates insulate management from capital market pressure for performance and significantly reduce the possibility of hostile takeovers (La Porta *et al.*, 2000; Nakamura, 2006; Prowse, 1992; Seki, 2005). Institutional investors such as pension funds, which are active in monitoring firms' strategic and financial performance in the United States and Europe, do not have significant equity holdings in Japanese firms. In addition, since the board (*torishimariyakukai*) of a Japanese company is typically a large body dominated by either former or current executives, it lacks the independence to serve as an effective internal monitor (Ballon and Tomita, 1988; Clark, 1979; Kang and Shivdasani, 1995; Kaplan, 1994). This relatively weak market-based governance, along with the lack of independent boards, makes Japan a distinct context in which to examine executive succession and strategic change. We look at this context by focusing on newly appointed presidents in large, publicly traded Japanese companies (the president, or *shacho*, is the chief executive officer in a Japanese company). The influence on strategy of both routine (planned) and non-routine (dismissal) executive succession is examined, along with the moderating effect of a firm's past performance and the power of the prior president.

Our findings contribute to the executive succession literature by examining the impact of succession on post-succession strategic change in a context noted for weak market-based governance and lack of board independence. We test the robustness of prior research, which has shown that poor firm performance and external pressure for shareholder wealth maximization drive both non-routine executive succession and post-succession strategic change in U.S. companies (Coughlan and Schmidt, 1985; Denis and Kruse, 2000; Denis and Serano, 1996; Goodstein and Boeker, 1991; Wiersema and Zhang, 2011). Our study also contributes to the corporate governance literature by finding that, in a significantly different corporate governance context from that of the United States, executive dismissal still plays a significant role in precipitating strategic change.

THEORY SECTION

Executive succession and strategic change

Prior literature has found that newly appointed CEOs have particular ability to enact strategic change in their organizations (Bigley and Wiersema, 2002; Westphal and Fredrickson, 2001). Hutzschenreuter, Kleindienst, and Greger (2012), in their review of the literature, offer three sources for the link between executive succession and strategic change: cognitive differences between the successor and incumbent, external pressures, and a mandate by the board of directors for the new executive to change firm strategy.

The nature of executive succession—routine versus dismissal—may also affect the likelihood and extent of post-succession strategic change. Prior research has found that CEO dismissal is often driven by performance and investor concerns (Coughlan and Schmidt, 1985; Denis and Kruse, 2000; Kaplan and Minton, 2012), suggesting that the nature of executive succession may influence the likelihood that a newly appointed executive differs in cognitive perspective. In addition, the board's decision to dismiss the firm's executive may be influenced by external pressures (Wiersema and Zhang, 2011), and such cases are more likely to lead to a mandate for change. Therefore, the nature of executive succession may have an impact on both the newly appointed executive's commitment to the status quo and the discretion to pursue change.

Executive succession differs in several respects in Japan and the United States. In the U.S., whether the CEO steps down voluntarily or is removed by the board is typically ascertained from news articles and/or the executive's age at departure (Shen and Cannella, 2002; Wiersema and Zhang, 2011). In Japanese companies, the nature of executive succession cannot be determined in the same way, since there is neither a mandatory retirement age, nor do companies usually publicize the reasons for an executive's departure. Instead, the succession process itself reveals the nature of the executive succession event—a "routine" succession is characterized by the president stepping down and taking

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on the position of *kaicho* (chairman of the board). The respective roles and duties of the president versus that of the *kaicho* are quite different from those in a U.S. company. The *kaicho* presides over the meetings of the *torishimariyakukai* (board), but also has an important management role. In Japan, the *kaicho* is a formal member of the firm's top management team (TMT; *jomukai*) and is at the top of the list of the company's executives provided in the *Yuka Shoken Hokokusho* filings (the Japanese equivalent of the U.S. 10-K). The influence of the retired president is significant since, as *kaicho*, he still holds an executive position within the firm. In this executive role, the *kaicho* is expected to provide the president with advice and counsel, as well as oversight (Schaede, 1994). The president, on the other hand, has primary responsibility for developing and executing strategy and managing the company. The *kaicho* can nonetheless be a powerful actor within the *jomukai,* and can exercise even greater power than the president (Kaplan and Minton, 1994). This arrangement differs sharply from that of U.S. companies, where, in the majority of cases, the CEO concurrently holds the position of chairman of the board (Worrell, Nemec, and Davidson, 1997), and where a retiring CEO usually relinquishes this board role when stepping down. Thus, a routine executive succession in a U.S. company results in the retiring CEO's departure from the company whereas, in Japan, a routine executive succession means that the retiring president becomes *kaicho* and thus remains as a member of the firm's top management team.

In Japan, when the departing president does not become the *kaicho*, it represents a significant departure from the customary succession process and constitutes a non-routine succession event (Kang and Shivdasani, 1995; Kaplan, 1994; Sakano and Lewin, 1999). A succession wherein the prior president does not become the *kaicho* means that the departing executive is completely removed from any further involvement in the affairs of the company. Such a succession event indicates a significant shift in power and influence. As a result, we propose that non-routine executive succession will lead to greater post-succession strategic change than routine succession because the new president will have greater managerial discretion and may even have a mandate for strategic change.

In the case of a routine succession, the departing president as *kaicho* is likely to influence the policies of the newly appointed president. Due to rigidity and a lack of openness to change stemming from tenure effects (Finkelstein and Hambrick, 1990; Hambrick, Geletkanycz, and Fredrickson, 1993), the commitment to the organizational status quo will be greater when the past president serves as *kaicho*. According to Quigley and Hambrick (2012), the continuing presence of the prior executive as board chair "restricts a successor's discretion" (p. 835), and there is greater adherence to the status quo. Therefore, we propose that the nature of executive succession has ramifications for the extent of post-succession strategic change, with non-routine succession leading to greater strategic change than routine succession events.

Hypothesis 1: Non-routine executive succession will be related to greater post-succession strategic change than routine executive succession.

Moderating role: firm performance and prior president duality

The extent to which non-routine executive succession leads to post-succession strategic change may also depend on a firm's prior financial performance. Poor prior performance not only tends to increase the probability of non-routine executive succession (Denis and Kruse, 2000), but also influences the probability that strategic change will occur after succession (Boeker and Goodstein, 1993). Organizations tend to be more committed to the strategic status quo when performance is high (Hambrick *et al.*, 1993), whereas poor performance can motivate strategic change (Tushman *et al.*, 1985). Thus, we propose that non-routine executive succession leads to greater post-succession strategic change when performance is poor.

The relative power of the prior president is also likely to influence whether a newly appointed president can enact strategic change. One indicator of executive power is duality—where the chief executive also holds the position of board chair. Since formal authority represents power that is derived from one's position in an organization, a chief executive who also holds the position of chairman of the board has a higher basis of power and influence (Finkelstein, 1992). In holding the position of chair, the chief executive has structural power over the directors on the board (Lorsch and MacIver, 1989), which shields the CEO from board monitoring (Davidson, Worrell, and Nemec, 1998). Prior research has found that, in firms with CEO duality, CEO succession is less likely (Ocasio, 1994), the successor CEO is more likely to be promoted from within (Cannella and Lubatkin, 1993), and the successor CEO is more likely to be demographically similar to the incumbent (Zajac and Westphal, 1996). Additional studies have provided evidence that firms with CEO duality are more likely to have boards that are less diligent in their monitoring of the firm and CEO (Tuggle *et al.*, 2010) and more likely to adopt provisions not in the best interests of shareholders, such as antitakeover measures (Mallette and Fowler, 1992). Daily and Dalton (1994) proposed that CEO duality may both enable and incentivize the CEO to maintain the status quo, yet also found that CEO duality was more prevalent among firms that went bankrupt. Thus, executive duality can create agency problems wherein the board is less able to serve as an effective monitor and the firm is more likely to adhere to the status quo.

In Japanese companies without a *kaicho*, the president holds the "informal" position of board chair. In such situations, the president has considerable power since there is no executive ranked higher and no one who provides oversight or advice. When such a powerful president has been dismissed, it represents a major management upheaval and indicates that there has been a significant shift in power within the firm. Such a non-routine executive succession provides the newly appointed president with greater discretion due to the lack of a predecessor serving as *kaicho*. In contrast, the routine succession of a powerful president means that the prior president now serves as *kaicho*, which is likely to minimize the discretion of the newly appointment president to enact post-succession strategic change.

Hypothesis 2: Financial performance will moderate the effect of the nature of executive succession, so that companies with non-routine succession will have greater post-succession strategic change when financial performance is low.

Hypothesis 3a: Prior president duality will moderate the effect of the nature of executive succession so that companies with non-routine succession will have greater post-succession strategic change when the prior president also held the informal position of chair.

Hypothesis 3b: Prior president duality will moderate the effect of the nature of executive succession so that companies with routine succession will have less post-succession strategic change when the prior president also held the informal position of chair.

METHODS

Sample

The sample for this study was selected from the population of Japanese publicly traded manufacturing companies ($n = 793$), listed in the first section of the Tokyo Stock Exchange and that experienced a president succession event during the 1999–2001 period. Japan experienced an asset price bubble period, or "bubble economy," from 1986 to 1990, in which real estate and stock prices were greatly inflated due to the availability of easy credit. The collapse of the bubble economy in the early 1990s resulted in a subsequent deflationary spiral and negative GNP growth. Thus, the period of our study, 1999–2001, covers a period of time when Japanese companies were faced with a great deal of environmental uncertainty and had to reassess the nature of their business.

To control for possible selection bias in our sample, we utilized the Heckman selection model (Heckman, 1979), which has been widely used in organization and strategy research to test for and control for sample selection bias. The Heckman model was highly significant indicating that there is a sample selection bias in that firms with a president succession are significantly different from firms without a president succession. Thus, we include the inverse Mills ratio (lambda) as a control variable in our models to account for sample selection bias.

Individual company financial information was obtained from the Nikkei's "NEEDS" database and *Yuka Shoken Hokokusho* filings. Data on executives and directors were collected from *Yuka Shoken Hokokusho*.

Dependent variable

Strategic change

At the corporate level, strategic change refers to changes in the scope of the firm (Wiersema and Bantel, 1992), and thus we utilize the absolute percentage change in the size of the company's core business to capture changes in the firm's strategic scope. Similar to prior studies, we used a three-year period to measure post-succession strategic change. The core business is the largest business in terms of the company's sales and thus represents the dominant strategic focus of the firm. Since single business firms will not have variation on this measure, we focus on multibusiness firms in our sample ($n = 214$). Our measure of strategic change captures both growth and decline in the importance of the firm's core business. Change in the core business size ranges in value from 0 to 62.5 percent, and has a mean of 8.3 percent. This measure was not normally distributed for our sample of firms, so we took the square-root transformation of the measure, which results in a more normally distributed dependent measure.

Explanatory variable

Nature of executive succession

Following prior studies (Kang and Shivdasani, 1995; Kaplan and Minton, 1994), we coded the nature of executive succession by what happens to the departing president. In Japan, upon retirement, it is common for the president to become the *kaicho* or *vice-kaicho*. The presence or absence of a *kaicho* can provide insights into the nature of executive succession. We coded an executive succession as routine when the departing president is appointed as *kaicho* or *vice-kaicho*, since this would be the normal course of events. Executive succession is coded as non-routine when the departing president is not appointed as the *kaicho* or *vice-kaicho*. In such situations, the company lacks a *kaicho*, and the president acts as the informal board chair. The *kaicho* is listed at the top of the company's directory of executives in the *Yuka Shoken Hokokusho* filings, and the president's name is listed below that of the *kaicho*.

Following this coding approach, 61 (28.5%) of the 214 executive succession events for multibusiness firms were coded as routine and 153 (71.5%) were coded as non-routine.

Control variables

We included controls in our models for industry munificence (industry sales growth), industry dynamism (volatility of industry sales growth), company size (log of employees), leverage (total debt to total assets), core business size (percentage of sales of the largest business), foreign stock ownership, and bank stock ownership as well as including industry dummies at the two-digit SIC level and time year dummies. In addition, we controlled for *jomukai* (TMT) size, *jomukai* stock ownership, and prior president tenure since these variables have been shown to result in less post-succession strategic change. Firm performance was measured using three different measures of performance: industry adjusted return on assets (ROA), change in ROA, and stock return. Prior president duality is a dummy variable with a value of 1 when there is no *kaicho* and the prior president also served as the informal board chair. All of these variables were measured for the year prior to executive succession.

RESULTS

Table 1 presents descriptive statistics and correlations for the full dataset used in our analysis (excluding the year and industry dummy variables and lambda).

Table 2 reports the results predicting the extent of post-succession strategic change. Our dependent measure is a change measure, but we should not observe a regression-towards-the-mean effect, since our measure does not distinguish between increases or decreases in the size of the firm's core business. The models also include year and industry dummy variables and lambda to account for sample selection bias. The year and industry dummy variables were not significant. Model 1a is the control model, which shows that core business size and prior president duality are negatively related to change in core business size as predicted. As shown in Model 1b, the coefficient for non-routine executive succession is positive and significant (0.05 level), providing support for Hypothesis 1 that non-routine executive succession will be related to greater post-succession strategic change than routine executive succession. To test the robustness of our results, we also examined longer time periods for the strategic change measure, which produced highly consistent outcomes. We also examined strategic change for subsequent periods and found that our study time period is not significantly different from more current time periods. To test the moderating effect of financial performance on the effect of non-routine executive succession on post-succession strategic change, we examine the interaction of non-routine executive succession with firm performance (we examined all three performance measures and the results were the same). As shown in Model 1c, the interaction is not significant, thus not providing

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Table 1. Descriptive statistics and correlations [a,b]

Variables	Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11	12	13	14
1. Strategic change	0.24	0.16														
2. Industry munificence	0.03	0.03	0.13													
3. Industry dynamism	0.04	0.03	−0.01	−0.40												
4. Company size	8.54	1.50	0.06	0.08	0.06											
5. Leverage	0.62	0.18	−0.01	−0.11	0.20	0.46										
6. Core business size	0.67	0.20	−0.31	0.00	−0.02	−0.26	−0.15									
7. Industry-adjusted ROA	0.00	0.04	−0.17	−0.02	−0.06	0.20	−0.00	−0.01								
8. Change in ROA	0.00	0.02	−0.15	−0.10	−0.09	−0.01	0.02	0.01	0.42							
9. Foreign stock ownership	0.10	0.12	−0.12	0.08	0.01	0.51	0.16	0.09	0.19	−0.08						
10. Bank stock ownership	0.37	0.15	0.02	−0.08	0.09	0.46	0.19	−0.24	0.29	0.07	0.28					
11. *Jomukai* size	7.50	3.96	0.06	0.07	0.00	0.61	0.31	−0.10	0.10	0.00	0.30	0.38				
12. *Jomukai* stock ownership	0.01	0.04	−0.01	0.06	0.00	−0.14	−0.13	0.15	0.05	−0.03	−0.06	−0.20	−0.04			
13. Prior president tenure	93.67	79.07	−0.12	0.07	0.06	−0.11	−0.04	0.09	0.13	0.01	−0.03	0.01	−0.08	0.11		
14. Prior president duality	0.63	0.48	−0.15	0.07	−0.11	−0.22	−0.07	0.09	0.03	0.09	−0.08	−0.18	−0.35	−0.06	0.23	
15. Non-routine succession	0.29	0.45	0.18	0.20	−0.06	−0.19	−0.17	0.06	−0.22	−0.15	−0.18	−0.27	−0.32	−0.10	0.03	0.15

$n = 214$ firms *Jomukai* = top management team
[a] Year and industry dummy variables and lambda are omitted.
[b] Correlations larger than 0.14 are significant at the level of $p < 0.05$, and those larger than 0.18 are significant at the level of $p < 0.01$.

support for Hypothesis 2. To test the moderating effect of prior president duality, we examine the interaction of non-routine executive succession with prior president duality (Hypothesis 3a) and the interaction of routine executive succession with prior president duality (Hypothesis 3b). For this analysis, we remove the control variable, prior president duality, from the model since the inclusion of both interaction terms already accounts for the direct effect of the variable. As shown in Model 1d,

Table 2. OLS analysis for the extent of post-succession strategic change[a]

Variables		Model 1a	Model 1b	Model 1c	Model 1d
Constant		0.33*	0.33*	0.33*	0.36**
Industry munificence		0.84	0.56	0.57	0.61
Industry dynamism		0.52	0.52	0.51	0.48
Company size		0.01	0.01	0.01	0.01
Leverage		−0.00	−0.00	−0.00	−0.00
Core business size		−0.21***	−0.21***	−0.21***	−0.22***
Industry−adjusted ROA		−0.01	−0.01	−0.01	−0.01
Change in ROA		−0.01	−0.00	−0.01	−0.00
Foreign stock ownership		−0.10	−0.08	−0.08	−0.06
Bank stock ownership		−0.05	−0.02	−0.02	−0.02
Jomukai size		0.00	0.00	0.00	0.00
Jomukai stock ownership		−0.02	0.08	0.08	0.02
Prior president tenure		−0.00	−0.00	−0.00	−0.00
Prior president duality		−0.04†	−0.04†	−0.04†	
Non-routine succession	**H1**		0.06*	0.06*	−0.03
Non-routine succession × change in ROA	**H2**			0.01	
Non-routine succession × prior president duality	**H3a**				0.04
Routine succession × prior president duality	**H3b**				−0.07**
F value		2.16**	2.27***	2.20***	2.39***
R-squared		0.26	0.28	0.28	0.30
Adjusted *R*-squared		0.14	0.16	0.15	0.17
Increase in *R*-square[b]			0.02*	0.02†	0.04**

$n = 214$ firms *Jomukai* = top management team.
[a] All models also include year and industry dummy variables and lambda to account for sample selection bias.
[b] Test of full model against the partial model.
†$p < 0.10$; *$p < 0.05$; **$p < 0.01$; ***$p < 0.001$ (two-tailed tests)

the interaction of non-routine succession and prior president duality is not significant, thus not providing support for Hypothesis 3a. The interaction of routine succession and prior president duality is significant and negative as expected, thus providing support for Hypothesis 3b that companies with routine succession will have less post-succession strategic change when the prior president also held the informal position of chair.

CONCLUSION

Executive succession can serve as a primary way in which organizations adapt and overcome organizational inertia (Boeker and Goodstein, 1993; Tushman *et al.*, 1985). Prior research has found that corporate governance and financial performance are important contextual factors that influence the nature of executive succession (Cannella and Shen, 2001; Zhang, 2006), but has given less attention to the governance context for post-succession strategic change. In particular, research on this issue has been focused exclusively on the United States, where companies have independent boards, incentivized compensation, and capital market pressure for shareholder wealth maximization. This study helps address robustness issues and enriches our understanding of the mediating role of governance by investigating how executive succession can lead to strategic change in Japan, a context noted for relatively weak market-based governance.

Our study provides evidence that, despite the lack of pressure for shareholder wealth maximization, executive succession can influence strategic change in Japanese companies. Specifically, we find that firms with non-routine executive succession experience a greater extent of post-succession strategic change. These findings also clarify our understanding of the strategic consequences of executive succession in Japanese companies, where prior research did not account for the nature of executive departure in finding that executive succession did not lead to significant strategic change (Sakano and Lewin, 1999). Our analysis reveals that, unlike U.S.-based research, firm performance is neither a predictor of executive dismissal nor influences the extent of post-succession strategic change. Our findings are consistent with the nature of corporate governance in Japan, where management and the board are insulated from capital market pressures for performance. Despite the lack of pressure for shareholder wealth maximization and management accountability for firm performance, however, Japanese boards may dismiss the president, and these non-routine executive successions lead—as in the United States—to more extensive post-succession strategic change than routine successions.

We also examine the moderating influence of executive power, as indicated by prior president duality, on the relationship between executive succession and strategic change. We find that the forced departure of a powerful president, as indicated by executive duality, does not influence post-succession strategic change. However, the routine departure of a powerful president who remains as *kaicho* significantly reduces the extent of post-succession strategic change.

By examining the strategic consequences of executive succession within Japanese companies, our study contributes to both the governance and succession literature. We find that, even where there is weak market-based governance and lack of board independence, executive succession represents a means for firms to strategically adapt. Our study builds on recent work that a newly appointed CEO's ability to influence strategy is influenced by whether or not the former CEO stays on as board chair (Quigley and Hambrick, 2012). The influence of the board chair can be significant in Japan since the *kaicho* is also the highest listed member of the firm's top management team. Not surprisingly, we find that in Japan routine executive succession, which is characterized by the president assuming the position of *kaicho*, significantly reduces the extent of post-succession strategic change. When the former president is dismissed and thus removed from any further involvement with the company, it represents a shift in power and influence and has significant ramifications for post-succession strategic change. Thus, our research suggests that, unlike in the United States, where external constituents can place pressure on boards to take action, executive dismissal within Japanese companies may not be induced by external market pressure for firm performance, but may instead represent an internal contest for control and opposition to the incumbent president (Ocasio, 1994). We propose that this internal struggle over control can act as a substitute to traditional "market-based" mechanisms of governance. These findings suggest that it may prove worthwhile to further investigate the role that a Japanese company's primary shareholders—financial institutions

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and corporate affiliates—play regarding the nature of executive succession.

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