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CEO turnover and properties of accounting information[☆]

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Abstract

Multiple-performance-measure agency models predict that optimal contracts should place greater reliance on performance measures that are more precise and more sensitive to the agent's effort. We apply these predictions to CEO retention decisions. First, we develop an agency model to motivate proxies for signal and noise in firm-level performance measures. We then document that accounting information appears to receive greater weight in turnover decisions when accounting-based measures are more precise and more sensitive. We also present evidence suggesting that market-based performance measures receive less weight in turnover decisions when accounting-based measures are more sensitive or market returns are more variable.

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1. Introduction

One of the primary contributions of agency theory has been to identify what properties make for a good measure of an agent's performance.

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Multiple-performance-measure agency models such as [Banker and Datar \(1989\)](#) and [Holmstrom and Milgrom \(1991\)](#) indicate that use of performance measures that are relatively more precise and more sensitive to the agent's effort can help mitigate agency costs. This research has spawned a growing empirical literature attempting to assess whether firms' corporate governance practices conform to these predictions. [Lambert and Larcker \(1987\)](#) and [Bushman et al. \(1996\)](#), for example, focus on boards' choices over annual compensation grants, and show that contracts substitute toward market- and accounting-based measures when such measures are better indicators of managerial performance. Other research addresses general governance structures and policies. For example, [Bushman et al. \(2004\)](#) document that the structure of incentives provided to firms' boards of directors and the extent of ownership concentration vary in systematic ways with properties of managerial performance measures.

Our objective in this paper is to study how the relation between various performance measures and CEO turnover is affected by properties of the firm's accounting system. Specifically, we examine cross-sectional variation in the weights placed on accounting and market return information in CEO turnover decisions, and relate this to properties of these performance measures. Many studies (beginning with [Coughlan and Schmidt, 1985](#); [Warner et al., 1988](#); [Weisbach, 1988](#)) have analyzed CEO turnover, and the development of this literature largely parallels that on CEO compensation. To date, however, fewer studies have attempted to explain cross-firm variation in the association of accounting- and market-based performance measures with executives' continued employment. One exception is [Defond and Park \(1999\)](#), which shows that industry-adjusted earnings factor more strongly into turnover decisions for firms in less concentrated industries.¹

While boards' compensation decisions have received considerable attention in academic literature on the use of performance measures, we offer three reasons why CEO turnover decisions might yield greater insights into how information is used in corporate board rooms. First, it is well documented (see [Hall and Liebman, 1998](#); [Murphy, 2000a](#)) that most firm-related variation in top executive wealth stems from changes in the value of executives' stock and option holdings. This raises the question of the extent to which annual compensation decisions have significant effects on executives' actions, and thus significant effects on firm value.² However, while boards may (at least partially) delegate compensation decisions to capital markets through the use of equity-based instruments, boards cannot delegate

¹There is a substantial literature on the relation between analyst forecast errors and the likelihood of CEO turnover. [Puffer and Weintrop \(1991\)](#) and [Farrell and Whidbee \(2003\)](#), for example, argue that the deviation of realized earnings from expected earnings may provide additional information about how CEO performance deviates from board expectations. While [Farrell and Whidbee \(2003\)](#) examine whether the properties of analyst forecasts (i.e., forecast dispersion) affect their weight in the turnover decision, this literature does not explore cross-sectional variation in the properties of firms' accounting systems, which is our main aim.

²Note that this question leaves open the issue of why, given the high opportunity costs of members' time, boards would bother going through the exercise of annual performance reviews and compensation grants if there is no effect on executives' actions.

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