Accounting Information, the Cost of Equity Capital and CEO Turnovers

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This study consists of two essays. The first essay investigates how the timely recognition of economic losses (TLR) under conservative accounting convention affects CEO turnovers. Bond, Goldstein and Prescott (2010, “Market-Based Corrective Actions”, Review of Finance Studies) theoretically demonstrate that high quality of other information available to decision-makers facilitates their using of market information to make CEO replacement decisions. I posit that timely information of losses recognized in accounting (TLR) increases the board’s ability to glean performance information from stock prices and thus improves corporate contracting decisions of executive termination made by the board on the basis of stock information. With a sample of 37 counties, I explore empirical evidence to support this position by documenting that TLR leads CEO turnovers more sensitive to stock returns. Evidence further shows that this effect of TLR is more pronounced in the markets or for firms with less financial (greater governance) corporate transparency.

The second essay investigates the role of the cost of equity capital in CEO turnover and capital investment decisions. Using data of U.S.-listed firms over the period 1997-2007, I find that the cost of equity is positively associated with the likelihood of CEO turnovers, even after controlling for earnings and market-based performance. Empirical results also demonstrate that this association is more pronounced for focused firms than for diversified firms or for firms with more investment opportunities. These results are consistent with the proposition that the cost of equity incrementally captures management consequences and agency costs/risks that are beyond those that have been recognized by earnings; the negative effect of agency problems on the cost of equity increases with the level of external financing, results in insufficient corporate investment for firms that need external capital, and therefore triggers CEO termination. Further evidence supports my position by showing that the cost of equity is negatively associated with firms’ capital investment and that this association is stronger for firms with more investment options.

**Keywords:** timely losses recognition; CEO turnover; cost of equity; corporate transparency; corporate diversification; investment opportunities
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