

Risk and CEO Turnover

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March 2007

Abstract

In this paper we theoretically and empirically investigate the role played by risk in influencing CEO turnover and in determining the sensitivity of CEO turnover to firm stock price and accounting performance. Employing a two period model with symmetric learning about CEO talent, we derive the optimal firing rule as a function of risk in observed performance deriving from uncertainty about a CEO's unobservable talent level and risk deriving from sources outside the CEO's control. We then test three implications of the model: 1). The probability of CEO turnover is increasing in the variance of the distribution over CEO talent (i.e., the idiosyncratic portion of a firm's stock return volatility); 2). The probability of CEO turnover is decreasing in performance risk that is beyond the CEO's control (e.g., that portion of a firm's stock return volatility due to market and industry returns); and 3). CEO turnover is less responsive to observed performance as performance risk beyond the CEO's control increases, and more responsive to observed performance as the variance of the distribution of CEO talent increases. We provide evidence consistent with these implications. In addition, we also find some evidence that the increased learning in bad times documented in Jenter and Kanaan (2006), which they argue is consistent with board's learning more during bad times, occurs primarily for firms where our model predicts learning about talent should be higher based on the firm's risk characteristics.