



CEO COMPENSATION, CASHFLOW FROM OPERATING ACTIVITIES AND STOCK RETURNS IN NIGERIA

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ABSTRACT

The objective of the study is to examine the effect of CEO compensation and cash flow from operating activities on stock returns among quoted banks in Nigeria. To achieve this objective, a model was specified and estimated. The variables used in the model are: Stock Returns (SR) as the dependent variable, independent variables include: CEO compensation (CEOCOMP), cash flow from operations activities (CFO), Firm's Age (FAGE), Firm's size (FSIZE), and Leverage (LEV). Descriptive statistics, correlation analysis, and fixed and random effect techniques of panel data estimation were used to analyze the data set from year 2012 to 2022 financial year. The findings show that firm size, CEO compensation are perceived to have deleterious effects on stock returns. The study also finds that CEO compensation has extensive negative effects on stock returns in the short run. Therefore, the study suggests that policies to stabilize the operations of the stock market as well as standardize CEO compensation should be maximized to help facilitate appropriate earnings to increase shareholders' wealth with no deception of any fictitious increase in income.

Keywords: CEO Compensation, Cash flow, operating activities, Stock returns

JEL: G3, G32

INTRODUCTION

A CEO change is a significant event in the life of a firm. The CEO's abilities, preferences, and ultimate decisions affect the firm through the projects it chooses to undertake, its financial policies, and its corporate culture, and to the extent that these characteristics and resulting decisions differ among individuals, a CEO change can alter the firm's direction and performance. A CEO change can be a highly visible event, often portrayed as a harbinger of a brighter future for the bank. Presumably, a new CEO can have a meaningful impact on a company's activities and, ultimately, its profits. However, a new CEO also brings with him or her a great deal of uncertainty for the company: it is both important and impossible to know with certainty what specific decisions the CEO will make, what strategic decisions he or she will make, much less the overall impact of the CEO on company value and overall performance.

When a company has a new chief executive officer (CEO), the uncertain ability of the CEO to change the value and performance of the company becomes apparent to the market over time. The process by which the market learns about this capability will affect the way it reacts to news about the company, which in turn will affect the volatility of the company's stock returns (Sanders, 2001).

Management turnover has been discussed in a large and growing body of literature because it is an important measure of how effectively banks are resolving the two principal-agent problems they face (the problem of linking management performance to the personal wealth of the management



team). It also helps to dissolve the "insider" alliance between controlling shareholders and management and to protect the interests of outside investors (minority shareholders). As a result, how management turnover is related to bank performance can be an important indicator of how a country's corporate governance system is functioning, especially in countries with less active firm-level markets (Al-Shammari, 2021).

This study examines the potentially important consequences of CEO turnover and stock price volatility. The volatility consequences of CEO turnover are important because changes in stock price volatility can have significant effects on firms, their management teams, and stakeholders. Increased volatility could lead to future changes in the bank's investment policy through increased cost of capital and reduced attractiveness of the firm's equity as a medium for acquisitions and compensation (Kahneman & Tversky, 1979).

This study emphasizes the importance of CEO competence uncertainty for firms' underlying cash flow uncertainty, creating a positive match between CEO competence, and thus compensation, and bank size. The relationship between CEO compensation and turnover and firm performance and characteristics has been the focus of much theoretical/empirical research. The relationship between CEO compensation and CEO turnover and firm performance and characteristics has been the focus of much theoretical/empirical research. In this study, we extend this analysis to a new dataset of large commercial banks.

The purpose of this work is to examine CEO Compensation, Cash flow from Operating Activities as they relate to Stock Returns in Nigeria. Despite the implementation of various reforms and regulatory measures geared towards the CEO's remuneration, the Nigerian banking sector continues to face some challenges regarding the impact huge compensation of CEO's in relation to wealth maximization of shareholders. This has cast aspersions and raise questions to debate the CEO's compensation, Firm size, firm age and leverage and if there is an economic sense for high CEO's compensation relative to returns (shareholders' wealth maximization) of DMBs,

Not limited to the above is the wearisomeness expressed by many researchers, policy makers, investors and potential investors regarding CEO's compensation, cash flow and stock returns as can be evidenced in the scholarly work of Sheikh et al., (2018). On the strength of the above, this study will strive to evaluate so as to answer the questions raised with regard to the outcome of CEO compensation and cash flow from operating activities on stock returns among quoted banks in Nigeria., using some selected deposit money banks with a window of observations spanning from, 2012 to 2022.

LITERATURE REVIEW

Empirical review

Some argue that the relationship between expected returns and volatility is strong. For example, Pindyck (1984) attributes much of the decline in stock prices in the 1970s to an increase in the risk premium due to higher volatility. On the other hand, Poterba & Summers (1986) argue that the time-series characteristics of volatility make this scenario unlikely. However, neither study directly examines the relationship between expected risk premium and volatility.

Kenneth (1986) used two statistical approaches to investigate the relationship between expected



returns, stock returns, and volatility. He used daily returns to compute estimates of predictable and unpredictable components using a univariate autoregressive integrated moving average (ARIMA) model. Regression of monthly excess holding period returns on the predictable component yielded little evidence of a positive relationship between existing volatility and the expected risk premium, but a strong negative relationship between excess holding period returns and the unpredictable component of volatility. He interprets this as indirect evidence of an existing positive relationship.

Black (1976) and Christie (1982) found that when stock prices fall, financial leverage increases and stock volatility increases. They observed a negative relationship between the level of volatility and stock returns. Black (1970) argued further that when firm equity values decline, debt ratios rise and equity volatility increases; Black and Christie argued that intertemporal variation in firms' financial leverage can partially explain the negative correlation between returns and future volatility. Black and Christie argued that the correlation between returns and future volatility.

Researchers have reported inconsistent findings on whether CEO turnover reduces organizational performance or is irrelevant (Kesner & Sebor, 1994). Studies that provide evidence of a negative relationship assume that CEO turnover and succession are inevitably disruptive events that lead to organizational instability, increased tension, and decreased morale and productivity (Allen et al, (1979); Grusky (1963)).

As a result, CEO turnover is often associated with a decline in a firm's market value (Beatty & Zajac, 1987). Some studies have also found no significant relationship between CEO turnover or succession and firm performance (Brown, 1982; Gamson & Scotch, 1964; Lieberman & Connor, 1972). Therefore, CEO turnover is expected to be accompanied by productivity revitalization and improved organizational performance.

Recent research on this topic has focused on identified contingencies, further clarifying this relationship. First, CEO turnover can be voluntary or forced, and the forces that initiate turnover affect firm performance following turnover; Dennis and Dennis (1995) find that CEO turnover leads to significant downsizing of operations and increased firm control activities. Wiersema (1995) finds that firms that remove CEOs often perform worse than firms that replace CEOs through a routine succession process. According to (Friedman & Singh, 1989), the market reaction to the voluntary replacement of a CEO is positive if the firm's performance was poor prior to the successor's appointment, but negative if the firm's performance was good prior to the successor's appointment.

In general, studies in the management and organizational literature (e.g., Kesner & Sebor, 1994; Virany et al, (1992)) emphasize that CEOs are valuable human capital for firms and their knowledge, competence, experience, and contribution to firm strategy and performance. Thus, research on the consequences of CEO turnover and succession is based primarily on how the loss, addition, or change in such knowledge, competence, and experience affects the organization. For example, traditional research in financial economics (Furtado & Karan, 1990; Huson et al, (2004)) adopts primarily an agency perspective. In this view, a change in leadership implies a change in management, resulting in potential changes in the conduct of shareholder interests.

Evidence on the relationship between CEO turnover and future performance shows mixed results.



This can be explained by the presence of several factors that affect the livelihood of CEO turnover, including director independence, the presence of large investors, and stock market participation. On the other hand, there is also evidence suggesting that CEO turnover has a positive impact on shareholder wealth and corporate management (Denis & Denis, 1995); a study using a detailed database of U.S. firms from 1985 to 1988 shows that CEO turnover, in the case of forced departures, has a positive impact on management performance has been shown to have a positive impact.

Murphy (1985) collected data on compensation and performance for 461 executives at 71 firms over several years. However, instead of estimating a simple cross-sectional relationship that showed no relationship between CEO compensation and performance. (Murphy, 1985) introduced “fixed effects” models and found a strong relationship between CEO compensation and performance. While he documented a relationship between compensation and performance also wrote a paper in the Harvard Business Review at the time stating that “CEOs are worth every nickel they can get.

Jensen & Murphy (1990) wrote an important paper that first used a different method. In that paper, they found that for every \$1,000 increase in shareholder value (measured as the change in the market value of the stock), CEO pay increased by \$3.25. Their interpretation was that while there is a relationship between pay and performance, the relationship is quite weak and could be strengthened more. The use of equity and stock options in executive compensation contracts increased abnormally, in part due to Jensen and Murphy's study. Options and equity have been an important component of executive compensation packages since the early 1990s.

Hall & Liebman (1998) asked whether CEOs were compensated like bureaucrats. They collected data on stock and stock options (which were not yet formally disclosed at the time) and found by Jensen & Murphy (1990) that for every \$1,000 increase in shareholder wealth, there was a \$5 to \$29 increase. They concluded that their work implies executive wealth, although this may still seem like a very weak relationship.

Bebechuk & Fried (2006) wrote an exciting book entitled "Compensation without performance." The book carefully articulates the difference between the often-discussed "arms-length bargaining" framework and what they call "managerial power," in essence, the viewpoint that the board of directors is captured by the CEO. This discourse provides a reason why the CEO salary (compensation) setting system needs reform.

Based on the discussion of market principles and behavioral assumptions of economic agents and their risk preferences, salary setting is viewed simply as a matter of optimal salary design (Mejia & Wiseman, 1997). Market principles are assumed to guide optimal salary levels and structures, compensating executives for the risks they are willing to take to manage the firm in the best interests of shareholders (Jensen & Meckling, 2010; Jensen & Murphy, 2022).

Kasznik & Lev (1995) and Lang & Lundholin (1993) argue that a positive and significant relationship exists between disclosure and firm size. The study by Watson et al, (2002) proves that voluntary disclosure by large firms is much less costly than that by small firms. Direct costs



incurred by voluntary disclosure include those associated with gathering and disseminating information, as well as indirect costs that may provide a competitive advantage. Field et al, (2005) and (Kajuter, 2006) measured firm size based on market capitalization and found a positive relationship between firm size measured by market capitalization and the level of risk disclosure for a sample of German firms; Amran et al, (2009) measured firm size based on total revenue for a sample of 100 Malaysian firms. and found a positive effect between firm size measured by total revenues and the level of risk disclosure.

Oliveira et al. (2001) measured firm size based on the number of employees. They found a positive relationship between firm size and the level of risk disclosure in Portuguese firms in 2005. Firms are at greatest risk of failure when they are young and small. Beyond the initial peak in mortality, often described as adolescent responsibility, exit rates monotonically decline to a positive asymptote (Carroll, 1983; Freeman et al, (1983); (Sorensen & Stuart, 2000). While many previous studies have focused on the relationship between age and mortality, the mechanism of firm failure is still an understudied phenomenon Baldwin et al, (1997); Bruderl et al, (1992); (McGrath, 1999).

Fichman & Levinthal (1991) suggest that the responsibility for newness is not a monotonically decreasing function of firm age, but that there is an initial "honeymoon" period during which early assets buffer new organizations. Firms that survive in the early years face very different problems than younger firms; as Aldrich and Auster point out, "the main problem faced by small, young organizations is that of strategic transformation (1986:193)." Amburgey et al. (1993) argue that older organizations, thanks to their accumulated asset stock, while younger organizations can suffer severe shocks because of their accumulated asset stock.

Cash flow patterns as a proxy for a firm's life cycle as derived from accounting information was examined by Dickson (2007). The researcher submits that the cash flow pattern provides a rigid and robust indicator of a firm's life cycle stage and allows researchers to evaluate a firm's current performance according to its current life cycle stage. Cash flow is calculated as $EBIT + depreciation - taxes$.

Theoretical review

A well-known stylized fact of financial time series is that they are often non-stationary, and most of them turn out to exhibit periods of high volatility after relatively calm phases. These different phases of volatility imply a time variance of ideas.

Pagan & William (1989) summarized that volatility can be divided into predictable and unpredictable portions, and that research attention has been focused on the determinants of the predictable portion, namely the conditional variance of the series. Several models of conditional volatility have been proposed to capture the volatility of financial time series. An excellent class of this model was first introduced by (Engler, 1982) and is known as the ARCH (autoregressive conditional heteroskedascity) model. This model was later generalized by (Bollersleu, 1986) into the GARCH (generalized ARCH) model by including lags in the conditional variance itself. A very common finding in these models for financial assets is that shocks to volatility are often very persistent.

As for stock market volatility, several authors have in fact found that accounting for regime change



reduces the persistent ARCH/GARCH effect described above, in order to formulate the link between uncertainty about CEO competence and stock return volatility, a simple model known as the learning model (Pastor & Veronesi, 2009) is used. In this model, there is an unknown managerial capability that affects profits, and market participants draw inferences about this capability as news about the firm arrives.

Evaluating the model's predictions regarding the relationship between uncertainty about CEO competence and stock return volatility is complicated by the fact that there is uncertainty about the competence of all CEOs and for all stocks. However, theoretically, learning about CEO competence should be most important when uncertainty about competence is highest (perhaps when a new CEO takes office). Therefore, if the goal is to measure how the market learns about CEO competence, it is natural to focus the study on the period after the new CEO takes office. This theory suggests that the market continually updates its assessment of CEO competence and that future profits are expected to change with changes in estimates of CEO competence. This is because uncertainty about managerial ability is likely to increase before and after a CEO change and decrease during the CEO's tenure. Moreover, this pattern should be primarily due to changes in the volatility of idiosyncratic returns, not firm systematic risk.

Matthew et al. (2003) also construct three models based on three factors that motivate CEO turnover and successor selection. The board's use of the threat of termination to motivate the CEO's efforts. These are the strategy hypothesis, the ability hypothesis, and the scapegoat hypothesis, which lead to different predictions of the impact of turnover on volatility. The first two predict that increased uncertainty about the strategic direction of the firm and increased uncertainty about management's ability to run the firm will increase volatility following turnover, respectively; the third predicts that volatility will remain unchanged and instead turnover will act only as an incentive device. The third prediction is that volatility will remain unchanged and instead turnover will act only as an incentive device.

METHODOLOGY

Panel data regression methods were used to estimate the model. The panel data analysis takes into account not only the time effect, but also the heterogeneity effect of the banks that we deal with. This captures the aforementioned characteristics by including quoted bank-specific effects with random or fixed effects. The random effects model assumes independence between the error term and the independent variables. The Hausman test was used to select the method for estimating fixed and random effects.

Model specification

The model for this study is based on the aforementioned theoretical considerations, with stock returns forming the dependent variable and the explanatory variables of interest being the CEO turnover and compensation of the sampled banks. The other variables are control variables on the model.

Generally, the mathematical form of the model is:

$$SR = f(\text{CEOCOMP}, \text{CFO}, \text{PAGE}, \text{FSIZE}, \text{LEV})$$

The above mathematical model is specified in a stochastic form as follows:

$$SR = \beta_0 + \beta_1CEOCOMP + \beta_2CFO+ \beta_3FSIZE +\beta_4LEV +\beta_5FAGE + \mu$$

Where;

SR =Stock returns

CEOCOMP = CEO compensation

CFO = cash flow from operating activities

FAGE = Firm Age

FSIZE = Firm size

LEV = Leverage

SR is the dependent variable while the others are the independent variables in the model above. μ is the stochastic error term and $\beta_0, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5$ and β_6 are the parameters of the model. The a priori expectations are: $B_0 \geq 0; \beta_1, \beta_2 > 0; \beta_3, \beta_4, \beta_5, \beta_6 < \text{or} > 0$. The nature of this study necessitates the use of secondary data. All data were sourced from the annual reports of quoted banks and the Nigerian Stock Exchange.

EMPIRICAL RESULTS

This section deals with the presentation and analysis of the empirical results from the estimation.

Descriptive statistics

Table 1: Descriptive statistics of variables

	SR	CEOCOMP	FAGE	FSIZE	LEV	CFO
Mean	7.637262	66940.51	19.14286	8.958690	0.861310	0.014643
Median	6.300000	37000.00	10.50000	9.00000	0.86000	0.01000
Maximum	27.00000	353000.0	45.0000	9.64000	1.23000	0.45000
Minimum	0.500000	6404.000	4.0000	8.26000	0.69000	-0.24000
Std. Dev.	6.660350	59996.17	15.03261	0.342066	0.081916	0.104495
Skewness	1.145233	2.003450	0.612459	-0.22422	1.661969	0.758482
Kurtosis	3.697481	8.224815	1.630953	2.295929	8.946876	5.599082
Jarque-Bera	20.0644	151.7388	11.81149	2.438881	162.4486	31.69742
Probability	0.00004	0.00000	0.002724	0.025395	0.00000	0.00000

Source: E-Views Output

The above table shows the descriptive statistics of the variables used. The minimum CEO compensation is about 64% while the maximum CEO compensation is about 35%. On average, CEO compensation is about 66%. The minimum firm age is 4years while the maximum firm age is 45 years. On average, firm age is about 9 years.

The minimum firm size is about 8%, the maximum firm size is about 10%. On average, firm size is about 9%. The minimum leverage for the firm is about 69% while the maximum leverage for the firm is about 104%. On average, leverage for the firm is about 86%. The Jarque-Bera statistics show that on the average, most of the variables were normally distributed.

Correlations analysis

The outcome from the correlation analysis is presented below:

Table 2: Correlation Matrix

	SR	CEOCOMP	CFO	FAGE	FSIZE	LEV
SR	1.000000	0.362463	-0.053363	-0.03173	0.565087	-0.281178
CEOCOMP	0.362463	1.000000	0.016114	0.232031	0.283932	-0.238461
CFO	-0.053363	0.016114	1.000000	0.083712	-0.030422	-0.145975
FAGE	-0.031735	0.232031	0.083712	1.000000	0.208848	0.411263
FSIZE	0.565087	0.283932	-0.050422	0.208848	1.000000	-0.073076
LEV	-0.281178	-0.238461	-0.145975	0.411263	-0.073076	1.000000

Source: E-Views Output

The table above shows that the correlation coefficient of the variable with respect to itself is 1.000. This indicates that a perfect correlation exists between the variable and itself. The correlation coefficients between the dependent and independent variables are discussed below:

The results indicate that a positive relationship exists between stock returns and CEO compensation; the correlation coefficient between SR and CEOCOMP is about 0.36, indicating that the strength of the relationship between the two is about 36%, indicating a weak positive relationship between stock returns and CEO compensation.

The result showed that there exists a negative relationship between stock returns and cash flow from operations management. The correlation co-efficient between SR and CFO is about with a value of -0.05 which means the strength of relationship between them is about -5% which shows a weak and negatively relationship between stock returns and cash flow from operations management.

The result shows that there exists a negative relationship between stock returns and firm age. The correlation co-efficient between SR and FAGE is about with a value of -0.03 which means the strength of relationship between them is about -3% which shows a weak negative relationship between stock returns and firm age.

The result also shows that there exists a positive relationship between stock returns and firm size. The correlation co-efficient between SR and FSIZE is about with a value of 0.57 which means the strength of relationship between them is about 57% which shows a strong positive relationship between stock returns and firm size.

The results show that there exists a negative association between stock returns and leverage. The correlation coefficient between SR and LEV is -0.28 and the strength of the relationship between the two is -28%, indicating a weak positive correlation between stock returns and leverage.

Regression analysis

A cross-section of the banking industry was used in this study. Due to the heterogeneity of the data in terms of bank size, it was necessary to correct for heteroskedasticity issues using white heteroskedasticity-consistent standard errors and covariance. The results are presented below:

Table 3: Ordinary Least Square (OLS) regression result

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	3.066945	47.77853	0.064191	0.949
CEOCOMP	-1.67E-05	1.03E-05	-1.62672	0.1086
FAGE	0.474296	0.563926	0.84106	0.4034
FSIZE	0.318278	6.872433	0.046312	0.9632
TL_TA	-7.2639	7.785456	-0.93301	0.3543
CFO	1.109363	3.752845	0.295606	0.7685
R-squared	0.816331	Durbin-Watson stat		1..464669
Adjusted R-squared	0.765469			
F-statistic	16.04986			
Prob(F-statistic)	0			

Source: E-Views Output

A summary of the regression results presented in the table above follows. R-squared value of 0.81 and Adj. R-squared value of 0.76 implies that about 76% of the total systematic variations in Stock Returns (SR) have been explained by all the independent variables taken together namely: CEO compensation (CEOCOMP), Cash flow from operating activities (CFO), Firm Age (FAGE), Firm Size (FSIZE), and Leverage (LEV).

Based on the overall statistical significance of the model as indicated by the F statistic, it was observed that the overall model is statistically significant as the calculated F statistic was significant at the 1% significance level. This suggests that there is a significant linear relationship between stock returns and the explanatory variables, as shown in the model.

Results in Table 1 above reveal the relevance of the individual coefficient of the explanatory variables, considering their signs, magnitudes, and their level of significance. The result shows that CEOCOMP being one of the major variables of interest exerts a negative and insignificant impact on stock returns. The variable also failed the statistical significance test. This result also implies that a unit change in CEO compensation leads to a decrease in returns of approximately (1.67E-05) units. This suggests that we accept hypothesis one H_{01} The effect of CEO compensation on stock returns is not significant.

In addition, the result with respect to cash flow from operating activities (CFO) shows a positive



but insignificant effect on stock returns. This means that as cash flow from operating activities increases, the stock returns also increases but not significantly. This result show that a unit change in cash flow from operating activities has the tendency to increase the stock returns with about (1.109363) units. The result suggests that we accept the hypothesis two (H_{02}) It states that the impact on cash flows from operating activities is not material.

The control variables are leverage, firm size, and firm age, result show that firm size and firm age respectively impact stock returns respectively, while leverage impact stock returns negatively. This implies that older firms tend to enjoy higher stock returns, the same for larger firms. That is, the larger the firm in terms of total assets the higher the stock returns.

Overall results indicate that the model is satisfactory by the significance of the model at the 1% level.

CONCLUSION

Based on the outcomes of this study, we believe that attractive compensation contracts will induce senior management to devote their efforts to enhancing the future growth of the firm, thereby increasing shareholder wealth maximization and, in turn, eliminating agency conflicts between top management and shareholders. We also assume that firms should increase their size to maximize wealth because firm size (total assets) and returns flow in the same direction. Furthermore, CEO compensation should be attractive to improve performance because CEO compensation is a performance motivator. Banks should maximize these means of generating profits to increase shareholder wealth.

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