

# **Absence of Consequences Following Accounting Restatements: Evidence from Audit Committee Members**

Current Draft:  
November 28, 2009

## **Abstract**

Prior research suggests that corporate directors suffer the loss of outside board positions following a financial reporting failure. This loss of board positions, however, does not occur at the same rate for all outside directors. To examine this apparent discrepancy between director actions and consequences, I test whether the retention of individual directors on the audit committee is related to either director characteristics or to CEO influence over the board of directors using a matched sample of restating and non-restating firms. Results indicate that the retention of directors on the audit committee is positively related to the quality of the director and negatively related to CEO influence over the board for both the restating and non-restating sample. Additional tests examining the retention of the audit committee following a reporting failure indicate that retention decisions are not associated with different accrual practices or rates of subsequent restatements.

## I. Introduction

This study empirically addresses whether the labor market for directors operates in an efficient manner to discipline those members of the audit committee that are deemed to have, theoretically, provided inferior monitoring of the financial reporting process and whether the retention of such members of the audit committee is associated with investors suffering additional long-term consequences.<sup>1</sup> Fama (1980) and Fama and Jensen (1983) postulate that the labor market for directors operates in an efficient manner, using reputational penalties rather than legal consequences, to discipline directors that are ineffective monitors; however, recent research has indicated that reputational penalties are not applied uniformly across all directors following a reporting failure [Srinivasan (2005) and Fich and Shivdasani (2007)]. As a result, some have questioned whether the labor market for directors operates in an effective way [Richardson (2005) and Helland (2006)].

Financial restatements are an acknowledgement that previously issued financial statements were not prepared in accordance with generally accepted accounting principles [Palmrose and Scholz (2004)] and that the firm's internal controls have failed to either prevent or detect the problem leading to the restatement prior to the issuance of the firm's financial statements [Kinney and McDaniel (1989)]. As a result, restatements provide information signals about the quality of an audit committee member whose primary fiduciary duty is overseeing the financial reporting process. An efficient labor market, as suggested by Fama (1980) and Fama and Jensen (1983), then uses this signal in an ex-post settling up process to take corrective action against those that are determined to be ineffective monitors.

---

<sup>1</sup> For purposes of this study, discipline of audit committee members following the announcement of a financial reporting failure will be confined to the loss of the individual director's seat on the audit committee.

While Srinivasan (2005), Fich and Shivdasani (2007), Gilson (1990), and Coles and Hoi (2003) present findings consistent with the workings of an efficient labor market for directors, the results of Srinivasan (2005) and Fich and Shivdasani (2007) also suggest that the penalties imposed on directors by the market were not done so consistently across all directors with financial oversight responsibilities. Richardson (2005) suggests that the response by the labor market to the issuance of restated financial statements, as reported by Srinivasan (2005), may not be either large enough or swift enough to indicate that the market has efficiently dealt with monitoring failures. The absence of directorial consequences following a financial reporting failure may, however, be the result of an efficient labor market correctly identifying audit committee members who have uncovered items requiring restatement, who, generally, lack culpability for the reporting failure, or whose expertise and experience as a monitor warrant further inclusion on the audit committee.

If the labor market for directors fails to operate in an efficient manner, the cause may not be market anomalies but, rather, agents interfering in the market's disciplinary process. Boards of directors are often constructed of both managers and outside directors, setting up the potential that an insider could dominate the board and engage in activities detrimental to the firm's investors [Fama (1980)].<sup>2</sup> Consistent with this assertion, Carcello et al. (2008a) present evidence indicating that CEO involvement in the nominating process can adversely impact audit committee effectiveness by increasing the likelihood of financial reporting failure. Such meddling in the process by which individuals are selected to remain on the board of directors by a powerful CEO may lead to the observed inconsistencies in the labor market's application of reputational penalties and may have far reaching effects on the firm's investors through

---

<sup>2</sup> Such activities may include, but are not limited to, causing directors that are ineffective monitors of management to be retained on the board of directors as well as the audit committee of the board.

continued aggressive accounting practices [Moore and Pheifer (2004)] and the increased likelihood of subsequently restating the financial statements.

In order to provide empirical evidence about the retention of audit committee members following their oversight of a reporting failure, I collect information on individual audit committee members who oversaw an income-decreasing financial restatement announced between July 1, 2002 and September 30, 2005 as reported by the General Accounting Office [GAO (2006)] and/or Audit Analytics. In order to address concerns about the culpability of individual audit committee members, sample firms were required to have experienced a previous, unrelated financial reporting failure. In addition, similar information was collected on the individual audit committee members of non-restating companies matched on industry, size, and, when available, auditor. Audit committee retention is then modeled as a function of variables indicating the level of influence the CEO has over the board and the audit committee, the involvement of the CEO in the nominating process, the quality of the individual director, and control variables that have been shown to be associated with director turnover.<sup>3</sup> My results suggest that the audit committee members of firms announcing a restatement do not suffer a higher rate of departure from the audit committee than their counterparts at non-restating firms matched on industry and size. My results additionally indicate that the quality and expertise of the individual directors positively affects the likelihood of remaining on the audit committee for both restating and non-restating firms and that the level of influence of the CEO over the board is negatively related to the likelihood that an individual director remains on the audit committee. Overall, these results provide evidence that the labor market for directors operates in an efficient and effective manner.

---

<sup>3</sup> Individual audit committee members identified as overseeing the restatement of a firm's financial statements will hereafter be referred to as "tainted".

In order to examine the potential long-term consequences of retaining tainted directors on the audit committee, I examine abnormal accruals and subsequent restatement activity for all restatement sample firms. Similar to DeFond and Subramanyam (1998) and Carver et al. (2009), a multivariate setting is used to examine accruals behavior over time and comparisons among groups are made to determine if firms retaining tainted audit committee members engage in more aggressive accounting practices. The results, however, suggest that such is not the case. I then examine the relation between subsequent income-decreasing restatements and audit committee retention in a multivariate setting to determine whether subsequent restatement activity is influenced by the retention of the tainted audit committee. The results indicate that firms retaining the entire audit committee following a restatement do not have a higher likelihood of experiencing a subsequent reporting failure. Overall, these results are supportive of the hypothesis that the labor market for directors operates in an efficient manner.

The remainder of this paper is organized as follows. Section II presents theory and hypotheses development. Section III discusses the sample selection and research methods used to examine the hypotheses. Section IV presents the empirical results, and Section V discusses the additional analyses, while Section VI concludes.

## **II. Theory and Hypotheses**

The separation of ownership and control in the modern corporation creates an agency relationship between the stockholders of a corporation and its manager. In this relationship, managers will expend company resources in order to maximize their own utility, while stockholders will engage in monitoring activities that limit the ability of managers to expend firm resources on non-pecuniary benefits [Jensen and Meckling (1976)]. These monitoring activities that shareholders choose to engage in may take many forms, such as annual audits, budget

constraints, or incentive compensation packages; however, Fama and Jensen (1983) suggest that the board of directors has become the principal tool in monitoring the activities of management and is the apex of decision control within the company due to the delegation of authority to it by diffuse shareholders.

While the board of directors delegates much of its decision control to management, it retains ultimate control over those managers and sets the major policies for the firm. As part of carrying out this fiduciary duty, the board of directors delegates responsibility for the oversight of the financial reporting process to the audit committee. As part of its duties, the audit committee is charged with auditor engagement decisions, oversight of the internal audit function, ensuring the effectiveness of internal controls, resolving conflicts between the external auditor and management, and ensuring the reliability of the financial statements. As a result, audit committees are generally viewed as enhancing the overall quality of monitoring and reducing agency costs to shareholders [Pincus et al. (1989), Beasley (1996), and DeFond et al. (2005)].

Prior studies additionally suggest that the quality of monitoring effectiveness is enhanced when the audit committee possesses stronger governance characteristics. Bedard et al. (2004) indicate that having at least one financial expert on the audit committee can improve the quality of reported earnings, and DeFond et al. (2005) and Davidson et al. (2004) both suggest that investors value the presence of financial expertise on the audit committee. Klein (2002a) also notes that greater audit committee independence can improve the reliability of earnings, and Carcello and Neal (2000 and 2003) suggest that audit committee independence influences the independent auditor's decision to issue a going concern opinion by more effectively shielding the auditor from dismissal. Finally, Lee et al. (2004) find that independent audit committees reduce the likelihood of auditor resignation and increase the likelihood that a quality auditor is engaged.

As a result, audit committees that possess financial expertise and are more independent of management may further enhance the integrity of the reporting process and provide investors with a higher level of assurance that reported earnings are reflective of the firm's true financial position.

A financial restatement, however, raises concerns about the ability of the audit committee to adequately oversee the financial reporting process. Restatements are an acknowledgement that previously issued financial statements were not prepared in accordance with generally accepted accounting principles [Palmrose and Scholz (2004)] and that the firm's internal controls have failed to either prevent or detect the problem leading to the restatement prior to the issuance of the firm's financial statements [Kinney and McDaniel (1989)]. The General Accounting Office (2002) also notes that questionable corporate accounting practices have likely played a role in the increasing number of financial restatements. Restatements may, therefore, be an indication that the audit committee has failed to effectively carry out its fiduciary duty to monitor the activities of management.

Consistent with this assertion, prior studies have found evidence that audit committee characteristics indicative of lax monitoring are associated with reporting failures. Abbott et al. (2004) find that firms are more likely to restate earnings when the audit committee is not independent of management, fails to have a minimum number of meetings, and fails to possess an audit committee financial expert. Farber (2005) indicates that firms accused of fraud, likewise, have fewer audit committee meetings and fewer audit committee financial experts than does a sample of matched non-fraud firms. Agrawal and Chadha (2005) also indicate that firms without an audit committee financial expert are more likely to restate earnings, while, contrary to Abbott et al. (2004), they find no evidence that audit committee independence is associated with

the likelihood to restate earnings. Overall, these findings suggest that less than effective monitoring of the reporting process by the audit committee contributes to the risk that a restatement will occur.

Recent regulatory changes have, likewise, implied that ineffective audit committee monitoring can increase the possibility of financial reporting failures. The Sarbanes-Oxley Act of 2002, the purpose of which was to improve the accuracy and reliability of financial reporting, contains provisions that seek to strengthen the audit committee's role in overseeing the reporting process. The Act now requires the audit committee to make auditor engagement decisions (Section 301) as well as approve all services provided by the firm's independent auditor (Sections 201 and 202). It additionally requires that the independent auditor report to the audit committee instead of management (Section 204). Furthermore, the Act requires the audit committee to establish procedures to handle complaints and concerns from the auditor as well as from employees about accounting, internal control, or auditing matters (Section 301) and requires issuers to either name an audit committee financial expert or to indicate the reasons why the firm does not possess an audit committee member with financial expertise (Section 407). Finally, the Act (Section 301), as well as both the NYSE (NYSE Listed Company Manual, Section 303A) and NASD (NASD Manual Rule 4350) listing standards, require that the audit committee be completely independent of management. These regulatory changes are consistent with prior research on audit committee effectiveness and are indicative of the role that audit committees are thought to play in mitigating the risk of financial reporting failures.

Despite evidence and regulatory suggestions that effective monitoring by the audit committee can improve the quality of financial reporting and reduce the likelihood of a financial reporting failure, audit committee members face few legal penalties following such an event.

Srinivasan (2005) found that fewer than six percent of outside directors from firms that had restated earnings were named as defendants in securities litigation, and this occurred only when the directors in question had sold company stock during the restatement period. Srinivasan (2005) further reports that those directors named as defendants generally did not suffer any personal financial penalties, since settlement amounts were typically paid by the company's D&O insurance carrier and by the company itself. As a result, the legal system provides audit committee members with limited incentives to carry out their fiduciary duty to the stockholders of the firm.

While the legal system generally lacks the ability to induce audit committee members to effectively carry out their fiduciary duties, the labor market for directors may, through reputational incentives, provide the necessary impetus for directors to monitor the financial reporting process. Audit committee members are able to develop reputations as experts in decision control and, as a result of their experience and reputation, receive additional benefits [Fama (1980) and Fama and Jensen (1983)]. These benefits are generally in the form of additional directorships that provide both financial and non-financial remuneration to the individual director [Brickley et al. (1999) and Harford (2003)]. These reputational incentives are, thus, based on past performance in decision control environments and may be adjusted as individual reputations are updated when current firm events reveal more information about an individual's ability to monitor the activities of management.

In the presence of an efficient labor market for directors, as suggested by Fama (1980) and Fama and Jensen (1983), this ex-post settling up process following the revelation of new information about director quality will result in effective directors either gaining new directorships or, at least, maintaining their current number of board seats, while directors that

have become tainted as a result of events indicative of laxity in the oversight of management are likely to suffer penalties in the form of fewer opportunities to serve on boards of directors, including the board of the firm required to restate its financial statements. Consistent with this assertion, Srinivasan (2005) and Fich and Shivdasani (2007) find that directors who oversee a financial reporting failure lose outside directorships at other firms and that this loss in board seats is exacerbated by their presence on the audit committee of the firm experiencing the reporting failure. Similarly, Gilson (1990) finds that fewer than 50 percent of incumbent directors and CEOs remain with a firm following the conclusion of a bankruptcy and directors who resign from these financially distressed companies serve on fewer boards of other companies. Finally, Coles and Hoi (2003) suggest that directors of companies that do not adopt the anti-takeover provisions contained in Pennsylvania Senate Bill 1310 are more likely to gain additional directorships. Thus, evidence suggests that the labor market for directors provides incentives for audit committee members to effectively discharge their duty to monitor the financial reporting process.

Although evidence suggests that the labor market operates in an efficient manner following the revelation of new information about director quality, the labor market's lack of uniformity in imposing penalties following a reporting failure raises questions about its ability to provide reputational incentives that are strong enough to induce audit committee members to effectively monitor the financial reporting process. Srinivasan (2005) reports that 48 percent of all outside directors lose their position on the board of a firm restating its earnings, and Fich and Shivdasani (2007) find that only 17 percent of all outside directors lose their board seat

following allegations of fraud.<sup>4</sup> Considering these events have a large negative impact on the valuation of the firm [Palmrose et al. (2004)] and that the extant literature has generally used these events to indicate monitoring failures on the part of the board and, more specifically, the audit committee, one might expect the percentage of outside directors retaining their position on the board of directors to be much lower. As a result, a disconnect appears to exist between the nature of the reporting failure and the consequences meted out by the labor market for directors.

Richardson (2005) suggests that this discrepancy may be the result of the market's inability to consistently provide directors with incentives to effectively monitor the financial reporting process, stating that the size and timeliness of the labor market's response to the issuance of restated financial statements, as reported by Srinivasan (2005), may not be either large enough or swift enough to indicate otherwise.<sup>5</sup> Beasley et al. (2007), however, suggest that audit committee members choose board appointments rather judiciously and consciously provide a strong effort in monitoring the activities of management and the financial reporting process. In addition, these board members were often nominated for a position on the audit committee due to either their financial or industry expertise. These results imply that the observed retention rates of directors following a financial reporting failure may, in fact, be due to an efficient market identifying directors who possess the requisite experience and expertise to faithfully discharge their fiduciary duties to the shareholders, who have sought to maintain their independence from

---

<sup>4</sup> The large difference between the reported rate of loss of board seats in these two studies may be attributable to differences in research design. Srinivasan (2005) uses announced restatements where, theoretically, "blame" can be affixed at the time of the announcement; whereas, Fich and Shivdasani (2007) use allegations of fraud where "blame" may not be affixed until some time before or at the time of the settlement of fraud litigation.

<sup>5</sup> Although the literature has generally viewed restatements as indicative of poor monitoring by the audit committee, I recognize that this may not always be the case. As a result, the apparent lack of consequences following a reporting failure could be the result of 1) a monitoring success, 2) less severe restatements, 3) lack of service on the audit committee during the period restated, and 4) a concerted effort on the part of others to undermine the reporting process. To the extent that variables included in the model fail to control for potentially positive signals about director quality following a reporting failure, bias is introduced into the analyses of director retention.

management and to improve the reporting process, and who, generally, lack culpability for the failures in the reporting process that initially led to the restatement.

If, as Richardson (2005) suggests, the labor market for directors fails to sufficiently discipline directors following a financial reporting failure, the decision authority concerning board appointments must be relatively free of natural market pressures. This may occur when the CEO is capable of either gaining control of the nominating process or is able to unduly influence the appointment of directors to the board. Shivdasani and Yermack (1999) indicate that when such does occur fewer independent, outside directors and more gray directors are appointed to the board. Further, Carcello et al. (2008a) suggest that CEO involvement in the nominating process can adversely impact audit committee effectiveness by increasing the likelihood of financial reporting failure. These results are suggestive of the CEO's ability to influence the composition of the board and to shield directors from labor market reprisals following a reporting failure. Thus, apparent discrepancies in the labor market's treatment of tainted audit committee members may stem from the concentration of power in the hands of a CEO who is capable of protecting others from the typical consequences of lax monitoring.

Another rationale for an agent to cause a tainted director to be retained on the audit committee is that the two share ties with one another outside the board of directors. Battiston, et al. (2003) and Fich and White (2003) both suggest that CEOs benefit from outside relationships with other board members and Thomas (2005) indicates that these types of ties may have delayed efforts by shareholders to remove Philip Purcell from the position of chairman and chief executive at Morgan Stanley. While the existence of such relationships are generally thought to benefit only the manager of a firm, it may also be indicative of the degree of loyalty necessary to induce the CEO to bring about the retention of a tainted audit committee member on the board.

As a result of this discussion, I develop the following hypothesis:

**H1:** The retention of tainted directors on the audit committee is related to the authority of the CEO.

In the presence of an efficient labor market for directors, however, the retention of tainted directors on the audit committee is likely associated with the qualitative characteristics of the individual director. Cohen et al. (2008) report that audit committee members in the post Sarbanes-Oxley era are more active, diligent, knowledgeable, and powerful, and DeZoort et al. (2007) indicate that audit committees act in a more conservative manner and are more concerned with the accuracy of the financial statements in the post Sarbanes-Oxley era. Consistent with these findings, Beasley et al. (2007) find that audit committee members appear committed to being engaged in substantive monitoring of the financial reporting process and that prior financial and industry experience are important prerequisites for audit committee service. As a result, the retention of tainted directors on the audit committee may be the result of an efficient market correctly identifying high-quality directors whose purpose is to maintain integrity in the financial reporting process. This leads to the following hypothesis:

**H2:** The retention of tainted directors on the audit committee is related to director quality.

The retention of tainted directors on the audit committee could lead to continued laxity in the oversight of the financial reporting process and, thus, the same type of behavior that led to the initial restatement. Economic theory would suggest that a manager engages in certain strategies knowing that the result could be a restatement of the financial statements. Once this event happens, some managers reassess their strategy and are unwilling to continue therein. For others, however, the original strategy had correctly considered the possibility that the firm would

be required to restate its financials, and, as a result, the strategy is as viable after the restatement as it was before. Consistent with this assertion, Moore and Pfeiffer (2004) present evidence indicating that managers do not abandon their prior strategies of aggressive reporting practices following a restatement. Consequently, the retention of tainted directors on the audit committee could result in continued poor reporting quality and an increase in the potential for future restatement activity. This leads to the following additional hypothesis:

**H3:** Financial reporting quality is related to the retention of tainted directors on the audit committee.

Restatements, by their nature, create uncertainty concerning the integrity of management, as well as about the ability of the audit committee to ensure the quality of future earnings. If inefficiencies exist in the labor market for directors, the retention of tainted directors on the audit committee could lead to continued weakness in the monitoring function and cause these concerns to be realized through a subsequent restatement, which could have a significant, negative impact on shareholder wealth [Abbott et al. (2004), Palmrose et al. (2004)]. In the presence of an efficient labor market, however, the retention of tainted directors on the audit committee may be due to the individual characteristics and expertise of the audit committee member.

Consequently, firms retaining tainted directors on the audit committee would be able to ensure the quality of the monitoring function and would not have a higher risk of subsequent restatement activity. This leads to the following additional hypothesis:

**H4:** Subsequent restatement activity is related to the retention of tainted directors on the audit committee.

### III. Research Methodology and Design

#### *Sample Determination*

The restatement sample consists of firms that announced a negative income adjusting restatement from July 1, 2002 to September 30, 2005 as reported by the General Accounting Office (GAO) (2006) and/or Audit Analytics (anchor restatements). In order to address concerns about the culpability of audit committee members for the restatement, sample firms will be furthered required to have experienced a prior financial restatement as identified by either the GAO (2002), the GAO (2006), or Audit Analytics. Of those firms identified as having potentially experienced multiple restatements, all SEC filings related to the identified restatements are examined to eliminate all but the first instance that a restatement is identified, non-negative income adjusting anchor restatements, restatements related to lease issues in 2005, and restatements that were announced but for which no restated filings are found.<sup>6</sup> In addition, all foreign firms are dropped from the sample. This process results in a potential sample of 143 firms that have experienced a restatement prior to the negative income adjusting anchor restatement. From this sample, 12 firms are dropped due to not being listed in the Compustat database, resulting in a sample of 131 multiple restatement firms.

These firms are then matched, based on industry (SIC Code), size (Assets), and, when available, auditor, with firms that have not experienced a restatement, as identified by either GAO (2002), GAO (2006) or Audit Analytics, during the period of time from October 1, 2005 to September 30, 2007. This process results in an additional six firms being dropped from the restatement sample due to insufficient data for the match, and one firm being dropped due to the

---

<sup>6</sup> Among the restating firms, seven firms have prior restatements that were announced more than four years prior to the announcement of the anchor restatement. Of these seven firms, four meet the necessary requirements to be included in the final analyses.

lack of a suitable match. As a result, the sample includes 124 firms that have experienced a multiple restatement and their corresponding non-restating match.

**[Insert Table 1]**

Information about both the firm and individual audit committee members are then collected from proxy filings made with the SEC for both the sample firm and its corresponding match. This process entailed coding information from the proxy filing made just prior to the announcement of the restatement as well as from the three proxy filings made subsequent to the announcement of the restatement. Consistent with other studies looking at audit committee characteristics, a “look-back” approach is used when collecting information specific to the audit committee, while board specific information is collected using a “look-forward” approach.<sup>7,8</sup> The data requirements imposed on the sample for inclusion result in an additional 30 firms being dropped from the sample. As a result, the final sample is made up of 94 firms that have experienced multiple restatements and their non-restating match. Table 1 contains a summary of the sample selection process, as well as, a summarization of the quality of the match for the final sample.

*Models*

In order to test hypotheses 1 and 2, I model the retention of a director on the audit committee as a function of variables indicating the level of authority possessed by the CEO, the involvement of the CEO in the nominating process, the audit committee member’s direct ties to

---

<sup>7</sup> A look back approach to data collection uses a firm’s filing made subsequent to the year of interest to collect certain data items. For example, the composition of a firm’s audit committee in 2005 is determined by examining the proxy filing made in 2006. A look forward approach uses a firm’s filing made in the year of interest to collect certain data items. For example, the composition of a firm’s board of directors in 2005 is determined by examining the proxy filing made in 2005.

<sup>8</sup> As a result of this approach, a two-year window is used to examine the retention of directors on the audit committee following a restatement.

the CEO, the quality of the individual director, and firm and individual specific control variables in the following probit model corrected for non-independent firm level observations using robust standard errors that take into account clustering by firm. Table 2 provides definitions of all variables used in this study.

$$\begin{aligned}
RETENTION = & \beta_0 + \beta_1 BOSS + \beta_2 CEO\_FOUNDER \\
& + \beta_3 CEO\_INVOLVE\_NC + \beta_4 CEO\_TIE + \beta_5 CEO\_TENURE \\
& + \beta_6 CEO\_APT\_BOD + \beta_7 CEO\_TURNOVER + \beta_8 SIZE \\
& + \beta_9 LITIGATION + \beta_{10} FIRM\_AGE + \beta_{11} BOARD\_SIZE \\
& + \beta_{12} PCT\_OUTSIDE + \beta_{13} CLASSIFIED + \beta_{14} AGE \\
& + \beta_{15} TENURE + \beta_{16} FIN\_EXPERT + \beta_{17} OUTSIDE\_CEO \\
& + \beta_{18} DIR\_OWN + \beta_{19} DIR\_GAIN \\
& + \beta_{20} RESTATE + \beta_i RESTATE * \Phi + \varepsilon
\end{aligned} \tag{1}$$

where  $\Phi$  is the vector of test and control variables.

**[Insert Table 2]**

The test variables *BOSS* [Dechow et al. (1996) and Dunn (2004)], *CEO\_FOUNDER* [Agrawal and Chadha (2005) and Carcello et al. (2008c)], *CEO\_APT\_BOD* [Wade et al. (1990)], *CEO\_TENURE* [Hermalin and Weisbach (1988)], and *CEO\_TURNOVER* [Farrell and Whidbee (2000)] measure the chief executive officer's ability to influence the decisions of the board of directors and, hence, the composition of the board. Likewise, *CEO\_INVOLVE\_NC* [Shivdasani and Yermack (1999) and Carcello et al. (2008a)] measures the involvement of the CEO in the nominating process by identifying those boards where 1) the CEO sits on the nominating committee of the board, 2) no nominating committee exists, but SEC filings indicate that the board, as a whole, acts on the nomination of directors, or 3) SEC filings directly state that management is involved in the nominating process. In the presence of inefficiencies in the labor

market for directors, I expect a positive relation between *RETENTION* and each of these variables.<sup>9</sup>

The test variable, *CEO\_TIE*, signifies the loyalties that may exist between the CEO and an audit committee member by identifying outside relationships that tie the individuals to one another. Fich and White [2003] and Battiston et al. [2003] examine such allegiances on the board of directors by identifying situations where directors serve on at least two boards together. Their approach indicates that outside relationships between the CEO and other board members are positively related with executive compensation and the probability that CEO initiated strategies are approved by the board of directors. As a result, this study will use a similar approach to identify instances where the CEO and audit committee member serve on other boards together as well as other outside relationships that directly tie the two to one another.<sup>10</sup> Likewise, the variable *OUTSIDE\_CEO* may indicate the degree of loyalty that exists between the CEO and individuals who have achieved the same level of status at other corporations. Thus, a positive relation is also expected between *RETENTION* and each of these variables.

In addition to the test variables, I control for firm-level effects that may be related to director turnover. These factors include (predicted relation with *RETENTION* in parentheses): the size of the firm (positive) [Hermalin and Weisbach (1988)], whether the firm is in a highly litigious industry as defined by Hogan and Jeter (1999) (negative), the number of years the firm has been publicly traded (positive) [Beasley (1996) and Desai et al. (2006)], the size of the board (no prediction) [Lipton and Lorsch (1992) and Jensen (1993)], the percentage of the board that is

---

<sup>9</sup> In this, as well as in subsequent analyses, the independence of the audit committee is not considered as a control variable due to the sample period considered and the lack of variation during the sample period concerning the independence of the audit committee.

<sup>10</sup> Other outside relationships are determined using biographical information contained in the proxy statement and may include, but are not limited to previous, joint service on a board of directors and prior employment relationships.

independent of management (negative) [Beasley (1996), Dechow et al. (1996), and Klein (2002a)], and whether the board of directors is elected to staggered terms (positive) [Bebchuk et al. (2002)]. All governance variables are collected from the appropriate proxy filing and are measured as of the proxy filing immediately preceding the restatement announcement unless otherwise noted. All other firm level variables are obtained from Compustat unless otherwise noted.

Finally, I control for individual-specific effects that may be associated with director turnover. These factors include (predicted relation with *RETENTION* in parentheses): the age of the individual audit committee member (no prediction) [Farrell and Whidbee (2000) and Yermack (2004)], the tenure of the audit committee member on the board of directors (positive) [Srinivasan (2005)], whether the audit committee member is the audit committee financial expert (negative) [Carcello et al. (2008a), Beasley et al. (2007), and Srinivasan (2005)], the percentage of the firm's common stock owned by the audit committee member (positive) [Farrell and Whidbee (2000) and Fich and Shivdasani (2007)], and whether the audit committee member experienced a net gain of outside directorships held following the restatement (positive) [Ferris et al (2003)].

In order to test hypothesis 3, I use discretionary accruals as a proxy for aggressive accounting choices. Estimation of discretionary accruals is done using the modified Jones model presented in Dechow et al. (1995) with further modifications suggested by Ball and Shivakumar (2006). This method estimates total accruals as a function of the change in revenues adjusted for the change in net receivables, the level of property, plant and equipment, and proxies for gains and losses to control for the asymmetric timeliness of gain and loss recognition. Tests conducted by Dechow et al. (1995) indicate that the modified Jones method of estimating total accruals

provides the most powerful test of earnings management, while Ball and Shivakumar (2006) demonstrate that controlling for asymmetric timeliness in gain and loss recognition substantially improves model specification. Formally presented, the model is:

$$TA = \alpha_1 + \alpha_2 \Delta REV - \Delta REC + \alpha_3 PPE + \alpha_4 CF + \alpha_5 DCF + \alpha_6 CF * DCF + \varepsilon \quad (2)$$

All variables are scaled by lagged total assets. Consistent with Butler et al. (2004) and Kothari et al. (2005), all variables are winsorized at the 1<sup>st</sup> and 99<sup>th</sup> percentiles to control for outliers before estimating equation 2 for each three, two, and one-digit SIC code grouping with at least 20 usable observations [Ashbaugh-Skaife et al. (2007)]. The prediction errors obtained from estimating equation 2 represent each firm's unadjusted abnormal accruals.

Kothari et al. (2005) indicates that estimated discretionary accruals are influenced by both contemporaneous and past firm performance; however, the modified Jones model attempts only to control for contemporaneous firm performance. As a result, unadjusted abnormal accruals contain a portion of what could be considered "normal" earnings management given the firm's level of performance [Carcello et al. (2008b)]. In order to correct for this problem, Kothari et al. (2005) suggest that abnormal accruals be performance adjusted based on each sample firm's prior year return-on-assets (ROA). Specifically, firms are ranked into deciles based on the prior year's ROA, and the median abnormal accrual is calculated for each industry group ROA decile, where the median ROA value excludes the sample firm. The sample firm's performance-adjusted abnormal accrual is then set equal to the difference between its unadjusted abnormal accrual and the median abnormal accrual for the proper industry group ROA decile.

Following the methodology of DeFond and Subramanyam (1998), Carcello et al. (2008b), and Carver et al. (2009), I then examine the behavior of abnormal accruals over the period of time beginning the year prior to the announcement of the restatement (Year -1) and

concluding the second year following the restatement (Year 2) using the following regression model:

$$\begin{aligned}
 PAAC = & \alpha + \beta_1 DUM_{0,1,2_{it}} + \beta_2 DUM_{1,2_{it}} + \beta_3 DUM_{2_{it}} \\
 & + \beta_4 MVE + \beta_5 M/B + \beta_6 DISTRESS + \beta_7 OCF \\
 & + \beta_8 LEVERAGE + \beta_9 BIG4 + \varepsilon
 \end{aligned} \tag{3}$$

The dummy variables  $DUM_{0,1,2}$ ,  $DUM_{1,2}$ , and  $DUM_2$  used in equation 3 provide a means of examining both the levels of accruals and changes in accruals over the period of time from the Year -1 to Year 2 by combining parameter estimates. Specifically, these items are calculated as follows:

$$\begin{aligned}
 \text{Year -1} & = \alpha \\
 \Delta \text{Year -1 to Year 0} & = \beta_1 \\
 \text{Year 0} & = \alpha + \beta_1 \\
 \Delta \text{Year 0 to Year 1} & = \beta_2 \\
 \text{Year 1} & = \alpha + \beta_1 + \beta_2 \\
 \Delta \text{Year 1 to Year 2} & = \beta_3 \\
 \text{Year 2} & = \alpha + \beta_1 + \beta_2 + \beta_3
 \end{aligned}$$

Equation 3 will be separately estimated for each of the following groups: restating firms that retain the entire audit committee in place following a restatement and firms that remove at least one tainted director from the audit committee. Accrual levels and changes will then be calculated and the appropriate joint tests conducted to determine the behavior of accruals within groups. Accrual levels and changes will then be compared across models to determine if differences exist between groups. By examining abnormal accruals in this manner, the relative aggressiveness of accounting choices can be determined and empirically tested. In the presence of inefficiencies in the labor market, I expect restating firms who retain all of the tainted

directors on the audit committee to be more aggressive in their accounting choices than restating firms who remove at least one tainted directors from the audit committee.

In order to further examine the potential impact to shareholders of retaining tainted directors on the audit committee, I model subsequent restatement activity as a function of audit committee retention and firm specific control variables in the following probit model:

$$\begin{aligned} SUB\_REST = & \beta_0 + \beta_1 AC\_RETAINED \\ & + \beta_2 IND + \beta_3 MIN\_SIZE + \beta_4 EXPERT + \beta_5 MIN\_MEET \\ & + \beta_6 BOARD\_SIZE + \beta_7 PCT\_OUTSIDE + \beta_8 OUT\_OWN \\ & + \beta_9 FINANCE + \beta_{10} BOSS + \beta_{11} MGT\_OWN \\ & + \beta_{12} CEO\_FOUNDER + \beta_{13} SIZE + \beta_{14} BIG4 + \varepsilon \end{aligned} \quad (4)$$

The variable *SUB\_REST* is determined by identifying all income-decreasing restatements that occur subsequent to the restating firm's anchor restatement and prior to September 30, 2007. Additionally, subsequent restatements were required to be unrelated to the firm's anchor restatement. The test variable *AC\_RETAINED* is then used to examine the relation between audit committee retention and subsequent restatement activity. The other variables in this model are used to control for audit committee characteristics, oversight mechanisms, management incentives, and management characteristics [Abbott, et al. (2004)]. In the presence of inefficiencies in the market for directors, I expect a positive relation between subsequent restatement activity and the differential decisions made regarding the composition of the audit committee.

## IV. Results

### *Primary Analysis*

Table 3 presents descriptive statistics on the retention of tainted directors on the audit committee of the board of directors, variables indicative of the ability of the CEO to influence the decisions of the audit committee members, variables indicative of the quality of the tainted directors, and other control variables for both my sample of restating firms and their corresponding match. The turnover rate on the audit committee of restating firms is 19.2% and is not significantly different from the audit committee turnover rate of non-restating firms. This result is consistent with the results of Fich and Shivdasani (2007) and Agrawal et al. (1999), who find no evidence indicating that outside directors experience an abnormal turnover rate on the boards of firms accused of financial statement fraud. The turnover rate for CEOs, however, is significantly higher for restating firms (27.7%) than for non-restating firms (11.7%), and results further indicate that CEOs at non-restating firms have a significantly longer tenure (7.7 years) than their counterparts at restating firms (5.8 years). No other significant differences are indicated between restating firms and their non-restating matches on variables indicative of the CEO's influence over the audit committee (*BOSS*, *CEO\_FOUNDER*, *CEO\_INVOLVE\_NC*, *CEO\_TIE*, and *CEO\_APT\_BOD*), as well as other control variables (*SIZE*, *LITIGATION*, *FIRM\_AGE*, *BOARD\_SIZE*, *PCT\_OUTSIDE*, and *CLASSIFIED*). Members of the audit committee at non-restating firms are found to own a significantly greater proportion of the outstanding common stock (0.75%) than their counterparts at restating firms (0.20%) and to have a significantly longer tenure on the board of directors (6.6 years) than their counterparts at restating firms (5.6 years); however, among other variables reflective of the quality of individual directors (*AGE*, *FIN\_EXPERT*, *OUTSIDE\_CEO*, and *DIR\_GAIN*), no significant differences exist. Overall, the descriptive statistics presented in Table 3 indicate few differences between restating firms and non-restating firms matched on industry, size, and, when available, auditor.

This lack of differences between groups may suggest that the labor market for directors operates in an efficient manner; however, it may indicate the ability of management to lessen the effect of reputational penalties to audit committee members following multiple financial reporting failures. These competing hypotheses are examined in detail below.

**[Insert Table 3]**

Table 4 presents the partial effect derived from estimating equation (1) that each variable has on the response probability of remaining on the audit committee for restating firms and their non-restating match, as well as the overall goodness of fit measures obtained from estimating equation (1).<sup>11</sup> The overall results indicate that model is significant at the 0.01 level (Wald  $\chi^2=66.70$ ) and that it has a Pseudo R<sup>2</sup> of 13.02%. For restating firms, the results indicate that *BOSS* and *CEO\_TIE* are significant at the 0.05 level and negatively related to the retention of directors on the audit committee, while *FIN\_EXPERT* and *PCT\_OUTSIDE* are significant at the 0.05 level and positively related to the retention of directors on the audit committee. In comparison, *CEO\_INVOLVE\_NC* and *CEO\_APT\_BOD* are significant at the 0.05 level and 0.10 level, respectively, and negatively related to the retention of directors on the audit committee of non-restating firms, while *CEO\_TENURE* is significant at the 0.05 level and positively related to the retention of directors on the audit committee at non-restating firms. Finally, at non-restating firms, *FIN\_EXPERT* and *DIR\_GAIN* are both significant at the 0.01 level and 0.05 level, respectively, and positively related to the retention of directors on the audit committee of the board of directors. Overall, these results suggest that the quality and experience of individual directors are important to decisions regarding the continuing composition of the audit committee at both restating and non-restating firms and that, generally, the level of influence of the CEO

---

<sup>11</sup> Equation (1) is estimated with standard errors corrected for clustering among firms.

negatively affects such composition decisions at both restating and non-restating firms.

Consequently, these results are supportive of the hypothesis that the labor market for directors operates in an efficient and effective manner.

**[Insert Table 4]**

### *Accruals Analysis*

Table 5 presents descriptive statistics for the measure of discretionary accruals and control variables for the sample firms that experienced a negative income adjusting restatement partitioned by the retention of the audit committee following the restatement. Panel A of Table 5 indicates that, following the announcement of a restatement, restating firms retaining the entire audit committee in place do not significantly differ from those firms removing at least one director from their audit committee with regard to *SIZE*, *M/B*, *DISTRESS*, *OCF*, or *BIG4*. Panel B of Table 5 indicates that neither the levels nor the changes in discretionary accruals are significantly different from zero for either firms retaining the audit committee intact or firms removing at least one director from their audit committee. Tests of differences further indicate that no differences exist between either the levels or the changes in discretionary accruals for the two groups of restating firms. As a result, the descriptive statistics provide initial evidence that firms retaining their audit committee intact following a restatement do not engage in more aggressive accounting practices than do firms who remove at least one director from the audit committee following a restatement.

**[Insert Table 5]**

Table 6 presents the results from estimating equation (3) using both restating firms that retain the entire audit committee in place and restating firms that remove at least one director

from the audit committee, as well as a comparison of the levels and changes in discretionary accruals for those companies. Panel A of Table 6 indicates that the base OLS models for both groups of restating firms are significant at the 0.01 level and that at least 16.99% of the variation in the performance adjusted accruals is explained by the variation in the independent variables. Panel A of Table 6 further indicates that *OCF* and *DISTRESS* are both significant at the 0.01 level and negatively related to performance adjusted discretionary accruals for firms retaining their audit committee intact following a restatement and that *DISTRESS* is significant at the 0.01 level and is negatively related to performance adjusted accruals for firms removing at least one director from the audit committee. No other control variables are significantly related to performance adjusted discretionary accruals for either group of firms. Panel B of Table 6 indicates that neither the level of discretionary accruals nor the change in discretionary accruals is significantly different from zero in any period examined for either group of firms. In addition, Panel B of Table 6 indicates that no significant differences exist between either the level of discretionary accruals or the change in discretionary accruals between the two groups. This evidence suggests that the decision to retain the entire audit committee following a restatement has no adverse effect on accounting choices when compared to removing at least one director from the audit committee following a restatement and supports the premise that the labor market for directors operates in an efficient and effective manner.

**[Insert Table 6]**

#### *Analysis of Subsequent Restatements*

Table 7 presents descriptive statistics for the dependent variable, as well as the independent variables, used to examine the relation between subsequent restatement activity and

the differential decisions concerning audit committee retention. Table 7 indicates that 20.51% of firms retaining the entire audit committee following a restatement experience a subsequent restatement, while 9.09% of firms removing at least one director from the audit committee following a restatement experience a subsequent restatement. The difference between the two groups of restating firms, however, is not significant. An examination of the variables used to control for audit committee characteristics, oversight mechanisms, management incentives, and management characteristics suggests that firms removing at least one director from the audit committee had weaker audit committee characteristics and greater management incentives. These differences, however, are not significant with the exception of *BOSS*, which indicates that firms removing at least one director from the audit committee had a significantly greater number of CEOs who also served as the chairman of the board (63.64% vs. 41.03%). Overall, these results provide initial evidence that stockholders do not suffer additional negative consequences as a result of audit committee retention decisions.

**[Insert Table 7]**

Table 8 presents results from estimating equation (4) using the sample of restating firms. The model is significant at the 0.05 level (Wald  $\chi^2=28.29$ ) and has a Pseudo  $R^2$  of 37.44%. Table 8 indicates that the decision to retain the audit committee intact following a restatement is not significantly related to subsequent restatement activity. Table 8 further indicates that *MIN\_SIZE* and *ASSETS* are significant at the 0.10 level and negatively related to subsequent restatements and that *BOARD\_SIZE* is significant at the 0.01 level and is positively related to subsequent restatement activity. These suggests that the decision to retain the audit committee intact following a restatement has no significant effect on the likelihood of a subsequent

restatement and, therefore, does not present additional long term consequences to the shareholders of those firms.

**[Insert Table 8]**

## **V. Additional Analysis**

A firm's corporate governance atmosphere may influence the effectiveness with which the labor market for directors disciplines those audit committee members which have been deemed to have engaged in a financial reporting failure. Beasley and Salterio (2001) and Klein (2002b) present evidence suggesting that boards of directors with stronger governance characteristics value knowledge, expertise, and independence on the audit committee, and DeFond et al. (2005) suggests that firms with stronger governance characteristics have incentives to make improvements to the audit committee. As a result, I follow the methodology of DeFond et al. (2005) and develop dichotomous measures of eight governance characteristics for each sample firm and its corresponding matched firm, such that values of one indicate strong governance and values of zero indicate weak governance. The governance characteristics are dichotomized as follows:

*Board Independence*-Prior studies have indicated that greater independence of the board of directors is associated with stronger corporate governance [Beasley (1996), Beasley et al. (2000), and Dechow et al. (1996)]. Following DeFond et al. (2005), I code firms with a one (strong governance) if the percent of outsiders on the board of directors is greater than 60%.

*Board Size*- Lipton and Lorsch (1992) and Jensen (1993) suggest that directors who serve on large boards generally lack the ability to work together and deal with complex information and are more easily controlled by the CEO. Yermack (1996) further finds a negative relation between board size and firm value. As a result, I follow DeFond et al. (2005) and code firms one

(strong governance) if the size of the firm's board is less than the sample median, and zero otherwise.

*BOSS*- Combining the duties of CEO and chairman of the board can interfere with the ability of the board to effectively carry out its duties. The Conference Board (2003) indicates this overlap may be a problem and suggests as one of its specific best practices that firms separate the duties of CEO and chairman. In addition, Beasley (1996) and Dunn (2004) provide evidence that combining the powers and authority of the CEO and chairman into one position increases the likelihood of financial statement fraud. Therefore, I code firms one (strong governance) if the positions of CEO and chairman of the board are separated, and zero otherwise.

*Management Involvement*-Carcello et al. (2008a) indicate that management involvement in the nominating process is associated with a higher incidence of financial restatements. Consequently, I code firms one (strong governance) if management is not involved in the nominating process, and zero otherwise.

*Compensation Committee Independence*-The NYSE and NASD now require listed firms to have a completely independent compensation committee or its equivalent in place (NYSE Listed Company Manual, Section 303A and NASD Manual Rule 4350). Such suggests that monitoring activities are improved when the compensation committee is completely independent. As a result, I code firms one (strong governance) if the compensation committee contains only independent, outside directors, and zero otherwise.

*Audit Committee Independence*-Klein (2002a) finds a negative association between audit committee independence and abnormal accruals, and Carcello and Neal (2003) indicate that more independent audit committees display greater effectiveness in shielding auditors from

reparations following the issuance of a going concern opinion. Abbott et al. (2004) also find a negative relation between audit committee independence and the incidence of restatements.

Bronson et al. (2007), however, suggest that the benefits of audit committee independence are realized only when the audit committee is completely independent. Consequently, I code firms one (strong governance) if the audit committee is completely independent, and zero otherwise.

*Audit Committee Size*-The NYSE and NASD require firms to have an audit committee consisting of at least three members (NYSE Listed Company Manual, Section 303A and NASD Manual Rule 4350). Such suggests that management may easily influence audit committees of fewer than three members. Likewise, large audit committees may face problems similar to those outlined by Lipton and Lorsch (1992) that large boards of directors encounter. As a result, I code firms one (strong governance) if the audit committee contains either three or four members, and zero otherwise.

*Audit Committee Meetings*-The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999) recommended open and frequent communication between the external auditor and the audit committee as well as interim reviews of the financial statements. As a result, audit committees have been viewed as being compliant with these recommendations if quarterly meeting of the committee members are held. Abbot et al. (2004) presents evidence consistent with this, suggesting that firms have a lower incidence of a financial reporting failure when the audit committee meets at least four times annually. Consequently, I code firms one (strong governance) if the audit committee surpasses the minimum requirement (four audit committee meetings annually) to comply with the BRC's recommendations, and zero otherwise.

I then construct a summary measure by summing across the eight characteristics for each sample firm and its respective match and then create a dichotomous measure of the corporate governance environment based on the median of the summed values. The dichotomous measure, thus, provides an indication of the relative strength of each firm's governance environment and is used to examine the effects of the overriding governance culture on the effectiveness of the labor market for directors.

Table 9 presents the partial effect that each variable has on the response probability of remaining on the audit committee for each category of firms partitioned by the presence of a financial reporting failure and the relative strength of the corporate governance environment. For restating firms with relatively weak governance environments, the results indicate that directors at firms with high litigation risk and directors with direct ties to the CEO are significantly less likely to remain on the audit committee, while directors with greater amounts of stock ownership are significantly more likely to remain on the audit committee. For restating firms with stronger corporate governance environments, the evidence suggests that directors identified as the audit committee financial expert and directors serving on classified boards are more likely to remain on the audit committee following the restatement, while audit committee members whose board tenure began after that of the CEO are less likely to remain on the audit committee. This evidence is generally consistent with prior results and suggests that issues of director independence, quality, and expertise influence audit committee composition following a restatement. Furthermore, the results indicate that similar issues affect audit committee composition at non-restating firms. Overall, this evidence indicates the labor market for directors operates in an effective manner; valuing such characteristics as director independence and individual experience and expertise.

**[Insert Table 9]**

Using a pooled sample of restating firms combines restatements that result from both intentional actions and unintentional errors and may mitigate the true effect of financial restatements [Hennes et al. (2008)]. As a result, I re-estimate equation (1) using only those restatements resulting from intentional actions and their appropriate matched firm.<sup>12</sup> Table 10 presents the partial effect that each variable has on the response probability of remaining on the audit committee for both intentional restatements and their non-restating match. For intentional restatements, the results indicate that *BOSS*, *CEO\_FOUNDER*, and *CEO\_TIE* are significant and negatively related to the retention of directors on the audit committee, while *CEO\_INVOLVE\_NC*, *CEO\_TENURE*, *FIN\_EXPERT*, and *PCT\_OUTSIDE* are significant and positively related to the retention of directors on the audit committee. In comparison, *FIN\_EXPERT*, *DIR\_OWN*, and *DIR\_GAIN* are significant and positively related to the retention of directors on the audit committee at non-restating firms. While the results do indicate weakness in the labor market for directors when the CEO is involved in the nominating process, the overall results are otherwise consistent with those reported in Table 4 and are generally supportive of an efficient labor market for directors.

**[Insert Table 10]**

**VI. Conclusions**

Prior research has indicated that outside directors face penalties from the labor market for such corporate failures as bankruptcy, allegations of fraud, and financial reporting failures [Gilson (1990), Fich and Shivdasani (2007), and Srinivasan (2005)]; however, the evidence presented in Agrawal et al. (1999), Srinivasan (2005), Fich and Shivdasani (2007), and Helland

---

<sup>12</sup> Restatements resulting from intentional actions are identified using the data from Hennes et al. (2008). This data is publicly available from: <http://sbaleone.bus.miami.edu/>.

(2006) indicates that labor market penalties are not imposed uniformly across all directors following a reporting failure. As a result, some have questioned whether the labor market for directors operates in an effective way [Richardson (2005) and Helland (2006)]. Such questions are supported by recent work, which suggests that inefficiencies in the determination of board composition can have adverse effects on the shareholders of a corporation [Carcello et al. (2008a)]. This, however, contradicts prior literature which has hypothesized that the labor market for directors operates in an efficient manner with shareholders using their voting rights to effectively determine the composition of the board of directors [Fama (1980) and Fama and Jensen (1983)].

In order to examine whether inefficiencies exist in the labor market for directors, I collect information on the individual audit committee members of firms experiencing multiple restatements of the financial statements and non-restating firms matched on industry, size, and, when available, auditor, and test whether retention on the audit committee is either related to the quality of the director or to the influence of the CEO over the board of directors and the audit committee. In addition, I investigate whether the investors of firms that retain all of the directors on the audit committee following a restatement experience adverse long-term consequences compared to firms that remove at least one director from the audit committee following a restatement by comparing the quality of accounting choices and subsequent restatement activity for each group of firms. I find that individual audit committee members at restating firms do not experience a higher departure rate from the audit committee than do individual audit committee members at non-restating firms. I also find that director quality and experience are positively related to continuance on the audit committee while CEO influence is negatively related to an individual's retention on the audit committee. I further find no evidence that investors of firms

who retain the audit committee intact following a restatement experience negative long-term consequences compared to firms that remove at least one director from the audit committee following a restatement. These results suggest that the labor market for directors works in an efficient manner by correctly identifying audit committee members who possess the necessary experience and expertise to execute their fiduciary duty to the shareholders of the corporation, as well as those audit committee members who may be either unduly influenced by the CEO of the firm or who may possess conflicts of interest.

Limitations of this study include the use of a sample that is relatively small in size and the potential for self-selection to determine the degree to which a firm is willing to alter the composition of the audit committee. As a result of the size of the final sample, limitations are placed on the number and type of examinations that can be made, thereby restricting further theoretical development. In addition, the use of firms that have experienced multiple reporting failures may limit the generalizability of the results due to the fact that most public firms have never experienced a financial reporting failure, much less multiple reporting failures. Furthermore, problems associated with self-selection may result from industry or other unobservable characteristics that lead to shareholders determining that the benefits that accrue as a result of a change in governance following a restatement are outweighed by the costs associated with such a change. This study is also limited in that it assumes board composition decisions are determined by the market and exclude decisions regarding continuing service on the board and/or its committees made for other, non-related reasons. Finally, existing inefficiencies in the labor market for directors may be masked due to the changes in board composition initiated by the Sarbanes-Oxley Act.

Currently, little is known about how the labor market for directors uses information to determine the composition of both boards of directors and the various committees of the board. Future studies might further investigate this issue by broadening the examination to include other events that may convey information to the labor market and initiate the ex-post settling up process. In addition, the effectiveness of the labor market's disciplinary actions could be investigated by examining the characteristics of replacement directors. Finally, an understanding of how the labor market for directors has changed subsequent to the passage of the Sarbanes-Oxley Act could lead to more effective regulations and recommendations concerning the process whereby board composition is determined and, thereby, more effective monitors of the activities of management.

## References

- Abbott, L.J., S. Parker, and G.F. Peters. 2004. Audit committee characteristics and restatements. *Auditing: A Journal of Practice & Theory* 23 (March): 68-87.
- Agrawal, A., J.F. Jaffe, and J.M. Karpoff. 1999. Management turnover and governance changes following the revelation of fraud. *Journal of Law and Economics* 42 (April): 309-342.
- Agrawal, A., and S. Chadha. 2005. Corporate governance and accounting scandals. *Journal of Law and Economics* 48 (October): 371-406.
- Ashbaugh-Skaife, H., D. Collins, W. Kinney. 2007. The discovery and consequences of internal control deficiencies prior to SOX-mandated audits. *Journal of Accounting and Economics* 44 (September): 166-192.
- Ball, R., and L. Shivakumar. 2006. The role of accruals in asymmetrically timely gain and loss recognition. *Journal of Accounting Research* 44 (May): 207-242.
- Battiston, S., E. Bonabeau, and G. Weisbuch. 2003. Decision making dynamics in corporate boards. *Physica A* 322: 567-582.
- Beasley, M.S. 1996. An empirical analysis of the relation between the board of director composition and financial statement fraud. *The Accounting Review* 71 (October): 443-465.
- and S.E. Salterio. 2001. The relationship between board characteristics and voluntary improvements in audit committee composition and experience. *Contemporary Accounting Research* 18 (Winter): 539-570.
- , J.V. Carcello, D.R. Hermanson, and P.D. Lapedes. 2000. Fraudulent financial reporting: Consideration of industry traits and corporate governance mechanisms. *Accounting Horizons* 14 (December): 441-454.
- , -----, -----, and T.L. Neal. 2007. The audit committee oversight process. Working Paper, The University of Tennessee.
- Bebchuk, L.A., J.C. Coates, IV, and G. Subramanian. 2002. The powerful antitakeover force of staggered boards: Theory, evidence, and policy. *Stanford Law Review* 54: 887-951.
- Bedard, J., S.M. Chtourou, and L. Courteau. 2004. The effect of audit committee expertise, independence, and activity on aggressive earnings management. *Auditing: A Journal of Practice & Theory* 23 (September): 13-35.
- Blue Ribbon Committee. 1999. *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*. Stamford, CT: BRC.

Brickley, J.A., J.S. Linck, and J.L. Coles. 1999. What happens to CEOs after they retire? New evidence on career concerns, horizon problems, and CEO incentives. *Journal of Financial Economics* 52: 341-377.

Bronson, S.N., J.V. Carcello, C.W. Hollingsworth, and T.L. Neal. 2008. Are fully independent audit committees really necessary? Working Paper, Michigan State University.

Butler, M., A.J. Leone, and M. Willenborg. 2004. An empirical analysis of auditor reporting and its association with abnormal accruals. *Journal of Accounting and Economics* 37: 139-165.

Carcello, J.V., T.L. Neal, Z. Palmrose, and S. Scholz. 2008a. CEO involvement in selecting board members and audit committee effectiveness. Working Paper, The University of Tennessee.

-----, C.W. Hollingsworth, A. Klein, and T.L. Neal. 2008b. Audit committee financial expertise, competing governance mechanisms, and earnings management. Working Paper, The University of Tennessee.

-----, B.T. Carver, M. Hoag, and T.L. Neal. 2008c. It's good to be the king: Founding CEOs, executive options backdating, and corporate governance. Working Paper, The University of Tennessee.

-----, and T.L. Neal. 2000. Audit committee composition and auditor reporting. *The Accounting Review* 75 (October): 453-467.

-----, and T.L. Neal. 2003. Audit committee characteristics and auditor dismissals following "new" going-concern reports. *The Accounting Review* 78 (January): 95-117.

Carver, B.T., C.W. Hollingsworth, and J. Stanley. 2009. Recent changes in auditor market shares and the financial reporting quality of clients that switch auditors. Working Paper, Clemson University.

Cohen, J., G. Krishnamoorthy, and A. Wright. 2008. Corporate governance in the post-Sarbanes-Oxley era: Auditor experiences. Working Paper, Boston College.

Coles, J.L., and C. Hoi. 2003. New evidence on the market for directors: Board membership and Pennsylvania Senate Bill 1310. *The Journal of Finance* 58 (February): 197-230.

Collins, D.W., and S.P. Kothari. 1989. An analysis of intertemporal and cross-sectional determinants of earnings response coefficients. *Journal of Accounting and Economics* 11: 143-181.

Davidson, III, W.N., B. Xie, and W. Xu. 2004. Market reaction to voluntary announcements of audit committee appointments: The effect of financial expertise. *Journal of Accounting and Public Policy* 23: 279-293.

Dechow, P.M., R.G. Sloan, and A.P. Sweeney. 1995. Detecting earnings management. *The Accounting Review* 70 (April): 193-225.

-----, -----, and ----- . 1996. Causes and consequences of earnings manipulation: An analysis of firms subject to enforcement actions by the SEC. *Contemporary Accounting Research* 13 (Spring): 1-36.

DeFond, M.L., and K.R. Subramanyam. 1998. Auditor changes and discretionary accruals. *Journal of Accounting and Economics* 25: 35-67.

DeFond, M.L., R.N. Hann, and X. Hu. 2005. Does the market value financial expertise on audit committees of board of directors? *Journal of Accounting Research* 43 (May): 153-193.

Desai, H., C. Hogan, and M. Wilkins. 2006. "The reputational penalty for aggressive accounting: Earnings restatements and managerial turnover." *The Accounting Review* 81(1): 83-112.

DeZoort, F.T., D.R. Hermanson, and R.W. Houston. 2007. Audit committee member support for proposed audit adjustments: Pre-SOX versus post-SOX judgments. *Auditing: A Journal of Practice & Theory* (Forthcoming).

Dunn, P. 2004. The impact of insider power on fraudulent financial reporting. *Journal of Management* 30: 397-412.

Fama, E.F. 1980. Agency problems and the theory of the firm. *Journal of Political Economy* 88: 288-307.

-----, and M.C. Jensen. 1983. Separation of ownership and control. *Journal of Law and Economics* 26 (June): 301-325.

Farber, D.B. 2005. Restoring trust after fraud: Does corporate governance matter? *The Accounting Review* 80 (April): 539-561.

Farrell, K.A., and D.A. Whidbee. 2000. The consequences of forced CEO succession for outside directors. *Journal of Business* 73: 597-627.

Ferris, S.P., M. Jagannathan, and A.C. Pritchard. 2003. Too busy to mind the business? Monitoring by directors with multiple board appointments. *The Journal of Finance* 58 (June): 1087-1111.

- Fich, E.M., and A. Shivdasani. 2007. Financial fraud, director reputation, and shareholder wealth. *Journal of Financial Economics* 86 (November): 306-336.
- , and L.J. White. 2003. CEO compensation and turnover: The effects of mutually interlocked boards. *Wake Forest Law Review* 38: 935.
- Freeman, R.N., and S. Tse. 1989. The multiperiod information content of accounting earnings: Confirmations and contradictions of previous earnings reports. *Journal of Accounting Research* 27 (Supplement): 49-79.
- General Accounting Office. 2002. Financial statement restatements: Trends, market impacts, regulatory responses, and remaining challenges, GAO-03-138.
- General Accounting Office. 2006. Financial restatements: Update of public company trends, market impacts, and regulatory enforcement activities, GAO-06-678.
- Gilson, S.C. 1990. Bankruptcy, boards, banks, and blockholders. *Journal of Financial Economics* 27: 355-387.
- Harford, J. 2003. Takeover bids and target directors' incentives: The impact of a bid on directors' wealth and board seats. *Journal of Financial Economics* 69: 51-83.
- Helland, E. 2006. Reputational penalties and the merits of class-action securities litigation. *Journal of Law and Economics* 49 (October): 365-395.
- Hennes, K.M., A.J. Leone, and B.P. Miller. 2008. The importance of distinguishing errors from irregularities in restatement research: The case of restatements and CEO/CFO turnover. *The Accounting Review* 83: 1487-1519.
- Hermalin, B.E., and M.S. Weisbach. 1988. The determinants of board composition. *RAND Journal of Economics* 19 (Winter): 589-606.
- Hogan, C.E., and D.C. Jeter. 1999. Industry specialization by auditors. *Auditing: A Journal of Practice & Theory* 18 (Spring): 1-17.
- Hribar, P., and D.W. Collins. 2002. Errors in estimating accruals: Implications for empirical research. *Journal of Accounting Research* 40 (March): 105-134.
- Jensen, M. C. and W. H. Meckling. 1976. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3: 305-360.
- , 1993. The modern industrial revolution, exit and failure of internal control systems. *Journal of Finance* 48: 831-880.

- Kinney, W.R., and L.S. McDaniel. 1989. Characteristics of firms correcting previously reported quarterly earnings. *Journal of Accounting and Economics* 11: 71-93.
- Klein, A. 2002a. Audit committee, board of director characteristics, and earnings management. *Journal of Accounting and Economics* 33: 375-400.
- Klein, A. 2002b. Economic determinants of audit committee independence. *The Accounting Review* 77 (April): 435-452.
- Kothari, S.P., A.J. Leone, and C.E. Wasley. 2005. Performance matched discretionary accruals measures. *Journal of Accounting and Economics* 39: 163-197.
- , 2001. Capital markets research in accounting. *Journal of Accounting and Economics* 31: 105-231.
- Lipton, M., and J. W. Lorsch. 1992. A modest proposal for improved corporate governance. *Business Lawyer* 48: 59-77.
- Lee, H.Y., V. Mande, and R. Ortman. 2004. The effect of audit committee and board of director independence on auditor resignation. *Auditing: A Journal of Practice & Theory* 23 (September): 131-146.
- Moore, E.A., and R.J. Pheifer. 2004. The effects of financial statement restatements on firms' financial reporting strategies. Working Paper, University of Massachusetts.
- New York Stock Exchange (NYSE), 2005. Listed Company Manual. New York, NY: NYSE. Available at: <http://www.nyse.com/Frameset.html?displayPage=/about/listed/1022221393251.html>
- Palmrose, Z., and S. Scholz. 2004. The circumstances and legal consequences of non-GAAP reporting: Evidence from restatements. *Contemporary Accounting Research* 21 (Spring): 139-180.
- , V.J. Richardson, and S. Scholz. 2004. Determinants of market reactions to restatement announcements. *Journal of Accounting and Economics* 37: 59-89.
- Pincus, K., M. Rusbarsky, and J. Wong. 1989. Voluntary formation of corporate audit committees among NASDAQ firms. *Journal of Accounting and Public Policy* 8: 239-265.
- Richardson, S.A. 2005. Discussion of consequences of financial reporting failure for outside directors: Evidence from accounting restatements and audit committee members. *Journal of Accounting Research* 43 (May): 335-342.
- Sarbanes-Oxley Act of 2002, Public Law 107-204, 107<sup>th</sup> Cong., 2nd session. 24 July.

- Shivdasani, A., and D. Yermack. 1999. CEO involvement in the selection of new board members: An empirical analysis. *The Journal of Finance* 54 (October): 1829-1853.
- Srinivasan, S. 2005. Consequences of financial reporting failure for outside directors: Evidence from accounting restatements and audit committee members. *Journal of Accounting Research* 43 (May): 291-334.
- The Conference Board. 2003. *Commission on Public Trust and Private Enterprise: Findings and Recommendations*. New York.
- The NASDAQ Stock Market, Inc. 2005. NASD Manual Online. Rockvale, MD. Available at: <http://nasd.complinet.com/nasd/display/index.html>.
- Thomas, L. 2005. The ties that bind at Morgan Stanley. *New York Times*, 24 April.
- Wade, J., C.A. O'Reilly, III, and I. Chandratat. 1990. Golden parachutes, CEOs, and the exercise of social influence. *Administrative Science Quarterly* 35: 587-603.
- Yermack, D. 2004. Remuneration, retention and reputation incentives for outside directors. *The Journal of Finance* 59 (October): 2281-2308.
- Zmijewski, M.E. 1984. Methodological issues related to the estimation of financial distress prediction models. *Journal of Accounting Research* 22 (Supplement): 59-82.

**Table 1****Sample Selection of Restating and Matching Firms****Panel A: Selection of Restatement Sample**

	<u>n</u>
All firms with negative income adjusting restatement preceded by another restatement	143
<b>Less:</b>	
Firms not listed on Compustat	5
Firms not listed on CRSP	7
Firms with insufficient data for match	6
Firms without a suitable match	1
Firms without any proxy data	10
Firms with insufficient proxy data	<u>20</u>
<b>Final Sample of Restating Firms</b>	<b>94</b>

**Panel B: SIC Digit Match**

<u>SIC Digits Used in Match</u>	<u>Number of Firms</u>	<u>Percent of Sample</u>	<u>Cumulative Percentage</u>
4	43	45.74%	45.74%
3	18	19.15%	64.89%
2	18	19.15%	84.04%
1	15	15.96%	100.00%

**Panel C: Assets (Millions)**

<u>Variable</u>	<u>Restate</u>	<u>Non-Restate</u>	<u>Difference</u>	<u>p Value</u>
<i>Assets</i>	3803.62	3707.548	96.072	0.9277

**Panel D: Auditor Match**

<u>Matched on Auditor</u>	<u>Number of Firms</u>	<u>Percent of Sample</u>
Yes	38	40.43%
No	56	59.57%

## Table 2 Variable Definitions

*RETENTION* = 1 if the director is retained on the audit committee;

*PAAC* = performance adjusted accruals;

*SUB\_REST* = 1 if the firm experiences a subsequent restatement;

*AC\_RETAINED* = 1 if all of the audit committee remains in place in the second year following the restatement;

*BOSS* = 1 if the positions of CEO and chairman are combined;

*CEO\_FOUNDER* = 1 if the CEO is the founder of the company or part of the founding family;

*CEO\_INVOLVE\_NC* = 1 if the CEO is involve in the nominating process;

*CEO\_TIE* = 1 if the audit committee member shares ties with the CEO outside the board of the restating firm;

*CEO\_TENURE* = the number of concurrent years that the CEO has served in that position at the time of the restatement;

*CEO\_APT\_BOD* = 1 if the audit committee member's tenure begins after that of the CEO;

*CEO\_TURNOVER* = 1 if the CEO is not retained by the firm in any capacity;

*SIZE* = the natural log of the total assets of the firm;

*MVE* = the natural log of the market value of equity;

*LITIGATION* = 1 if the firm is in a highly litigious industry [Hogan and Jeter (1999)];

*FIRM\_AGE* = number of years firm is listed on Compustat;

*BOARD\_SIZE* = the number of directors on the board at the time of the restatement;

*PCT\_OUTSIDE* = the percentage of outside directors on the board at the time of the restaement;

*CLASSIFIED* = 1 if members of the board of directors serve staggered terms;

*IND* = 1 if the audit committee is completely independent of management at the time of the restatement;

*MIN\_SIZE* = 1 if the audit committee has three or more members at the time of the restatement;

*EXPERT* = 1 if the audit committee contains at least one person with financial expertise at the time of the restatement;

*MIN\_MEET* = 1 if the audit committee met at least 4 times in the year of the restatement;

*DUM*<sub>0,1,2</sub> = 1 in the year of the restatement, the first year following the restatement, or the second year following the restatement;

*DUM*<sub>1,2</sub> = 1 in either the first or second year following the restatement;

*DUM*<sub>2</sub> = 1 in the second year following the restatement;

*M/B* = the market value of the firm scaled by the lagged book value of the firm;

*DISTRESS* = Zmijewski's (1984) financial condition index;

*OCF* = cash flows from operations scaled by lagged total assets;

*LEVERAGE* = total debt scaled by lagged total assets;

*BIG4* = 1 if the firm is audited by a Big 4 firm;

*FINANCE* = 1 if the firm engaged in a merger or required financing in the year of the restatement;

*MGT\_OWN* = the combined ownership of the inside directors in the year of the restatement;

*OUT\_OWN* = the combined ownership of the outside directors in the year of the restatement;

*AGE* = the age of the audit committee member;

*TENURE* = the number of years the director has served on the board;

*FIN\_EXPERT* = 1 if the audit committee member is identified as the audit committee financial expert at the time of the restatement;

*OUTSIDE\_CEO* = 1 if the audit committee member is the CEO at another company;

*DIR\_OWN* = the percentage of the common stock owned by the audit committee member at the time of the restatement;

## Table 2 Continued

*DIR\_GAIN* = 1 if the audit committee member has a net gain of at least one outside directorship following the restatement announcement;

*TA* = total accruals computed following Hribar and Collins (2002);

*ΔREV* = one year change in net sales;

*ΔREC* = one year change in net receivables;

*PPE* = gross property, plant, and equipment;

*CF* = operating cash flow; and

*DCF* = 1 if operating cash flow is less than zero.

**Table 3**  
**Descriptive Statistics by Restating and Non-Restating Firms**

<u>Variable</u>	<u>Restate</u>	<u>Non-Restate</u>	<u>Difference</u>
<i>RETENTION</i>	0.808	0.831	-0.024
<i>BOSS</i>	0.543	0.543	0.000
<i>CEO_FOUNDER</i>	0.245	0.277	-0.032
<i>CEO_INVOLVE_NC</i>	0.149	0.170	-0.021
<i>CEO_TIE</i>	0.120	0.087	0.033
<i>CEO_TENURE</i>	5.830	7.702	-1.872 *
<i>CEO_APT_BOD</i>	0.438	0.446	-0.007
<i>CEO_TURNOVER</i>	0.277	0.117	0.160 ***
<i>SIZE</i>	3803.620	3707.548	96.072
<i>LITIGATION</i>	0.479	0.500	-0.021
<i>FIRM_AGE</i>	19.074	19.362	-0.287
<i>BOARD_SIZE</i>	8.064	8.149	-0.085
<i>PCT_OUTSIDE</i>	0.628	0.637	-0.009
<i>CLASSIFIED</i>	0.457	0.521	-0.064
<i>AGE</i>	58.905	59.898	-0.992
<i>TENURE</i>	5.584	6.605	-1.022 **
<i>FIN_EXPERT</i>	0.388	0.343	0.045
<i>OUTSIDE_CEO</i>	0.174	0.160	0.014
<i>DIR_OWN</i>	0.002	0.007	-0.005 **
<i>DIR_GAIN</i>	0.136	0.139	-0.003

\*,\*\* Significant at the 0.10 and 0.05 levels, respectively, based on two-tailed tests.

**Table 4**  
**Probit Regression of Audit Committee Retention on Variables Indicative of the CEO's Influence over the Audit Committee, Variables Indicative of the Quality of the Audit Committee Member, and Other Control Variables**

<u>Variable</u>	Dependent Variable:	
	Retention on the Audit Committee	
	<u>Non-Restate</u>	<u>Restate</u>
	<u>Coefficient</u>	<u>Coefficient</u>
<i>BOSS</i>	0.0620	-0.5484 **
<i>CEO_FOUNDER</i>	-0.1060	0.7002
<i>CEO_INVOLVE_NC</i>	-0.6243 **	-0.0496
<i>CEO_TIE</i>	-0.3575	-0.6053 **
<i>CEO_TENURE</i>	0.0365 **	-0.0103
<i>CEO_APT_BOD</i>	-0.3314	-0.2291
<i>CEO_TURNOVER</i>	-0.2186	-0.1007
<i>SIZE</i>	-0.1050	0.0833
<i>LITIGATION</i>	-0.0077	-0.3691
<i>FIRM_AGE</i>	0.0051	-0.0051
<i>BOARD_SIZE</i>	0.0650	-0.0967
<i>PCT_OUTSIDE</i>	0.6340	1.3787 **
<i>CLASSIFIED</i>	0.0222	0.2116
<i>AGE</i>	-0.0126	0.0051
<i>TENURE</i>	-0.0133	-0.0147
<i>FIN_EXPERT</i>	0.6716 ***	0.5209 **
<i>OUTSIDE_CEO</i>	0.0523	0.1835
<i>DIR_OWN</i>	1.1036	6.7269
<i>DIR_GAIN</i>	1.0144 **	0.5105
<i>n</i>	649	
<i>Wald <math>\chi^2</math></i>	73.19	
<i>Prob &gt; <math>\chi^2</math></i>	0.0007	
<i>Pseudo R<sup>2</sup></i>	0.1349	

\*, \*\*, \*\*\* Significant at the 0.10, 0.05, and 0.01 levels, respectively, based on two-tailed tests.

**Table 5**  
**Descriptive Statistics for Accruals Analysis**

**Panel A: Control Variables<sup>a</sup>**

<u>Variable</u>	<u>Retain All of Audit Committee</u>	<u>Do Not Retain All of Audit Committee</u>	<u>Difference</u>
<i>MVE</i>	5.944	5.983	-0.039
<i>M/B</i>	1.767	1.892	-0.125
<i>DISTRESS</i>	-2.811	-2.539	-0.271
<i>OCF</i>	-0.016	-0.028	0.012
<i>LEVERAGE</i>	0.242	0.339	-0.097 **
<i>BIG4</i>	0.767	0.743	0.023

**Panel B: Discretionary Accruals**

	<u>Year -1</u>	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year -1 to Year 0</u>	<u>Year 0 to Year 1</u>	<u>Year 1 to Year 2</u>
Retain All of Audit Committee	-0.0011	-0.0271	0.0368	0.1166	-0.0260	0.0639	0.0797
Do Not Retain All of Audit Committee	-0.0834	-0.0797	0.0906	-0.0108	0.0037	0.1704	-0.1014
Difference	0.0823	0.0526	-0.0538	0.1274	-0.0297	-0.1064	0.1812

\*\* Significant at the 0.05 level based on two-tailed tests.

<sup>a</sup>The values presented are the mean value for the control variables.

**Table 6**  
**Comparison of Financial Reporting Quality between Restating Companies that Retain All Directors on the Audit Committee Following a Restatement Announcement and Restating Companies that Remove at least One Director from the Audit Committee**

**Panel A: Regression Results**

<b>Variable</b>	<b>Retain All of AC</b>		<b>Do Not Retain All of AC</b>	
	<b>Coefficient</b>	<b>t-Stat</b>	<b>Coefficient</b>	<b>t-Stat</b>
<i>Intercept</i>	-0.0228	-0.25	0.0004	0.00
<i>Dum<sub>0,1,2</sub></i>	-0.0200	-0.30	-0.0067	-0.06
<i>Dum<sub>1,2</sub></i>	0.0461	0.67	0.1560	1.31
<i>Dum<sub>2</sub></i>	-0.0007	-0.01	-0.0810	-0.67
<i>Size</i>	0.0049	0.38	-0.0083	-0.33
<i>M/B</i>	-0.0015	-0.16	-0.0768	-2.99 ***
<i>OCF</i>	-0.7223	-12.36 ***	-0.1651	-1.32
<i>Distress</i>	-0.0360	-3.72 ***	-0.0300	-1.57
<i>Leverage</i>	-0.0200	-0.17	0.2694	1.22
<i>Big4</i>	-0.1168	-1.57	-0.0670	-0.58
<i>n</i>	119		145	
<i>F Statistic</i>	20.14		3.07	
<i>Prob. &gt;F</i>	<0.01		<0.01	
<i>R<sup>2</sup></i>	0.6245		0.1699	

**Panel B: Discretionary Accruals Levels and Changes Derived from OLS Regression**

<b>Year Relative to Restatement Announcement</b>	<b>Retain All of AC</b>	<b>Do Not Retain All of AC</b>	<b>Difference</b>
Year -1	-0.0228	0.0004	-0.0232
Year -1 to Year 0	-0.0200	-0.0067	-0.0133
Year 0	-0.0428	-0.0063	-0.0365
Year 0 to Year 1	0.0461	0.1560	-0.1099
Year 1	0.0033	0.1497	-0.1464
Year 1 to Year 2	-0.0007	-0.0810	0.0803
Year 2	0.0026	0.0687	-0.0661

\*\*\* Significant at the 0.01 levels based on two-tailed tests.

**Table 7**  
**Descriptive Statistics for Restating Firms Removing at Least One Director from the Audit Committee and Restating Firms Maintaining the Entire Audit Committee in Place**

<b>Variable</b>	<b>Retain All of AC</b>	<b>Do Not Retain All of AC</b>	<b>Difference</b>
<i>SUB_REST</i>	0.2051	0.0909	0.114
<i>IND</i>	0.6154	0.5455	0.070
<i>MIN_SIZE</i>	0.9487	0.9273	0.021
<i>EXPERT</i>	0.7692	0.7455	0.024
<i>MIN_MEET</i>	0.8718	0.8000	0.072
<i>BOARD_SIZE</i>	8.0513	8.0727	-0.021
<i>PCT_OUTSIDE</i>	0.6491	0.6137	0.035
<i>OUT_OWN</i>	0.0129	0.0140	-0.001
<i>FINANCE</i>	0.1795	0.2727	-0.093
<i>BOSS</i>	0.4103	0.6364	-0.226 **
<i>MGT_OWN</i>	0.1539	0.1339	0.020
<i>CEO_FOUNDER</i>	0.2564	0.2364	0.020
<i>SIZE</i>	4797.1470	3099.1180	1698.029
<i>Big4</i>	0.8462	0.7091	0.137

\*, \*\*, \*\*\* Significant at the 0.05 level based on two-tailed tests.

**Table 8**  
**Probit Regression of Subsequent Negative, Income Adjusting Restatement on**  
**Variable Indicating Whether the Entire Audit Committee was Retained Following a**  
**Restatement and Control Variables**

<b>Variable</b>	<b>Dependent Variable:</b>	
	<b>Coefficient</b>	<b>Z-Stat</b>
<i>Intercept</i>	-0.9305	-0.62
<i>AC_RETAINED</i>	0.7693	1.53
<i>IND</i>	-0.6293	-1.13
<i>MIN_SIZE</i>	-2.3732	-1.92 *
<i>EXPERT</i>	-0.5919	-1.07
<i>MIN_MEET</i>	1.2826	1.31
<i>BOARD_SIZE</i>	0.5312	2.64 ***
<i>PCT_OUTSIDE</i>	-0.2903	-0.20
<i>OUT_OWN</i>	5.3178	0.92
<i>FINANCE</i>	-1.1659	-1.57
<i>BOSS</i>	-0.7303	-1.30
<i>MGT_OWN</i>	-1.0342	-0.84
<i>CEO_FOUNDER</i>	0.0571	0.05
<i>SIZE</i>	-0.4002	-1.77 *
<i>Big4</i>	-0.0911	-0.10
<i>n</i>	94	
<i>Wald <math>\chi^2</math></i>	28.29	
<i>Prob &gt; <math>\chi^2</math></i>	0.0130	
<i>Pseudo R<sup>2</sup></i>	0.3744	

\*,\*\*\* Significant at the 0.10 and 0.01 levels, respectively, based on two-tailed tests.

**Table 9**  
**Probit Regression of Audit Committee Retention on Variables Indicative of the CEO's Influence over the Audit Committee, the Quality of the Firm's Relative Governance Structure, Variables Indicative of the Quality of the Audit Committee Member, and Other Control Variables**

<u>Variable</u>	<u>Dependent Variable: Retention on Audit Committee</u>			
	<u>Weak Gov./</u> <u>Non-Restate</u>	<u>Strong Gov./</u> <u>Non-Restate</u>	<u>Weak Gov./</u> <u>Restate</u>	<u>Strong Gov./</u> <u>Restate</u>
	<u>Coefficient</u>	<u>Coefficient</u>	<u>Coefficient</u>	<u>Coefficient</u>
<i>CEO_FOUNDER</i>	-0.2177	0.0794	0.4417	0.5699
<i>CEO_TIE</i>	-0.4127	-0.2898	-1.3350 ***	-0.3923
<i>CEO_TENURE</i>	0.0004	0.0435 *	-0.0546	-0.0152
<i>CEO_APT_BOD</i>	0.0236	-0.6512 **	0.1646	-0.5265 *
<i>CEO_TURNOVER</i>	0.0198	-0.8477 ***	-0.0308	-0.1536
<i>LITIGATION</i>	0.3990	-0.0856	-0.8577 **	-0.2542
<i>FIRM_AGE</i>	0.0186	0.0066	0.0059	-0.0083
<i>CLASSIFIED</i>	0.3235	-0.1126	0.3441	0.4692 *
<i>AGE</i>	-0.0362	-0.0047	-0.0241	0.0161
<i>TENURE</i>	0.0486	-0.0309	-0.0315	-0.0043
<i>FIN_EXPERT</i>	0.9347 **	0.6571 **	-0.0411	0.9270 ***
<i>OUTSIDE_CEO</i>	-0.1770	-0.0045	-0.3658	0.3854
<i>DIR_OWN</i>	24.0979	1.7702	82.7852 ***	-3.2876
<i>n</i>	649			
<i>Wald <math>\chi^2</math></i>	101.20			
<i>Prob &gt;<math>\chi^2</math></i>	<0.001			
<i>Pseudo R<sup>2</sup></i>	0.1436			

\*, \*\*, \*\*\* Significant at the 0.10, 0.05, and 0.01 levels, respectively, based on two-tailed tests.

**Table 10**  
**Probit Regression of Audit Committee Retention on Variables Indicative of the CEO's Influence over the Audit Committee, Variables Indicative of the Quality of the Audit Committee Member, and Other Control Variables for Irregular Restatements and Matched Firms**

<u>Variable</u>	Dependent Variable:	
	Retention on the Audit Committee	
	Non-Restate	Restate
	Coefficient	Coefficient
<i>BOSS</i>	0.1344	-1.0736 **
<i>CEO_FOUNDER</i>	0.3500	-1.0568 *
<i>CEO_INVOLVE_NC</i>	-0.5961	2.7714 ***
<i>CEO_TIE</i>	-0.9050	-0.7110 *
<i>CEO_TENURE</i>	-0.0256	0.0578 *
<i>CEO_APT_BOD</i>	-0.0707	-0.3605
<i>CEO_TURNOVER</i>	-0.3687	-0.7297 *
<i>SIZE</i>	-0.0990	0.2357 *
<i>LITIGATION</i>	-0.0669	-0.0196
<i>FIRM_AGE</i>	0.0064	-0.0300 **
<i>BOARD_SIZE</i>	0.0869	0.0519
<i>PCT_OUTSIDE</i>	-0.5040	6.6160 ***
<i>CLASSIFIED</i>	-0.1215	0.2652
<i>AGE</i>	0.0110	-0.0037
<i>TENURE</i>	-0.0070	-0.0473
<i>FIN_EXPERT</i>	1.1321 **	0.8959 *
<i>OUTSIDE_CEO</i>	0.2673	-0.3087
<i>DIR_OWN</i>	236.8906 ***	41.3642
<i>DIR_GAIN</i>	6.0131 ***	-0.1966

\*, \*\*, \*\*\* Significant at the 0.10, 0.05, and 0.01 levels, respectively, based on two-tailed tests.