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The Lack of Consequences for Audit Committee Members Following Accounting Restatements and the Resulting Impact on Investors

A Dissertation
Presented for the
Doctor of Philosophy
Degree
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Brian Todd Carver
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Dedication

This dissertation is dedicated to my wife, Dede, and my children, Matthew, Rebecca, Daniel, and Joshua for their sacrifices throughout this process and for their constant encouragement.

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Abstract

Prior research has assumed that financial reporting failures indicate that individual directors have provided inferior monitoring of the reporting process and has found that directors suffer the loss of board positions following reporting failures. These penalties, however, are not uniformly applied across all outside directors. Using a sample of firms that have experienced multiple reporting failures and a matched sample of non-restating firms, I collect information on individual audit committee members and investigate whether retention on the audit committee is related to the quality of the director or to the influence of the CEO over the board of directors. I then examine whether the retention of directors on the audit committee is related to further aggressive accounting practices and to additional negative consequences for investors in the long run. I find 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. I further find that the retention of directors on the audit committee following a reporting failure is not related to future aggressive accounting practices. Test examining other long-term consequences to investors are inconclusive. Overall, these results suggest that the labor market for directors operates in an efficient and effective manner.

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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.[1] 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

[1] 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.

in an ex-post settling up process to take corrective action against those that are determined to be ineffective monitors.

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)].[2] Consistent with this assertion, Carcello et al. (2008a) present evidence indicating that CEO involvement in the

[2] 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.

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 continued aggressive accounting practices [Moore and Pheifer (2004)], earnings reports with lower information content [Anderson and Yohn (2002) and Wilson (2008)], and increases in systematic risk.

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.[3] My results suggest that the audit committee members of firms announcing a restatement do not

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

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 and the nominating process 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.

In order to examine the potential long-term consequences of retaining tainted directors on the audit committee, I calculate abnormal accruals, earnings response coefficients, and systematic risk for all sample firms. Similar to DeFond and Subramanyam (1998) and Carver et al. (2008), a multivariate setting is used to examine accruals behavior over time and comparisons among groups will be 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. Similar to Wilson (2008), I then examine the relation between abnormal returns and unexpected earnings in a multivariate setting to determine whether the informativeness of earnings is influenced by the retention of tainted audit committee. The results indicate that firms retaining a majority of directors on the audit committee do not have lower information quality in announced earnings. Finally, I examine whether firms retaining tainted audit committee members have higher levels of systematic risk following the announcement of a restatement. The results indicate that no differences exist in the change in systematic risk over the two-year period following the announcement of a restatement for the differential

groups of restating firms. 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 posses 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 and audit committee members 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 that 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.[4] 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

[4] 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.

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.[5] 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 management and to improve the reporting process, and who,

[5] 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.

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.

A third motivation for a CEO to cause a tainted director to be retained on the audit committee is that the agent wishes to exploit the individual director's penchant for laxity in the oversight of the financial reporting process to engage in the 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 desire on the part of a CEO to continue engaging in a strategy that could result in another restatement may provide the impetus for the agent to bring about the retention of tainted audit committee members.

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.

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

H1a: The retention of tainted directors on the audit committee is related to the authority of the CEO.

H1b: The retention of tainted directors on the audit committee is related to director quality.

H2: Financial reporting quality is related to the retention of tainted directors on the audit committee.

If inefficiencies exist in the labor market for directors, retaining a tainted director on the audit committee may benefit the manager of a firm, while it is likely to have negative long-term consequences for the shareholders of the firm. Restatements, by their nature, cause revisions in past and future earnings, increase uncertainty concerning the integrity of management and the quality of future earnings, and provide information about the past practices of management. As a result, investors are likely to revise their perceptions of financial statement risk causing future earnings announcements to be viewed more skeptically, and market participants are likely to reassess a firm's systematic risk based on the nature of the firms actions following the restatememt. Consistent with this idea, Anderson and Yohn (2002) and Wu (2002) indicate that the

information content of earnings is lower following a restatement, and Cloninger and Waller (2000) indicate that, following the announcement of fraud, systematic risk remains unchanged only in those cases where management's purpose in committing the fraud was to expropriate shareholder wealth.

The faith investors place in the reported financial figures that is lost following a reporting failure can, however, be restored. Farber (2005) finds that firms who have engaged in fraudulent financial reporting are able to regain a portion of the investors' trust lost through fraudulent activity by improving corporate governance. In addition, Wilson (2008) indicates that investors' concerns about the informativeness of earnings diminish rather quickly following a restatement with earnings response coefficients returning to pre-restatement levels in four quarters on average, and Cloniger and Waller (2000) indicate that systematic risk is lowered following the announcement of fraud when corrective actions are taken. Thus, the negative consequences experienced by investors following a restatement may be able to be reversed if actions are taken to reduce the risk that the reported financial numbers are not reflective of the true financial position of the company.

In the presence of an efficient labor market, retaining tainted directors on the audit committee indicates to investors that those directors possess the necessary characteristics to ensure that quality is maintained in the monitoring function. Consequently, investors are not likely to view changes in perceived financial statement risk, the quality of future earnings, and a firm's systematic risk differentially based on the perceived level of corrective action taken against individual directors. This leads to the following additional hypotheses:

H3: Earnings response coefficients are related to the retention of tainted directors on the audit committee.

H4: Subsequent measures of systematic risk are 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.[6] 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 either the CRSP or Compustat databases, 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

[6] 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.

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 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.

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.[7] The data requirements imposed on the sample for inclusion result in an additional 54 firms being dropped from the sample. As a result, the final sample is made up of 70 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. (Tables are located in the appendix.)

Models

[7] 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.

In order to test hypothesis 1, 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 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:

$$\begin{aligned} RETENTION = {} & \beta_0 + \beta_1 BOSS + \beta_2 CEO\_FOUNDER + \\ & \beta_3 CEO\_INVOLVE\_NC + \beta_4 CEO\_TIE + \beta_5 CEO\_TENURE \\ & + \beta_6 CEO\_APT\_BOD + \beta_7 SIZE + \beta_8 LITIGATION \\ & + \beta_9 BOARD\_SIZE + \beta_{10} PCT\_OUTSIDE + \beta_{11} AGE \\ & + \beta_{12} TENURE + \beta_{13} FIN\_EXPERT + \beta_{14} OUTSIDE\_CEO \\ & + \beta_{15} DIR\_OWN + \beta_{16} DIR\_GAIN \\ & + \beta_{17} RESTATE * BOSS + \beta_{18} RESTAE * CEO\_FOUNDER \\ & + \beta_{19} RESTATE * CEO\_INVOLVE\_NC \\ & + \beta_{20} RESTATE * CEO\_TIE + \beta_{21} RESTATE * CEO\_TENURE \\ & + \beta_{22} RESTATE * CEO\_APT\_BOD \\ & + \beta_{23} RESTATE * SIZE + \beta_{24} RESTATE * LITIGATION \\ & + \beta_{25} RESTATE * BOARD\_SIZE \\ & + \beta_{26} RESTATE * PCT\_OUTSIDE + \beta_{27} RESTATE * AGE \\ & + \beta_{28} RESTATE * TENURE + \beta_{29} RESTATE * FIN\_EXPERT \\ & + \beta_{30} RESTATE * OUTSIDE\_CEO + \beta_{31} RESTATE * DIR\_OWN \\ & + \beta_{32} RESTATE * DIR\_GAIN + \beta_{33} RESTATE + \varepsilon \end{aligned} \tag{1}$$

where

RETENTION = 1 if the tainted director is retained on the audit committee, else 0;

BOSS = 1 if the positions of chairman and CEO are combined, else 0;

CEO_FOUNDER	= 1 if the CEO is the founder of the company or is part of the founding family, else 0;
CEO_INVOLVE_NC	= 1 if CEO is involved in the nominating process, else 0;
CEO_TIE	= 1 if the audit committee member shares ties with the CEO outside the board of directors of the restating firm, else 0[8];
CEO_TENURE	= the number of concurrent years that the CEO has served in that position at the time of the restatement announcement;
CEO_APT_BOD	= 1 if the audit committee member's tenure begins after that of the CEO, else 0;
SIZE	= the natural log of the total assets of the firm (Compustat #6);
LITIGATION	= 1 if the firm is in a highly litigious industry as defined by the firm's two-digit SIC code at the time of the restatement [(Hogan and Jeter (1999)], else 0;
BOARD_SIZE	= the number of directors serving on the board at the time of the restatement announcement;
PCT_OUTSIDE	= the percentage of outside directors on the board at the time of the restatement announcement;
AGE	= the age of the audit committee member;

[8] Ties between the CEO and audit committee members 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.

TENURE	= the number of years that the audit committee member has served on the board of directors;
FIN_EXPERT	= 1 if the audit committee member is identified as the audit committee financial expert in the year of the restatement, else 0;
OUTSIDE_CEO	= 1 if the audit committee member is the CEO at another company, else 0;
DIR_OWN	= percentage of firm's common stock owned by the audit committee member;
DIR_GAIN	= 1 if the audit committee member has a net gain of at least one outside directorship following the issuance of restated financial statements, else 0; and
RESTATE	=1 if the firm experience a restatement of the financial statements, else 0.

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)], and *CEO_TENURE* [Hermalin and Weisbach (1988)] 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.[9]

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.[10] 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),

[9] 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.

[10] 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.

the size of the board (no prediction) [Lipton and Lorsch (1992) and Jensen (1993)], and the percentage of the board that is independent of management (negative) [Beasley (1996), Dechow et al. (1996), and Klein (2002a)]. 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 2, 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:

$$\frac{TA_{ij}}{A_{ijt-1}} = \alpha_{1ij}\left(\frac{1}{A_{ijt-1}}\right) + \alpha_{2ij}\left[\frac{\Delta REV_{ij} - \Delta REC_{ij}}{A_{ijt-1}}\right] + \alpha_{3ij}\left(\frac{PPE_{ij}}{A_{ijt-1}}\right) + \alpha_{4ij}\left(\frac{CF_{ij}}{A_{ijt-1}}\right) + \alpha_{5ij}\left(\frac{DCF_{ij}}{A_{ijt-1}}\right) + \alpha_{6ij}\left(\frac{CF_{ij} * DCF_{ij}}{A_{ijt-1}}\right) + \varepsilon_{ij} \quad (2)$$

where

TA_{ij} = total accruals for firm *i* in industry *j* [Compustat #123 – (Compustat #308 - Compustat #124)] [Hribar and Collins (2002)];

A_{ijt-1} = lagged total assets for firm *i* in industry *j* (Compustat #6);

ΔREV_{ij} = the change in revenues from year *t-1* to year *t* for firm *i* in industry *j* (Compustat#12);

ΔREC_{ij} = the change in net receivables from year *t-1* to year *t* for firm *i* in industry *j* (Compustat #2);

PPEij = the gross property, plant, and equipment for firm *i* in industry *j* (Compustat #7);

CF_{ij} = cash flow from operations for firm *i* in industry *j* (Compustat #308)

DCF_{ij} = 1 if CF_{ij} <0, else 0;

CF_{ij}*DCF_{ij} = interaction between CF_{ij} and DCF_{ij}; and

ε_{ij} = the error term.

Consistent with Butler et al. (2004) and Kothari et al. (2005), all variables are winsorized at the 1st and 99th 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 parameter estimates obtained from estimating equation 2 are then used to calculate expected accruals as follows:

$$\frac{EA}{A_{t-1}} = \hat{\alpha}_1\left(\frac{1}{A_{t-1}}\right) + \hat{\alpha}_2\left[\frac{\Delta REV \ - \Delta REC}{A_{t-1}}\right] + \hat{\alpha}_3\left(\frac{PPE}{A_{t-1}}\right) + \hat{\alpha}_4\left(\frac{CF}{A_{t-1}}\right) + \hat{\alpha}_5\left(\frac{DCF}{A_{t-1}}\right) + \hat{\alpha}_6\left(\frac{CF \ * DCF}{A_{t-1}}\right) \quad (3)$$

Each firm's unadjusted abnormal accruals are then calculated as the difference between total accruals, TA/A_{t-1}, and expected accruals, EA/A_{t-1}.

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. (2008), 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:

$$PAAC_{it} = \alpha + \beta_1 DUM_{0,1,2_{it}} + \beta_2 DUM_{1,2_{it}} + \beta_3 DUM_{2_{it}} + \beta_4 SIZE_{it} + \beta_5 M/B_{it} + \beta_6 DISTRESS_{it} + \beta_7 OCF_{it} + \beta_8 LEVERAGE_{it} + \beta_9 BIG4_{it} + \varepsilon_{it} \quad (4)$$

where

$PAAC_{it}$ = performance adjusted accruals for firm *i* in year *t*;

$DUM_{0,1,2it}$ = 1 if year t is the year of the restatement, the year following the restatement, or the second year following the restatement for firm *i*, else 0;

$DUM_{1,2it}$ = 1 if year t is the year following the restatement or the second year following the restatement for firm *i*, else 0;

DUM_{2it} = 1 if year t is the second year following the restatement for firm *i*, else 0;

$SIZE_{it}$ = the natural log of the market value of equity in year *t* for firm *i*;

M/B_{it} = the market value of the firm in year *t* divided by the book value of assets in year *t-1* for firm *i*;

$DISTRESS_{it}$ = Zmijewski's (1984) financial condition index in year *t* for firm *i*;

OCF_{it} = cash flow from operations in year *t* scaled by total assets in year *t-1* for firm *i*;

$LEVERAGE_{it}$ = total debt in year *t* divided by total assets in year *t* for firm *i*;

$BIG4_{it}$ = 1 if firm *i* is audited by a Big 4 firm in year *t*, else 0;

ε_{it} = the error term for firm *i* in year *t*.

The dummy variables $DUM_{0,1,2it}$, $DUM_{1,2it}$, and DUM_{2it} used in equation 4 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:

Year –1 = α

ΔYear –1 to Year 0 = β_1

Year 0 = $\alpha + \beta_1$

ΔYear 0 to Year 1 = β_2

Year 1 = $\alpha + \beta_1 + \beta_2$

ΔYear 1 to Year 2 = β_3

Year 2 = $\alpha + \beta_1 + \beta_2 + \beta_3$

Equation 4 will be separately estimated for each of the following groups: restating firms that remove less than a majority of the tainted directors from the audit committee and firms that remove a majority of tainted directors 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 remove less than a majority of the tainted directors from the audit committee to be more aggressive in their

accounting choices than restating firms who do remove a majority of the tainted directors from the audit committee.

In order to examine how the retention of tainted audit committee members affects the information content of earnings, I use the earnings response coefficient to quarterly earnings announcements for the 9 quarters, excluding the quarter of the restatement announcement, beginning one quarter prior to the restatement announcement and ending 8 quarters subsequent to the restatement announcement. Similar to the methodology employed by Wilson (2008), I estimate the following equation:

$$\begin{aligned} CAR_{it} &= \alpha + \sum_{t=1}^{8} \alpha_{2,t}\, QTR_{it} + \alpha_3 RETAIN\_MAJ\_AC_i \\ &+ \beta_1 UE_{it} + \beta_2 UE_{it} * RETAIN\_MAJ\_AC_i + \beta_3 UE_{it} * QTR_{it} \\ &+ \beta_4\, UE_{it} * RETAIN\_MAJ\_AC_i * QTR_{it} \\ &+ \beta_5 NONLINEAR_{it} + \sum_{k=6}^{11} \beta_k\, CONTROLS_{it} \\ &+ \sum_{k=12}^{17} \beta_k\, UE_{it} * CONTROLS_{it} + \varepsilon_{it} \end{aligned} \qquad (5)$$

where

CAR_{it} = the three-day cumulative abnormal return surrounding the earnings announcement date for firm i at quarter t based upon value-weighted returns and calculated using EVENTUS;

QTR_{it} = 1 if firm i's earnings announcement belongs to quarter t, else 0;

$RETAIN\_MAJ\_AC_i$ = 1 if firm *i* retains a majority of the audit committee intact following the restatement, else 0;

UE_{it} = is the unexpected earnings for firm i at quarter t's announcement date calculated as the difference between actual reported earnings

per share and the mean analyst forecast using the First Call database scaled by the closing stock price two days prior to the issuance of the earnings announcement; and

$NONLINEAR_{it}$ = UE_{it}* $\left| UE_{it} \right|$ and controls for documented non-linear association in the price earnings relation [Freeman and Tse (1989), Subramanyam (1996), and Lipe et al. (1998)].

Control variables are then described as follows:

M/B_{it} = the market value of the firm *i* at quarter *t* (Compustat #14 * Compustat #61) divided by the book value of the firm *i* at quarter *t* (Compustat #59) and controls for firm growth [Collins and Kothari (1989) and Kothari (2001)];

$BETA_{it}$ = the market-model beta for firm *i* estimated over the period beginning 255 trading days prior to the earnings announcement at quarter *t* and ending two trading days prior to the earnings announcement at quarter *t* and controls for firm systematic risk [Collins and Kothari (1989), Easton and Zmijewski (1989), and Kothari (2001)];

$SIZE_{it}$ = natural log of the market value of equity (Compustat #14 * Compustat #61) for firm *i* at quarter *t* [Easton and Zmijewski (1989)].

$LOSS_{it}$ = 1 if reported earnings per share is less than 0 for firm *i* in quarter *t* and controls for the lower information content of earnings announcements with negative earnings per share [Hayn (1995)] , else 0;

$Q4_{it}$ = 1 if firm *i*'s earnings announcement for quarter *t* is for the fourth quarter

of the fiscal year and controls for the lower earnings quality of fourth quarter earnings announcements [Mendenhall and Nichols (1988) and Salamon and Stober (1994)] , else 0; and

$STDRET_{it}$ = standard deviation of stock returns for the 25 trading days prior to the earnings announcement for firm *i* at quarter *t*.

For each group of firms examined, parameter estimates obtained from equation 5 will be used to calculate their earnings response coefficient for each quarter examined in the study. Calculation of the ERCs for each group are only shown for the quarter prior to the restatement and for the four quarters following the restatement for brevity and are as follows:

Firms removing a majority of the tainted directors from the audit committee following a restatement:

Prior-Quarter = β_1

Q1 = $\beta_1 + \beta_{3,t=1}$

Q2 = $\beta_1 + \beta_{3,t=2}$

Q3 = $\beta_1 + \beta_{3,t=3}$

Q4 = $\beta_1 + \beta_{3,t=4}$

Firms keeping a majority of the audit committee intact following the restatement:

Prior-Quarter = $\beta_1 + \beta_2$

Q1 = $\beta_1 + \beta_2 + \beta_{3,t=1} + \beta_{4,t=1}$

Q2 = $\beta_1 + \beta_2 + \beta_{3,t=2} + \beta_{4,t=2}$

Q3 = $\beta_1 + \beta_2 + \beta_{3,t=3} + \beta_{4,t=3}$

Q4 = $\beta_1 + \beta_2 + \beta_{3,t=4} + \beta_{4,t=4}$

In the presence of inefficiencies in the market for directors, I expect restating firms removing less than a majority of the tainted directors from the audit committee to exhibit earnings response coefficients that are significantly lower than the earnings response coefficients of restating firms who do remove a majority of the tainted directors from the audit committee.

In order to examine how the retention of tainted directors on the audit committee affects the systematic risk of the restating firm, I estimate the beta for each firm during the period prior to the restatement announcement, as well as for the period two years following the announcement of the restatement. Beta is estimated using the value-weighted index of market returns available from the Center for Research in Security Prices (CRSP) and a 220-day estimation period beginning at day –240 and ending at day –21, where day 0 is the day of the restatement announcement (two years following the restatement announcement). Comparisons are then made between the changes in beta for restating firms retaining a majority of the audit committee in place and restating firms that fail to retain a majority of tainted directors on the audit committee. In addition, changes in beta for the differential remedial actions following a restatement are examined in a multivariate setting using the following equation:

$$\Delta Beta_i = \alpha + \beta_1 RETAIN\_MAJ\_AC_i + \beta_2 \Delta LogEquity_i + \beta_3 \Delta ROA_i + \beta_4 \Delta Sales_i + \varepsilon \quad (6)$$

where

$\Delta Beta_i$ = the change in beta for firm *i*;

$RETAIN\_MAJ\_AC_i$ = 1 if firm *i* retains a majority of the audit committee intact following the restatement, else 0;

$\Delta LogEquity_i$ = the change in the log of the market equity of firm *i* measured

two days prior to the restatement announcement and two days prior to the two year anniversary of the restatement announcement;

ΔROA_i = the change in net income scaled by lagged total assets for firm *i*; and

$\Delta Sales_i$ =the change in net sales scaled by lagged total assets for firm *i*.

In the presence of inefficiencies in the market for directors, I expect systematic risk to increase following the announcement of the restatement, and I expect significant differences in systematic risk based on the differential decisions made regarding the composition of the audit committee.

IV. Results

Primary Analysis

Table 2 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 25.8% 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. In addition, no significant differences are indicated between restating firms and their non-restating matches on either variables indicative of the CEO's influence over the audit committee (*BOSS, CEO_FOUNDER, CEO_INVOLVE_NC, CEO_TIE, CEO_TENURE,* and *CEO_APT_BOD*), or other control variables (*SIZE, LITIGATION, BOARD_SIZE,* and *PCT_OUTSIDE*). Member of the audit committee at non-restating firms are found to own a significantly greater proportion of the outstanding common stock (0.89%) than their counterparts at restating firms (0.26%); however, among other variables reflective of the quality of individual directors (*AGE, TENURE, FIN_EXPERT, OUTSIDE_CEO,* and *DIR_GAIN*), no significant differences exist. Overall, the descriptive statistics presented in Table 2 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. (Tables are located in the appendix.)

Table 3 Panel A presents results from estimating equation (1) with standard errors corrected for clustering among firms. The model is significant at the 0.01 level (Wald χ^2=57.10) and has a Pseudo R^2 of 11.63%. Table 3 Panel B, then, presents the partial effect that each variable has on the response probability of remaining on the audit committee for restating firms and their non-restating match. For restating firms, the results indicate that *BOSS* and *CEO_TIE* are significant at the 0.10 level and 0.05 level, respectively, and negatively related to the retention of directors on the audit committee, while *FIN_EXPERT* is 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 0.10 level and 0.05 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 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 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. (Tables are located in the appendix.)

Accruals Analysis

Table 4 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 a majority of the audit committee following the restatement. Panel A of Table 4 indicates that, following the announcement of a restatement, restating firms maintaining a majority of the audit committee in place do not significantly differ from those firms removing a majority of directors from their audit committee with regard to *SIZE, M/B, DISTRESS, OCF, LEVERAGE,* or *BIG4*. Panel B of Table 4 indicates that neither the levels nor the changes in discretionary accruals are significantly different from zero for firms removing a majority of the directors from their audit committee and that only the level of discretionary accruals in the second year following the restatement are significantly different from zero for firms maintaining a majority of the audit committee in place following the restatement. Although the level of accruals in the second year following the restatement is significantly different from zero at the 0.10 level for firms maintaining a majority of their audit committee in place, tests of differences indicate that they are not significantly different from the level of accruals for firms removing a majority of directors from the audit committee. In addition, tests of differences indicate that no other differences exist between either the levels or the

changes in discretionary accruals for the two groups. As a result, the descriptive statistics provide limited initial evidence that accruals become more positive for firms retaining a majority of the audit committee in place in the years following the announcement of the restatement; however, the descriptive statistics generally indicate a lack of consequences based on the differential approach to audit committee composition following a restatement. (Tables are located in the appendix.)

Table 5 presents the results from estimating equation (4) using both restating firms that retain a majority of the audit committee in place and restating firms that remove a majority of directors from the audit committee, as well as, a comparison of the levels and changes in discretionary accruals for those companies. Panel A of Table 5 indicates that the base OLS models for both groups of restating firms are significant at the 0.01 level and that at least 54% of the variation in the performance adjusted accruals is explained by the variation in the independent variables. Panel A of Table 5 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 a majority of their audit committee in place following a restatement and that *DISTRESS* is significant at the 0.10 level and is negatively related to performance adjusted accruals for firms removing a majority of directors 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 5 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 5 indicates that no significant differences exist between the level of discretionary accruals or the change in

discretionary accruals between the two groups. This evidence suggests that the decision to retain a majority of the audit committee in place following a restatement has no adverse effect on accounting choices when compared to removing a majority of the directors from the audit committee following a restatement and supports the premise that the labor market for directors operates in an efficient and effective manner. (Tables are located in the appendix.)

Analysis of Earnings Response Coefficients

Table 6 presents descriptive statistics for the independent variables used in estimating the earnings response coefficients for the sample firms that experienced a negative income adjusting restatement partitioned by the retention of a majority of the audit committee following the restatement. Table 6 indicates that unexpected earnings are negative and significantly different from zero at the 0.10 level for firms retaining a majority of the audit committee in place; however, unexpected earnings are not significantly different between the two groups. Table 6 also indicates that *M/B* is 2.8 and 1.9 and *BETA* is 1.17 and 1.11 for firms maintaining a majority of the audit committee in place and firms removing a majority of the directors from the audit committee, respectively. The mean SIZE (measured as the natural log of the market value of equity) of the firms is $7.44 million and $7.27 million, respectively. The mean STDRET is 0.018 and 0.020, respectively. Test of differences indicate no differences exist between the two groups. (Tables are located in the appendix.)

Table 7 presents results from estimating equation (5) using the sample of restating firms. Results presented in Table 7 indicate that the earnings response coefficient (ERC)

for firms that remove a majority of the directors from the audit committee is positive and significantly different from both zero and the corresponding ERC for firms maintaining a majority of the audit committee in place following a restatement in quarter 4, while no other ERCs or differences in ERCs are significantly different from zero; however, the model is not significant (F=1.18, p=0.2176) rendering all inferences obsolete. This suggests that the decision to retain a majority of directors on the audit committee following a restatement has no effect on the information content of earnings; however; much caution should be used regarding this analysis due to the small number of sample firms with data available to examine earnings response coefficients. (Tables are located in the appendix.)

Analysis of Beta

Table 8 presents descriptive statistics on the systematic risk of restating firms prior to announcing a restatement and two years following the restatement announcement, as well as by audit committee composition decision for the same time period. Panel A of Table 8 indicates that beta increases, in general, for firms following the announcement of a restatement, but this increase is not significantly different from zero. Panels B and C of Table 8, likewise, indicate that beta increases for both groups of restating firms but not by a significant amount. Based on the theory developed by Cloninger and Waller (2000), insignificant changes in beta following a restatement are indicative of "rotten apples" within the company; however, both groups of restating firms potentially suffer from this problem indicating an overall absence of additional

consequences to investors when a majority of directors are kept in place on the audit committee following a financial reporting failure. (Tables are located in the appendix.)

Table 9 presents descriptive statistics on the changes in beta from prior to the restatement announcement to two years following the restatement announcement, as well as results from estimating equation (6) for all restatement firms with available data. Panel A of Table 9 indicates, consistent with Table 8, that differences in the change in beta between the two groups were not significantly different from zero; suggesting that no additional consequences are suffered based on the differential decisions regarding the composition of the audit committee following a restatement. Panel A of Table 9 further indicates a lack of significant differences between the two groups of restating firms. Panel B of Table 9 indicates that the regression model is not significant ($F=0.53$, $p=0.7112$); once again suggesting that investors do not suffer additional negative consequences when a majority of the directors on the audit committee are kept in place. As with inferences regarding the information content of earnings, however, much caution should be used regarding this analysis due to the small number of sample items. (Tables are located in the appendix.)

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 in the following equation:

$$
\begin{aligned}
&RETENTION = \beta_0 + \beta_1 CEO\_FOUNDER + \beta_2 CEO\_TIE \\
&+ \beta_3 CEO\_TENURE + \beta_4 CEO\_APT\_BOD + \beta_5 LITIGATION \\
&+ \beta_6 AGE + \beta_7 TENURE + \beta_8 FIN\_EXPERT \\
&+ \beta_9 OUTSIDE\_CEO + \beta_{10} DIR\_OWN \\
&+ \beta_{11} RESTAE * CEO\_FOUNDER \\
&+ \beta_{12} RESTATE * CEO\_TIE + \beta_{13} RESTATE * CEO\_TENURE \\
&+ \beta_{14} RESTATE * CEO\_APT\_BOD \\
&+ \beta_{15} RESTATE * LITIGATION + \beta_{16} RESTATE * AGE \\
&+ \beta_{17} RESTATE * TENURE + \beta_{18} RESTATE * FIN\_EXPERT \\
&+ \beta_{19} RESTATE * OUTSIDE\_CEO + \beta_{20} RESTATE * DIR\_OWN \\
&+ \beta_{21} STRONG\_GOV * CEO\_FOUNDER \\
&+ \beta_{22} STRONG\_GOV * CEO\_TIE \\
&+ \beta_{23} STRONG\_GOV * CEO\_TENURE \\
&+ \beta_{24} STRONG\_GOV * CEO\_APT\_BOD \\
&+ \beta_{25} STRONG\_GOV * LITIGATION + \beta_{26} STRONG\_GOV * AGE \\
&+ \beta_{27} STRONG\_GOV * TENURE \\
&+ \beta_{28} STRONG\_GOV * FIN\_EXPERT \\
&+ \beta_{29} STRONG\_GOV * OUTSIDE\_CEO \\
&+ \beta_{30} STRONG\_GOV * DIR\_OWN \\
&+ \beta_{31} RESTAE * STRONG\_GOV * CEO\_FOUNDER \\
&+ \beta_{32} RESTATE * STRONG\_GOV * CEO\_TIE \\
&+ \beta_{33} RESTATE * STRONG\_GOV * CEO\_TENURE \\
&+ \beta_{34} RESTATE * STRONG\_GOV * CEO\_APT\_BOD \\
&+ \beta_{35} RESTATE * STRONG\_GOV * LITIGATION \\
&+ \beta_{36} RESTATE * STRONG\_GOV * AGE
\end{aligned}
$$

$$
\begin{aligned}
&+ \beta_{37} RESTATE * STRONG\_GOV * TENURE \\
&+ \beta_{38} RESTATE * STRONG\_GOV * FIN\_EXPERT \\
&+ \beta_{39} RESTATE * STRONG\_GOV * OUTSIDE\_CEO \\
&+ \beta_{40} RESTATE * STRONG\_GOV * DIR\_OWN \\
&+ \beta_{41} RESTATE + \beta_{42} STRONG\_GOV \\
&+ \beta_{43} RESTATE * STRONG\_GOV + \varepsilon
\end{aligned}
\qquad (7)
$$

where

STRONG_GOV = 1 if the firm has a relatively strong corporate governance environment, else 0; and all other variables are defined as above.

Table 10 Panel A presents results from estimating equation (7) with standard errors corrected for clustering among firms. The model is significant at the 0.01 level (Wald χ^2=68.55) and has a Pseudo R^2 of 10.53%. Table 10 Panel B, then, presents the partial effect that each variable has on the response probability of remaining on the audit committee of 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 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. In addition, the directors of these firms are less likely to remain on the audit committee if the firm is in a highly litigious industry. For restating firms with stronger corporate governance environments, the evidence suggests that directors identified as the audit committee financial expert are more likely to remain on the audit committee following the restatement. Such evidence, consistent with prior results, suggests that issues of director independence, quality, and expertise, as well as

litigation risk 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. (Tables are located in the appendix.)

Grouping firms based on whether or not the audit committee is substantially changed following a restatement may be arbitrary and may mask the consequences to shareholders of firms that make no changes to the composition of the audit committee following a restatement. As a result, I re-evaluate all subsequent analyses grouping restating firms into those that made no changes to the composition of the audit committee and those that made some change to the composition of the audit committee. Table 11 presents descriptive statistics for sample firms based on this classification criteria. These results indicate that firms retaining the audit committee in tact following a restatement have significantly fewer CEOs who also serve as the chairman of the board (45.2% vs. 66.7%) and significantly fewer directors on the audit committee whose term began after that of the CEO (36.2% vs. 49.6%). No other significant differences between the two groups of firms are indicated. Overall, the descriptive statistics presented in Table 11 are consistent with prior analyses and suggest that changes in the composition of the audit committee were more likely to take place at firms where CEO authority and influence may have been perceived by the labor market to have impaired the effectiveness of the audit committee. (Tables are located in the appendix.)

Table 12 presents results of estimating equation (4) for both firms making no change in the composition of the audit committee and firms making any change in the

composition of the audit committee, as well as a comparison of the levels and changes in discretionary accruals for each group of firms. Panel A of Table 12 indicates that the base OLS model for each group is significant at the 0.01 level and that, at least, 32% (R^2=0.3281 and 0.6356) of the variation in discretionary accruals is explained by the variation in the independent variables. Panel B of Table 12 indicates that firms making a change in the composition of their audit committee have accruals in each year that are significantly less than zero and that the difference between the level of accruals in year 2 of firms making a change in the composition of the audit committee is significantly less than that of firms making no change in the composition of the audit committee. Such, seemingly, indicates that firms making no change in the audit committee do so in order to capitalize on the monitoring ineffectiveness of the audit committee; however, a closer examination of the results indicates that much of this difference is due to the level of accruals in the year prior to the restatement announcement and that neither the level of accruals nor the changes in accruals for firms making no change in the composition of the audit committee is significantly different from zero.[11] Consequently, these results present no evidence that firms making no change in the composition of the audit committee do so to engage in aggressive accounting practices. Furthermore, these results, when coupled with those presented in Table 11, suggest that both the labor market for directors and the auditor effectively identify those firms where audit committee composition at the time of the restatement provided less than adequate protection to the interest of the shareholders. Additional analyses using earnings

[11] Compustat reports data items using restated information. As a result, I hand collect non-restated data from the original 10-Ks filed with the SEC for those firms making a change in the composition of the audit committee and re-perform the analysis. Results are qualitatively similar.

response coefficients and systematic risk (not reported), similar to prior analyses, fail to produce significant models, thereby, presenting no evidence that investors suffer any consequences as a result of retaining the entire audit committee following a restatement. Overall, these analyses suggest that the labor market for directors operates in an effective manner and that investors do not suffer any adverse consequences as a result of differential decisions concerning the composition of the audit committee following a restatement. (Tables are located in the appendix.)

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 (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 at least a majority of the directors on the audit committee following a restatement experience adverse long-term consequences compared to firms

that remove at least a majority of the directors from the audit committee following a restatement by comparing the quality of accounting choices, the information content of earnings, and the systematic risk of 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 a majority of their directors on the audit committee following a restatement experience negative long-term consequences compared to firms that remove a majority of the directors 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 loss of sample items due to data requirements in some analyses may lead to inferences that are misleading. The use of firms that have experienced multiple reporting failures may also 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.

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Appendix

Table 1. Sample Selection of Restating and Matching Firms

Panel A: Selection of Restatement Sample

	n
All firms with negative income adjusting restatement preceeded by another restatement	143
Less:	
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	44
Final Sample of Restating Firms	70

Panel B: SIC Digit Match

SIC Digits Used in Match	Number of Firms	Percent of Sample	Cumulative Percentage
4	36	51.43%	51.43%
3	11	15.71%	67.14%
2	13	18.57%	85.71%
1	10	14.29%	100.00%

Panel C: Assets (Millions)

Variable	Restate	Non-Restate	Difference	p Value
Assets	3997.045	3961.364	35.681	0.978

Panel D: Auditor Match

Matched on Auditor	Number of Firms	Percent of Sample
Yes	25	35.71%
No	45	64.29%

Table 2. Descriptive Statistics by Restating and Non-Restating Firms

Variable	Restate	Non-Restate	Difference
Retention on the Audit Committee	0.742	0.777	-0.035
BOSS	0.571	0.543	0.029
CEO_FOUNDER	0.243	0.271	-0.029
CEO_INVOLVE_NC	0.157	0.200	-0.043
CEO_TIE	0.136	0.112	0.024
CEO_TENURE	6.257	7.786	-1.529
CEO_APT_BOD	0.436	0.422	0.014
SIZE	3997.045	3961.364	35.681
LITIGATION	0.514	0.529	-0.014
BOARD_SIZE	8.171	8.229	-0.057
PCT_OUTSIDE	0.612	0.625	-0.013
AGE	58.597	59.853	-1.255
TENURE	5.975	6.757	-0.782
FIN_EXPERT	0.356	0.311	0.045
OUTSIDE_CEO	0.182	0.155	0.027
DIR_OWN	0.003	0.009	-0.006 *
DIR_GAIN	0.119	0.143	-0.025

* Significant at the 0.10 level based on a two-tailed test.

Table 2, continued.

Retention on the Audit Committee =	1 if the director is retained on the audit committee;
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;
SIZE =	the natural log of the total assets of the firm;
LITIGATION =	1 if the firm is in a highly litigious industry [Hogan and Jeter (1999)];
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 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;
DIR_GAIN =	1 if the audit committee member has a net gain of at least one outside directorship following the restatement announcement;

Table 3. 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

Panel A: Regression Results

	Dependent Variable: Retention on the Audit Committee	
Variable	**Coefficient**	**Z-Stat**
Intercept	0.9668	0.96
BOSS	0.1020	0.45
CEO_FOUNDER	-0.1868	-0.66
CEO_INVOLVE_NC	-0.5284	-1.80 *
CEO_TIE	-0.1585	-0.46
CEO_TENURE	0.0422	2.35 **
CEO_APT_BOD	-0.4408	-2.03 **
SIZE	-0.1199	-2.02 **
LITIGATION	0.0605	0.26
BOARD_SIZE	0.0953	1.99 **
PCT_OUTSIDE	0.5996	0.89
AGE	-0.0134	-0.96
TENURE	-0.0124	-0.77
FIN_EXPERT	0.6254	2.65 ***
OUTSIDE_CEO	0.0132	0.05
DIR_OWN	1.6928	1.07
DIR_GAIN	1.1740	2.73 ***
*RESTATE*BOSS*	-0.5430	-1.62
*RESTATE*CEO_FOUNDER*	0.7031	1.34
*RESTATE*CEO_INVOLVE_NC*	0.4008	0.86
*RESTATE*CEO_TIE*	-0.4130	-0.93
*RESTATE*CEO_TENURE*	-0.0432	-1.70 *
*RESTATE*CEO_APT_BOD*	0.2024	0.62
*RESTATE*SIZE*	0.1637	1.73 *
*RESTATE*LITIGATION*	-0.3606	-1.08
*RESTATE*BOARD_SIZE*	-0.1674	-2.05 **
*RESTATE*PCT_OUTSIDE*	0.3314	0.38
*RESTATE*AGE*	0.0149	0.75
*RESTATE*TENURE*	0.0006	0.02
*RESTATE*FIN_EXPERT*	-0.2031	-0.64
*RESTATE*OUTSIDE_CEO*	0.2002	0.55
*RESTATE*DIR_OWN*	6.9248	0.86
*RESTATE*DIR_GAIN*	-0.6200	-1.09
RESTATE	-0.2858	-0.21
n	487	
Wald χ^2	57.10	
Prob $>\chi^2$	0.0057	
Pseudo R^2	0.1163	

Table 3, continued.

Panel B: Cumulative Effect of Each Variable by Restatement Group

	Dependent Variable: Retention on the Audit Committee			
	Non-Restate		Restate	
Variable	**Coefficient**		**Coefficient**	
BOSS	0.1020		-0.4410	*
CEO_FOUNDER	-0.1868		0.5163	
CEO_INVOLVE_NC	-0.5284	*	-0.1276	
CEO_TIE	-0.1585		-0.5715	**
CEO_TENURE	0.0422	**	-0.0010	
CEO_APT_BOD	-0.4408	**	-0.2384	
SIZE	-0.1199	**	0.0438	
LITIGATION	0.0605		-0.3001	
BOARD_SIZE	0.0953	**	-0.0721	
PCT_OUTSIDE	0.5996		0.9310	
AGE	-0.0134		0.0015	
TENURE	-0.0124		-0.0118	
FIN_EXPERT	0.6254	***	0.4223	**
OUTSIDE_CEO	0.0132		0.2135	
DIR_OWN	1.6928		8.6176	
DIR_GAIN	1.1740	***	0.5539	

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

Table 3, continued.

Retention on the Audit Committee =	1 if the director is retained on the audit committee;
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;
SIZE =	the natural log of the total assets of the firm;
LITIGATION =	1 if the firm is in a highly litigious industry [Hogan and Jeter (1999)];
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 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;
DIR_GAIN =	1 if the audit committee member has a net gain of at least one outside directorship following the restatement announcement;
RESTATE =	1 if the firm experienced a restatement of the financial statements; and

Table 4. Descriptive Statistics for Accruals Analysis

Panel A: Control Variables[a]

Variable	Retain Majority of Audit Committee	Remove Majority of Audit Committee	Difference
SIZE	5.713	6.235	-0.522
M/B	1.783	1.134	0.649
DISTRESS	-2.478	-3.201	0.723
OCF	-0.035	0.087	-0.122
LEVERAGE	0.281	0.300	-0.019
BIG4	0.718	0.792	-0.074

Panel B: Discretionary Accruals

	Year -1	Year 0	Year 1	Year 2	Year -1 to Year 0	Year 0 to Year 1	Year 1 to Year 2
Retain Majority of Audit Committee	0.009	0.018	0.020	0.138 *	0.009	0.002	0.118
Remove Majority of Audit Committee	-0.009	-0.008	0.110	-0.066	0.001	0.118	-0.176
Difference	0.018	0.026	-0.090	0.204	0.007	-0.115	0.294

* Significant at the 0.10 level based on two-tailed tests.

[a]The values presented are the mean value for the control variables. The control variables are defined as:

Table 4, continued.

SIZE =	the natural log of the market value of equity;
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; and
BIG4 =	1 if the firm is audited by a Big 4 firm.

Table 5. Comparison of Financial Reporting Quality between Restating Companies Removing a Majority of Directors from the Audit Committee Following a Restatement Announcement and Restating Companies Maintaining a Majority of the Audit Committee in Place

Panel A: Regression Results

	Retain Majority of AC		Remove Majority of AC	
Variable	**Coefficient**	**t-Stat**	**Coefficient**	**t-Stat**
Intercept	-0.0894	-0.93	-0.1620	-0.54
$Dum_{0,1,2}$	-0.0038	-0.05	-0.0042	-0.04
$Dum_{1,2}$	0.0107	0.14	0.0471	0.46
Dum_{2}	-0.0137	-0.18	-0.1406	-1.32
Size	0.0101	0.71	-0.0349	-1.41
M/B	-0.0023	-0.22	0.0068	0.14
OCF	-0.7482	-11.36 ***	0.3282	1.11
Distress	-0.0412	-3.78 ***	-0.1143	-1.90 *
Leverage	0.1064	0.87	0.1566	0.43
Big4	-0.1077	-1.30	-0.0629	-0.57
n	123		47	
F Statistic	16.33		5.00	
Prob. >F	<0.01		<0.01	
R^2	0.5654		0.5490	

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

Year Relative to Restatement Announcement	Retain Majority of AC	Remove Majority of AC	Difference
Year -1	-0.0894	-0.1620	0.0726
Year -1 to Year 0	-0.0038	-0.0042	0.0004
Year 0	-0.0932	-0.1663	0.0730
Year 0 to Year 1	0.0107	0.0471	-0.0364
Year 1	-0.0825	-0.1191	0.0366
Year 1 to Year 2	-0.0137	-0.1406	0.1269
Year 2	-0.0962	-0.2597	0.1635

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

Table 5, continued.

$DUM_{0,1,2}$ =	1 in the year of the restatement, the first year following the restatement, or the second year following the restatement;
$DUM_{1,2}$ =	1 in either the first or second year following the restatement;
DUM_{2} =	1 in the second year following the restatement;
SIZE =	the natural log of the market value of equity;
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; and
BIG4 =	1 if the firm is audited by a Big 4 firm.

Table 6. Descriptive Statistics for Analysis of Earnings Response Coefficients

Variable	Retain Majority of Audit Committee Mean (N)	Remove Majority of Audit Committee Mean (N)	Difference
UE	-0.038 *	-0.043	0.005
	(207)	(63)	
NONLINEAR	-0.055	-0.047	-0.008
	(207)	(63)	
M/B	2.800 *	1.919 ***	0.881
	(203)	(58)	
BETA	1.169 ***	1.107 ***	0.063
	(205)	(63)	
SIZE	7.435 ***	7.272 ***	0.163
	(203)	(58)	
STDRET	0.018 ***	0.020 ***	-0.002
	(205)	(63)	

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

The values presented are the mean value for the control variables. The control variables are defined as:

UE =	the difference between actual reported earnings per share and the mean analyst forecast scaled by the closing stock price two days prior to the earnings announcement;
NONLINEAR =	UE*|UE|;
M/B =	the market value of the firm scaled by the market value of the firm;
BETA =	the market model beta of the firm;
SIZE =	the natural log of the market value of equity; and
STDRET =	the standard deviation of stock returns for the 25 days prior to the earnings announcement.

Table 7. Comparison of the Changes in the Information Content of Earnings between Restating Companies Removing a Majority of Directors from the Audit Committee Following a Restatement Announcement and Restating Companies Maintaining a Majority of the Audit Committee

Sum of Coefficient Estimates	Retain Majority of Audit Committee ERC		Remove Majority of Audit Committee ERC		
Quarter Prior to Restatement	0.264		0.279		
Quarter 1	0.203		0.363		
Quarter 2	0.337		0.183		
Quarter 3	0.295		0.081		
Quarter 4	0.176	+	0.954	*	+
Quarter 5	0.344		0.294		
Quarter 6	0.304		0.369		
Quarter 7	0.224		0.144		
Quarter 8	0.076		0.270		
n	252				
F Statistic	1.18				
Prob. > F	0.2176				
R^2	0.2179				

* Significant at the 0.10 level based on two-tailed tests.
+ Significantly different between groups at the 0.10 level based on two-tailed tests.

Table 8. Comparison of Pre-Restatement and Post-Restatement Beta

Panel A: All Restating Firms

Period	Beta	Difference	t-Stat	p-value	N
Pre-Restatement	0.9584				
Post-Restatement	1.1032	0.1448	1.2367	0.2189	108

Panel B: Restating Firms Maintaining a Majority of Directors on AC

Period	Beta	Difference	t-Stat	p-value	N
Pre-Restatement	0.9563				
Post-Restatement	1.1133	0.1570	1.1202	0.2661	80

Panel C: Restating Firms Removing a Majority of Directors from AC

Period	Beta	Difference	t-Stat	p-value	N
Pre-Restatement	0.9647				
Post-Restatement	1.0744	0.1098	0.5064	0.6168	28

Table 9. Comparison of the Change in Beta between Restating Companies Removing a Majority of Directors from the Audit Committee Following a Restatement Announcement and Restating Companies Maintaining a Majority of the Audit Committee in Place

Panel A: Summary Statistics

	Retain Majority of Audit Committee	Remove Majority of Audit Committee	
Variable	**Mean (N)**	**Mean (N)**	**Difference**
ΔBeta	0.157	0.110	0.047
	(40)	(14)	
ΔLogEquity	0.477 ***	0.344 *	0.133
	(37)	(13)	
ΔROA	0.037 *	0.057 *	-0.020
	(30)	(10)	
ΔSales	-0.009	0.051	-0.060
	(30)	(10)	

Panel B: Regression Results

	Dependent Variable: ΔBeta	
Variable	**Coefficient**	**t-Stat**
Intercept	-0.0078	-0.04
RETAIN_MAJ_AC	0.0931	0.40
ΔLogEquity	0.0260	0.19
ΔROA	1.1187	1.10
ΔSales	-0.4028	-0.81
n	37	
F Statistic	0.53	
Prob. > F	0.7112	
R^2	0.0626	

*,*** Significant at the 0.10 and 0.01 level based on two-tailed tests.

ΔBeta = the change in beta over the sample period;
RETAIN_MAJ_AC = 1 if the firm retains a majority of the audit committee in tact following the restatement;
ΔLogEquity = the change in the log of the market equituy of the firm over the sample period;
ΔROA = the change in net income scaled by lagged total assets over the sample period; and
ΔSales = the change in net sales scalled by lagged total assets.

Table 10. 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

Panel A: Regression Results

	Dependent Variable: Retention on the Audit Committee		
Variable	**Coefficient**	**Z-Stat**	
Intercept	2.5377	1.38	
CEO_FOUNDER	-0.7723	-2.28	**
CEO_TIE	-0.2375	-0.27	
CEO_TENURE	0.0111	0.40	
CEO_APT_BOD	0.1790	0.42	
LITIGATION	0.6937	1.79	*
AGE	-0.0459	-1.49	
TENURE	0.0650	1.87	*
FIN_EXPERT	1.1551	2.12	**
OUTSIDE_CEO	0.0409	0.08	
DIR_OWN	14.6766	0.71	
*RESTATE*CEO_FOUNDER*	1.0199	1.51	
*RESTATE*CEO_TIE*	-1.2045	-1.24	
*RESTATE*CEO_TENURE*	-0.0344	-0.80	
*RESTATE*CEO_APT_BOD*	-0.2004	-0.32	
*RESTATE*LITIGATION*	-1.6388	-2.98	***
*RESTATE*AGE*	-0.0070	-0.17	
*RESTATE*TENURE*	-0.0699	-1.39	
*RESTATE*FIN_EXPERT*	-1.2382	-1.97	**
*RESTATE*OUTSIDE_CEO*	-0.1561	-0.24	
*RESTATE*DIR_OWN*	94.0834	2.58	
*STRONG_GOV*CEO_FOUNDER*	0.8866	1.76	*
*STRONG_GOV*CEO_TIE*	0.0345	0.04	
*STRONG_GOV*CEO_TENURE*	0.0154	0.44	
*STRONG_GOV*CEO_APT_BOD*	-0.6942	-1.40	
*STRONG_GOV*LITIGATION*	-0.7264	-1.61	
*STRONG_GOV*AGE*	0.0388	1.13	
*STRONG_GOV*TENURE*	-0.0877	-2.21	**
*STRONG_GOV*FIN_EXPERT*	-0.7756	-1.25	
*STRONG_GOV*OUTSIDE_CEO*	0.0286	0.05	
*STRONG_GOV*DIR_OWN*	-13.4653	-0.65	

Table 10, continued.

Variable	Dependent Variable: Retention on the Audit Committee Coefficient	Z-Stat
*RESTATE*STRONG_GOV*CEO_FOUNDER*	-0.6614	-0.72
*RESTATE*STRONG_GOV*CEO_TIE*	0.9053	0.80
*RESTATE*STRONG_GOV*CEO_TENURE*	-0.0040	-0.08
*RESTATE*STRONG_GOV*CEO_APT_BOD*	0.2755	0.37
*RESTATE*STRONG_GOV*LITIGATION*	1.5716	2.37 **
*RESTATE*STRONG_GOV*AGE*	0.0263	0.55
*RESTATE*STRONG_GOV*TENURE*	0.0897	1.51
*RESTATE*STRONG_GOV*FIN_EXPERT*	1.5706	2.10 **
*RESTATE*STRONG_GOV*OUTSIDE_CEO*	0.5273	0.66
*RESTATE*STRONG_GOV*DIR_OWN*	-96.3905	-2.55
RESTATE	2.2288	0.91
STRONG_GOV	-1.2778	-0.61
*RESTATE*STRONG_GOV*	-3.5519	-1.27
n	487	
Wald χ^2	68.55	
Prob $>\chi^2$	0.0079	
Pseudo R^2	0.1053	

Panel B: Cumulative Effect of Each Variable by Restatement Group

Variable	Dependent Variable: Retention on Audit Committee Weak Gov./ Non-Restate Coefficient	Strong Gov./ Restate Coefficient	Weak Gov./ Restate Coefficient	Strong Gov./ Restate Coefficient
CEO_FOUNDER	-0.7723 **	0.1143	0.2476	0.4727
CEO_TIE	-0.2375	-0.2030	-1.4420 ***	-0.5022
CEO_TENURE	0.0111	0.0265	-0.0234	-0.0119
CEO_APT_BOD	0.1790	-0.5153 **	-0.0215	-0.4403
LITIGATION	0.6937 *	-0.0327	-0.9451 **	-0.0998
AGE	-0.0459	-0.0071	-0.0529 *	0.0122
TENURE	0.0650 *	-0.0227	-0.0049	-0.0029
FIN_EXPERT	1.1551 **	0.3795	-0.0830	0.7119 **
OUTSIDE_CEO	0.0409	0.0695	-0.1152	0.4407
DIR_OWN	14.6766	1.2114	108.7600 ***	-1.0957

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

Table 10, continued.

Retention on the Audit Committee =	1 if the director is retained on the audit committee;
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;
SIZE =	the natural log of the total assets of the firm;
LITIGATION =	1 if the firm is in a highly litigious industry [Hogan and Jeter (1999)];
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 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;
DIR_GAIN =	1 if the audit committee member has a net gain of at least one outside directorship following the restatement announcement;
RESTATE =	1 if the firm experienced a restatement of the financial statements; and
STRONG_GOV =	1 if the firm has a relatively strong corporate governance environment.

Table 11. Descriptive Statistics for Restating Firms Retaining Full Audit Committee and Restating Firms Removing at Least One Member from the Audit Committee

Variable	Retain All of AC	Do Not Retain All of AC	Difference	
BOSS	0.4516	0.6667	-0.215	*
CEO_FOUNDER	0.2903	0.2051	0.085	
CEO_INVOLVE_NC	0.1290	0.1795	-0.050	
CEO_TIE	0.1048	0.1603	-0.056	
CEO_TENURE	5.1935	7.1026	-1.909	
CEO_APT_BOD	0.3619	0.4962	-0.134	**
SIZE	4302.4350	3754.3000	548.135	
LITIGATION	0.4839	0.5385	-0.055	
BOARD_SIZE	7.9032	8.3846	-0.481	
PCT_OUTSIDE	0.6419	0.5875	0.054	
AGE	58.1619	58.9466	-0.785	
TENURE	6.1905	5.8015	0.389	
FIN_EXPERT	0.2952	0.2443	0.051	
OUTSIDE_CEO	0.2000	0.1679	0.032	
DIR_OWN	0.0034	0.0020	0.001	
DIR_GAIN	0.1429	0.0992	0.044	

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

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;
SIZE = the natural log of the total assets of the firm;
LITIGATION = 1 if the firm is in a highly litigious industry [Hogan and Jeter(1999)];
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 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; and
DIR_GAIN = 1 if the audit committee member has a net gain of at least one outside directorship following the restatement announcement.

Table 12. 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

	Retain All of AC		Do Not Retain All of AC	
Variable	**Coefficient**	**t-Stat**	**Coefficient**	**t-Stat**
Intercept	-0.0243	-0.22	-0.5260	-2.61 **
$Dum_{0,1,2}$	-0.0127	-0.14	0.0184	0.20
$Dum_{1,2}$	0.0448	0.48	-0.0214	-0.24
Dum_{2}	0.0036	0.04	-0.0936	-1.03
Size	0.0046	0.27	-0.0258	-1.30
M/B	-0.0008	-0.07	0.0327	0.73
OCF	-0.7230	-10.56 ***	-0.5664	-2.65 ***
Distress	-0.0353	-3.10 ***	-0.1919	-4.50 ***
Leverage	-0.0564	-0.37	0.7872	3.17
Big4	-0.1086	-1.12	-0.1233	-1.26
n	87		83	
F Statistic	14.92		3.96	
Prob. >F	<0.01		<0.01	
R^2	0.6356		0.3281	

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

Year Relative to Restatement Announcement	Retain All of AC	Do Not Retain All of AC	Difference
Year -1	-0.0243	-0.5260 **	0.5017
Year -1 to Year 0	-0.0127	0.0184	-0.0311
Year 0	-0.0370	-0.5075 **	0.4706
Year 0 to Year 1	0.0448	-0.0214	0.0662
Year 1	0.0078	-0.5289 **	0.5367
Year 1 to Year 2	0.0036	-0.0936	0.0971
Year 2	0.0114	-0.6225 ***	0.6339 *

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

Table 12, continued.

$DUM_{0,1,2}$	=	1 in the year of the restatement, the first year following the restatement, or the second year following the restatement;
$DUM_{1,2}$	=	1 in either the first or second year following the restatement;
DUM_{2}	=	1 in the second year following the restatement;
SIZE	=	the natural log of the market value of equity;
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; and
BIG4	=	1 if the firm is audited by a Big 4 firm.

Vita

Brian Todd Carver was born in Lebanon, Tennessee, on May 31, 1971. He grew up in rural Macon County, Tennessee, and graduated from Macon County High School in 1989. He then went to the University of Tennessee-Knoxville where he received his B.S. in Agriculture Economics in 1993 and his M.S. in Agriculture Economics in 1995. Brian was married to the former Donna Lee Balthrop of Chapmansboro, Tennessee on June 15, 1996. Their first son, Matthew Dean, was born on March 8, 2000, and, on April 4, 2002, their only daughter, Patsy Rebecca, was born. Later that year, Brian enrolled in the accounting program at Middle Tennessee State University and completed the necessary educational requirements in May of 2003. On December 2, 2003, their second son, Daniel Carlton, was born. In August 2004, Brian enrolled in the doctoral program in accounting at the University of Tennessee-Knoxville. On November 7, 2006, a third son, Joshua Lee, was born to Brian and Donna. Currently, Brian is finishing his requirements for his doctorate in Business Administration from the University of Tennessee-Knoxville.