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The retention of directors on the audit committee following an accounting restatement

Brian T. Carver *

Richard C. Adkerson School of Accountancy, Mississippi State University, United States

ABSTRACT

Prior research suggests that corporate directors suffer the loss of outside board positions following a financial reporting failure. This loss of board positions, however, does not occur at the same rate for all outside directors. To examine this apparent discrepancy between director actions and consequences, I examine whether the retention of individual directors on the audit committee is related to director characteristics and/or CEO influence over the board of directors. Results indicate that the retention of directors on the audit committee is positively related to the influence of the CEO and weakly related to the qualitative characteristics of the audit committee member. I then classify my sample of restatements based on their underlying cause and re-examine the retention of audit committee members at restating firms. Results suggest that the involvement of the CEO in the nominating process can affect the composition of the audit committee at firms where restatements are the result of intentional misapplications of GAAP.

1. Introduction

Between 1997 and 2005, the number of companies acknowledging that previously issued financial statements were not prepared in accordance with generally accepted accounting principles increased significantly (GAO, 2002, 2006). Over this same period of time, audit committees became increasingly responsible for overseeing the financial reporting process and the resulting quality of the reported financial statements (SOX, 2002; NYSE, 2013). Consequently, restatements provide valuable information signals about the quality of the audit committee that are then used in an ex-post settling up process to take corrective action against those directors that are determined to be ineffective monitors

* Tel.: +1 662 325 1632; fax: +1 662 325 1646.
E-mail address: bcarver@cobilan.msstate.edu

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(Fama, 1980; Fama and Jensen 1983).[1] Given the general negative market response to financial restatements (Palmrose et al., 2004), the ex-post settling up process could be expected to result in strong corrective action against audit committee members; however, in practice, not all directors are subject to the same consequences (Agrawal et al., 1999; Srinivasan, 2005; Fich and Shivdasani, 2007; Helland, 2006). As a result, the inconsistency in actions against directors has led to questions about the effectiveness of the ex-post settling up process (Richardson, 2005; Helland, 2006). This study empirically addresses these questions by examining whether the retention of corporate directors on the audit committee following a financial restatement is related to individual director characteristics and/or the CEO's influence over the board of directors.

Richardson (2005) suggests that the observed retention rates of directors following a financial reporting failure are the result of an insufficient response to information signals about director quality. If true, decisions regarding board and committee membership must be relatively free of natural market pressures.[2] Consistent with this assertion, Carcello et al. (2011) present evidence indicating that CEO involvement in the nominating process can adversely impact audit committee effectiveness by increasing the likelihood of financial reporting failure. Such meddling in the nomination process by a powerful CEO may be associated with the observed lack of uniformity in the treatment of directors following a reporting failure and may have far reaching effects for the firm's investors.

Recent research, however, suggests that, in the post Sarbanes–Oxley (SOX) period, audit committee members choose board positions carefully, are nominated for election because of their expertise, and place a stronger emphasis on monitoring effectiveness (Beasley et al., 2009). Consistent with this idea, Cohen et al. (2010) and DeZoort et al. (2008) indicate that audit committee members are more involved and more knowledgeable about the financial reporting process and are more concerned with the accuracy of the financial statements in the post-SOX era. As a result, the variability in corrective actions following a reporting failure may be the result of the correctly identifying high-quality directors whose main purpose is to maintain the integrity of the financial reporting process.

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). 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, characteristics of the individual director, and control variables that have been shown to be associated with director turnover.[3] Results indicate that both the influence of the CEO and the involvement of the CEO in the nominating process positively affect the likelihood of an individual director remaining on the audit committee following a restatement. Moreover, the results suggest that directors with greater incentives to monitor the financial reporting process are less likely to be retained on the audit committee following the restatement. Together, these results provide initial evidence that the CEO may be able to interfere in the ex-post settling up process and, thereby, affect the composition of the audit committee following a restatement.

While most of the literature examining the consequences of financial restatements considers all reporting failures equally, Hennes et al. (2008) indicate that classifying financial restatements as involving either errors (unintentional misapplications of GAAP) or irregularities (intentional misapplications of GAAP) can greatly improve the power of hypotheses tests. As a result, I use the Hennes et al. (2008) database to classify all restatements in my sample and reexamine the retention of audit committee members at restating firms. For firms with reporting failures resulting from irregularities, the influence of the CEO and the involvement of the CEO in the nominating process continue to be

[1] For purposes of this study, corrective action against or the 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.

[2] This may occur when an insider is able to dominate the board of directors and engage in activities that are detrimental to the firm's investors (Fama, 1980). Such activities may include, but are not limited to, causing directors who are ineffective monitors of management to be retained on the board of directors as well as the audit committee of the board.

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