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Financial executive qualifications, financial executive turnover, and adverse SOX 404 opinions[☆]

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ABSTRACT

This study attempts to provide a comprehensive understanding of the interrelationships among chief financial officers' (CFOs') professional qualifications, SOX Section 404 internal control weakness, CFOs' turnover, CFOs' qualification improvement, and correction of material weaknesses. We find that firms receiving initial adverse SOX 404 opinions for 2004 have less qualified CFOs. Adverse SOX 404 opinion recipients experience more CFO turnover in 2005, and these firms are more likely to hire CFOs having improved qualifications. Results show that simply hiring a new CFO is not associated with SOX 404 opinion improvement. Opinion improvement requires hiring a better qualified CFO.

1. Introduction

The Sarbanes-Oxley Act (SOX) was passed in 2002 in response to a wave of corporate accounting scandals. Some view it as the most significant financial legislation of the past 70 years (PricewaterhouseCoopers, 2004). SOX's Section 404 requires public companies and their external auditors to report on the effectiveness of the companies' internal control over financial reporting (ICOFR). Auditors are required to issue an adverse opinion on the ICOFR if one or more material weaknesses exist (PCAOB Standard No. 2; Standard No. 5).[1] SOX 404 is intended to increase investor confidence in companies' financial reports and in the underlying processes and controls integral to their production.

Companies with adverse SOX 404 opinions are associated with lower earnings quality (Ashbaugh-Skaife et al. 2008; Chan et al. 2008), and larger management forecast errors (Feng et al. 2009). Improvement in SOX 404 opinions is associated

[☆] *Data Availability*: Data used in this study are available from public sources.

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[1] Material weakness is the key concept in evaluating the effectiveness of ICOFR under SOX 404. The Public Company Accounting Oversight Board (PCAOB) defines a material weakness as a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected (PCAOB Auditing Standard No. 2, 2004). When one or more material weaknesses exist in a company's ICOFR, SOX 404 requires auditors to indicate the weakness(es) in their reports. We refer to these instances as 'adverse SOX 404 reports.' On May 24, 2007, the PCAOB adopted Auditing Standard No. 5, which replaces the term "more than remote likelihood" with "reasonably possible" when defining internal control material weakness. Auditing Standard No. 2 was in effect during our sample period.

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with improved earnings quality (Ashbaugh-Skaife et al. 2008), and reduced management forecast errors (Feng et al. 2009). Thus, understanding the determinants of adverse SOX 404 opinions and subsequent corrective actions is important. Prior literature (Ge and McVay, 2005; Doyle et al.2007; Ashbaugh-Skaife et al. 2007) investigates determinants of internal control deficiencies. Explanatory variables largely consist of companies' financial conditions (such as loss status and leverage) and companies' other characteristics (such as size, growth, and complexity). However, the actions companies take to fix control problems remain largely unexplored. We extend prior research by asking whether chief financial officers' (CFOs') turnover and qualifications are associated with adverse SOX 404 opinions and correction of internal control material weaknesses.

CFOs supervise the recording and reporting functions in corporations. The nature of CFOs' duties has been heavily impacted by SOX, and the CFO turnover rate has increased over the past several years. Leone (2006), discussing a survey of Fortune 500 companies' CFOs, reports annual CFO turnover rates of 13 percent, 16 percent, and 19 percent respectively in the post-SOX years of 2003–2005.[2] For CFOs, the most significant provision of SOX is Section 404, which emphasizes the relationship between the financial reports and the underlying processes and controls integral to producing those reports. Both Congressional mandate and prevailing business practices hold CFOs accountable for these. According to Deloitte & Touche's Internet-based CFO Center (2008), "accounting, control, risk management and asset preservation are the province of the CFO. The CFO must ensure company compliance with financial reporting and control requirements."

The quality of the CFO's performance should be a function of the CFO's expertise and incentives. A number of studies have investigated the impact of management incentives on the quality of earnings (Healy, 1985; Cheng and Warfield, 2005; Bergstresser and Philippon, 2006). Little evidence is available on the effect of management *expertise* on the quality of earnings, or on the underlying quality of ICOFR.[3] In this paper, we focus on the role of the CFO's expertise (measured by professional qualifications) in the initial determination of adverse SOX 404 opinions and in the subsequent improvements in ICOFR. We also examine the impact of adverse SOX 404 opinions on the CFOs' turnover and on the new CFOs' qualifications.

Given CFOs' key role in ensuring internal control quality, we anticipate firms with less-qualified CFOs are more likely to receive adverse SOX 404 opinions. Since poorly performing managers are more likely to be replaced (Coughlan and Schmidt, 1985; Gilson, 1989; Beneish, 1999; Engel et al., 2003; Desai et al. 2006), companies receiving initial adverse SOX 404 opinions should experience higher CFO turnover.[4] New CFOs are likely to have better qualifications (more experience or better accounting credentials) if companies receiving adverse SOX 404 opinions seek to upgrade the quality of their ICOFR. We expect hiring new, better qualified CFOs improves subsequent SOX 404 opinions.

To investigate these hypotheses, we sample companies that disclose auditors' initial SOX 404 assessments in Form 10-Ks filed in 2005. The sample consists of 2478 companies: 416 receiving adverse SOX 404 opinions and 2062 receiving clean SOX 404 opinions. Our empirical results are summarized as follows. First, companies receiving initial adverse SOX 404 opinions have CFOs with weaker qualifications (in terms of accounting knowledge and experience as CFOs). Second, adverse opinion companies experience more subsequent CFO turnover. Third, among companies experiencing CFO turnover, those with adverse SOX 404 opinions hire more qualified new CFOs. This holds whether qualifications of new CFOs are compared to those of their predecessors, or to new CFOs at companies with clean SOX 404 opinions. Finally, adverse SOX 404 opinion companies that simply hire new CFOs do not improve their internal control quality. Instead, only those hiring more qualified CFOs receive better SOX 404 opinions in the following year. This finding suggests a positive influence of the newly hired CFO's professional qualifications on internal control quality improvement. This is an important practical implication for companies desiring to correct SOX 404 material weaknesses.

It is important to note that the association between CFO qualifications and internal control quality could be determined endogeneously. Some unobservable firm characteristics could drive both constructs. For instance, firms with inadequate resources are more likely to employ less qualified CFOs, and are also more likely to have poor internal controls. Although we control for firm size and financial performance, those factors are unlikely to be exhaustive measures of firm resources. However, in addition to showing that firms with poor initial CFO qualifications are more likely to receive adverse SOX 404 opinions, the study also finds that firms receiving adverse opinions tend to experience CFO turnover, and firms hiring improved CFOs are better at fixing their control problems. These subsequent results suggest that the association between CFO qualifications and internal control quality is unlikely to be driven solely by omitted variables.

This study's contributions are three-fold. First, it contributes to the nascent SOX 404 literature. Prior studies of determinants and improvements of adverse SOX 404 opinions mainly focus on companies' financial characteristics. This study finds that CFOs' qualifications are important, providing practical guidance for companies seeking to improve their

[2] Tuna (2008, p. B5) asserts that "CFOs are quitting or being ousted because the demands of the job are growing." CFO turnover at large companies remained at high levels in 2006 (14.1%) and 2007 (19.5%) according to Tuna.

[3] The distinction between quality of ICOFR and quality of reported earnings numbers is important. A company's ICOFR influences the expected quality of all numbers contained in financial reports, not just earnings. Furthermore, low earnings quality can refer to characteristics, such as low persistence or high discretionary accruals, that do not necessarily constitute misstatements that ICOFR is intended to prevent.

[4] CFO turnover following adverse SOX 404 opinions is unlikely to be simply punitive in nature since adverse SOX 404 opinions do not imply that companies have committed any reporting errors, only that the companies' internal controls are inadequate to make future reporting problems highly unlikely. Instead, SOX 404-related CFO turnover might be a more complex phenomenon in which CFO turnover can be either voluntary or involuntary. We discuss this issue when stating our second hypothesis in Section 3.