

The Monitoring Effectiveness of Co-opted Audit Committees

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Abstract: In this paper, we investigate the impact of audit committee co-option on financial reporting quality. We adapt the Coles et al. (2010) measure of board co-option and calculate audit committee co-option as the proportion of audit committee members appointed to the board after the current Chief Executive Officer (CEO) took office. Because CEOs are often actively involved in the director nomination and selection process, we expect that higher levels of audit committee co-option will be associated with less effective monitoring, as evidenced by more financial statement misstatements and greater absolute discretionary accruals. Consistent with our expectations, we find a positive relation between audit committee co-option and misstatements as well as between audit committee co-option and absolute discretionary accruals. Our findings should be of interest to regulators, investors, and other stakeholders because we provide new evidence about how potential CEO influence on director nominations and audit committee appointments impacts the effectiveness of monitoring.

1. Introduction

One of the central functions of the board of directors and of the audit committee is to monitor management. As such, the parties responsible for board of director nominations and audit committee appointments could have a significant influence on the monitoring effectiveness of these governance mechanisms. Consistent with this, the cofounder of Corporate Library, a corporate governance research and consulting company, states, “[t]here’s only one thing that matters and that’s who gets to decide who sits on the board” (Strebel 2011). More forcefully, activist investor Carl Icahn states, “members of the board are cronies appointed by the very CEOs they’re supposed to be watching” (Bloomberg Businessweek 2005). The importance of board composition and access to director nominations is highlighted by regulators in the provisions of the Sarbanes-Oxley Act of 2002 (SOX) and by stock exchanges in changes to listing requirements following the passage of SOX. Specifically, SOX changed the composition of audit committees by allowing only “independent” directors to serve, where independent directors are defined as those who are not current or former employees of the company. Moreover, effective January 1, 2004, the New York Stock Exchange (NYSE) and the National Association of Dealers Automated Quotations (NASDAQ) changed their listing requirements to prevent Chief Executive Officers (CEOs) from having formal influence over director nominations by requiring fully independent nominating committees.

Prior research examines a variety of board of director characteristics and their impact on monitoring effectiveness. This research typically tests for an association between proxies for monitoring effectiveness (e.g., financial reporting quality) and the proportion of outsiders (or non-employees) on the board. For example, prior studies document a negative association between board independence and paying greenmail (Kosnik 1987), earnings management using

discretionary accruals (Klein 2002), company performance (Duchin et al. 2010), and the value relevance of disclosures (Song et al. 2010).

Coles et al. (2010) use an alternative measure of board independence – board co-option – which is measured as the proportion of directors that joined the board after the acting CEO took office. As a measure of board independence, board co-option is based on the premise that the acting CEO can directly or indirectly influence director nominations and that those directors who join the board after the CEO took office (i.e., the co-opted directors) may feel a sense of allegiance to the CEO such that their effectiveness as monitors may be impaired.¹ Coles et al. (2010) investigate the effect of board co-option on CEO compensation and company risk. Using each of these outcomes, they find evidence suggesting that as board co-option increases, the quality of board monitoring decreases. For example, they find that higher levels of board co-option lead to higher CEO pay and increased company risk. Evidence in Coles et al. (2010) suggests that, although directors nominated to the board after the CEO is appointed to office may meet all of the exchange and regulatory listing requirements to be considered independent in appearance, they may not be independent in fact.²

Building on the arguments in Coles et al. (2010), we posit that co-option on the audit committee could have a significant effect on financial reporting quality because the audit committee has the primary responsibility for monitoring management’s financial reporting. We

¹ Prior research also suggests that CEOs prefer sympathetic board members because actions of these directors are aligned with interests of the CEO, rather than with interests of shareholders. For example, Westphal and Zajac (1996) find that companies with powerful CEOs appoint directors who maintain and reinforce the CEO’s power. In addition, Westphal and Zajac (1995) find that greater demographic similarity between the CEO and board members is associated with more generous CEO compensation. Moreover, Gerety et al. (2001) find that when the board does not have a nominating committee and CEOs are involved in director selection, investors react negatively to proposed director compensation plans.

² For example, the former CEO of The Walt Disney Company, Michael Eisner, once appointed the principal of his children’s school to Disney’s board. In this case, regulatory rules consider the appointed board member to be independent but the appointed board member could arguably be sympathetic to Eisner’s interests and therefore be a less effective monitor (Duchin et al. 2010).

adapt the Coles et al. (2010) measure of board co-option and calculate audit committee co-option as the proportion of audit committee members appointed to the board after the current CEO took office.³ In our tests, we investigate the relation between audit committee co-option and financial reporting quality using two widely-accepted measures of financial reporting quality – financial statement misstatements (as revealed through restatements) and absolute discretionary accruals (estimated using the performance-adjusted modified Jones model (Kothari et al. 2005)).⁴ We expect that higher levels of audit committee co-option will be associated with lower levels of financial reporting quality because co-opted audit committee members may feel a sense of allegiance to the sitting CEO (despite the SOX requirement that audit committees be fully independent).

Consistent with our predictions, we find that the likelihood of a financial statement misstatement is higher and that discretionary accruals are larger when audit committee co-option is higher.⁵ Our results are robust to controls for other governance variables (i.e., CEO duality, the proportion of directors who are outsiders, auditor type, and auditor tenure) and company characteristics (e.g., size, age, operating volatility, profitability, and leverage) found in prior research to influence misstatements and discretionary accruals. Our results are also robust to several alternative measures of audit committee co-option (i.e., a tenure-weighted approach, a quintile approach, and an industry-adjusted approach), to the removal of observations with very

³ In separate tests, we also investigate whether the Coles et al. (2010) measure of board co-option influences financial reporting quality.

⁴ We follow prior research and interpret higher values of absolute discretionary accruals as an indication of lower financial reporting quality, or more earnings management. See, for example, Chen et al. (2008), Francis and Yu (2009), Boone et al. (2012), and Cao et al. (2012).

⁵ We find no relation, however, between board co-option and misstatements or discretionary accruals. In addition, in untabulated analyses, we perform tests with both audit committee co-option and board co-option in the models. In both the misstatements and absolute discretionary accruals models, we continue to find a positive and significant relation between audit committee co-option and the likelihood of financial statement misstatement.

long or very short CEO tenure, and to controlling for director experience.⁶ In each of these tests, we find a negative association between audit committee co-option and financial reporting quality as proxied for by financial statement misstatements and absolute discretionary accruals.

Our findings should be of interest to regulators, investors, and other stakeholders interested in the effects of corporate governance on financial reporting quality because we provide new evidence about how potential CEO influence on audit committee appointments and on director nominations impacts monitoring effectiveness. Specifically, we provide evidence suggesting that higher audit committee co-option leads to weaker monitoring over financial reporting as evidenced by a higher incidence of financial statement misstatements and more extreme discretionary accruals. These findings suggest that current regulations for the appointment of directors may not be sufficient to provide effective oversight and they support recent attempts by the Securities Exchange Commission (SEC) to give investors more access to the process by which directors are nominated to the board.⁷ Similarly, our findings support a recent proposal to extend nominating committee membership to shareholders who are not members of the board of directors (Strebel 2011). Under such a proposal, shareholders would serve on a company's nominating committee, but would not have access to regular board meetings. This change would presumably allow shareholders to nominate directors whose interests are aligned with those of shareholders rather than management. In the absence of the proposals described above, our findings suggest that companies should provide (or exchanges should require) more education for directors about their roles and responsibilities.

⁶ We follow Coles et al. (2010) and use average director tenure to proxy for director experience.

⁷ In 2010, the SEC adopted an amendment to Exchange Act Rule 14a-11 that would have required companies to include shareholder nominated directors in the proxy materials but the U.S. Court of Appeals repealed the amendment in July of 2011 (Securities Exchange Commission 2012).

Finally, our findings should be of interest to academic researchers, regulators, auditors, and directors because they demonstrate that audit committee co-option is an important determinant of the effectiveness of monitoring. Specifically, we find that audit committee co-option has explanatory power above traditional corporate governance measures such as the percentage of outsiders on the board and whether the CEO serves on the nominating committee.

The remainder of this paper is organized as follows. In section 2, we discuss the background and prior literature. In section 3, we develop our hypotheses. Section 4 describes our sample selection and data. Section 5 presents the results of our empirical tests. Section 6 presents the results of additional analyses. Section 7 evaluates the robustness of our results, and section 8 offers concluding remarks.

2. Background and Prior Literature

According to agency theory, the actions of managers (who have incentives to act in their own interests rather than in the interests of stakeholders) should be monitored. A variety of corporate governance mechanisms, including oversight by a board of directors, can perform this monitoring role (Jensen 1993, Shleifer and Vishny 1997, Armstrong et al. 2010). As such, the primary roles of board members are to monitor and advise management (Jensen and Meckling 1976, Fama 1980). Prior research investigates the effectiveness of board monitoring within a variety of different contexts, including the payment of greenmail (Kosnik 1987), takeover resistance (Weisbach 1993, Buchholz and Ribbens 1994), CEO succession (Zajac 1990), and financial reporting quality (Klein 2002).⁸

⁸ Greenmail transactions occur when a company purchases its own stock at a premium in order to protect against hostile takeovers. These stock repurchases entrench management because they eliminate minority shareholders who could take over the company.

Some research suggests that the monitoring effectiveness of boards might suffer because of managerial hegemony. The theory of managerial hegemony suggests that managers have implied, rather than formal, power over board members and other corporate governance mechanisms.⁹ Thus, managers can use this implied power to bypass established governance structures, such as the board of directors and the audit committee, in order to achieve their own objectives, making the board a “rubber stamp” that ratifies management’s proposals and decisions (Herman 1981).

Given agency theory and the theory of managerial hegemony, prior research investigates the process whereby directors are selected to serve on the board, or more specifically, the role of the CEO in the director selection process.¹⁰ This process consists of identifying, screening, nominating, and electing directors. Prior research finds that, at least pre-SOX, CEOs typically approve initial director nominations (Hermalin and Weisbach 1998) and that nominated directors are generally voted into office by the shareholders because they typically run for open positions without opposition (Cai et al. 2009).¹¹ This gives CEOs at least indirect influence over director selection. In addition, Shivdasani and Yermack (1999) find that CEOs influence the director selection process by nominating fewer independent directors and by adding more grey directors to their boards.¹² They also suggest that CEO involvement on the nominating committee reduces the effectiveness of board monitoring.

In recent years, new regulations surrounding the composition of the board’s audit and nominating committees have been enacted. For example, SOX prohibits the appointment of

⁹ For a discussion of the theory of managerial hegemony, see Mace (1971), Herman (1981), Vance (1983), and Wolfson (1984).

¹⁰ See Withers et al. (2012) for a multidisciplinary review of the director selection literature.

¹¹ Shareholders do have the option to withhold their votes and forgo electing nominated directors, but prior research finds that these situations are very rare since under some director selection systems, nominated directors need only to receive a single affirmative vote from one shareholder in order to be elected to the board (Hillman et al. 2011).

¹² Grey directors are affiliated with management but are not employees. These may include, for example, business partners, family members, and former employees.

inside and grey directors to the audit committee, thereby making the audit committee ‘fully independent.’¹³ In addition, in 2004, the NYSE and NASDAQ listing requirements changed so that CEOs are prohibited from sitting on the nominating committee. Despite these regulatory changes, we posit that CEOs can still exercise considerable influence over the appointment of directors. Consistent with this, the executive search firm SpencerStuart reports that in 2010, 22 percent of director nominations to the board of the Standard and Poor’s 500 companies came from the CEO or other insiders (SpencerStuart 2010). Recent research also finds that the CEO not only influences director selection to the board, but also influences appointments to the audit committee. For example, Beasley et al. (2009) interviewed 42 audit committee members from February 2004 through 2005 and found that 38 percent of audit committee members met with or spoke with the CEO prior to their appointment to the board. Additionally, 33 percent had personal ties to management before joining the audit committee.

In his 1999 speech on the evolution of corporate governance, then SEC Chairman, Arthur Levitt, stated “...the link between a company’s management, directors and its financial reporting system has never been more crucial.” Since that time, many studies investigate the relation between corporate governance mechanisms and financial reporting quality. For example, Klein (2002) investigates the relation between audit committee characteristics and earnings management. She finds that companies with more independent audit committees report less extreme abnormal accruals. In addition, in a concurrent study investigating the effects of CEO power over the audit committee’s monitoring of internal control quality, Lisic et al. (2012) find that more powerful CEOs reduce the effectiveness of the audit committee as evidenced by an increased incidence of internal control weaknesses. Finally, using a sample of pre-SOX observations, Carcello et al. (2011) find that the probability of financial statement misstatements

¹³ Inside directors are company employees.

is greater when the CEO sits on the nominating committee (so influences the selection of directors to the board). They conclude that some of the benefits of an independent audit committee and financial experts are eliminated when CEO's have direct influence over board member nominations.¹⁴

Although our study is similar to Carcello et al. (2011) in some respects, we offer several new contributions to the literature. First, we focus on a measure of audit committee independence rather than on a measure of board independence. Carcello et al. (2011) investigate the outcome of situations where CEOs hold formal positions that allow them to influence board appointments. In contrast, our measure allows for the possibility of informal CEO influence over appointments to the board and to the audit committee. Second, we use absolute discretionary accruals, in addition to financial statement misstatements, to proxy for financial reporting quality. The advantages of this measure are that it can be computed for the universe of companies with available data and it does not rely on some party's ability and willingness to detect and report a misstatement. Third, as described below, we employ a new measure of CEO influence over the board and board committees that: 1) captures both direct and indirect influence, and 2) exhibits variation across companies in the period after regulatory changes render the Carcello et al. (2011) measure invariant.¹⁵

Our measure is inspired by Coles et al. (2010) who form a measure of potential CEO influence based on the notion that CEOs are at least implicitly involved in the process whereby directors are selected to the board. Coles et al. (2010) measure board co-option as the proportion of directors that joined the board after the current CEO took office. They find a positive relation

¹⁴ Also see, for example, Beasley (1996), Dechow et al. (1996), Carcello and Neal (2000), Xie et al. (2003), and Dehaan et al. (2012) for other investigations of the relation between governance and financial reporting quality.

¹⁵ Additionally, when we follow Carcello et al. (2011) and include CEO service on the nominating committee (pre-SOX) as a control variable in our tests, we find that audit committee co-option is still, confirming that it has incremental explanatory power for financial reporting quality.

between board co-option and both CEO pay and company risk, and interpret these results as suggesting that higher levels of board co-option lead to less effective board monitoring. We use our measure of audit committee co-option, which we derive from Coles et al. (2010) measure of board co-option, to test for a relation between audit committee co-option and financial reporting quality.

Two recent studies use variables similar to the board and audit committee co-option to measure monitoring. For example, Dechow et al. (2010) include the proportion of directors who joined the board *before* the CEO took office as a measure of governance in their study of the relation between asset securitizations and executive compensation. Specifically, they include an indicator variable set to one when more than half of the board members joined the board prior to the CEO's appointment, and zero otherwise. They find that reported securitization gains are less sensitive to pre-securitization earnings when more than half of the directors were appointed before the CEO took office but find no difference in the sensitivity of CEO compensation to reported securitization gains. In a concurrent paper, Lisic et al. (2011) measure the proportion of audit committee members that joined the audit committee *before* the CEO took office, which they label audit committee 'independence in fact' (rather than 'independence in appearance'). They find that companies with audit committees that are more independent in fact are less likely to dismiss their auditors following the receipt of material weakness reports. This finding suggests that more independent audit committees safeguard auditor independence and allow for better monitoring of management. Similarly, we anticipate that greater audit committee co-option (which is the opposite of their independence in fact measure) will lead to less effective monitoring and to more managerial discretion over financial reporting.

3. Hypothesis Development and Research Design

3.1 Hypothesis Development

Prior research finds a positive association between financial reporting quality and the percentage of independent directors on the board (Klein 2002) and a negative association between financial reporting quality and CEO service on the nominating committee (Carcello et al. 2011). In contrast to this prior research, we focus on the role of the audit committee in determining financial reporting quality because the audit committee has direct responsibility for oversight related to financial reporting. We expect less effective monitoring in companies with higher audit committee co-option, so we predict that financial reporting quality will be lower when co-option is higher. Thus, our alternative hypothesis is:

H1: Financial reporting quality will be lower when a greater proportion of audit committee members are co-opted.

We measure financial reporting quality using financial statement misstatements (as revealed through restatements) and discretionary accruals. With respect to financial statement misstatements, when monitoring is weak, managers may be more likely to make financial reporting choices that do not follow Generally Accepted Accounting Principles (GAAP). Financial statement restatements are evidence of prior misstatements, and restatements should be issued whenever financial reporting choices deviated materially from GAAP. Thus, we expect a positive relation between audit committee co-option and financial statement misstatements (as evidenced by subsequent restatements). With respect to discretionary accruals, weak monitoring should allow managers greater discretion in the reporting of accruals. Thus, we expect a positive relation between audit committee co-option and the absolute value of discretionary accruals.

3.2 Calculating Co-option

We calculate board co-option as the proportion of directors who joined the board following the CEO's appointment and calculate audit committee co-option as the proportion of audit committee members who joined the board following the CEO's appointment. Specifically, we adapt the co-option measure in Coles et al. (2010) and calculate audit committee co-option (*AC_CO-OPTION*) as:

$$AC_CO - OPTION = \frac{\# \text{ audit committee members added to the board after the CEO's appointment}}{\# \text{ members on the audit committee}}.$$

We identify inputs to our audit committee co-option measure from Riskmetrics. Since companies typically hold their annual meetings during the first three or four months of the fiscal year, we follow prior literature and assume that the board and committees organized at that meeting are responsible for monitoring the financial reporting decisions made by managers throughout the fiscal year. Our sample includes only those companies where the CEO is in office from the start of the fiscal year through the earnings announcement date (which is typically 60 or so days after year-end). This omits observations where the audit committee could not be co-opted simply because the CEO joined the board following the annual meeting and ensures that the CEO was able to influence the final financial reporting outcome (because the CEO, auditor, and audit committee exercise judgment over accruals and complex financial statement accounts after the fiscal year-end).¹⁶ In our sample, audit committee co-option ranges from 0 to 1, with a mean value of 0.57. Thus, more than half of audit committee members are

¹⁶ As a robustness test, in situations where a CEO turnover occurs midway through the year, we include all observations where the CEO at fiscal year-end was in place for the majority of the fiscal year (i.e., for six months or greater) and find the results unchanged.

co-opted on average, and there is significant variation in the amount of audit committee co-option across our sample companies.¹⁷

3.3 Tests with Financial Statement Misstatements

Prior research uses misstatements (as evidenced by restatements of previously issued financial statements) to indicate poor financial reporting quality (Kinney et al. 2004, Archambeault et al. 2008, Carcello et al. 2011, Cao et al. 2012). We take a similar approach and investigate the relation between audit committee co-option and misstatements by estimating the following model:

$$MISSTATEMENT_{it} = \Gamma_0 + \Gamma_1 AC_CO-OPTION_{it} + \Gamma_2 CONTROLS_{it} + \Gamma_3 YearFE + \Sigma_{it} \quad (1)$$

where:

- $MISSTATEMENT_{it}$ = an indicator variable set to one if the company misstated its financial statements in year t , zero otherwise;
- $AC_CO-OPTION_{it}$ = audit committee co-option, measured as the number of audit committee members joining the board after the CEO took office divided by the total number of members on the audit committee;
- $CONTROLS_{it}$ = controls for company and governance characteristics;
- $YearFE$ = year fixed effects; and
- Σ_{it} = the error term.

We estimate Equation (1) using logit regression and we cluster standard errors by company to control for multiple appearances of companies within our sample period (Petersen 2009). A positive and significant coefficient on $AC_CO-OPTION$ reveals that financial statements are more likely to be misstated when audit committees are more co-opted.

Because we are not aware of a generally accepted misstatement model, we estimate a model of misstatements using variables based on prior research. Consistent with prior

¹⁷ Interestingly, the sample contains 1,051 observations where no members of the audit committee are co-opted and 1,883 observations where all of the members of the audit committee are co-opted.

restatement research, we control for company characteristics associated with misstatements (e.g., Abbott et al. 2004, Kinney et al. 2004, Carcello et al. 2011, Cao et al. 2012) and governance characteristics associated with financial reporting quality (e.g., Klein 2002, Myers et al. 2003, Chen et al. 2008). In our model, we include year fixed effects (*YEARFE*) to control for variation in the dependent variable across time.

With respect to company characteristics, we control for mergers and acquisitions (*M&A*) following Kinney et al. (2004) and the need for financing (*FINANCING*) following Erickson et al. (2006). We control for business complexity using the number of business segments (*SEGMENTS*) and foreign operations (*FOREIGN*) because prior research finds a negative relation between complexity and financial reporting quality.¹⁸ We also control for the levels of accounts receivable and inventory scaled by total assets (*AR_IN*). We control for financial performance using return on assets from the current year (*ROA*) and an indicator variable set to one if the company reported negative net income for the current and previous year (*NEG_ROA*) because prior research suggests a relation between operating performance and the likelihood of misstatements or fraud.¹⁹ We follow Erickson et al. (2006) and control for uncertainty related to company operations and business environment, as proxied by returns volatility (*RETURNS_VOL*). We follow Cao et al. (2012) and control for market incentives (*BTM*), company size (*SIZE*), and leverage (*LEVERAGE*).

¹⁸ See, for example, Doyle et al. (2007) and Ashbaugh-Skaife et al. (2008).

¹⁹ Several studies find an association between the likelihood of misstatements or fraud and operating performance. Kinney and McDaniel (1989) find that less profitable companies are more likely to misstate and Beasley (1996) finds that companies with repeated losses are more likely to engage in financial fraud. Note, however, that Summers and Sweeney (1998) find a positive relation between performance and misstatements and Erickson et al. (2006) find mixed evidence on the relation between operating performance and misstatements or fraud.

With respect to governance characteristics, we control for CEO tenure (*LNCEO_TENURE*)²⁰ to proxy for CEO power, CEO involvement on the nominating committee (*CEO_ON_NOM*), CEO-Chairman duality (*CEOCHAIR*), the percentage of outsiders on the board (*%OUTSIDERS*), and whether the board has staggered director appointments (*STAGGERED*). Following Carcello et al. (2011), we also control for board characteristics – specifically, board size (*BOARDSIZE*) and audit committee size (*ACSIZE*).²¹ We also control for external auditor characteristics that may impact the likelihood of misstatement. Specifically, we include the number of consecutive years to date during which the auditor has audited the company (*LNAUDITOR_TENURE*)²² and whether the company is audited by a large auditor (*BIGN*). Finally, we add an indicator variable representing whether the company operates in a highly litigious industry (*LITIGATION*).²³

We expect a positive relation between *M&A* and misstatements because Kinney et al. (2004) suggest that acquisitions increase the likelihood of misstatements due to new, difficult, or contentious accounting issues. Based on findings in Carcello et al. (2011), we expect a positive relation between *CEO_ON_NOM* and misstatements. We also expect a negative relation between *%OUTSIDERS*, *BOARDSIZE*, and *ACSIZE* and misstatements because prior research finds that a higher percentage of outsiders on the board, larger audit committees, and larger

²⁰ Due to skewness in the distribution of CEO tenure, we follow prior research and take the natural log of CEO tenure (see, for example, Puffer and Weintrop 1991, Hazarika et al. 2011, Bugeja et al. 2012).

²¹ The results are robust to including a large audit committee indicator where the definition of a large audit committee (as in Carcello et al. (2011)) derives from the Recommendations of the Blue Ribbon Committee on Improving Audit Quality. Prior research finds that larger audit committees are better monitors because these committees generally have more resources available and are better able to oversee auditors, question management, and monitor the company's control environment (Anderson et al. 2004, Carcello et al. 2011).

²² Due to skewness in the distribution of auditor tenure, we follow prior research and take the natural log of tenure (i.e., the number of years during which the auditor has audited the company) (see, for example, Stanley and DeZoort 2007, Gul et al. 2009, and Carcello et al. 2011).

²³ We follow prior research and designate industries with SIC codes 2833-2836, 3570-3577, 3600-3674, 5200-5961, and 7370 as highly litigious (see, for example, Gul et al. 2009, Lim et al. 2010, Reichelt and Wang 2010, and Cassell et al. 2012).

boards are associated with higher quality financial reporting.²⁴ Finally, we expect companies that engage a Big N auditor to be less likely to misstate. Because prior research provides no basis for additional predictions, we form no expectations on signs of the other control variables.

3.4 Absolute Discretionary Accruals Tests

Following prior research, we use the absolute value of discretionary accruals to proxy for financial reporting quality, where smaller values of absolute discretionary accruals indicate better financial reporting quality (or less earnings management).²⁵ We follow Dechow et al. (1995) and Kothari et al. (2005) and use the residuals from the cross-sectional modified Jones model to estimate discretionary accruals, but we follow Chen et al. (2008) and Francis and Yu (2009) and include operating income scaled by lagged total assets.²⁶ Thus, we calculate discretionary accruals by estimating the following cross-sectional regression by two-digit SIC code and year:

$$TA_{it} = \alpha_0 + \alpha_1 (1/AT_{it-1}) + \alpha_2 (\Delta REV_{it} - \Delta AR_{it}) + \alpha_3 PPE_{it} + \alpha_4 OpIncome_{it} + \gamma_{it} \quad (2)$$

where:

TA_{it}	= total accruals for company i in year t , calculated as the difference between income before extraordinary items (Compustat Item IBC) and operating cash flows ($OANCF$);
AT_{it-1}	= assets (AT) at the beginning of year t ;
ΔREV_{it}	= the change in total revenue ($SALE$) from year $t-1$ to t ;
ΔAR_{it}	= the change in accounts receivable ($RECT$) from year $t-1$ to t ;
PPE_{it}	= gross property, plant, and equipment ($PPEGT$) in year t ;
$OpIncome_{it}$	= operating income ($OIADP$) in year t ;
γ_{it}	= the estimate of discretionary accruals;

²⁴ See, for example, Lipton and Lorsch (1992), Jensen (1993), and Dechow et al. (1996).

²⁵ See, for example, Jones (1991), Dechow et al. (1995), Myers et al. (2003), Kothari et al. (2005), Chen et al. (2008), Francis and Yu (2009), Boone et al. (2012), and Cao et al (2012).

²⁶ In addition, untabulated results are robust to the inclusion of alternative performance measures (e.g., net income or lagged ROA) used by prior research and suggested by Kothari et al. (2005).

and TA_{it} , ΔREV_{it} , ΔAR_{it} , PPE_{it} , and $OpIncome_{it}$ are all scaled by AT_{it-1} .

We use all available observations from Compustat but omit companies in regulated industries (with SIC codes 4000-4999) and financial companies (SIC codes 6000-6999), and we require at least 10 industry-year observations in each two-digit SIC code and year group. To minimize the impact of extreme observations, we follow Brown and Pinello (2007) and winsorize all variables entering the modified Jones model at the ± 1 percent level.

To test for a relation between of audit committee co-option and financial reporting quality, we estimate the following general model:

$$ABS_DISCACC_{it} = \beta_0 + \beta_1 AC_CO-OPTION_{it} + \beta_2 CONTROLS_{it} + \beta_3 YearFE + \mu_{it} \quad (3)$$

where:

$ABS_DISCACC_{it}$ = the absolute value of the discretionary accruals estimate from equation (2);

μ_{it} = the error term;

and all other variables are as previously defined.

We estimate Equation (3) using ordinary least squares regression and we use robust standard errors, clustering at the company level. A positive and significant coefficient on $AC_CO-OPTION$ would suggest lower financial reporting quality when there is greater audit committee co-option.

We follow prior research (e.g., DeFond and Jiambalvo (1994), Dechow et al. (1995), Becker et al. (1998), Butler et al. (2004), Menon and Williams (2004), and Hribar and Nichols (2007)) and control for company characteristics that could influence discretionary accounting choices. Specifically, we control for market incentives (BTM), company age (AGE), size ($SIZE$), cash flow from operations (CFO), cash flow volatility (CFO_VOL), sales volatility

(*SALES_VOL*), current year losses (*LOSS*), leverage (*LEVERAGE*), and whether the company operates in a highly litigious industry (*LITIGATION*).²⁷ Additionally, we include all of the governance control variables from the previous model (i.e., *LNCEO_TENURE*, *CEO_ON_NOM*, *CEOCHAIR*, *STAGGERED*, *%OUTSIDERS*, *BOARDSIZE*, *ACSIZE*, *BIGN*, and *LNAUDITOR_TENURE*).

We follow prior research when making predictions about signs of the control variables. As in Matsumoto (2002) and Hribar and Nichols (2007), we expect a negative relation between *BTM* and absolute discretionary accruals since more risky companies and those with more growth opportunities are likely to report large accruals. Following Dechow et al. (1995), we expect a positive relation between cash flows from operations (*CFO*) and absolute discretionary accruals. As in Hribar and Nichols (2007), we expect a positive relation between the volatility of cash flows (*CFO_VOL*) and sales (*SALES_VOL*) and absolute discretionary accruals. Following Zhao and Chen (2008), we expect a positive relation between the use of staggered boards (*STAGGERED*) and abnormal accruals. As in Klein (2002), we expect a negative relation between abnormal accruals and the percentage of outsiders on the board (*%OUTSIDERS*). We also expect a negative relation between audit committee size (*ACSIZE*) and absolute discretionary accruals because large audit committees have more available resources, which should allow for more effective monitoring of management and higher financial reporting quality. Finally, we expect companies audited by Big N auditors (*BIGN*) to report lower absolute discretionary accruals because large auditors have more resources to monitor

²⁷ In untabulated results, we include industry fixed effects rather than the litigious industry indicator variables in our models. We do this to ensure that variation across industries beyond that captured by the control variables does not influence our inferences. To control for industry effects, we create indicator variables for each of the Fama French 48 industry classifications (Fama and French 1997). Consistent with our tabulated results, we find positive associations between audit committee co-option and misstatements and between audit committee co-option and absolute discretionary accruals.

discretionary financial reporting and may experience greater reputation costs when reporting failures occur.

4. Sample Selection and Data

Our sample consists of all companies with the data necessary to compute audit committee co-option, discretionary accruals, and the control variables.²⁸ We collect director data from Riskmetrics and the Investor Responsibility Research Center (IRRC), CEO data from Execucomp, and financial data from the Compustat Fundamentals Annual database. Our sample period begins in 2000 (since restatement data are available from Audit Analytics from 2001 onward) and ends in 2010. Note that the Audit Analytics database contains restatements made to correct accounting that does not conform GAAP so our sample of misstatements does not include restatements due to changes in accounting principles, GAAP-to-GAAP changes, or changes in estimates. Following DeFond and Park (1997), we delete companies with total assets (*AT*) less than one million dollars, and to minimize the impact of extreme observations, we winsorize all continuous variables at ± 1 percent. We present the details of our sample selection in Table 1, Panel A. Our final sample includes 8,156 observations (from 1,629 unique companies).

Table 1, Panel B reveals that sample observations are evenly distributed across the selected sample period. Table 1, Panel C presents Fama and French (1997) industry classifications. Our sample represents a large number of industries, with the Computers industry representing the greatest proportion (at 12.2 percent of the sample) and the Tobacco industry representing the lowest proportion (at 0.06 percent).

²⁸ Recall that we eliminate companies that operate in regulated (SIC codes 4000 through 4999) and financial industries (SIC 6000 through 6999) when estimating absolute discretionary accruals. As such, companies from these industries are not included in our final sample.

We present descriptive statistics in Table 2. The mean age of sample companies is almost 27 years and only 16 percent of sample observations report a current year loss. This suggests that our sample is generally comprised of well-established, relatively profitable companies. With respect to governance variables, we find that the average CEO tenure for sample observations is 8.3 years, CEOs sit on 4 percent of the nominating committees, and the CEO also serves as Chairman of the Board in 60 percent of sample observations. In addition, 20 percent of sample observations have staggered boards, almost 72 percent of board members are outside directors, and the mean (median) audit committee has 3.5 (3) members. Finally, nearly 96 percent of sample observations are audited by a Big N auditor.

We present Spearman and Pearson correlations in Table 3. We do not find significant univariate correlations between the absolute value of discretionary accruals (*ABS_DISACC*) and audit committee co-option (*AC_CO-OPTION*) or board co-option (*B_CO-OPTION*), or between misstatements and *B_CO-OPTION*. We do find, however, positive and significant correlations between *AC_CO-OPTION* and misstatements.

5. Results

5.1 Tests using Financial Statement Misstatements

Table 4 presents the results of analyses investigating the impact of audit committee co-option and board co-option on the likelihood of financial statement misstatements. In Column 1, we find a positive and significant association ($p\text{-value} \leq .05$) between audit committee co-option and the likelihood of a financial statement misstatement, suggesting that greater audit committee co-option results in lower financial reporting quality. Thus, more co-opted audit committees are less effective monitors. In Column 2, we find no relation between board co-option and the

likelihood of a financial statement misstatement, suggesting that co-option of the board as a whole has no effect on financial reporting quality and monitoring.²⁹

Our results are robust to company-specific variables and governance variables used in prior research. Regarding the control variables, consistent with prior research, we find that companies with higher levels of accounts receivables and inventory (*AR_IN*), greater stock price volatility (*RETURNS_VOL*), and lower growth potential (*BTM*) are more likely to misstate their financial statements. Among the corporate governance control variables, we find that the percentage of outsiders on the board (*%OUTSIDERS*) and larger boards (*BOARDSIZE*) are negatively associated with the likelihood of a financial statement misstatement. However, we do not find significant coefficients on CEO service on the nominating committee (*CEO_ON_NOM*), audit committee size (*ACSIZE*), or Big N auditors (*BIGN*). The significance of audit committee co-option after including common corporate governance control variables reveals that our alternative monitoring measure (*AC_CO-OPTION*) has incremental explanatory power in explaining financial reporting quality.

5.2 Tests using Absolute Discretionary Accruals

In Table 5, we investigate whether audit committee co-option and board co-option affect another commonly used financial reporting quality measure, absolute discretionary accruals. In Column 1, we find that the coefficient on *AC_CO-OPTION* is significantly positive (p-value ≤ 0.05). Thus, higher levels of audit committee co-option are associated with more discretionary reporting by managers and with lower financial reporting quality. As with the test involving

²⁹ In untabulated analysis, we investigate the impact of audit committee co-option on the likelihood of financial statement misstatements after controlling for board co-option. We continue to find that audit committee co-option is positively associated with the likelihood of financial statement misstatements (p-value ≤ 0.01).

financial statement misstatements, the association between audit committee co-option and lower financial reporting indicates that more co-opted audit committees are less effective monitors.

With respect to company specific characteristics, consistent with prior research, we find a negative association between growth potential (*BTM*) and absolute discretionary accruals. We also find positive associations between volatility, both cash flow volatility (*CF_VOL*) and sales volatility (*SALES_VOL*), and absolute discretionary accruals. With respect to the governance related variables, consistent with prior research, we find a negative association between *ACSIZE* and absolute discretionary accruals. This result is consistent with prior research and suggests that larger audit committees and larger boards are better monitors. However, we find no significant relation between CEO involvement on the nominating committee (*CEO_ON_NOM*), the percentage of outsiders on the board (*%OUTSIDERS*), or the use of a Big N auditor (*BIGN*) and absolute discretionary accruals. Most importantly, we find, however, a positive association between audit committee co-option (*AC_CO-OPTION*) and absolute discretionary accruals, again illustrating that audit committee co-option has incremental explanatory power over traditional measures of board and audit committee monitoring.

In Column 2, we find no relation between board co-option and absolute discretionary accruals. This finding coincides with the notion that the audit committee, rather than the board, has the ultimate responsibility for monitoring financial reporting quality.³⁰

6. Additional Analyses

In additional analyses, we investigate the impact of co-option on financial reporting quality using a sample of post-SOX observations. To perform this test, we eliminate all

³⁰ In untabulated analyses, we investigate the impact of audit committee co-option on absolute discretionary accruals after controlling for board co-option. We continue to find a positive association between audit committee co-option and absolute discretionary accruals (p-value ≤ 0.10).

observations from companies with fiscal years ending before 2003. Our sample size decreases to 6,112 observations, representing 1,347 unique companies. The post-SOX sample allows us to test whether co-option influences financial reporting quality in a setting where regulatory rules require audit committees to be fully independent and to have at least one designated financial expert.

6.1 Post-SOX Tests using Financial Statement Misstatements

In Table 6, we investigate the impact of audit committee co-option and board co-option on the likelihood of financial statement misstatements using the sample of post-SOX observations. In Column 1, we find a positive and significant association between audit committee co-option and the likelihood of financial statement misstatement ($p\text{-value} \leq .10$), suggesting that greater audit committee co-option results in lower financial reporting quality, even in regulatory environment where all audit committee members are required to be fully independent. Thus, despite regulatory requirements aimed at increasing monitoring effectiveness, we find that more co-opted audit committee members are less effective monitors. In Column 2, we find no relation between board co-option and the likelihood of financial statement misstatements. This result is consistent with the results in Table 5, and suggests that board co-option has no impact on financial reporting quality or monitoring post-SOX.

6.2 Post-SOX Tests using Absolute Discretionary Accruals

Table 7 presents the results of analyses investigating the impact of audit committee co-option and board co-option on absolute discretionary accruals. In Column 1, we find a positive and significant association between audit committee co-option and absolute discretionary accruals ($p\text{-value} \leq .10$). Thus, we find that greater audit committee co-option results in lower financial reporting quality post-SOX. In Column 2, we continue to find no relation between

board co-option and absolute discretionary accruals, again suggesting that board co-option has no impact on financial reporting or monitoring.

7. Robustness Checks

In this section, we describe the results of a series of robustness checks designed to ensure that our primary results are not sensitive to the measurement of co-option, industry effects, length of CEO tenure, or director inexperience.

7.1 Additional Measures of Audit Committee Co-option

We use three alternative measures of audit committee co-option to ensure that our results are not sensitive to our method of calculating audit committee co-option. Specifically, we calculate audit committee co-option using a tenure-weighted approach, a quintile approach, and an industry-adjusted approach.

The tenure-weighted approach follows Coles et al. (2010). Tenure weighted co-option is calculated as the number of tenure-years served by directors added after the appointment of a new CEO divided by the number of director-years served by all directors. This measure places more weight on board members who joined the board before the CEO took office under the assumption that these directors might be more influential. In untabulated analyses, we find that tenure-weighted audit committee co-option is positively associated with the likelihood of financial statement misstatements and with absolute discretionary accruals. However, we find no relation between tenure-weighted board co-option and misstatements or absolute discretionary accruals. Overall, these results are consistent with the findings using our original measure of audit committee co-option (*AC_CO-OPTION*).

Under the quintile approach, we create the second alternative measure of audit committee co-option that classifies audit committee co-option (and board co-option) into quintiles by industry and year. This approach ensures that our results are not due to extreme observations and does not assume that the relation between financial reporting quality and co-option is linear. In untabulated analyses, we find a positive association between audit committee co-option and misstatements and between audit committee co-option and absolute discretionary accruals. However, as in prior tests, we find no relation between the quintile measure of board co-option and financial statement misstatements or absolute discretionary accruals.

Finally, we calculate an industry-adjusted measure of co-option because director turnover may vary by industry. Here, we calculate industry-adjusted audit committee co-option (and industry-adjusted board co-option) by taking the company specific co-option measure and subtracting the median value of co-option in the two digit SIC code industry-year. In untabulated analyses, we find that industry-adjusted audit committee co-option is positively associated with both financial statement misstatements and absolute discretionary accruals. However, as with the previous tests, we no relation between industry-adjusted board co-option and financial statement misstatements or absolute discretionary accruals. This finding is consistent with our previous tests in that higher audit committee co-option appears to reduce the quality of monitoring.

7.2 Eliminating Observations with Very Short and Very Long CEO Tenure

Next, we perform all of the previous tests after eliminating observations with very short or very long CEO tenure (i.e., those observations where the CEO has been in office for less than 2 years or more than 25 years to date, where 2 and 25 years are at the 5th and 95th percentiles of the CEO tenure distribution, respectively). We do this to ensure that a mechanical relation

(where co-option is very low when CEOs have very short tenures, and very high when CEOs have very long tenures) is not driving our inferences. Although this reduces our sample size by 1,416 observations, in untabulated analyses, we continue to find a positive association between audit committee co-option and misstatements and between audit committee co-option and absolute discretionary accruals.

7.3 Controlling for Average Director Tenure

Another possible explanation for our findings is that audit committee co-option captures director inexperience because, all else equal, higher values of co-option indicate that audit committee members have been more recently added to the company's board. In untabulated analyses, we find that the average director tenure in our sample is 8.6 years, which is comparable with the average in Coles et al. (2010). We perform all of the previous tests after controlling for average director tenure and continue to find a positive relation between audit committee co-option and financial statement misstatements and between audit committee co-option and absolute discretionary accruals. Thus, our results are not driven by director inexperience, suggesting that managerial hegemony may be responsible for lower quality monitoring.

8. Conclusion

In this study, we investigate how CEO hegemony over directors affects audit committee monitoring of the financial reporting process. Prior research finds that more independent boards (i.e., those with a greater proportion of directors who are not company employees and do not have other relationships with managers) are more effective monitors. However, these studies do not consider the CEO's direct and indirect influence over the selection of potentially sympathetic directors to the board. We use an alternative measure of independence – co-option – which

measures the proportion of directors who have joined the audit committee or the board following the appointment of the CEO. We do this because prior research suggests that CEOs have influence over director nominations and because the theory of managerial hegemony suggests that these newly appointed directors may be more sympathetic to the preferences of management, making them less effective monitors, than directors appointed to the board before the CEO took office.

We investigate whether the co-option of audit committees and boards appears to influence the quality of monitoring over the financial reporting process, as proxied for by financial statement misstatements and discretionary accruals. We find that higher levels of audit committee co-option leads to a greater likelihood of financial statement misstatements and to higher absolute discretionary accruals, even after controlling for company-specific measures found in prior research to influence financial reporting quality. Additionally, our results are robust to other governance controls including the proportion of outsiders on the board, CEO-Chairman duality, and CEO service on the nominating committee. Furthermore, our results are robust to alternative measures of co-option, industry fixed effects, the omission of observations with very long and very short CEO tenure, and average director tenure.

We contribute to research on financial reporting quality and monitoring by documenting that co-opted audit committees reduce monitoring effectiveness by allowing greater discretion in financial reporting. We expect that our findings will be of interest to academic researchers because we provide a powerful, but easy to calculate, measure that is associated with the effectiveness of audit committee monitoring. Our findings should also interest investors, regulators, and other stakeholders concerned with the effectiveness of audit committee monitoring. Finally, our findings lend some support to proposals to give shareholders more

access to the director nomination process because they indicate that financial reporting quality is lower when CEOs can have even indirect influence over the selection of directors to the board and to board committees.

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Appendix A - Variable Definitions

Variable Name	Description
<i>TA</i>	Total accruals for company <i>i</i> , calculated as the difference between income before extraordinary items (<i>IBC</i>) and operating cash flows (<i>OANCF</i>);
<i>AT</i>	Beginning of the year total assets (<i>AT</i>);
ΔREV	The change in total revenue from year <i>t-1</i> to <i>t</i> (<i>SALE</i>);
ΔAR	The change in accounts receivable from year <i>t-1</i> to <i>t</i> ;
<i>PPE</i>	Gross property, plant, and equipment (<i>PPEGT</i>);
<i>OpIncome</i>	Operating income (<i>OIADP</i>) divided by lagged assets (<i>AT</i>);
<i>DISCACC</i>	Estimate of discretionary accruals.
<i>MISSTATEMENT</i>	An indicator variable set to one if the company misstated the financial statements during the fiscal year.
<i>AC_CO-OPTION</i>	Audit committee co-option, measured as the number of audit committee members joining the board after the CEO took office divided by the total number of members on the audit committee;
<i>B_CO-OPTION</i>	Board co-option, measured as the total new members of the board that were appointed after the CEO took office divided by total board size;
<i>BTM</i>	Book to market, calculated as beginning common equity (<i>CEQ</i>) divided by beginning of the year share price (<i>PRCC_F</i>) multiplied by the number of common share outstanding (<i>CSHO</i>).
<i>AGE</i>	The company age, calculated as the number of years in which the company has total assets (<i>AT</i>) greater than zero;
<i>SIZE</i>	The natural log of total assets (<i>AT</i>).
<i>CFO</i>	Operating cash flows (<i>OANCF</i>) scaled by total assets (<i>AT</i>).
<i>CFO_VOL</i>	The standard deviation of operating cash flows (<i>OANCF</i>) scaled by total assets (<i>AT</i>) over the prior four years.
<i>SALES_VOL</i>	The standard deviation of sales (<i>SALE</i>) scaled by total assets (<i>AT</i>) over the prior four years.
<i>LOSS</i>	An indicator value set to one if the company had negative net income (<i>NI</i>) during the year, zero otherwise.
<i>LAGGED_ROA</i>	The lagged value of ROA calculated as lagged income before extraordinary items (<i>IB</i>) scaled by lagged total assets (<i>AT</i>).
<i>LEVERAGE</i>	The debt-to-assets ratio calculated as total long term debt (<i>DLTT</i>) scaled by total assets (<i>AT</i>).
<i>LNCEO_TENURE</i>	The CEO tenure, calculated as the natural log of the number of years the CEO was in office.
<i>CEO_ON_NOM</i>	An indicator variable set to one if the CEO served on the nominating committee, zero otherwise.
<i>CEOCHAIR</i>	An indicator variable set to one if the CEO is the chairman of the board, zero otherwise.
<i>STAGGERED</i>	An indicator variable set to one if election of directors for a company is staggered, 0 otherwise.
<i>%OUTSIDERS</i>	The percentage of independent directors on the board calculated as the number of independent directors divided by total board size.
<i>BOARDSIZE</i>	The size of the board as of the annual shareholder meeting date.
<i>ACSIZE</i>	The size of the audit committee as of the annual shareholder meeting date.
<i>BIGN</i>	An indicator variable set to one if the company was audited by a Big X auditor.
<i>LNAUDITOR_TENURE</i>	The natural log of the number of years that the company was audited by the current auditor.
<i>AR_IN</i>	The proportion of accounts receivable (<i>RECT</i>) and inventory (<i>INVT</i>) to total assets (<i>AT</i>).
<i>RETURNS_VOL</i>	The daily stock return volatility during the previous and current year.

<i>FOREIGN</i>	The proportion of company sales generated in foreign countries (Compustat Segment File)
<i>SEGMENT</i>	The count of the number of operating, business, and geographic segments for each company during each year.
<i>M&A</i>	An indicator variable set to one if the company engaged in an acquisition during the year (<i>SALE_FN</i>), following Kinney et al. (2004).
<i>FINANCING</i>	An indicator variable set to one if M&A is not equal to one and if the number of shares outstanding (<i>CSHO</i>) increased by at least 10 percent during the year, or if M&A is not equal to one and if long-term debt increased by at least 20 percent during the year, and 0 otherwise.
<i>NEG_ROA</i>	An indicator variable set to one if the company reported a loss in the prior or current year.
<i>ROA</i>	Return on assets measured as net income before extraordinary items (<i>IB</i>) divided by lagged total assets (AT_{t-1})
<i>YearFE</i>	Year fixed effect

Table 1 – Sample Selection

Panel A – Number of Observations for Co-option on the Audit Committee

Companies with available data to compute audit committee co-option and board co-option	14,007
Observations missing from Compustat	2,635
Observations missing from IRRC and Riskmetrics	1,417
Observations missing from Audit Analytics	1,799
Final Sample	8,156*

*Representing 1,629 unique companies

Panel B – Observations by Year

Fiscal Year	Frequency	Percent
2000	610	7.48
2001	707	8.67
2002	727	8.91
2003	766	9.39
2004	776	9.51
2005	749	9.18
2006	745	9.13
2007	676	8.29
2008	700	8.58
2009	838	10.27
2010	862	10.57
Total	8,156	100%

Panel C - Observations by Fama and French (1997) Industry Classification

Industry	Description	N	%
1	Agriculture	9	0.11
2	Food Products	241	2.96
3	Candy & Soda	21	0.26
4	Beer & Liquor	48	0.59
5	Tobacco Products	5	0.06
6	Recreation	53	0.61
7	Entertainment	57	0.7
8	Printing and Publishing	125	1.54
9	Consumer Goods	193	2.37
10	Apparel	179	2.2
11	Healthcare	194	2.38
12	Medical Equipment	304	3.73
13	Pharmaceutical Products	370	4.54

14	Chemicals	301	3.7
15	Rubber and Plastic Products	63	0.77
16	Textiles	33	0.41
17	Construction Materials	200	2.46
18	Construction Materials	126	1.55
19	Steel Works Etc	183	2.25
20	Fabricated Products	27	0.33
21	Machinery	462	5.67
22	Electrical Equipment	134	1.65
23	Automobiles and Trucks	50	0.61
24	Aircraft	163	2
25	Shipbuilding and Railroad Equipment	82	0.91
26	Defense	20	0.25
27	Precious Metals	30	0.37
28	Non-Metallic and Industrial Metal Mining	12	0.15
29	Coal	47	0.58
30	Petroleum and Natural Gas	27	0.33
31	Utilities	385	4.73
32	Communication	54	0.66
34	Business Services	94	1.15
35	Computers	992	12.2
36	Computer Software	330	4.05
37	Electronic Equipment	723	8.88
38	Measuring and Control Equipment	237	2.91
39	Business Supplies	198	2.43
40	Shipping Containers	56	0.69
41	Transportation	111	1.36
42	Wholesale	340	4.18
43	Retail	650	7.94
44	Restaurants, Hotels, Motels	227	2.79
Total		8,156	100%

Table 2 - Descriptive Statistics

Variable	N	Mean	Std Dev	25th Pctl	Median	75th Pctl
<i>ABS_DISCACC</i>	8156	0.049	0.055	0.016	0.035	0.064
<i>MISSTATEMENT</i>	8156	0.101	0.301	0.000	0.000	0.000
<i>AC_CO-OPTION</i>	8156	0.562	0.368	0.250	0.600	1.000
<i>B_CO-OPTION</i>	8156	0.476	0.284	0.231	0.500	0.714
<i>BTM</i>	8156	0.496	0.408	0.259	0.414	0.622
<i>AGE</i>	8156	26.760	16.050	13.000	21.000	41.000
<i>SIZE</i>	8156	4,208.151	7,637.36	590.35	1,443.97	3,955.44
<i>CFO</i>	8156	0.123	0.096	0.072	0.117	0.172
<i>CF_VOL</i>	8156	0.044	0.038	0.020	0.034	0.055
<i>SALES_VOL</i>	8156	0.129	0.119	0.056	0.096	0.165
<i>LOSS</i>	8156	0.159	0.366	0.000	0.000	0.000
<i>LAGGED_ROA</i>	8156	0.047	0.122	0.024	0.056	0.093
<i>LEVERAGE</i>	8156	0.175	0.159	0.012	0.158	0.278
<i>CEO_TENURE</i>	8156	8.249	7.370	3.007	5.907	10.763
<i>CEO_ON_NOM</i>	8156	0.041	0.197	0.000	0.000	0.000
<i>CEOCHAIR</i>	8156	0.602	0.490	0.000	1.000	1.000
<i>STAGGERED</i>	8156	0.200	0.400	0.000	0.000	0.000
<i>%OUTSIDERS</i>	8156	0.718	0.151	0.625	0.750	0.846
<i>BOARDSIZE</i>	8156	8.849	2.172	7.000	9.000	10.000
<i>ACSIZE</i>	8156	3.470	1.060	3.000	3.000	4.000
<i>BIGN</i>	8156	0.957	0.204	1.000	1.000	1.000
<i>AUDITOR_TENURE</i>	8156	12.806	9.454	5.000	10.000	18.000
<i>AR_IN</i>	8156	0.265	0.157	0.145	0.248	0.352
<i>RETURNS_VOL</i>	8156	0.330	0.241	0.121	0.296	0.462
<i>FOREIGN</i>	8156	0.283	0.275	0.000	0.225	0.481
<i>SEGMENT</i>	8156	5.392	2.953	3.000	5.000	7.000
<i>M&A</i>	8156	0.141	0.348	0.000	0.000	0.000
<i>FINANCING</i>	8156	0.215	0.411	0.000	0.000	0.000
<i>NEG_ROA</i>	8156	0.239	0.426	0.000	0.000	0.000
<i>ROA</i>	8156	0.045	0.124	0.024	0.056	0.092

Note: In this table, we present descriptive statistics for *SIZE*, *LNCEO_TENURE*, and *LNAUDITOR_TENURE* before the logarithmic transformation.

Table 3 - Selected Correlations

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
(1) <i>ABS_DISACC</i>		0.023	0.010	-0.003	0.006	0.011	-0.040	-0.008	-0.030	-0.136	-0.080	-0.008	-0.062
(2) <i>MISSTATEMENT</i>	0.025		0.041	0.022	0.023	0.047	0.015	0.032	-0.116	-0.055	-0.059	0.037	-0.029
(3) <i>AC_CO-OPTION</i>	0.009	0.039		0.871	0.637	0.004	0.177	-0.004	-0.101	-0.070	-0.066	-0.067	-0.019
(4) <i>B_CO-OPTION</i>	-0.003	0.021	0.870		0.687	0.009	0.219	-0.003	-0.063	-0.021	-0.048	-0.060	-0.024
(5) <i>LNCEO_TENURE</i>	-0.006	0.021	0.628	0.679		-0.007	0.243	-0.035	-0.070	-0.147	-0.068	-0.103	-0.024
(6) <i>CEO_ON_NOM</i>	0.011	0.047	0.004	0.009	-0.003		0.011	0.080	-0.106	-0.011	-0.003	-0.014	-0.018
(7) <i>CEOCHAIR</i>	-0.044	0.015	0.177	0.219	0.247	0.011		0.079	0.065	0.047	0.057	-0.009	0.011
(8) <i>STAGGERED</i>	-0.012	0.032	-0.004	-0.003	-0.036	0.080	0.079		-0.080	0.075	-0.016	0.049	-0.031
(9) <i>%OUTSIDERS</i>	-0.031	-0.115	-0.087	-0.057	-0.075	-0.110	0.056	-0.082		0.152	0.267	0.079	0.092
(10) <i>BOARDSIZE</i>	-0.118	-0.051	-0.056	-0.011	-0.134	-0.010	0.048	0.073	0.108		0.417	0.133	0.226
(11) <i>ACSIZE</i>	-0.078	-0.057	-0.046	-0.039	-0.063	-0.004	0.063	-0.011	0.247	0.418		0.080	0.138
(12) <i>BIGN</i>	0.003	0.037	-0.065	-0.060	-0.108	-0.014	-0.009	0.049	0.064	0.123	0.080		0.153
(13) <i>LNAUDITOR_TENURE</i>	-0.042	-0.028	-0.018	-0.027	-0.023	-0.029	0.002	-0.038	0.090	0.198	0.120	0.167	

Notes: Spearman correlations above the diagonal and Pearson correlations below the diagonal. **Bold** values indicate significance at the <.05 level (two-tailed test). All variables are defined in Appendix A.

Table 4 – Regressions of a Misstatement Indicator on Co-Option and Control Variables

	Prediction	(1)			(2)		
		coef	p-value		coef	p-value	
<i>INTERCEPT</i>	?	-4.805	0.000	***	-4.790	0.000	***
<i>AC_CO-OPTION</i>	+	0.342	0.042	**			
<i>B_CO-OPTION</i>	+				0.051	0.431	
<i>M&A</i>	+	0.051	0.330		0.059	0.304	
<i>FINANCING</i>	?	0.163	0.111		0.163	0.112	
<i>SEGMENTS</i>	?	-0.015	0.634		-0.017	0.606	
<i>FOREIGN</i>	?	0.275	0.388		0.260	0.416	
<i>AR_IN</i>	?	0.685	0.084	*	0.678	0.088	*
<i>RETURNS_VOL</i>	?	0.693	0.036	**	0.700	0.033	**
<i>NEG_ROA</i>	?	0.148	0.278		0.148	0.276	
<i>ROA</i>	?	0.366	0.305		0.339	0.338	
<i>BTM</i>	?	0.253	0.057	*	0.253	0.058	*
<i>SIZE</i>	?	-0.004	0.950		-0.003	0.962	
<i>LEVERAGE</i>	?	-0.132	0.767		-0.133	0.765	
<i>LNCEO_TENURE</i>	?	0.018	0.828		0.096	0.306	
<i>CEO_ON_NOM</i>	+	0.234	0.139		0.239	0.135	
<i>CEOCHAIR</i>	?	-0.027	0.819		-0.025	0.831	
<i>STAGGERED</i>	?	-0.059	0.634		-0.059	0.635	
<i>%OUTSIDERS</i>	-	-0.817	0.019	**	-0.844	0.016	**
<i>BOARDSIZE</i>	-	-0.084	0.094	*	-0.082	0.101	
<i>ACSIZE</i>	-	-0.014	0.366		-0.012	0.384	
<i>BIGN</i>	-	0.736	0.960		0.744	0.030	
<i>LNAUDITOR_TENURE</i>	?	0.040	0.552		0.041	0.536	
<i>LITIGATION</i>	?	0.472	0.002	***	0.469	0.002	***
<i>YEARFE</i>		Included			Included		
N		8,156			8,156		
Pseudo R ²		0.100			0.100		

Notes: We use one-tailed tests when we make predictions on sign, and two-tailed tests otherwise. We estimate these regressions using a logitregression and cluster all standard errors by company (Petersen 2009). ***, **, and * indicate $p < 0.010$, $p < 0.050$, and $p < 0.10$, respectively. All variables are defined in Appendix A.

Table 5 - Regressions of Absolute Discretionary Accruals on Co-Option and Control Variables

	Prediction	(1)			(2)		
		coef	p-value		coef	p-value	
<i>INTERCEPT</i>	?	0.034	0.000	***	0.035	0.000	***
<i>AC_CO-OPTION</i>	+	0.004	0.049	**			
<i>B_CO-OPTION</i>	+				0.002	0.216	
<i>BTM</i>	-	-0.005	0.004	***	-0.005	0.008	***
<i>AGE</i>	?	0.000	0.001	***	0.000	0.001	***
<i>SIZE</i>	?	0.000	0.908		0.000	0.911	
<i>CFO</i>	?	0.097	0.000	***	0.097	0.000	***
<i>CFO_VOL</i>	+	0.308	0.000	***	0.308	0.000	***
<i>SALES_VOL</i>	+	0.034	0.000	***	0.034	0.000	***
<i>LOSS</i>	?	0.034	0.000	***	0.034	0.000	***
<i>LEVERAGE</i>	?	-0.001	0.845		-0.001	0.849	
<i>LNCEO_TENURE</i>	?	-0.001	0.270		-0.001	0.588	
<i>CEO_ON_NOM</i>	?	-0.003	0.441		-0.003	0.447	
<i>CEOCHAIR</i>	?	-0.002	0.108		-0.002	0.108	
<i>STAGGERED</i>	+	-0.001	0.396		0.000	0.398	
<i>%OUTSIDERS</i>	-	0.001	0.410		0.001	0.444	
<i>BOARDSIZE</i>	?	-0.001	0.186		-0.001	0.203	
<i>ACSIZE</i>	-	-0.001	0.051	*	-0.001	0.049	**
<i>BIGN</i>	-	0.005	0.970		0.005	0.974	
<i>LNAUDITOR_TENURE</i>	?	0.000	0.914		0.000	0.901	
<i>LITIGATION</i>	?	0.003	0.030	**	0.003	0.030	**
<i>YEARFE</i>		Included			Included		
N		8,156			8,156		
Adjusted R ²		0.151			0.151		

Notes: We use one-tailed tests when we make predictions on sign, and two-tailed tests otherwise. We estimate these regressions using a OLS regression and cluster all standard errors by company (Petersen 2009). ***, **, and * indicate p<0.010, p<0.050, and p<0.10, respectively. All variables are defined in Appendix A.

Table 6 - Post-SOX Regressions of a Misstatement Indicator on Co-Option and Control Variables

	Prediction	coef	p-value			coef	p-value		
<i>INTERCEPT</i>	?	-4.726	0.000	***	-4.682	0.000	***		
<i>AC_CO-OPTION</i>	+	0.371	0.059	*					
<i>B_CO-OPTION</i>	+				0.118	0.372			
<i>M&A</i>	+	-0.296	0.030	**	-0.287	0.034	**		
<i>FINANCING</i>	?	0.053	0.667		0.053	0.672			
<i>SEGMENTS</i>	?	-0.003	0.924		-0.005	0.897			
<i>FOREIGN</i>	?	0.249	0.472		0.241	0.488			
<i>AR_IN</i>	?	0.871	0.036	**	0.872	0.036	**		
<i>RETURNS_VOL</i>	?	0.816	0.048	**	0.816	0.044	**		
<i>NEG_ROA</i>	?	0.112	0.514		0.112	0.511			
<i>ROA</i>	?	0.481	0.361		0.455	0.383			
<i>BTM</i>	?	0.546	0.002	***	0.548	0.002	***		
<i>SIZE</i>	?	0.014	0.825		0.013	0.837			
<i>LEVERAGE</i>	?	0.084	0.882		0.100	0.859			
<i>LNCEO_TENURE</i>	?	0.055	0.580		0.125	0.278			
<i>CEO_ON_NOM</i>	+	0.472	0.103		0.489	0.095	*		
<i>CEOCHAIR</i>	?	-0.068	0.615		-0.070	0.606			
<i>STAGGERED</i>	?	-0.154	0.331		-0.155	0.329			
<i>%OUTSIDERS</i>	-	-1.076	0.018	**	-1.116	0.015	**		
<i>BOARDSIZE</i>	-	-0.146	0.021	**	-0.145	0.022	**		
<i>ACSIZE</i>	-	-0.038	0.194		-0.036	0.209			
<i>BIGN</i>	-	0.648	0.923		0.650	0.925			
<i>LNAUDITOR_TENURE</i>	?	0.122	0.146		0.124	0.138			
<i>LITIGATION</i>	?	0.391	0.020	**	0.390	0.020	***		
<i>YEARFE</i>		Included			Included				
N		6,112			6,112				
Pseudo R ²		0.126			0.125				

Notes: We use one-tailed tests when we make predictions on sign, and two-tailed tests otherwise. We estimate these regressions using a logit regression and cluster all standard errors by company (Petersen 2009). ***, **, and * indicate p<0.010, p<0.050, and p<0.10, respectively. All variables are defined in Appendix A.

**Table 7 - Post-SOX Regressions of Absolute Discretionary Accruals on
Co-Option and Control Variables**

	Prediction	(1)			(2)		
		coef	p-value		coef	p-value	
<i>INTERCEPT</i>	?	0.020	0.003	***	0.021	0.002	***
<i>AC_CO-OPTION</i>	+	0.003	0.068	*			
<i>B_CO-OPTION</i>	+				0.004	0.153	
<i>BTM</i>	-	-0.002	0.149		-0.002	0.152	
<i>AGE</i>	?	0.000	0.014	***	0.000	0.015	***
<i>SIZE</i>	?	0.000	0.979		0.000	0.958	
<i>CFO</i>	?	0.115	0.000	***	0.115	0.000	***
<i>CFO_VOL</i>	+	0.307	0.000	***	0.307	0.000	***
<i>SALES_VOL</i>	+	0.036	0.000	***	0.035	0.000	***
<i>LOSS</i>	?	0.036	0.000	***	0.036	0.000	***
<i>LEVERAGE</i>	?	0.004	0.438		0.004	0.430	
<i>LNCEO_TENURE</i>	?	-0.001	0.170		-0.001	0.283	
<i>CEO_ON_NOM</i>	?	0.002	0.694		0.002	0.686	
<i>CEOCHAIR</i>	?	-0.003	0.063	*	-0.003	0.059	*
<i>STAGGERED</i>	+	0.004	0.043	**	0.004	0.043	**
<i>%OUTSIDERS</i>	-	0.005	0.204		0.004	0.231	
<i>BOARDSIZE</i>	?	-0.001	0.105		-0.001	0.118	
<i>ACSIZE</i>	-	0.000	0.196		0.000	0.183	
<i>BIGN</i>	-	0.002	0.259		0.002	0.262	
<i>LNAUDITOR_TENURE</i>	?	0.000	0.813		0.000	0.790	
<i>LITIGATION</i>	?	0.001	0.444		0.001	0.445	
<i>YEARFE</i>		Included			Included		
N		6,112			6,112		
Adjusted R ²		0.155			0.155		

Notes: We use one-tailed tests when we make predictions on sign, and two-tailed tests otherwise. We estimate these regressions using a OLS regression and cluster all standard errors by company (Petersen 2009). ***, **, and * indicate p<0.010, p<0.050, and p<0.10, respectively. All variables are defined in Appendix A.