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THE ROLE OF FINANCIAL REPORTING QUALITY IN THE SELECTION OF NEW AUDIT
COMMITTEE MEMBER

by

DONGLIANG LEI

A dissertation submitted to the Graduate Faculty in Business in partial fulfillment of the
requirements for the degree of Doctor of Philosophy, The City University of New York

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This manuscript has been read and accepted for the Graduate Faculty in Business in satisfaction of the dissertation requirement for the degree of Doctor of Philosophy.

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Abstract

THE ROLE OF FINANCIAL REPORTING QUALITY IN THE SELECTION OF NEW AUDIT
COMMITTEE MEMBER

by

Dongliang Lei

Advisor: Professor Joseph Weintrop

Prior studies investigating the selection of audit committee members (ACMs) often focus on board-level and director demographic characteristics. In this paper, I investigate whether boards select new ACMs from corporate environments with similar financial reporting quality. Using the appointee firm's financial report quality as a proxy for new ACMs' financial reporting attributes, I find that firms are more likely to appoint new ACMs with financial reporting attributes similar to firms' financial reporting culture for a sample of 275 new ACM appointments from 2007 to 2011. I find that firms appointing ACMs with relatively weak (strong) financial reporting attributes are more likely to have decreased (increased) subsequent financial reporting quality. I also find that firms appointing ACMs with relatively weak financial reporting attributes suffer more deterioration on their subsequent financial reporting quality when their financial reporting culture are more different from the ACMs' financial reporting attributes.

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The Role of Financial Reporting Quality in the Selection of New Audit Committee Member

1. Introduction

In October 2014, Public Company Accounting Oversight Board (PCAOB) Investor Advisory Group presented a report to Securities and Exchange Commission (SEC) stating their concerns about the effectiveness of audit committees. There were concerns that audit committee members may have less training, experience, and time than the auditors and executives they are expected to oversee and scrutinize.¹ As a result, concerns were raised that shareholders were not being well protected. In this paper, I investigate if companies seek to address these concerns by adjusting the composition of audit committees through the appointments of new audit committee members (ACMs). Specifically, I investigate (1) if boards select new ACMs from corporate environments with similar financial reporting quality; and (2) if the appointments of new ACMs affect appointer firms' subsequent financial reporting quality (FRQ).

The duties of the audit committee were initially outlined by the SEC.² Concerns about the ability of audit committees to monitor financial reporting and disclosure were elevated after outbreak of some major reporting scandals. The role of the audit committee in oversight of financial reporting and disclosure has become a topic of discussion among investors, regulators, and academics since 2002. To address investors' concerns and regain their confidence in the U.S. security market, the Sarbanes-Oxley Act (SOX) was enacted to implement requirements for the responsibilities, composition and conduct of audit committee. Of interest in this paper is the requirement section 301. Section 301 of SOX requires independent directors to serve on audit

¹ Some investors suggested that the performance of audit committees should be reviewed by certain independent evaluators and the evaluations of the audit committee should be reported publicly to shareholders. In brief remarks to the Investor Advisory Group, SEC chair said that they had planned to issue a concept release exploring possible avenues to elevating the work of audit committees.

² Audit committee is mainly charged with responsibilities including oversight of financial reporting and disclosure, selection and monitoring of independent auditors, and monitoring the internal control functions.

committees. Further, all major stock exchanges (e.g. NYSE, NASDAQ, and AMEX) enacted new regulations requiring public companies to have an audit committee with at least three members and to have at least one member with accounting or related financial expertise.

After SOX, companies proactively search for independent ACMs and ACMs with financial reporting attributes. Many studies investigate the composition of ACMs focusing on incumbent members' personal characteristics. Klein (2002) document a positive relation between ACM independence and firm's FRQ. She argues that independent ACMs are less likely to be influenced by the CEOs and more likely to protect shareholders' interests by performing their fiduciary duties. Other studies find that ACMs' financial and accounting expertise is positively associated with firms' FRQ (Abbott, Parker, and Peters 2004; Dhaliwal, Naiker, and Navissi 2010). Their findings suggest that financial and accounting knowledge can provide ACMs with an effective means of monitoring financial reporting process.

Some prior studies focus on incumbent directors' fundamental financial reporting beliefs and behaviors in earnings management. Chiu, Teoh, and Tian (2012) document that a firm sharing a common director with an earnings manipulating firm is more likely to manage earnings in a similar fashion. They argue that incumbent directors' beliefs on financial reporting could be adversely influenced via board connection of shared directors, which results in lower firm FRQ.

Other studies focus on the selection of new director members. Westphal and Zajac (1995) find that new directors resemble the existing board members in terms of functional backgrounds, age, and education levels when boards are more powerful than the CEOs. Their results suggest that boards are more likely to appoint new directors with demographic characteristics similar to existing board members.

Different from prior studies, my paper looks at the new ACMs' financial reporting beliefs and their ability to monitor financial reporting. Since it is very difficult to specifically quantify an ACM's financial reporting beliefs, for the purpose of testing, I assume the FRQ of the companies they come from represents their financial reporting beliefs and attributes.³

New ACMs' individual financial reporting attitudes and beliefs are important factors that could affect their own commitments and behaviors in fulfilling their responsibilities. An individual committee member's commitment and performance could have a strong impact on a firm's FRQ. In addition, new ACMs' financial reporting attributes could also affect appointer firms' financial reporting culture through influencing other ACMs' financial reporting beliefs and behaviors. Thus, I argue that appointer firms may evaluate new ACMs' financial reporting attributes to determine if they align with the incumbent committee members' financial reporting norms. To find out whether firms strategically seek ACMs with comparable financial reporting attributes, I investigate the association between appointer firms' financial reporting culture and new ACMs' financial reporting attributes in the fiscal year prior to the appointments.

On the one hand, firms could appoint new ACMs with similar financial reporting attributes. I propose that firms with high financial reporting quality ("Strong Firms") will appoint prospective ACMs with strong financial reporting attributes ("Strong ACMs") to increase the homogeneity and cohesiveness of committee membership. Homogeneity and cohesiveness enhance communication between members, increasing board and committee effectiveness (Westphal and Zajac 1995; Ingley and Walt 2003). For firms with low financial reporting quality ("Weak Firms"), they might appoint prospective ACMs with weak financial reporting attributes

³ The audit committee members' individual financial reporting attributes are defined as their attitudes, beliefs and commitments in how intensively they should oversee the management and monitor the financial reporting of the company. For example, how should managers use their judgments and discretions in applying controversial accounting principles and how transparent financial information should be disclosed in the financial statements.

(“Weak ACMs”) for at least two reasons. First, Weak firms face big challenge in competing with strong firms for qualified director candidates because weak firms’ high litigation risk could drive potential qualified directors away from these firms.⁴ Second, relative to CEOs in strong firms, those in weak firms are more likely to exercise power with less oversight and monitoring. CEOs in weak firms are more likely to influence the selection process by avoiding ACMs inclined to closely monitor management (Zajac and Westphal 1996; Shivdasani and Yermack 1999).

On the other hand, firms could appoint new ACMs with dissimilar financial reporting attributes. Strong firms could be indifferent to prospective ACMs’ financial reporting attributes. For instance, when firms select candidates to sit in multiple committees (e.g. compensation committee and audit committee), appointer firms might value new member’s other complementary expertise and have no preference on his financial reporting skills. Thus, strong firms would appoint weak ACMs if new members’ other expertise is essential to serve the compensation committee. For firms with low financial reporting quality, their incumbent directors could have high litigation and reputation risk because these firms are more likely to have earnings management, financial restatement, and fraud. Thus, it is likely that their boards intend to appoint strong ACMs to improve firms’ financial reporting quality and to lower incumbent members’ litigation and reputation risk.

In this paper, I use appointer firms’ FRQ in the fiscal year prior to new ACM appointments as a proxy for firms’ financial reporting culture. To proxy for prospective ACMs’ financial reporting attributes, I use their appointee firms’ FRQ in the fiscal year prior to the appointments. Following prior studies, I use several FRQ measures to proxy for new ACMs’

⁴ I argue that, relative to strong firms, weak firms are more likely to have higher litigation risk because they have following characteristics: poor firm performance, high management discretions, and weak corporate governance (Cornett et al. 2008; Farber 2005; Abbott et al 2004; Xie et al. 2003).

financial reporting attributes, including abnormal accruals models, small positive earnings and negative earnings surprises avoidance (Jones 1991; Burgstahler and Dichev 1997; Ge, Matsumoto, and Zhang 2011).

To examine these questions, I construct a sample of 275 new ACM appointments from Directorship Files of the GMI ratings database for Russell 3000 firms from 2007 to 2011. Different from prior studies focusing on the board level characteristics and investigating the samples of *all* existing directors, my paper focuses only on appointments of new ACMs that come from outside the appointer firms.⁵ My sample consists of only active corporate executives from other companies for two reasons: first, corporate executives (e.g. CEOs, CFOs) from outside firms are regarded as valuable outside directors with unique expertise and business experiences that can monitor and advise the incumbent management in a way that other outside directors are not able to (Fahlenbrach, Low, and Stulz 2010). Second, corporate executives represent the “tone of the top” in their firms and they have direct and influential links to firms’ financial reporting quality.

Controlling for appointer firms characteristics, corporate governance environments, and new ACMs’ individual characteristics, I document a significant positive association between appointer firms’ financial reporting quality and new ACMs’ financial reporting attributes in the fiscal year prior to the appointments. The results suggest that appointer firms are more likely to select new ACMs with financial reporting attributes similar to firms’ financial reporting culture.

⁵ Many prior studies focus on the board level characteristics and perform their tests using samples of all existing directors. For example, boards and audit committees with more independent directors are negatively associated with earnings management and financial statement fraud (Beasley 1996; Klein 2002). Directors and ACMs with specific expertise, skills and knowledge can better enhance firms’ corporate governance and performance (DeZoort and Salterio 2001; Abbott, Parker, and Peters 2004; Dhaliwal, Naiker, and Navissi 2010).

The results also suggest that new ACM's financial reporting attributes are important factors that appointing firms would consider in the ACM selection process.

Next, I investigate how appointments of new ACMs affect the appointer firms' subsequent financial reporting quality. In my change analyses, I find that firms appointing ACMs with similar financial reporting attributes are more likely to have very little change in firms' subsequent FRQ. However, firms appointing relatively weak (strong) ACMs would have decreased (increased) subsequent FRQ. In addition, I document that strong firms appointing ACMs with relatively weak financial reporting attributes suffer more deterioration on their subsequent FRQ when their financial reporting culture are more different from the ACMs' financial reporting attributes.

Using a sample of new non-ACM director appointments (e.g. compensation committee members and nominating committee members), I also test the impact of financial reporting attributes on the selection of non-ACM directors. I find no significant association between non-ACM directors' financial reporting attributes and appointer firms' FRQ. The results suggest that appointer firms do not prefer selecting new non-ACM directors with financial reporting attributes similar to their firms' financial reporting culture.

In the robustness tests, I use different financial quality measures to proxy for new ACM's financial reporting attributes and re-examine the new ACM selection model. I find that appointer firms' financial reporting quality is positively associated with new ACMs' financial reporting attributes in the fiscal year prior to the appointments. The results suggest that appointer firms are more likely to appoint new ACMs with financial reporting attributes similar to their firms' financial reporting culture.

My paper contributes to the ACM selection literatures in the following aspects. First, different from prior ACM selection literatures focusing on board-level characteristics and incumbent members' characteristics, my paper investigates how new outside ACMs' financial reporting attributes affect firms' decisions on selecting new ACMs. I document that firms strategically seek new ACMs' with individual financial reporting attributes similar to their financial reporting culture. This finding suggests that new ACM's financial reporting attributes are important determinants of new ACM selection.

Second, I document that appointer firms' subsequent FRQ is affected by new ACMs' financial reporting attributes. I find that firms appointing relatively weak (strong) ACMs would have decreased (increased) subsequent FRQ. I also find that firms appointing ACMs with relatively weak financial reporting attributes suffer more deterioration on their subsequent financial reporting quality when their financial reporting culture are more different from the ACMs' financial reporting attributes.

Third, I also examine the selection of non-ACM directors and find no significant positive association between non-ACM directors' financial reporting attributes and appointer firms' FRQ. I find that appointer firms do not appoint new non-ACM directors with similar financial reporting attributes. The results suggest that non-ACM directors' financial reporting attributes are not determinants of director selection.

Last, my results provide an implication to the recent debate on the quality of audit committee. On one hand, I find that firms could have lower subsequent FRQ if they appoint a new ACM with relatively weaker financial reporting attributes. This finding may support some investors' and regulators' concern that a weak ACM might adversely impact firms' FRQ. On the

other hand, I find that about 58% of the firms appoint new ACMs with financial reporting attributes highly similar to their financial reporting culture, which would decrease the committee heterogeneity and increase committee effectiveness. This suggests that many firms do have a selection mechanism for self-improvement in practice. This selection mechanism might ensure the continuity and consistency of audit committees' quality.

The rest of the paper is structured as follows. Section 2 provides institutional background and literature review. Section 3 develops my hypotheses. Section 4 provides my research design and section 5 discusses data. Section 6 discusses my main results, section 7 presents additional analyses, and section 8 concludes.

2. Institutional Background and Literature Review

A board of directors is elected by the shareholders to oversee the activities of a company. Board responsibilities include CEO selection, succession and compensation; discussing, reviewing and approving strategic decisions; nominating suitable candidates for election to the board; appointing and dismissing the independent auditor; and providing monitoring, advising and resource provisioning functionality (Withers et al., 2012; Renee et al. 2008). In a U.S. publicly traded company, these responsibilities are usually shared by three committees of the board: the audit committee, the compensation committee, and the nominating/governance committee.

The audit committee plays an important role in fulfilling the board's corporate governance and oversight responsibilities. The audit committee is charged with the following responsibilities: the transparency and accuracy of financial reporting and disclosures, effectiveness of internal and external audit functions, the robustness of internal controls and internal audit systems, and oversight of the company's risk management policies and programs (Kukreja 2012).

The nominating committee of the board of directors is mainly charged with the task of identifying, screening, and nominating new members. In the United States, director candidates are usually identified through either director networks or professional recruiter firms and then screened by the nominating committee composed of all independent directors. After the nominating committee screens and ranks the candidates, all other board members and the CEO usually meet the candidates. Only those most qualified candidates are nominated and voted by the shareholders (Withers et al., 2012; Monks & Minow 2004).

The ACM selection decision is a two-way process in which appointer firms and candidates come together to produce the selection outcome. On the candidate side, the candidates' demographic characteristics, skills, expertise, and experiences underlie their abilities to contribute to the board. On the appointer firm side, board-level and firm-level factors determining ACM selection includes firm size, firm performance, firm corporate governance environment and board characteristics.

2.1 Director Expertise, Experience and Backgrounds

New ACMs with unique expertise, knowledge and experiences are usually favored by appointer firms because their expertise and skills help the boards to fulfill their duties more effectively and enhance firms' financial reporting quality. For example, ACMs with financial knowledge are more effective in overseeing the financial reporting process and ensuring high-quality financial reporting because they better understand auditing and financial reporting matters and clearly discern the substance of any disagreement between management and external auditors (DeZoort and Salterio 2001). Likewise, Abbott et al. (2004) document a significant negative association between audit committees with financial expertise and financial statement restatements. Dhaliwal et al. (2010) find that accrual quality is positively associated with audit committee members' accounting expertise. These findings suggest that financial and accounting knowledge provide audit committee member with an effective means of monitoring financial reporting process. Other studies also provide evidence that investors react positively to the new appointment of financial experts to a firms' audit committee (Davidson, Xie and Xu 2004).

In addition, new directors with industry expertise have knowledge of the opportunities, competition, technology and even the regulations of a specific industry. This knowledge enables such directors to understand the dynamics of the industry and facilitates their review and

approval of management's strategic decisions (Castanias and Helfat 2001). Also, Kor and Sundaramurthy (2009) argue that directors develop business connections with suppliers, distributors and consumers in the industry, which helps firms to acquire resources, expand their business networks and achieve firm growth. Thus, appointer firms could seek new directors' with industry expertise to join the board.

2.2 Director multiple directorship

Prior studies have documented mixed evidence on whether having corporate directors sitting on multiple boards is harmful or beneficial to a firm. Directors with multiple directorships can provide management with access to a variety of key resources, such as capital, suppliers, or customers. In addition, directors with multiple directorships are more effective in detecting and reducing earnings management because they are more likely to engage in effective monitoring to maintain and protect their reputation (Ferris, Jagannathan, and Pritchard 2003). Yang and Krishnan (2005) find that audit committee members' experience on other boards as outside directors is positively associated with lower quarterly abnormal accruals. Carcello and Neal (2003) provide evidence that audit committee directors with multiple directorships are less likely to support dismissal of the auditor following a going concern opinion.

Sitting on multiple boards could be detrimental to firms' governance or performance due to the distractions and time constraints. Beasley (1996) documents a positive relationship between the number of outside directorships in other firms held by outside directors and the likelihood of financial statement fraud. Fich and Shivdasani (2006) report that firms with busy directors have weak corporate governance and relatively poor performance. New director's multiple directorships could be a determinant of director selection.

2.3 Female Directors

Several studies find that appointments of female directors are positively associated with subsequent firm performance and they argue that female directors often have diverse and valuable knowledge, information, or skills and their presences enrich board perspectives, debate and decision making (Carter et al. 2003; Erhardt et al. 2003). Gul, Srinidhi, and Tsui (2007) find that earnings quality is higher for firms with female directors or firms with higher proportion of female directors on the board. Gul et al. (2007) argue that not only do women demonstrate greater risk aversion and ethical behaviors but also they are better at obtaining voluntary information which reduces information asymmetry between women directors and managers.

2.4 Corporate Governance and Financial Reporting Quality

There is a fundamental agency problem for firms with the separation of ownership (the shareholders) and the control (management). Agency theory posits that managers' behaviors are driven by self-interests and that they make decision to satisfy their self-interests. Managers typically have more control over firm's operational and financial information and they can discretionarily withhold or disclose the information to shareholders (Beyer, Cohen, Lys and Walther 2010). One effective way to mitigate the agency problem is to develop a corporate governance mechanism that monitors the actions, policies and operations of corporate management. Strong corporate governance mechanisms are generally associated with effective monitoring of firms' activities, alignment of interests of shareholders and the managers, increased informativeness of financial statements and high firm financial reporting quality (Ashbaugh-Skaife, Collins, Kinney, and LaFond 2008; Doyle, Ge, and McVay 2007; Klein 2002).

2.5 Financial Reporting Quality and Earnings Management

Prior studies use different measures to proxy for financial reporting quality. These reporting quality measures include abnormal accruals, small positive earnings and negative earnings surprise avoidance (Jones 1991; Burgstahler and Dichev 1997; Ge, Matsumoto, and Zhang 2011). Prior studies view these measures as indicators of earnings management, which is assumed to erode financial reporting quality through reducing the usefulness and reliability of earnings information (Dechow, Ge, and Schrand 2010).⁶

Some accounting and financial reporting standards allow managers to exercise their judgments when estimating and reporting firms' financial conditions, which creates opportunity for managers to manage earnings to window-dress firms' financial statements, to increase their compensations and to secure their jobs. Prior studies document that firms report income-increasing unexpected accruals prior to seasoned equity offers, initial public offers and stock-financed acquisitions (Teoh, Welch and Wong 1998a, Teoh; Welch and Wong 1998b; Erickson and Wang 1998).

A major strand of literature on earnings management investigates the abnormal accruals generated from an accruals model.⁷ These studies measure firm's total accruals and decompose the total accruals into normal and abnormal components. The normal accruals are interpreted as reflection of firm's fundamental performance. The abnormal accruals reflect the distortion induced by mis-application of accounting principles or earnings management. Thus, many prior studies use abnormal accruals to proxy earnings management or low FRQ. For example, Xie,

⁶ Healy and Wahlen (1999) define earnings management as: "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers."

⁷ The most common accruals models are the Healy (1985) Model, DeAngelo (1986) Model, the Jones (1991) Model, the Modified Jones Model (Dechow et al. 1995), and the Cross-sectional Jones Model (DeFond and Jiambalvo 1994).

Davidson, and Dadalt (2003) use abnormal accruals to proxy FRQ and document that independent board members and board members with corporate or financial backgrounds are associated with lower abnormal accruals or higher firm FRQ.

Burgstahler and Dichev (1997) provide evidence that managers manage firms' earnings to avoid earnings losses. They investigate the pooled cross-sectional distribution of earnings and find unusually low frequencies of small losses and unusually high frequencies of small positive income. The abnormal discontinuity of earnings distribution around zero earnings suggests that managers intentionally manage earnings enough to report a small profit.

Degeorge, Patel, and Zeckhauser (1999) document that meeting or beating the consensus analyst forecast is an indication of earnings management based on the discontinuity in the distribution of forecast errors. Other studies also provide evidence that firms use different mechanisms to manipulate earnings to beat analyst forecasts, including managing tax expense, the classification of income statement items and repurchasing stock (Dhaliwal, Gleason, and Mills 2004; McVay 2006; Hribar, Jenkins, and Johnson 2006).

2.6 Board size

The number of directors on a board is an important factor that affects board's effectiveness. Theory proposes that a larger board cannot perform its functions as effectively as a smaller board because process losses increase as board size grows (Jensen 1993). For example, larger boards impede the free and effective exchange of ideas between directors. In addition, larger boards are less effective because of high coordination costs and free rider problems. Yermack (1996) concludes that small boards are more effective in monitoring CEOs' actions because they make decisions more quickly and are less easily controlled by managers than large

boards. Vafeas (2000) document that earnings of firms with the smallest boards are perceived as being more informative by market participants.

2.7 Percentage of independent outside directors

Researchers have also shown great interest in the percentage of independent, outside directors. Boards dominated by outside directors are in a better position to monitor and control managers because they are less likely to be influenced by the CEOs and more likely to protect shareholders' interests by performing their board duties. Weisbach (1988) documents that boards with a greater proportion of outside independent directors are more likely to remove a poorly performing manager. Shivdasani (1993) finds that firms whose boards have a greater proportion of outsiders tend to make better acquisition-related decisions. Beasley (1996) finds a negative relationship between the percentage of outside directors and the likelihood of fraud. These findings suggest that independent outside directors contribute to strong corporate governance.

2.8 CEO/Chair duality

There is a considerable concentration of power in the hands of the CEO when CEO is also the chair of board. Such CEO duality can establish strong and unambiguous leadership. According to agency theory, however, the CEO/Chair duality promotes CEO entrenchment by reducing board monitoring effectiveness. Jensen (1993) argues that it is difficult for the board to perform its function effectively because CEOs cannot separate the function as the chair of the board from personal interest. For example, the CEO/Chair duality can permit the CEO to control information available to other board members. Dechow, Sloan, and Sweeney (1996) document that firms whose CEOs serve as chair of board are more likely to be subject to SEC accounting enforcement. Thus, firms separating the CEO and chairman positions are more likely to have strong internal corporate governance mechanism.

3. Hypothesis Development

3.1 New ACM Selection

Prior studies argue that director candidates' personal attributes and their fit with incumbent board members are major determinants of director nominations (Olson & Adams, 2004; Withers et al., 2012). If new ACM's financial reporting attributes could influence incumbent members' financial reporting norms and beliefs, it is likely that boards will evaluate new ACMs' compatibility with other incumbent members in terms of their financial reporting attributes.

On one hand, firms could appoint new ACMs with similar financial reporting attributes. Westphal and Zajac (1995) document a positive association between relatively powerful board and the board-new-director demographical similarity, suggesting that a powerful board of directors is more likely to select new directors demographically similar to it. Since new ACMs' financial reporting attributes might influence firms' financial reporting culture, I expect appointer firms to evaluate their financial reporting compatibility with those of new ACMs'. I propose that firms with high financial reporting quality will appoint strong ACMs to increase the homogeneity, salience and cohesiveness of committee membership. Homogeneity and cohesiveness of committee members will enhance communication between them, increase committee effectiveness, and improve firm financial reporting quality.

Firms with low financial reporting quality could appoint prospective ACMs with weak financial reporting attributes for at least two reasons. First, there could be an inadequate supply of qualified directors in the market. According to the survey conducted by Corporate Board Member & PWC in 2009, more than half of the participating directors indicated that there was a

shortage of qualified directors for public companies.⁸ Weak firms could face big challenge in competing with strong firms for qualified director candidates because weak firms' high litigation risk could drive potential qualified directors away from these firms. Second, CEOs in weak firms may influence the ACM selection and favor candidates with low financial reporting oversight commitment. Zajac and Westphal (1996) find that CEOs influence the selection process by avoiding directors inclined to closely monitor management in order to reinforce their relative powers.⁹

On the other hand, firms could appoint new ACMs with dissimilar financial reporting attributes. For firms with high financial reporting quality, they might appoint weak ACMs if their CEOs are powerful enough to influence the ACM selection by appointing directors permissive of management discretion. In addition, Strong firms could be indifferent to prospective ACMs' financial reporting attributes. For example, when firms select candidates to sit in multiple committees (e.g. compensation committee and audit committee), appointer firms might value new member's other complementary expertise and have no preference on his financial reporting skills. In other words, a weak ACM could be appointed to strong firms if he or she possesses other expertise that is essential to serve other committees (e.g. compensation committee).

Firms with low financial reporting quality might appoint strong ACMs to improve firm financial reporting quality. Incumbent directors of weak firms could be exposed to high litigation and reputation risk because these firms are more likely to have earnings management,

⁸ https://www.boardmember.com/Article_Details.aspx?id=4205&terms=what+directors+think+2009.

⁹ In December 2003, U.S. listing requirements altered the formal involvement of CEOs in the board member selection process. For example, Exchange regulations require NYSE-listed companies to have a nominating committee comprising solely independent directors, and the NASDAQ's and the American Stock Exchange LLC's (AMEX) listing provisions require director nominees to be recommended or selected by either a majority of the independent directors or by a nominating committee comprising solely independent directors. However, powerful CEOs can potentially affect the selection process to the extent that the nominating committee considers CEOs' preferences before appointing director candidates (Carcello, Neal, Palmrose, and Scholz 2011).

restatements, and fraud (Cornett et al. 2008; Farber 2005; Abbott et al 2004; Xie et al. 2003). To lower their risks, incumbent directors can either choose to resign from their positions or improve firm financial reporting quality. To improve firm financial reporting quality, incumbent directors can appoint strong ACMs to the board because they can bring in new financial reporting skills and experience. As boards' strategy on new ACMs selection is unclear, I state my first hypothesis in null form:

H1: There is no association between appointer firms' financial reporting culture and new ACMs' financial reporting attributes in the fiscal year prior to the appointments.

3.2 Appointer firm Subsequent FRQ

Audit committees of public companies have a federal regulatory responsibility to ensure compliance with SEC requirements for financial reporting and disclosure. Any change in audit committee structure, such as appointment of a new ACM, could result in a change of committee's functionality and performance. Prior studies argue that director's beliefs on earnings management could be influenced through direct communication of information and interaction with other director (Chiu et al. 2012). Thus, a newly appointed ACM could also influence existing ACMs' financial reporting beliefs and behaviors, which would have some impact on firms' subsequent FRQ. For example, firms appointing new ACMs with relatively weak financial reporting attributes could have decreased subsequent FRQ because incumbent committee members might change their beliefs in financial reporting oversight and become more passive in monitoring the management.

In addition, the change in appointer firms' subsequent FRQ could be related to the magnitude of difference between appointer firms' financial reporting culture and new ACMs' financial reporting attributes. Prior studies argue that homogeneity and cohesiveness of board

members lead to high levels of satisfaction and commitment to the group and enhance communication between members, resulting in increased board effectiveness (Westphal and Zajac 1995; Ingley and Walt 2003). On the contrary, committee heterogeneity might adversely affect committee effectiveness because it might increase conflict among members, increase coordination and communication costs. When strong firms appoint relatively weak ACMs, firms could suffer more deterioration in future FRQ if their financial reporting culture is more different from new ACMs' financial reporting attributes. When weak firms appoint strong ACMs, it is more difficult to predict firms' future FRQ because the improvement of FRQ through appointing strong ACMs could be offset by the deterioration of FRQ through increasing the heterogeneity of the committee. Thus, I predict that:

H2: Appointments of new ACMs with financial reporting attributes different from appointer firms' FRQ would have no impact on the change of firms' subsequent FRQ.

3.3 New non-ACM director Selection

Different from ACMs, whose major responsibility is to ensure firm's compliance with SEC requirements for financial reporting and disclosure, non-ACM directors (e.g. nominating committee members and compensation committee members) have different major responsibilities include CEO selection, succession and compensation; discussing, reviewing and approving strategic decisions; nominating suitable candidates for election to the board. Thus, appointer firms need new directors with other skills and expertise to serve in different committees. In order to satisfy firms' needs, firms have to give up some candidates with financial expertise when they select non-ACM directors. In such situations, new candidates' financial reporting attributes might not be important factor in the selection of non-ACM directors because appointer firms value new directors' other expertise more and prefer new directors with expertise other than financial expertise. Thus, I expect a non-significant association between

appointer firms' financial reporting culture and non-ACM directors' financial reporting attributes. My third hypothesis, stated in alternative form, is as follows:

H3: There is no association between appointer firms' financial reporting culture and new non-ACM directors' financial reporting attributes in the fiscal year prior to the appointments.

4. Research Design

In examining the effect of new ACM's financial reporting attributes on the new ACM selection, I use the following ordinary least square (OLS) regression model, using as a dependent variable the appointer firms' financial reporting quality (*DA_Appointer*) in the fiscal year prior to the new ACM appointments:

$$DA_Appointer = \alpha_1 + \alpha_2 DA_Appointee + \alpha_3 ACM\ Characteristics + \alpha_4 Appointer\ firm\ Characteristics + \alpha_5 Other\ Controls + \alpha_6 Year\ Dummy\ Variable + \alpha_7 Industry\ Dummy\ Variable + \varepsilon$$

4.1 New ACM Selection

Controlling for new ACM individual characteristics and appointer firm characteristics, the model investigates the association between the appointer firms' financial reporting culture and new ACMs' financial reporting attributes prior to the new ACM appointments. Using a cross sectional Jones Model (1991), I measure appointer firms' FRQ as the discretionary accruals in the fiscal year prior to the new ACM appointments. The independent variable is the prospective ACM's financial reporting attributes (*DA_Appointee*), which is measured as the appointee firm's discretionary accruals in the fiscal year prior to the new ACM appointments.¹⁰ As illustrated in Figure 1, ABC, Inc. appointed Tom, CEO of XYZ, Inc., as the new ACM on April 1, 2009. I measure both firms' discretionary accruals in the fiscal year prior to appointment and test the

¹⁰ I estimate the abnormal accruals as the residuals of the cross sectional Jones Model (1991) by year and by two-digit SIC industry for all compustat firms. Instead of using absolute abnormal accruals, I use firms' raw abnormal accruals level to proxy for firms' FRQ because: first, many prior studies use raw abnormal accruals to proxy earning management and they document a negative association between strong corporate governance and abnormal accruals (Becker et al 1998; Xie et al 2003). Second, firms with same magnitude of abnormal accruals have different level of litigation risk because firms with high income-increasing accruals are more likely to be sued than those with high income-decreasing accruals. Thus, similar to auditors, directors of firms with high income-increasing accruals could have higher litigation and reputation risk and they have more incentives to improve firms' financial reporting quality.

association between *DAt-1_Appointer* and *DAt-1_Appointee*. All other control variables are all measured at fiscal year t-1.

4.2 New ACM Characteristics

The ACM selection could also be determined by the prospective ACMs' characteristics, including expertise, prior director experience, age, and gender. To control for ACM expertise, I use two variables *Financial Expertise* and *Industry Expertise*. Xie et al. (2003) document that board and audit committee members with financial and corporate backgrounds provide better monitoring of the financial reporting process and reduce firm abnormal accruals. They argue that a director with corporate or financial expertise is more familiar with the ways that earnings can be managed. *Financial Expertise* is defined as an indicator variable that takes the value of 1 if a new ACM has financial expertise. Appointer firms seek new director with industry expertise because a director's industry knowledge and experience enhances monitoring and advising roles. To control for director industry expertise, I use *Industry Expertise*, an indicator variable that takes the value of 1 if a new ACM comes from a firm in the same industry as the appointer firm. Gray and Nowland (2013) argue that prior experiences as a director is the most relevant expertise directors can possess to perform their complex tasks. They find that shareholders value a new board member's prior director experience. Thus, appointer firms may also consider candidate's director experience in the selection process. To control for director experience, I use *MultipleDirector*, which is defined as the number of new ACM's other directorships. In addition, prior studies document that age is associated with behavioral tendencies, such as managerial decision-making style. Taylor (1975) finds that older executives seek more information before making decisions and take more time in making them. I control for ACM age using *Age*, defined as the age of new ACMs in the year prior to the appointment. Finally, several studies find that

female directors positively affect subsequent firm performance and they argue that female directors often have diverse and valuable knowledge, information, or skills (Carter et al. 2003; Erhardt et al. 2003). I control for ACM sex using *Female*, an indicator variable that takes the value of 1 for female ACM.

4.3 Appointer firms' Firm-level and Board-level Characteristics

I also control for some appointer firms' firm-level and board-level characteristics because they could be associated with both appointer firms' financial reporting quality and ACM selection. First, powerful CEOs and CEOs with long tenure have more opportunities and are more likely to manage earnings and influence the ACM selection. To control for CEOs' influences, I use *Duality_Appointer*, an indicator variable takes the value of 1 when CEO is the chairman of the board in the appointer firm in the year prior to the ACM appointment; *Ceotenure_Appointer*, the number of years CEO works for the appointer firm as of the year prior to the ACM appointment. Second, I control for appointer firm's board characteristics. *Boardtenure_Appointer* is defined as the average number of years that incumbent board members have served as of the year prior to the ACM appointment. *Boardsize_Appointer* is defined as the number of board members in the fiscal year prior to the ACM appointment. *Board_Ind%_Appointer* is defined as the ratio of the number of independent directors to board size in the fiscal year prior to the ACM appointment. Last, prior studies document that CEOs are more likely to join boards of large and established firms (Fahlenbrach et al. 2010). I control for other appointer firm characteristics, including firm size, performance, leverage, operating cash flows, sales growth, market to book ratio and its auditor.

4.4 Other Control Variables

If the appointer firm and the appointee firm share a director or executive in the fiscal year prior to the new ACM appointment, it is possible that this interlocking position has similar effects on both firms' financial reporting quality (Chiu et al. 2012). If both the appointer firm and the appointee firm use the same auditor to audit their financial statements in the year before new appointments, the auditor may have similar impact to both firms' FRQ and drive these firms' FRQ to change in the same direction. To control for these impacts, I include two control variables in my model. *Interlock* is defined as an indicator variable takes the value of 1 if a common director or executive serves both the appointer firm and appointee firm in the fiscal year prior to the appointment. *Sameauditor* is defined as an indicator variable which takes a value of 1 if the appointer firm hires the same auditor as the appointee firm in the fiscal year prior to the appointment and 0 otherwise.

I also control for some appointee firms' characteristics, including appointee firms' size (*Size_Appointee*) and appointee firms' performance (*ROA_appointee*). *Size_Aappointee* is defined as the natural log of total assets of the appointee firm in the year prior to the ACM appointment. *ROA_Appointee* is defined as the ratio of net income to total assets of the appointee firm in the year prior to the ACM appointment.

4.5 Change Analysis on Appointer firm Subsequent FRQ

To test my second hypothesis, I perform the following change analysis to investigate the effects of appointments of ACMs on appointer firms' subsequent FRQ, controlling for changes in appointer firms' characteristics:

$$\text{Change in DA_Appointer} = \alpha_1 + \alpha_2 \text{ Gap} + \alpha_3 \text{ Negative} + \alpha_4 \text{ Gap} * \text{Negative} + \alpha_5 \text{ Change in Appointer firm Characteristics} + \alpha_6 \text{ Year Dummy Variable} + \alpha_7 \text{ Industry Dummy Variable} + \varepsilon$$

The dependent variable is the change in appointer firms' discretionary accruals (*Change in DA_Appointer*), defined as the change in appointer firms' discretionary accruals between fiscal year prior to (Year t-1) and fiscal year subsequent to (Year t+1) the appointment year (Year t). As illustrated in Figure 2 Part A, the change in ABC, Inc.'s discretionary accruals is calculated using its discretionary accruals in fiscal year 2010 to deduct that in fiscal year 2008. The test independent variable, *Gap*, is defined as the difference between appointer firm's rank of discretionary accruals and appointee firm's rank of discretionary accruals. I first rank all Compustat firms' discretionary accruals by year and industry from 1 to 10.¹¹ Then, I subtract appointee firm's rank from appointer firm's rank to obtain the variable *Gap*. The distribution of the variable *Gap* is presented in Figure 2 Part B. The value of *Gap* ranges from -9 to 8, with about 58.6% of the observations distributing within -2 to 2. This distribution suggests that more than half of the appointer firms are more likely to appoint new ACMs with financial reporting attributes relatively similar to their financial reporting culture. Here, I define firms with negative (positive) *Gap* value as appointer firms with stronger (weaker) FRQ relative to appointee firms in the year prior to the appointment. The variable *Negative* is defined as an indicator variable which takes the value of 1 if the value of *Gap* variable is negative, and 0 otherwise. Other control variables are also measured as changes from Year t-1 to Year t+1.

¹¹ Firms at the top decile with lowest discretionary accruals are assigned value of 1. Firms at the bottom decile with highest discretionary accruals are assigned value of 10.

5. Data and Descriptive Statistics

5.1 Sample Selection

I use several different databases to construct my sample. The ACM appointments and the board data come from Directorship Files of GMI ratings database from the period 2007 to 2011.¹² I obtain the accounting data from Compustat, executive information from Execucomp and analyst forecast data from IBES. Definitions of the variables are in Appendix A.

My paper focuses only on new appointments of active executive ACMs for the following reasons: first, corporate executives (e.g. CEOs, CFOs) are regarded as valuable outside directors with unique expertise and business experiences, capable of monitoring and advising the management in a way that other outside directors are not able to do (Fahlenbrach et al. 2010). Second, corporate executives create the “tone of the top” in their firms and they have direct and influential links to firms’ corporate governance and reporting policy. Last, since it is difficult to specifically quantify an ACM’s beliefs in financial reporting, I use the appointee firm’s FRQ as the proxy. This requires the ACM appointment observations to have public financial information in the years before and after the appointments. Non-executive ACMs (e.g. accountants, lawyers, and professors) come from firms without publicly financial information to measure their financial reporting attributes. The retired executives ACMs had retired from the appointee firms at the time of the appointments, thus they might not have influence on appointee firm’s operations and reporting policy.

Table 1 presents the sample selection for new ACM appointments sample. I construct the initial sample of new ACM appointments from the GMI ratings database for Russell 3000 firms

¹² GMI Ratings offers access to annual corporate governance datasets from 2001 through 2012. GMI Ratings covers Russell 3000 firms starting year 2006 to 2012. I restrict my sample period of ACM appointments from 2007 to 2011 because I need director data one year ahead of the appointments for the ACM selection model and one year after the sample period for the change analysis.

and identify 1,361 new ACM appointments.¹³ I hand collect these new ACMs' information from proxy statements. I identify the appointee firms these new ACMs worked for at the fiscal year prior to the appointments and their primary positions at the appointee firms. I drop 31 observations due to missing information in the proxy statements. Since I focus only on appointments of new active executive ACMs, I drop 361 observations and 122 observations for non-executive and retired executive ACM appointments, respectively.¹⁴ Last, I drop 239 observations and 333 observations due to missing financial data in the Compustat files for appointer firms and appointee firms, respectively. My final sample consists of 275 observations of new active executive ACM appointments from 2007 to 2011.

I use the same GMI ratings database from the period 2007 to 2011 to construct the sample of new non-ACM appointments for my third hypothesis. I perform the same procedures to hand collect new director information for my non-ACM directors. The sample consists of all new appointments of executive directors who do not serve the audit committees.

5.2 Descriptive Statistics

Table 2 presents the descriptive statistics for the variables in my regression analyses. The means of *DA_Appointer* and *DA_Appointee* are 0.002 and 0.032 and they are significantly different, which suggests that appointer firms have significantly lower discretionary accruals than appointee firms in the fiscal year prior to the appointments.

¹³ I define a new ACM appointment to take place when the appointment is publicly announced for the first time but not on the proxy statement date. Since some directors can be appointed any time during the interim period, it is more accurate to measure appointer firms' FRQ and new ACMs' financial reporting attributes using the announcement dates, which is closer to the appointment decision. I hand-collected the appointment dates for new ACM appointments from LexisNexis and their public filings (e.g. 8-Ks filings and proxy statements).

¹⁴ Active executive ACMs appointments include all new ACMs currently work at executive positions in the appointee firms. For example, Chief Executive Officer, Chief Financial Officer, Vice president, Senior Vice president etc. This is to ensure that the executive ACMs actively participate in the appointee firms' operations and they could have direct influences on appointee firms' corporate governance and financial reporting. The non-executive ACMs do not serve as executives in a public company and their primary positions include lawyers, public accountants, professors, and consultants etc.

I also provide descriptive statistics for appointer and appointee firms' financial and corporate governance characteristics. For appointee firms, the means of *Size_Appointee* and *ROA_Appointee* are about 8.63 and 0.04 respectively. For appointer firms, the means of *Size_Appointer* and *ROA_Appointer* are 7.71 and 0.003 respectively. The appointee firms are larger and have higher performance than the appointer firms. Appointer firms' average leverage is 21 percent, average operating cash flow to assets is 8 percent, and average sales growth is 16.6 percent. Finally, the market-to-book ratio is 2.36. In the year prior to ACM appointments, appointer firms' boards on average have 9.34 members. These members on average serve in the firms for about 7.52 years and 75 percent of them are independent directors to the firms. The CEOs of appointer firms on average serve the firms for about 5.44 years and 50.9 percent of them also serve as the chairman of the board.

Finally, I provide descriptive statistics for the new ACMs and other variables. The new ACMs on average are 53.3 years old and serve only 1.59 other directorship in other firms. Thirteen percent of the new ACMs are female directors. About twenty-two percent of new ACMs come from firms in the same industry as the appointer firms and seven percent of them have the financial expertise. About two percent of observations have interlocking director or executive serving both the appointer firms and appointee firms before appointments. Twenty-four percent of the appointer firms hire the same auditor as the appointee firms in the fiscal year prior to the appointments.

Table 3 Panel A presents the distribution of new ACM appointments by year. The appointment of active new executive ACMs accounts for about 20 percent every year. Year 2008 and Year 2011 have the highest appointments of 63 and 64 ACMs, which takes up 46 percent of all appointments.

Table 4 presents the Pearson (Spearman) pair-wise correlations below (above) the diagonal among all the variables. The correlation coefficients are indicated in bold if the correlation are significant at 5% level ($p < 0.05$). In general, the appointer firms' discretionary accruals are positively correlated with their firm characteristics (for example, Size and ROA) and appointee firms' discretionary accruals. Appointer firms' firm size and ROA are also positively associated with appointee firms' firm size and ROA.

6. Main Results

6.1 Effect of New ACM's financial reporting attributes on ACM Selection

Table 5 presents the results of the OLS regression for my Hypothesis 1. The coefficient on my test variable, *DA_Appointee*, is 0.2 and is significant at 5% level in the Model (1). After controlling for appointer firms' characteristics and AMCs' individual characteristics, the coefficient of *DA_Appointee* is 0.18 and it is significant at 5% level. These positive significant coefficients provide evidence that appointer firms' discretionary accruals are positively associated with appointee firms' discretionary accruals in the fiscal year prior to the ACM appointments. After controlling for these correlated variables, this positive association is likely to be driven by the appointer firms' selection decisions on new ACMs. For example, strong appointer firms prefer appointing ACM candidates with strong financial reporting attributes, possibly because they would like to maintain high levels of FRQ. Thus, the results suggest that appointer firms are more likely to strategically appoint new ACMs with financial reporting attributes similar to their firms' financial reporting culture. The appointer firms' discretionary accruals are positively related to their return on assets and negatively related to their operating cash flow. Further, the coefficients on *Female*, *Financial_expertise* and *ROA_Appointee* are significantly negative, which suggest that appointer firms with lower discretionary accruals are more likely to appoint female ACMs, ACMs with financial expertise and ACMs from appointee firms with high performance.

6.2 Change Analysis on Appointer firm Subsequent FRQ

Table 6 presents the results of the univariate test on change of appointer firms' subsequent FRQ. The dependent variable, *Change in DA_Appointer*, is defined as the change in appointer firms' abnormal accruals between the fiscal year prior to (Y_{t-1}) and the fiscal year

subsequent to (Y_{t+1}) the appointment year (Y_t). Mean of *Change in DA_Appointer* for strong firms appointing relatively weak ACMs ($Gap < 0$) is 0.06. Mean of *Change in DA_Appointer* for weak firms appointing relatively strong ACMs ($Gap > 0$) is -0.022. For firms appointing ACMs with similar financial reporting attributes ($Gap = 0$), their mean of *Change in DA_Appointer* is 0.0005.¹⁵ The univariate results provide some evidences that firms appointing ACMs with similar financial reporting attributes have almost no change in firms' subsequent FRQ. However, firms appointing ACMs with dissimilar financial reporting attributes are more likely to have some changes on their subsequent FRQ. For example, the FRQ of strong firms appointing relatively weak ACMs would decrease subsequent to the appointments. The FRQ of weak firms appointing relatively strong ACMs would increase subsequent to the appointments. These results suggest that it is critical important for appointer firms to select new ACMs because ACMs' financial reporting attributes could have a big impact on firms' FRQ.

Table 7 presents the results of the multivariate test on the change of appointer firms' subsequent FRQ for my Hypothesis 2. In both models, I use *Change in DA_Appointer* as the dependent variable to investigate how appointments of new ACMs may impact the appointer firms' subsequent FRQ. In model 1, the coefficient on *Gap* is -0.0077 and it is significant at 1% level. The results are consistent with results in table 6. It shows that the appointments of new ACMs with financial reporting attributes different from firm's financial reporting culture would have an inverse impact on appointer firms' subsequent FRQ. For example, strong (weak) firms appointing relatively weak (strong) ACMs would have decreased (increased) subsequent FRQ.

¹⁵ I perform a one-way ANOVA analysis on the mean for these three groups of change in discretionary accruals and the results suggest the mean differs significantly among the groups. I also perform two sample t-test for each of the two groups and find that the mean of strong firms appointing weak ACMs is significantly greater than those of firms appointing similar ACMs and weak firms appointing strong ACMs. However, the mean of weak firms appointing strong ACMs is not significantly different from that of firms appointing similar ACMs.

In model 2, I further investigate how appointments of different new ACMs impact appointer firms' subsequent FRQ. I include an indicator variable *Negative* and the interaction term of *Gap* and *Negative* in the model. The coefficient on *Gap* is 0.0062 and the coefficient on *Negative* is -0.042. Both coefficients are not significant. The coefficient on their interaction term is -0.0358 and it is significant at the 1% level after controlling for changes of appointer firms' firm-level and board-level characteristics. The results provide evidence that comparing to other appointments, strong firms appointing relatively weak ACMs would subsequently have significant lower FRQ. The result suggests that appointing an ACM with weak financial reporting attributes is more likely to lower the appointer firm's FRQ. The significant coefficient of the interaction term also provide evidence that when the difference/gap between strong firms' financial reporting culture and weak ACMs' financial reporting attributes increases (*Gap* takes value from -1 to -9), the impact of deterioration on appointer firms' FRQ increases (discretionary accruals changes from 0.035 to 0.32). This suggests that firms appointing ACMs with relatively weak financial reporting attributes suffer more deterioration on their subsequent financial reporting quality when their financial reporting culture are more different from the ACMs' financial reporting attributes.

The coefficients on *Size_ATF_change* and *CFO_ATF_change* are significantly negative, suggesting that change of firm size and operating cash flow are negatively associated with the change in firm's abnormal accruals. Further, the appointer firms' changes in ROA and leverage are positively associated with the change in firm's abnormal accruals. Last, change of CEO tenure is negatively associated with change in firm's abnormal accruals.

6.3 Selection of non-ACM director appointments

Table 8 presents the results of the OLS regression for my Hypothesis 3. I use the same research model to test the effect of new directors' financial reporting attributes on the selection of non-ACM director appointments. The coefficient on my test variable, *DA_Appointee*, is 0.049 in the Model (1). After controlling for appointer firms' characteristics and AMCs' individual characteristics, the coefficient of *DA_Appointee* is 0.0264 in model (2). In both models, the test independent variable is not significantly associated with the dependent variable. This insignificant association provides evidence that appointer firms' discretionary accruals are not associated with appointee firms' discretionary accruals in the fiscal year prior to the non-ACM director appointments. The results suggest that appointer firms might not prefer selecting new non-ACM directors with financial reporting attributes similar to their financial reporting culture as they do in selecting new ACMs. Appointer firms could value new directors' other skills and expertise more because these skills are more important and more useful than their financial reporting attributes in serving the board.

7. Additional Analyses

The Jones discretionary Model (1991) has an implicit assumption that revenues are nondiscretionary. In situations when revenue is manipulated, the Jones Model will remove some of the manipulated earnings from the discretionary accrual measure which will cause the estimate of earnings management to be biased (Dechow, Sloan, and Sweeney 1995). In this section, I re-examine the ACM selection model of my Hypothesis one using different financial quality measures used in prior literatures.

7.1 Robustness tests of ACM selection using other discretionary accruals measures

First, following Dechow et al. (1995), I modify the Jones Model to exclude growth in credit sales to mitigate the measurement misspecification of discretionary accruals in Jones Model when discretion is exercised over revenues. Specifically, I adjust the original Jones Model (1991) by subtracting the change in account receivables from the change in revenue. Using the modified Jones Model, I measure appointer firms' FRQ as the abnormal accruals in the fiscal year prior to the new ACM appointments. New ACM's financial reporting attribute is measured as the appointee firm's abnormal accruals. In Table 9 Model 1, the coefficient of test independent variable is 0.15 and is significant at 10% level. The results suggest that appointer firms are more likely to strategically appoint new ACMs with financial reporting attributes similar to their firms' financial reporting culture.

Second, prior studies argue that the correlation between performance and the residuals from the Jones model and modified Jones model could be a concern in tests of earnings management when samples experience extreme performance (Kothari, Leone, and Wasley 2005; Dechow et al. 2010). Kothari et al. (2005) suggest controlling for the normal level of accruals conditional on ROA. They control for the impact of performance on estimated abnormal accrual

using a performance-matched firm's discretionary accrual. Following Kothari et al. (2005), I identify a firm from the same industry and same year with the closest past year ROA to that of the sample firm. I deduct the control firm's abnormal accruals from those of the sample firm to generate performance match abnormal accruals.¹⁶ Alternatively, Kothari et al. (2005) control for performance on abnormal accruals using a linear regression with ROA included in the Jones model as an additional regressor. I also estimate the abnormal accruals of my sample firms using the cross-sectional Jones model with current year ROA included in the model. The results are presented on model 2 and model 3 in Table 9. Both models present a positively significant association between appointer firms' discretionary accruals and appointee firms' discretionary accruals in the fiscal years prior to the appointments. The results are robust when I control for the normal level of accruals conditional on ROA.

Third, to mitigate the concern on lack of comparability of abnormal accruals between two firms from two different industries in the process of selecting new ACMs, I also run the same regression of ACM selection using the industry-adjusted abnormal accruals estimated from the Jones model. The assumption is, after the abnormal accruals are adjusted for the industry mean, the impact of industry on firms' abnormal accruals is identical for both the appointer firm and the appointee firm. The results in Table 9 model 4 provide same evidences that appointer firms' discretionary accruals are positively associated with appointee firms' discretionary accruals in the fiscal year prior to the ACM appointments.

Last, prior studies argue that extreme accruals need to be reversed in the future periods because they are more likely to contain estimation error (Dechow and Dichev 2002). An estimation error happens when future cash flow realization differs from managers' accruals estimate. The error will be corrected by posting an entry to reverse accruals. Thus, firms with

¹⁶ I use the cross sectional Jones Model to estimate the abnormal accruals for all the firms.

extreme accruals are more likely to reverse their accruals in the future. To mitigate the concern that firms might have large accruals reversal in the years of appointments, I construct a three-year average of abnormal accruals prior to the appointments to measure firms' financial reporting quality. In table 9 model 5, the dependent (independent) variable is the appointer (appointee) firms' three-year average of abnormal accruals prior to the appointments. The coefficient of test independent variable is 0.196 and is significant at 5% level. The results suggest that appointer firms are more likely to strategically appoint new ACMs with financial reporting attributes similar to their firms' financial reporting culture.

7.2 Robustness tests of ACM selection using other financial reporting quality measures

Prior studies have used various measures as indicators of financial reporting quality including abnormal accruals, small positive earnings and negative earnings surprises avoidance (Jones 1991; Burgstahler and Dichev 1997; Ge, Matsumoto, and Zhang 2011). Many prior studies have debated the strengths and weaknesses of all these measures and their findings on some of these measures are mixed.

Table 10 presents the results of my additional analyses using the negative earnings surprises avoidance and the small positive earnings as the dependent variable. In model 1, I calculate the percentage of fiscal quarters in the year prior to the ACM appointments for both appointer firms and appointee firms that beat the analyst consensus forecasts by three cents per share or less. The dependent (independent) variable *MoB%_Appointer* (*MoB%_Appointee*) is defined as the percentage of quarters the appointer (appointee) firms beat the analyst consensus forecasts by three cents per share or less. The coefficient on *MoB%_Appointer* is 0.138 and is significant at 10% level after controlling for other variables. Using the negative earnings surprises avoidance as the FRQ measure, I still have the robust results that appointer firms are

more likely to appoint new ACMs with financial reporting attributes similar to their firms' financial reporting culture.

In model 2, the dependent variable *LossAvoid_Appointer* is an indicator variable which takes the value of 1 if the appointer firm has earnings between 0 and 1 cent in the fiscal year prior to the appointment. After controlling for other variables, the coefficient on *LossAvoid_Appintee* is positively significant at 5% level. The positive association suggests that appointer firms' FRQ is positively associated with appointee firms' FRQ in the fiscal year prior to the new ACM appointments. Thus, the results are robust to usage of small positive earnings as the FRQ measure.

7.3 Robustness tests of non-ACM director appointments using other financial reporting quality measures

In this section, I test whether appointer firms value new non-ACM directors' financial reporting attributes in the director selection process using other financial reporting quality measures. Table 11 presents the results of my additional analyses using the negative earnings surprises avoidance and the small positive earnings as the dependent variable. In both models, the test independent variable is negative and it is not significantly associated with the dependent variable. The results are consistent with those using discretionary accruals measure in table 8. The results suggest that non-ACM director's financial reporting attributes are not important determinants of the non-ACM director selection. Appointer firms do not require new non-ACM directors to have financial reporting attributes similar to their firm's financial reporting culture.

8. Conclusions

The purpose of this paper is to examine the effect of prospective ACMs' financial reporting attributes on the new ACM selection. Using appointee firm's FRQ as a proxy for new ACMs' financial reporting attributes, I find that appointer firms select new ACMs with financial reporting attributes similar to their financial reporting culture. The results suggest that new ACM's financial reporting attributes are important determinants of ACM selection because new ACM's financial reporting attributes influence incumbent members' commitments and performance, and appointer firm's financial reporting quality.

In addition, I investigate how the appointments of new ACMs affect appointer firms' subsequent financial reporting quality. I document that appointer firms' subsequent FRQ is affected by the new ACMs' financial reporting attributes. Firms appointing relatively weak ACMs would have decreased subsequent FRQ, while firms appointing relatively strong ACMs would have increased subsequent FRQ. I also find that strong firms appointing relatively weak ACMs have significant lower subsequent FRQ than other firms. In addition, I find that firms appointing ACMs with relatively weak financial reporting attributes suffer more deterioration on their subsequent financial reporting quality when their financial reporting culture are more different from the ACMs' financial reporting attributes.

Finally, I examine the effect of new non-ACMs' financial reporting attributes on the selection of non-ACM directors. I find no significant positive association between non-ACM director's financial reporting attributes and appointer firms' FRQ in the fiscal year prior to the appointments. The results suggest that appointer firms do not prefer selecting new non-ACM directors with financial reporting attributes similar to their firms' financial reporting culture.

Figure 1. An example of New Audit Committee Member Selection
Company ABC, Inc. appointed Tom, CEO of XYZ, Inc., as ACM on 4/1/2009

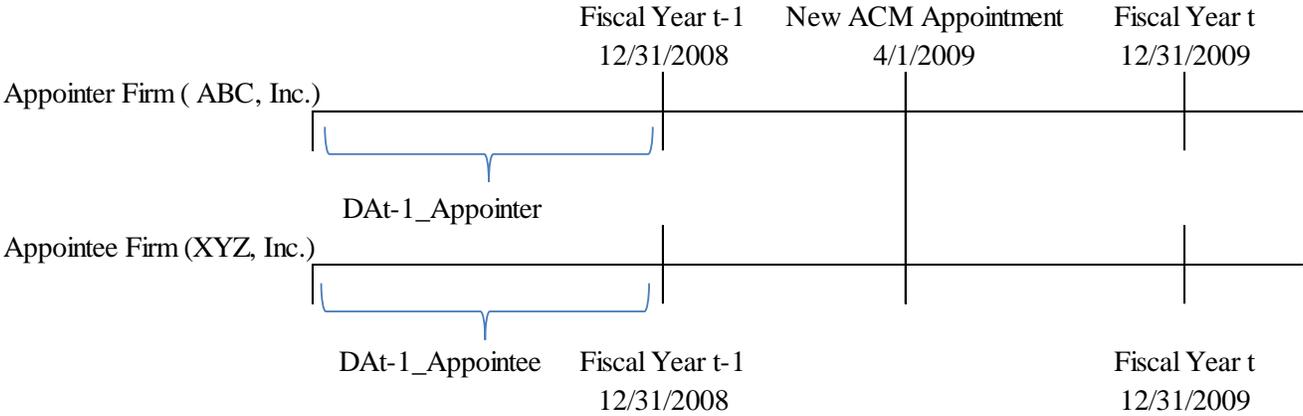
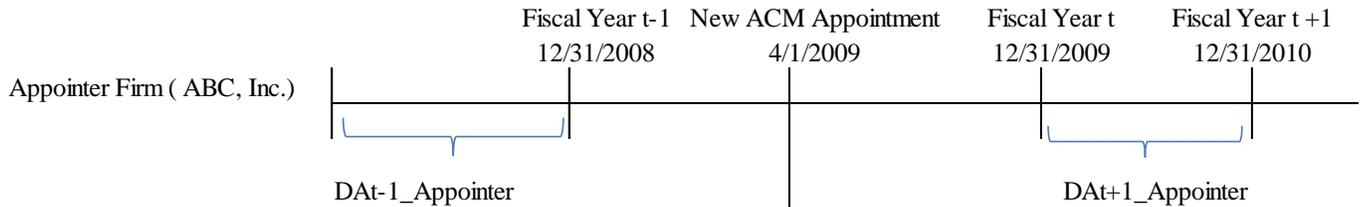


Figure 2. Change Analysis on Appointer firms' subsequent FRQ

Part A. Example of change analysis on ABC, Inc.



Part B. Distribution of the variable Difference

Difference	Observation	Percentage
-9	1	0.36%
-8	3	1.09%
-7	1	0.36%
-6	8	2.91%
-5	16	5.82%
-4	15	5.45%
-3	23	8.36%
-2	32	11.64%
-1	28	10.18%
0	39	14.18%
1	31	11.27%
2	31	11.27%
3	19	6.91%
4	11	4.00%
5	6	2.18%
6	6	2.18%
7	4	1.45%
8	1	0.36%

Total 275 100%

Notes: Variable Difference is defined as the difference between appointer firm's rank of discretionary accruals and appointee firm's rank of discretionary accruals. I first rank all Compustat firms' discretionary accruals by year and industry from 1 to 10. Then, I subtract appointee firm's rank from appointer firm's rank to obtain the variable Difference.

Table 1
Sample Selection

Description	# of observations
Total new outside ACM appointments from GMI Ratings Database (2007-2011)	1,361
Less observations without director information in the proxy statement	(31)
Less observations of retired executive ACM appointments	(122)
Less observations of non-executive ACM appointments	(361)
Less observations missing financial data in Compustat for appointer firms	(239)
Less observations missing financial data in Compustat for appointee firms	(333)
Final sample of new executive ACM appointments	275

Notes: Table 1 presents the sample selection for new audit committee member ("ACM") appointments sample. The initial sample includes 1,361 new ACM appointments from Directorship Files of GMI ratings database for Russell 3000 firms from 2007 to 2011. I hand collect the information about these new ACMs in the proxy statements to identify their appointee firms and their primary positions. Since my paper focuses on appointments of active executive ACMs, I exclude observations of retired executive and non-executive ACM appointments. I also drop observations missing financial data in Compustat for the appointer and appointee firms. My final sample consists of 275 observations of new executive ACM appointments.

Table 2
Descriptive Statistics

Variable	N	Mean	Std. Dev.	P25	P50	P75
Dependent Variables						
DA_Appointer	275	0.002	0.174	-0.033	0.011	0.067
Test Variables						
<i>Appointee Firms:</i>						
DA_Appointee	275	0.032	0.119	-0.022	0.021	0.074
Size_Appointee	275	8.631	2.071	7.296	8.668	10.031
ROA_Appointee	275	0.041	0.130	0.023	0.055	0.094
<i>Appointer Firms:</i>						
Size_Appointer	275	7.711	1.905	6.198	7.766	9.078
ROA_Appointer	275	0.003	0.159	-0.013	0.039	0.076
MTB_Appointer	275	2.355	4.888	1.391	2.181	3.851
Leverage_Appointer	275	0.207	0.219	0.036	0.178	0.297
CFO_Appointer	275	0.078	0.128	0.036	0.091	0.138
Salegrowth_Appointer	275	0.166	0.665	-0.019	0.075	0.191
Duality_Appointer	275	0.509	0.501	0.000	1.000	1.000
Boardsize_Appointer	275	9.338	2.357	8.000	9.000	11.000
Boardtenure_Appointer	275	7.515	3.816	5.143	7.000	9.333
Board_Ind%_Appointer	275	0.746	0.138	0.667	0.778	0.857
Ceotenure_Appointer	275	5.444	5.580	2.000	4.000	7.000
Big4_Appointer	275	0.935	0.248	1.000	1.000	1.000
<i>New ACM:</i>						
MultipleDirector	275	1.589	0.825	1.000	1.000	2.000
Age	275	53.287	6.818	49.000	53.000	58.000
Female	275	0.135	0.342	0.000	0.000	0.000
Interlocked	275	0.018	0.134	0.000	0.000	0.000
Sameauditor	275	0.240	0.428	0.000	0.000	0.000
Ind_expertise	275	0.218	0.414	0.000	0.000	0.000
Financial_expertise	275	0.076	0.266	0.000	0.000	0.000

Notes: All variables are defined and calculated in the fiscal year prior to ACM appointments. All firm financial variables are winsorized at the 1% level each tail to deal with outlier observations. Please see Appendix A for the variable definitions.

Table 3
Analysis on New ACM Appointments

Distribution of new executive ACM appointments by year

Appointing Year	# of observations	Percentage
2007	51	19%
2008	63	23%
2009	46	17%
2010	51	19%
2011	64	23%
Total	275	100%

Table 4

Pearson (Spearman) correlations below (above) the diagonal among variables

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23
1 DA_Appointer	1.00	0.11	0.14	0.36	0.03	0.06	-0.11	0.01	0.10	0.16	0.04	0.03	0.03	0.05	0.11	0.06	-0.03	0.03	-0.05	0.08	-0.01	0.06	0.03
2 DA_Appointee	0.14	1.00	0.00	0.12	0.01	-0.02	-0.01	0.02	0.02	-0.01	0.03	0.02	0.08	-0.09	-0.01	0.05	-0.03	0.11	-0.04	-0.04	0.24	-0.02	-0.08
3 Size_Appointer	0.16	-0.03	1.00	0.26	-0.10	0.38	0.15	-0.13	0.20	0.70	0.11	0.33	-0.11	-0.05	0.12	0.06	0.01	-0.25	0.12	0.47	0.05	0.36	0.00
4 ROA_Appointer	0.43	0.11	0.32	1.00	0.32	-0.07	0.64	0.19	0.09	0.25	0.20	0.10	0.07	-0.02	0.08	-0.09	0.03	-0.07	0.02	0.04	0.04	-0.01	-0.04
5 MTB_Appointer	-0.03	-0.02	-0.11	0.04	1.00	-0.15	0.33	0.24	0.02	0.00	-0.02	-0.06	0.06	0.02	-0.03	-0.11	0.05	0.12	0.08	-0.03	0.05	0.07	0.02
6 Leverage_Appointer	0.00	-0.13	0.22	-0.04	-0.30	1.00	-0.06	-0.10	0.13	0.26	0.05	0.05	0.01	0.05	0.05	0.04	0.05	-0.05	0.11	0.21	-0.07	0.16	0.05
7 CFO_Appointer	-0.10	0.07	0.25	0.64	0.03	-0.01	1.00	0.05	0.01	0.17	0.20	-0.01	0.10	-0.02	0.03	-0.06	0.04	-0.11	0.01	0.07	0.04	-0.01	-0.03
8 Salegrowth_Appointer	0.00	0.03	-0.14	-0.01	0.07	0.01	-0.08	1.00	-0.06	-0.17	-0.14	-0.11	-0.01	-0.04	-0.04	-0.01	0.08	0.15	0.05	-0.06	0.09	-0.06	-0.06
9 Duality_Appointer	0.05	0.03	0.21	0.08	-0.02	0.06	0.03	-0.02	1.00	0.13	0.08	0.13	0.43	0.02	0.07	0.05	-0.12	-0.03	0.01	0.11	-0.05	0.03	0.07
10 Boardsize_Appointer	0.17	-0.06	0.69	0.28	-0.06	0.13	0.20	-0.04	0.13	1.00	0.16	0.22	-0.06	-0.10	0.06	-0.01	0.00	-0.16	0.02	0.35	0.06	0.32	-0.01
11 Boardtenure_Appointer	0.07	0.03	0.05	0.20	0.00	-0.03	0.19	-0.11	0.05	0.07	1.00	0.04	0.26	-0.06	0.13	-0.06	0.06	-0.10	0.05	0.08	-0.01	0.14	0.04
12 Board_Ind%_Appointer	0.11	0.05	0.27	0.11	-0.06	-0.06	0.02	-0.02	0.14	0.17	-0.04	1.00	-0.16	0.06	0.06	0.01	0.00	0.03	0.04	0.15	0.02	0.11	-0.07
13 Ceotenure_Appointer	0.05	0.07	-0.13	0.07	0.05	-0.07	0.06	0.01	0.32	-0.08	0.35	-0.14	1.00	0.01	0.06	-0.05	-0.01	0.03	-0.02	-0.01	-0.11	0.04	0.14
14 Interlocked	0.04	-0.13	-0.05	0.00	0.11	0.04	0.00	-0.02	0.02	-0.09	-0.06	0.07	-0.02	1.00	0.05	-0.01	0.11	-0.07	0.06	0.01	-0.05	0.04	-0.01
15 MultipleDirector	0.06	-0.05	0.16	0.12	-0.03	0.01	0.10	-0.06	0.08	0.11	0.09	0.04	0.02	0.07	1.00	0.33	-0.07	0.08	0.01	-0.04	-0.07	0.07	-0.04
16 Age	0.04	0.13	0.09	-0.02	-0.12	0.02	-0.04	0.00	0.05	0.03	-0.06	0.02	-0.11	-0.04	0.30	1.00	-0.16	-0.03	0.11	0.10	-0.09	-0.02	0.03
17 Female	-0.07	-0.06	0.00	0.07	0.04	0.07	0.07	0.01	-0.12	0.00	0.01	0.01	-0.04	0.11	-0.06	-0.15	1.00	0.02	-0.07	0.11	0.02	0.10	0.05
18 Ind_expertise	0.01	0.06	-0.25	-0.09	0.06	0.02	-0.16	0.11	-0.03	-0.15	-0.10	0.05	0.07	-0.07	0.06	-0.04	0.02	1.00	-0.05	-0.13	0.01	-0.04	-0.01
19 Financial_expertise	-0.11	-0.02	0.11	0.05	0.04	0.07	0.04	-0.01	0.01	0.01	0.06	0.03	0.00	0.06	-0.01	0.10	-0.07	-0.05	1.00	-0.05	-0.02	0.08	0.06
20 Size_Appointee	0.08	-0.01	0.50	0.15	-0.09	0.15	0.13	-0.01	0.10	0.30	0.03	0.14	-0.07	0.01	-0.01	0.13	0.10	-0.10	-0.05	1.00	0.00	0.12	0.02
21 ROA_Appointee	0.02	0.28	0.17	0.15	-0.01	0.00	0.14	0.06	-0.03	0.07	0.02	0.07	-0.06	-0.05	-0.04	-0.07	0.05	-0.05	-0.01	0.27	1.00	0.08	0.05
22 Big4_Appointer	0.04	-0.05	0.37	0.07	-0.03	0.11	0.12	0.03	0.03	0.31	0.13	0.09	0.07	0.04	0.08	-0.01	0.10	-0.04	0.08	0.15	0.10	1.00	0.11
23 Sameauditor	0.05	-0.06	0.00	0.05	0.03	0.07	0.02	0.02	0.07	-0.02	0.05	-0.05	0.10	-0.01	-0.04	0.00	0.05	-0.01	0.06	0.05	0.11	0.11	1.00

Notes: All variables are defined and calculated in the fiscal year just prior to ACM appointments. All firm financial variables are winsorized at the 1% level each tail to deal with outlier observations. Please see Appendix A for the variable definitions. The correlation coefficients in bold are significant at p<0.05.

Table 5
Effects of New ACMs' Financial Reporting attributes on ACM Selections

<i>Dependent Variable:</i>	(1)		(2)	
<u>DA_Appointer</u>	Coefficients	t-Statistics	Coefficients	t-Statistics
<i>Test Variable:</i>				
DA_Appointee	0.2001	2.29 **	0.1855	2.34 **
<i>Control Variables:</i>				
Size_Appointer			0.0063	0.73
ROA_Appointer			0.9050	12.32 ***
MTB_Appointer			-0.0004	-0.25
Leverage_Appointer			0.0131	0.27
CFO_Appointer			-0.7486	-8.30 ***
Salegrowth_Appointer			-0.0217	-1.50
Duality_Appointer			-0.0200	-1.05
Boardsize_Appointer			0.0038	0.65
Boardtenure_Appointer			-0.0008	-0.32
Board_Ind%_Appointer			0.0937	1.35
Ceotenure_Appointer			0.0017	0.87
MultipleDirector			-0.0128	-1.13
Age			0.0011	0.80
Female			-0.0461	-1.80 *
Ind_expertise			-0.0155	-0.69
Financial_expertise			-0.0705	-2.01 **
Size_Appointee			-0.0015	-0.30
ROA_Appointee			-0.1316	-1.80 *
Big4_Appointer			-0.0426	-1.05
Interlocked			0.0803	1.24
Sameauditor			0.0241	1.14
Intercept	-0.0038	-0.36	-0.1679	-1.00
INDUSTRY DUMMY	NO		YES	
YEAR DUMMY	NO		YES	
Number of Observations	275		275	
R ²	0.02		0.63	

Notes: This table presents the coefficient estimates from the ordinary least square ("OLS") regression of new ACM appointments. The dependent variable is appointer firms' abnormal accruals in the fiscal year just prior to the ACM appointment. The test independent variable is appointee firms' abnormal accruals in the year prior to the appointments. All firm financial variables are winsorized at the 1% level each tail to deal with outlier observations. Please see Appendix A for the variable definitions. *, **, and *** represent the 10%, 5%, and 1% significance levels, respectively.

Table 6
Univariate Test of Change on Appointer Firms' Subsequent FRQ

Change in DA_Appointer	Observations	Mean	Std. Dev.
Gap <0	116	0.06143	0.183765
Gap =0	35	0.000454	0.101866
Gap >0	97	-0.02158	0.136106

Total 248

Notes: This table presents the results of the univariate test on change of appointer firms' subsequent FRQ. The dependent variable, Change in DA_Appointer, is defined as the change in appointer firms' abnormal accruals between the fiscal year prior to (Yt-1) and the fiscal year subsequent to (Yt+1) the appointment year (Yt). Gap is defined as the difference between appointer firm's rank of discretionary accruals and appointee firm's rank of discretionary accruals. Gap is smaller than 0 when strong firms appoint relatively weak ACMs. Gap equals to 0 when firms appoint similar ACMs. Gap is larger than 0 when weak firms appoint relatively strong ACMs.

Table 7
Change Analysis on Appointer Firms' Subsequent FRQ

<i>Dependent Variables:</i>	(1)		(2)	
<u>Change in DA_Appointer</u>	<u>Coefficients</u>	<u>t-Statistics</u>	<u>Coefficients</u>	<u>t-Statistics</u>
<i>Test Variable:</i>				
Gap	-0.0077	-2.75 ***	0.0062	1.08
Negative			-0.0423	-1.45
Gap*Negative			-0.0358	-3.83 ***
<i>Control Variables:</i>				
Size_ATF_change	-0.0740	-2.76 ***	-0.0670	-2.57 ***
ROA_ATF_change	0.6236	12.82 ***	0.6236	13.26 ***
MTB_ATF_change	-0.0005	-0.43	-0.0008	-0.67
CFO_ATF_change	-0.6688	-8.90 ***	-0.7308	-9.80 ***
Leverage_ATF_change	0.2337	2.71 ***	0.2201	2.63 ***
Salegrowth_ATF_change	-0.0336	-1.61	-0.0235	-1.16
Duality_ATF_change	0.0259	1.24	0.0382	1.86 *
Boardsize_ATF_change	0.0001	0.02	-0.0011	-0.20
Board_Ind%_ATF_change	0.0204	0.38	0.0413	0.80
Boardtenure_ATF_change	0.0018	0.40	0.0011	0.26
Ceotenure_ATF_change	-0.0025	-0.94	-0.0044	-1.67 *
Intercept	-0.0803	-0.69	-0.0811	-0.72
INDUSTRY DUMMY	YES		YES	
YEAR DUMMY	YES		YES	
Number of Observations	248		248	
R ²	0.65		0.68	

Notes: This table presents the coefficient estimates for the change analysis on appointer firms' subsequent financial reporting quality ("FRQ"). The dependent variable, Change in DA_Appointer, is defined as the change in appointer firms' abnormal accruals between fiscal year prior to (Y_{t-1}) and fiscal year subsequent to (Y_{t+1}) the appointment year (Y_t). The test variables are Gap, Negative and their interaction term Gap*Negative. Gap is defined as the difference between appointer firm's rank of discretionary accruals and appointee firm's rank of discretionary accruals. Negative is defined as an indicator variable which takes the value of 1 if the difference between appointer firm's rank of discretionary accruals and appointee firm's rank of discretionary accrual is negative, and 0 otherwise. All firm financial variables are winsorized at the 1% level each tail to deal with outlier observations. Please see Appendix A for the variable definitions. *, **, and *** represent the 10%, 5%, and 1% significance levels, respectively.

Table 8
Selection of new non-ACM Directors

<i>Dependent Variable :</i>	(1)		(2)	
	DA_Appointer		DA_Appointer	
	Coefficients	t-Statistics	Coefficients	t-Statistics
<i>Test Variable:</i>				
DA_Appointee	0.0490	1.35	0.0264	0.78
<i>Control Variables:</i>				
Size_Appointer			-0.0061	-1.48
ROA_Appointer			0.8261	12.68 ***
MTB_Appointer			0.0004	0.60
Leverage_Appointer			0.0428	1.29
CFO_Appointer			-0.6863	-8.92 ***
Salegrowth_Appointer			0.0056	0.27
Duality_Appointer			-0.0027	-0.28
Boardsize_Appointer			0.0002	0.10
Boardtenure_Appointer			0.0034	2.30 **
Board_Ind%_Appointer			-0.0196	-0.52
Ceotenure_Appointer			0.0008	0.84
MultipleDirector			0.0006	0.11
Age			-0.0011	-1.44
Female			-0.0068	-0.53
Ind_expertise			-0.0015	-0.13
Size_Appointee			0.0018	0.63
ROA_Appointee			-0.0057	-0.14
Big4_Appointer			-0.0613	-2.56 **
Sameauditor			-0.0060	-0.59
Intercept	0.0238	4.06 ***	0.1658	1.64
INDUSTRY DUMMY	NO		YES	
YEAR DUMMY	NO		YES	
Number of Observations	413		413	
R ²	0.00		0.63	

Notes: This table presents the coefficient estimates from the ordinary least square ("OLS") regression of new non-ACM director appointments. The dependent variable is appointer firms' abnormal accruals in the fiscal year just prior to the non-ACM appointment. The test independent variable is appointee firms' abnormal accruals in the year prior to the appointments. All firm financial variables are winsorized at the 1% level each tail to deal with outlier observations. Please see Appendix A for the variable definitions. *, **, and *** represent the 10%, 5%, and 1% significance levels, respectively.

Table 9
Selection of new ACM - Other Discretionary Accrual Measures

<i>Dependent Variable:</i> DA_Appointer	(1)		(2)		(3)		(4)		(5)	
	Modified-Jones Model		Jones Model Performance Matched		Jones Model ROA_Included		Jones Model Industry Adjusted		Jones Model Three-Year Average	
	Coefficients	t-Statistics	Coefficients	t-Statistics	Coefficients	t-Statistics	Coefficients	t-Statistics	Coefficients	t-Statistics
<i>Test Variable:</i>										
DA_Appointee	0.1526	1.71 *								
DA_Appointee			0.1747	2.10 **						
DA_Appointee					0.1583	1.86 *				
DA_Appointee							0.1606	1.98 **		
DA_Appointee									0.1969	2.10 **
<i>Control Variables:</i>										
Size_Appointer	0.0129	1.32	-0.0070	-0.39	0.0081	1.04	0.0024	0.26	0.0112	1.33
ROA_Appointer	0.9122	11.25 ***	1.2393	8.42 ***	0.5990	9.06 ***	0.9043	11.87 ***	0.4065	5.76 ***
MTB_Appointer	0.0003	0.15	-0.0090	-2.51 **	0.0012	0.73	-0.0008	-0.41	0.0002	0.10
Leverage_Appointer	0.0251	0.47	0.1051	1.05	0.0153	0.36	0.0151	0.30	-0.0037	-0.08
CFO_Appointer	-0.7500	-7.60 ***	-0.8687	-4.76 ***	-0.6365	-7.92 ***	-0.7504	-8.03 ***	-0.2412	-2.78 ***
Salegrowth_Appointer	-0.0368	-2.09 **	0.0316	0.96	0.0008	0.06	-0.0231	-1.55	-0.0075	-0.54
Duality_Appointer	-0.0251	-1.18	0.0222	0.57	-0.0162	-0.95	-0.0127	-0.64	0.0072	0.39
Boardsize_Appointer	0.0030	0.46	-0.0066	-0.54	0.0001	0.01	0.0046	0.77	0.0016	0.30
Boardtenure_Appointer	-0.0012	-0.43	-0.0044	-0.83	-0.0008	-0.32	-0.0011	-0.42	0.0027	1.05
Board_Ind%_Appointer	0.1181	1.53	0.1082	0.71	0.0761	1.23	0.0986	1.37	0.1326	1.99 **
Ceotenure_Appointer	0.0021	1.00	-0.0017	-0.44	0.0023	1.34	0.0015	0.76	0.0012	0.66
MultipleDirector	-0.0120	-0.95	-0.0063	-0.26	-0.0062	-0.61	-0.0139	-1.18	-0.0046	-0.43
Age	0.0016	1.00	0.0027	0.93	0.0006	0.46	0.0010	0.66	0.0007	0.49
Female	-0.0527	-1.83 *	-0.0612	-1.13	-0.0437	-1.91 *	-0.0434	-1.63	-0.0230	-0.94
Ind_expertise	-0.0105	-0.42	0.0324	0.72	0.0021	0.11	-0.0207	-0.89	-0.0004	-0.02
Financial_expertise	-0.0818	-2.08 **	-0.1606	-2.19 **	-0.0786	-2.52 **	-0.0622	-1.71 *	-0.0836	-2.48 **
Size_Appointee	-0.0024	-0.42	-0.0099	-0.91	0.0004	0.09	-0.0012	-0.23	-0.0031	-0.62
ROA_Appointee	-0.1286	-1.58	-0.0193	-0.14	-0.1352	-2.21 **	-0.1185	-1.56	-0.1216	-1.76 *
Big4_Appointer	-0.0391	-0.87	0.0589	0.69	-0.0394	-1.09	-0.0534	-1.27	-0.0786	-2.01 *
Interlocked	0.0788	1.04	0.1107	0.87	0.0550	0.96	0.0727	1.08	0.0724	1.17
Sameauditor	0.0224	0.94	-0.0066	-0.15	0.0205	1.09	0.0228	1.04	0.0184	0.91
Intercept	-0.2841	-1.54	-0.3629	-1.05	-0.0313	-0.21	-0.1153	-0.66	-0.2986	-1.85 *
INDUSTRY DUMMY	YES		YES		YES		YES		YES	
YEAR DUMMY	YES		YES		YES		YES		YES	
Number of Observations	252		253		275		275		275	
R ²	0.63		0.49		0.54		0.62		0.54	

Notes: This table presents the coefficient estimates from the OLS regression of new ACM appointments using different discretionary accrual measures. In the first four models, the dependent variable is defined as appointer firms' abnormal accruals in the fiscal year just prior to the ACM appointment. The test independent variable is appointee firms' abnormal accruals in the year prior to the appointments. In Model 5, the dependent (independent) variable is the appointer (appointee) firms' three-year average of abnormal accruals prior to the appointments. All firm financial variables are winsorized at the 1% level each tail to deal with outlier observations. Please see Appendix A for the variable definitions. *, **, and *** represent the 10%, 5%, and 1% significance levels, respectively.

Table 10
Selection of new ACM - Other Financial Reporting Quality Measures

<i>Dependent Variable:</i>	(1)		(2)	
	MoB%_Appointer		LossAvoid_Appointer	
<i>Test Variable:</i>	Coefficients	t-Statistics	Coefficients	t-Statistics
MoB%_Appointee	0.1386	1.79 *		
LossAvoid_Appointee			0.1609	2.23 **
<i>Control Variables:</i>				
Size_Appointer	-0.0530	-2.59 ***	0.0042	0.29
ROA_Appointer	-0.2898	-1.33	0.0147	0.12
MTB_Appointer	0.0049	1.00	-0.0027	-0.88
Leverage_Appointer	-0.1349	-1.09	-0.0276	-0.34
CFO_Appointer	0.3776	1.38	-0.1780	-1.19
Salegrowth_Appointer	-0.0098	-0.26	-0.0052	-0.20
Duality_Appointer	0.0048	0.11	0.0115	0.36
Boardsize_Appointer	0.0243	1.73	0.0128	1.33
Boardtenure_Appointer	0.0002	0.03	-0.0038	-0.88
Board_Ind%_Appointer	0.0796	0.52	0.0722	0.64
Ceotenure_Appointer	-0.0018	-0.42	0.0039	1.23
Interlocked	0.1233	0.83	0.0058	0.06
MultipleDirector	0.0176	0.69	-0.0108	-0.56
Age	0.0033	0.93	0.0004	0.15
Female	0.0727	1.20	-0.0375	-0.84
Ind_expertise	-0.0608	-1.08	0.0549	1.40
Financial_expertise	0.0689	0.83	0.0911	1.52
Size_Appointee	0.0066	0.59	-0.0007	-0.08
ROA_Appointee	0.3441	1.63	0.0736	0.59
Big4_Appointer	0.0687	0.72	0.0170	0.25
Sameauditor	-0.0861	-1.75 *	-0.0059	-0.17
Intercept	-0.0659	-0.18	-0.2256	-0.77
INDUSTRY DUMMY	YES		YES	
YEAR DUMMY	YES		YES	
Number of Observations	240		305	
R ²	0.35		0.31	

Notes: This table presents the coefficient estimates from the OLS regressions of new ACM appointments using other financial reporting quality measures. The dependent variables are MoB%_Appointer and LossAvoid_Appointer. MoB%_Appointer is defined as the percentage of quarters the appointer firm meets/beats the analyst consensus forecasts by three cents per share or less within the 4 quarters of the fiscal year prior to the ACM appointment. LossAvoid_Appointer is an indicator variable which takes the value of 1 if the appointer firm's earnings is between 0 and 1 cent in the fiscal year just prior to the appointments, and 0 otherwise. The independent variables are MoB%_Appointee and LossAvoid_Appointee. All firm financial variables are winsorized at the 1% level each tail to deal with outlier observations. Please see Appendix A for the variable definitions. *, **, and *** represent the 10%, 5%, and 1% significance levels, respectively.

Table 11
Selection of new non-ACM Directors - Other Financial Reporting Quality Measures

<i>Dependent Variable :</i>	(1)		(2)	
	MoB%_Appointer		LossAvoid_Appointer	
	Coefficients	t-Statistics	Coefficients	t-Statistics
<i>Test Variable:</i>				
MoB%_Appointee	-0.0758	-1.43		
LossAvoid_Appointee			-0.0029	-0.06
<i>Control Variables:</i>				
Size_Appointer	0.0056	0.45	0.0073	0.76
ROA_Appointer	0.2440	1.16	-0.0076	-0.05
MTB_Appointer	0.0032	1.16	0.0000	0.03
Leverage_Appointer	0.1173	1.09	0.0596	0.76
CFO_Appointer	-0.2623	-1.02	-0.3291	-1.78 *
Salegrowth_Appointer	0.0014	0.02	-0.0215	-0.45
Duality_Appointer	0.0130	0.43	-0.0297	-1.30
Boardsize_Appointer	-0.0049	-0.61	-0.0087	-1.56
Boardtenure_Appointer	0.0047	1.04	-0.0004	-0.11
Board_Ind%_Appointer	0.1683	1.42	0.1632	1.89 *
Ceotenure_Appointer	0.0030	1.11	-0.0020	-0.92
MultipleDirector	-0.0062	-0.36	0.0034	0.25
Age	0.0047	1.93 *	0.0010	0.53
Female	-0.0137	-0.35	0.0529	1.76
Ind_expertise	-0.0187	-0.51	-0.0078	-0.28
Size_Appointee	0.0087	1.09	-0.0078	-1.23
ROA_Appointee	0.0974	0.56	0.0355	0.41
Big4_Appointer	-0.0906	-1.15	-0.0514	-0.91
Sameauditor	0.0054	0.18	-0.0063	-0.27
Intercept	-0.5015	-1.59	-0.0079	-0.03
INDUSTRY DUMMY	YES		YES	
YEAR DUMMY	YES		YES	
Number of Observations	406		476	
R ²	0.28		0.29	

Notes: This table presents the coefficient estimates from the OLS regressions of new non-ACM director appointments using other financial reporting quality measures. The dependent variables are MoB%_Appointer and LossAvoid_Appointer. MoB%_Appointer is defined as the percentage of quarters the appointer firm meets/beats the analyst consensus forecasts by three cents per share or less within the 4 quarters of the fiscal year prior to the non-ACM director appointments. LossAvoid_Appointer is an indicator variable which takes the value of 1 if the appointer firm's earnings is between 0 and 1 cent in the fiscal year just prior to the appointments, and 0 otherwise. The independent variables are MoB%_Appointee and LossAvoid_Appointee. All firm financial variables are winsorized at the 1% level each tail to deal with outlier observations. Please see Appendix A for the variable definitions. *, **, and *** represent the 10%, 5%, and 1% significance levels, respectively.

Appendix A: Variable Definitions

Variables	Definitions
<u>Dependent Variable:</u>	
DA_Appointer	Appointer firm's abnormal accruals in the fiscal year prior to the ACM appointment.
LossAvoid_Appointer	An indicator variable which takes the value of 1 if the appointer firm's earnings is between 0 and 1 cent in the fiscal year prior to the appointments, and 0 otherwise.
MoB%_Appointer	The percentage of quarters the appointer firm meets/beats the analyst consensus forecasts by three cents per share or less within the 4 quarters of the fiscal year prior to the ACM appointment.
Change in DA_Appointer	The change in appointer firm's abnormal accruals between the fiscal year prior to (Yt-1) and the fiscal year subsequent to (Yt+1) the appointment (Yt).
<u>Test Variables:</u>	
Gap	The difference between appointer firm's rank of discretionary accruals and appointee firm's rank of discretionary accruals.
Negative	An indicator variable which takes the value of 1 if the value of the variable <i>Gap</i> is negative, and 0 otherwise.
DA__Appointee	Appointee firm's abnormal accruals in the fiscal year prior to the ACM appointment.
LossAvoid__Appointee	An indicator variable which takes the value of 1 if the appointee firm's earnings is between 0 and 1 cent in the fiscal year prior to the appointment, and 0 otherwise.
MoB%__Appointee	The percentage of quarters the appointee firm meets/beats the analyst consensus forecasts by three cents per share or less within the 4 quarters of the fiscal year prior to the ACM appointment.

Control Variables:

Appointer Firms

Size_Appointer	Appointer firm's natural log of total assets.
ROA_Appointer	Appointer firm's performance, which is the ratio of net income to total assets.
MTB_Appointer	Market to book ratio, defined as appointer firm's market value of equity over book value of equity.
Leverage_Appointer	Leverage ratio, defined as appointer firm's long-term debt plus debt in current liabilities over total assets.
CFO_Appointer	Cash flow from operating activities deflated by total assets.
Salegrowth_Appointer	Sales growth, defined as appointer firm's percentage change in total sales.
Boardsize_Appointer	The number of board members of appointer firm's in the fiscal year prior to the appointment.
Board_Ind%_Appointer	The ratio of the number of independent directors to board size in the fiscal year prior to the appointment.
Duality_Appointer	An indicator variable which takes the value of 1 if the appointer firm's CEO is the chairman of the board, and 0 otherwise.
Ceotenure_Appointer	The number of years CEO works for the appointer firm as of the year prior to the ACM appointment.
Boardtenure_Appointer	The average number of years that incumbent board members have served as of the year prior to the ACM appointment.
Big4_Appointer	An indicator variable which takes the value of 1 if the appointer firm hires a Big 4 auditor to audit their financial statements in the fiscal year prior to the appointment, and 0 otherwise.

Appointee Firms

Size__Appointee Appointee firm's natural log of total assets.
ROA__Appointee Appointee firm's performance, which is the ratio of net income to total assets.

ACM Characteristics:

MultipleDirector The number of new ACM's other directorships.
Age The age of new ACM in the year prior to the appointment.
Female An indicator variable which takes the value of 1 if the ACM is a female, and 0 otherwise.
Ind_expertise An indicator variable which takes the value of 1 if the new ACM comes from a firm in the same industry as the appointer firm, and 0 otherwise.
Financial_expertise An indicator variable which takes a value of 1 if the new ACM has financial expertise and 0 otherwise.

Other Variables:

Interlocked An indicator variable which takes a value of 1 if a common director or executive serves both the appointer firm and appointee firm in the fiscal year prior to the appointment , and 0 otherwise.
Sameauditor An indicator variable which takes a value of 1 if the appointer firm hires the same auditor as the appointee firm in the fiscal year prior to the appointment and 0 otherwise.

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