

Appointment of New Executives and Subsequent SOX 404 Opinion

Abhijit Barua
Florida International University

Yun-Chia Yan
University of New Orleans

The chief financial officer (CFO) and the chief executive officer (CEO) of a company play a crucial role in financial reporting process. This paper examines the relation between the appointment of the new executives and the receipt of subsequent initial SOX 404 opinions. Our results show that adverse SOX 404 reports will be more likely at firms that have recently hired a new CFO. This has important implications, from a public interest standpoint, for both investors and auditors. Overall, the paper contributes to the corporate governance and internal control weakness research by providing direct evidence regarding CFO turnover and subsequent SOX 404 opinions.

INTRODUCTION

This paper examines the relation between the appointment of the new executives and the receipt of subsequent initial Sarbanes-Oxley Act (SOX) Section 404 opinions. The chief financial officer (CFO) and the chief executive officer (CEO) of a company play a crucial role in financial reporting. SOX states that CFOs and CEOs are personally responsible for accurate and reliable financial reporting, and for maintaining effective internal controls. Therefore it is of public interest to examine the appointment of the new CFO and CEO and subsequent internal control reports.

Surprisingly, there is little prior research related to the effects of a new CFO on the quality of financial reporting. In a recent study, Geiger and North (2006) examine the changes in discretionary accruals surrounding the appointment of a new CFO. They find that discretionary accruals decreased significantly following the appointment of a new CFO. Our study addresses a different dimension of the quality of financial reporting by examining the relation between the appointment of the new executives and subsequent SOX 404 opinions. In our analyses, we use 1,230 non-financial firms with a fiscal year end between 11/15/2004 and 02/28/2005. The results show that adverse SOX 404 reports will be more likely at firms that have recently hired a new CFO. Given the importance placed by SOX on the role of individual executives on financial reporting, our study provides useful evidence about the role of executives in maintaining effective internal controls.

The next section discusses the background and develops the research question. This is followed by a discussion of method and results. The paper ends with a summary and conclusions.

BACKGROUND AND HYPOTHESIS

The role of the chief executive officer (CEO) and chief financial officer (CFO) in corporate governance and the financial reporting process has gained a lot of attention from regulators and accounting professions in recent years. During the congressional hearings held following the Enron and WorldCom failures, chief executives asserted that they did not know much about the details of financial reporting and that such issues had been delegated to the CFO. Fueled by such shirking of responsibility, SOX includes specific language that puts the onus for ensuring the reliability of financial reports on the CEO and CFO.

Section 302 (Corporate Responsibility for Financial Reports) of SOX (SOX 2002) states that:

“The CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer”.

As discussed in detail later, there are important reasons to expect that the quality of internal controls will be dependent on the individuals who occupy the CEO and CFO positions of a company. A CFO nowadays has to be responsible for both financial and non-financial (internal control quality) performance of a company. Given that a new CFO will have less experience with the financial reporting processes of the company, one may expect that the possibility of receiving an adverse SOX 404 opinion is higher in a company with a new CFO.

Related Research

Related Research on Internal Control

Section 404 of SOX requires management assess and publicly report on the effectiveness of their firm's internal controls, and that auditors publicly provide an opinion on management's assessment, as well as the effectiveness of the internal controls. SOX 404 became effective for accelerated filers for fiscal years ending on or after November 15, 2004¹. During the last few years, a large number of studies investigate various issues related to internal control, for example, the effect of internal control deficiencies on firm risk and cost of equity capital (Ashbaugh et al. 2006; Ogneva et al. 2007), the relation between accruals quality and internal controls (Doyle et al. 2007a), the market reaction to adverse SOX 404 opinions (DeFranco et al. 2005; Cheng et al. 2006), and the association between internal control weakness disclosures and auditor actions (Raghunandan & Rama 2006; Ettredge et al. 2006).

Since our study examine whether the appointment of new executives is associated with subsequent adverse SOX 404 opinions, we discuss few studies that have examined factors associated with the disclosure of material weaknesses in internal control. Ge and McVay (2005) examine companies that disclose material weaknesses in internal control, pursuant to Section 302 of SOX. They find that: (1) poor internal control is usually related to an insufficient commitment of resources for accounting controls; (2) material weaknesses in internal control tend to be related to deficient revenue-recognition policies, lack of segregation of duties, deficiencies in the period-end reporting process and accounting policies, and inappropriate account reconciliation; and (3) disclosing a material weakness is positively associated with business complexity (e.g., multiple segments and foreign currency), negatively associated with firm size (e.g., market capitalization), and negatively associated with firm profitability (e.g., return on assets). Doyle et al. (2007b) examine determinants of weaknesses in internal control for 779 firms disclosing material weaknesses from August 2002 to 2005. They find that these firms tend to be smaller, younger, financially weaker, more complex, growing rapidly, or undergoing restructuring. Ashbaugh et al. (2007) use firms' disclosures of internal control problems prior to audits mandated by Section 404 of the SOX to investigate the economic factors that expose firms to internal control failure risks and managements' incentives to discover and report internal control deficiencies (ICDs). They find that firms making pre-SOX 404 ICD disclosures typically have more complex operations, recent changes in organization structure, more accounting risk exposure, fewer resources to invest in internal control and higher incidence of auditor resignation relative to firms that do not report internal control problems.

Related Research on Executive Turnover

Although the CFO has been long recognized as having an important role in the company's financial reporting process, prior research examining the relation between the CFO and the company's reported financial results is limited. In contrast, there is a somewhat more extensive literature on the relationship between CEO tenure and financial reporting.

In the first published academic study on CFO turnover, Mian (2001) investigates why firms replace their CFOs using a sample of 2,227 CFO appointments over the 1984-1997 time period. He documents that: (1) the external CFO succession rate is markedly higher than the external CEO succession rate, (2) the incidence of retirement is less common for CFOs as compared to the top executive, (3) CFO turnover is preceded by poor market performances, a decline in operating return on assets and abnormally high CEO turnover, and (4) the CFO turnover is associated with a significant negative market reaction.

Some prior studies have studied the turnover of top executives in general, including the top five executives. Since the CFO typically tends to be a top five executive, we briefly review two relevant studies.

Gilson (1989) investigates senior management turnover in financially distressed firms. He finds that (1) in any given year, 52% of sampled firms experience turnover if they are either in default on their debt, bankrupt, or privately restructuring their debt to avoid bankruptcy; (2) a significant number of changes are initiated by firms' bank lenders; (3) following their resignation from these firms, managers are not subsequently employed by another exchange-listed firm for at least 3 years. His results are consistent with managers experiencing large personal costs when their firms default. Gilson's results also indicate that when managerial costs of financial distress are high, managers have incentives to reduce the likelihood of default by borrowing less, choosing less risky investment projects, and managing their firms more efficiently.

Fee and Hadlock (2004) study management turnover for the top five executives in a sample of 443 large firms from 1993 through 1998. Their results show that (1) the rate of forced turnover for non-CEOs is not less than that for CEOs, but the sensitivity of turnover to firm performance is smaller for non-CEOs; (2) the likelihood of non-CEO turnover is associated with CEO dismissals, particularly when the replacement CEO is an outsider; (3) new positions obtained by the dismissed executives are significantly inferior to their prior jobs.

During the congressional hearings following the Enron failure, significant attention was focused on the fact that many employees of Enron were also former employees of Andersen, the firm that audited Enron. Given such legislative interest, three recent studies have examined earnings management surrounding the appointment of a CFO who was a former employee of the firm that audited the company.

Dowdell and Krishnan (2004) compare the level of discretionary accruals in a sample of 172 test companies that appointed to the position of chief financial officer personnel who are former employees of the companies' auditors, with a control sample of companies that appointed new CFOs who were not affiliated with their auditors. Their results show that (1) firms with affiliated CFOs are associated with greater earnings management than firms with unaffiliated CFOs, and (2) the association is stronger for nonpartners who moved from the audit firm to the client with little or no time gap.

Menon and Williams (2004) calculate abnormal accruals for sample firms in 1998 and 1999, and find that firms employing former partners as officers or directors report larger signed and unsigned abnormal accruals than other firms, after controlling for other factors that plausibly affect abnormal accruals. They also observe a disproportionately higher (lower) proportion of former partner firms than expected just meeting (missing) analysts' earnings forecasts.

Geiger et al. (2005) examine a sample of firms where financial reporting executives such as the CFO, VP-Finance, or Controller were hired by a public company directly from their external audit firm. Their results indicate that earnings management, in the form of increased accounting accruals, is no greater immediately before or after hiring in the companies engaging in this hiring practice compared to three separate control groups hiring individuals from other sources or retaining their incumbent financial reporting executives. They also find that changes in accruals surrounding the hiring of these former auditors is relatively stable over the 11-year period studied.

While the above noted studies have examined issues related to the appointment of a CFO who had previously worked with the firm that audited the company, Geiger and North (2006) examine the changes in discretionary accruals surrounding the appointment of a new CFO irrespective of whether or not the CFO had worked previously at the firm that audited the company. Using a sample of 712 companies that appointed a new CFO in the period 1994 to 2000, they find that discretionary accruals decreased significantly following the appointment of a new CFO. Their tests indicate that this reduction is significantly greater for the group of CFO-hiring firms than for a control group of non-hiring firms, and that the changes are not driven by a concurrent appointment of a new CEO. They also find that their results are largely driven by firms that hire a new CFO from outside the company. Their study shows that a firm's discretionary accruals are significantly reduced surrounding the appointment of a new CFO.

Aier et al. (2005) investigate whether the characteristics of chief financial officers are associated with accounting errors (using accounting restatements as a proxy). They investigate several metrics of financial literacy similar to those suggested for members of audit committees by the NYSE-NASD Blue Ribbon Committee. These metrics include years of work as a CFO, experience at another company, advanced degrees (like M.B.A.s), and professional certification (like a CPA). They use a logit model to test whether the likelihood of an earnings restatement is related to the above metrics of financial literacy (measured at the date of the original accounting error). Overall, their results are consistent with restatements being negatively associated with the CFO's financial expertise. Specifically, they find that companies with CFOs that (1) have more work experience, and (2) are M.B.A.s, and/or CPAs, are significantly less likely to restate their earnings.

In contrast to the limited prior research on the effects of CFO turnover on financial reporting, there is a more extensive literature on the effects of CEO turnover on financial reporting. Pourciau (1993) uses data from 267 US companies to examine evidence of earnings management associated with nonroutine executive changes. Her results show that incoming executives (1) manage accruals in a way that decreases earnings in the year of the executive change and increases earnings the following year, and (2) record large write-offs and special items in the year of the management change.

Murphy and Zimmerman (1993) study the behavior of a variety of financial variables surrounding CEO departures. They document that turnover-related changes in R&D, advertising, capital expenditures, and accounting accruals are due mostly to poor performance.

Reitenga and Tearney (2003) examine CEO turnovers that are the result of a mandatory retirement policy. They find evidence of earnings management in departing CEOs' final years and final two years, with the evidence being stronger when the CEO retained his or her board seat after retirement; that independent directors and CEO stockholdings appear to mitigate the earnings management; and that institutional stockholders appear to exacerbate earnings management in CEOs' final years.

While the above noted studies have examined the association between earnings management following the appointment of new CEOs, other studies have examined the role of accounting numbers in the CEO retention and termination decisions. DeFond and Park (1999) show that (1) the frequency of CEO turnover is greater in highly competitive industries than in less competitive industries (2) relative performance evaluation -based (firm-specific) accounting measures are more closely associated with CEO turnover in high (low) competition industries. In a more recent study, Engel et al. (2003) document that (1) accounting information appears to receive greater weight in turnover decisions when accounting-based measures are more precise and more sensitive, and (2) market-based performance measures receive less weight in turnover decisions when accounting-based measures are more sensitive or market returns are more variable.

Blackwell et al. (1994) examine the relation between accounting-based performance and the turnover and promotion of managers of subsidiaries of Texas bank holding companies over the period 1984-1987. They found that turnover of subsidiary bank managers is negatively related to subsidiary performance, while promotions are positively related to performance. Their results also show that holding own-bank performance constant, turnover increases with holding-company performance, which is consistent with the view that turnover decisions are based on performance relative to a firm-specific benchmark.

Defond and Hung (2004) investigate the relation between investor protection (the strength of the legal

institutions that facilitate law enforcement) and corporate governance (identifying and terminating poorly performing CEOs). Their tests indicate that (1) strong law enforcement institutions significantly improve the association between CEO turnover and poor performance, whereas extensive investor protection laws do not, and (2) in countries with strong law enforcement, CEO turnover is more likely to be associated with poor stock returns when stock prices are more informative. They document that finding strong law enforcement institutions are associated with improved CEO turnover-performance sensitivity is consistent with good corporate governance requiring law enforcement institutions capable of protecting shareholders' property rights.

Two studies have examined the association between executive turnovers subsequent to financial reporting problems. Agrawal et al. (1999) investigate the assertion that firms suspected or charged with fraud have unusually high turnover among senior managers or directors. Their results show that (1) in univariate comparisons, there is some evidence that firms committing fraud have higher managerial and director turnover. (2) but in multivariate tests that control for other firm attributes, such evidence disappears. Their findings indicate that the revelation of fraud does not, in general, increase the net benefits to changing managers or the firm's leadership structure. Desai et al. (2006) examine management turnover and the subsequent employment of displaced managers at firms announcing earnings restatements during 1997 or 1998. They find that (1) 60 percent of restating firms experience a turnover of at least one top manager within 24 months of the restatement compared to 35 percent among age-, size-, and industry-matched firms; and (2) the subsequent employment prospects of the displaced managers of restatement firms are poorer than those of the displaced managers of control firms. Their results suggest that both corporate boards and the external labor market impose significant penalties on managers for violating GAAP.

In summary, there is an extensive literature on the effect of CEO turnover on financial reporting. In contrast, research about the association between CFO turnover and financial reporting is fairly recent. We add to this emerging research stream by examining the association between CFO turnover and internal control quality.

Hypothesis

Internal controls are dependent on people. When a new CFO or a new CEO joins a company, it is likely that their way of doing things will be quite different from those of their predecessors. Hence, it is likely that there will be changes in the financial reporting process; such changes in turn increase the likelihood of material weaknesses in internal control. Thus, our hypothesis (in the alternative form) is:

H_A: Material weaknesses in internal controls are more likely when the CEO or CFO is new.

METHOD

Model

We use the following binary logistic regression model to examine the relation between the appointment of a new CEO and CFO and the receipt of subsequent SOX404 opinions.

$$MW = \alpha + \beta_1 NEWCFOs + \beta_2 NEWCEOs + \beta_3 LnMV + \beta_4 ROA + \beta_5 SGROWTH + \beta_6 DE + \beta_7 AU + \beta_8 RECINV + \beta_9 RESTRUCTURE + \beta_{10} LOSS + \beta_{11} FOROPS + \beta_{12} SQSEG + \varepsilon$$

The variables are defined as follows:

<i>MW</i>	= Indicator variable takes a value of 1 if the firm has a presence of material weakness in Internal control, else zero.
<i>NEWCFOs</i>	= Indicator variable takes a value of 1 if CFO tenure= 1 or 2, else zero.
<i>NEWCEOs</i>	= Indicator variable takes a value of 1 if CEO tenure= 1 or 2, else zero.
<i>LnMV</i>	= Natural logarithm of market value of the firm.
<i>ROA</i>	= Return on assets.
<i>SGROWTH</i>	= Sales growth measured as $(Sales_t - Sales_{t-1}) / Sales_{t-1}$.
<i>DE</i>	= Debt equity ratio.
<i>AU</i>	= Indicator variable takes a value of 1 if the firm is audited by one of the big 4 auditors, else zero.
<i>RECINV</i>	= Receivable plus inventory scaled by total assets.
<i>RESTRUCTU</i>	= Indicator variable takes a value of 1 if the firm has restructuring charge, else zero
<i>RE</i>	
<i>LOSS</i>	= Indicator variable takes a value of 1 if the firm's income before extraordinary items is negative, else zero
<i>FOROPS</i>	= Indicator variable takes a value of 1 if the firm has foreign operations, else zero
<i>SQSEG</i>	= Square root of number of business segments

Base on recent research related to internal control opinions (e.g., Krishnan 2005; Ashbaugh et al. 2007; Doyle et al. 2007b), we expect that adverse SOX 404 reports will be less likely at firms that are 1) more profitable 2) highly leveraged, 3) have a substantial proportion of assets in receivables and inventory, and 4) are more complex (in terms of number of segments or having foreign operations) or have had a restructuring.

Our assertion is that since the new CFOs have less experience (one or two years tenure) in the company, the possibility of receiving an adverse SOX 404 opinion in the subsequent year is higher in a company with CFO turnover than a company without CFO turnover. So the coefficient sign of *NEWCFOs* should be positive.

Sample

Table 1 provides derivation of the sample. We begin with 2,043 firms that are included in the 2005 version of the Corporate Library's *Board Analyst* database. We then delete 21 firms with CEO tenure data or CFO tenure data missing. This reduces the sample down to 2,022.

We then merge *Board Analyst* database sample with SOX 404 opinions sample from *AuditAnalytics* database. There are 59 firms from the *Board Analyst* database that do not have data in *AuditAnalytics*, so the merged sample becomes 1,963. We delete 259 firms in the financial sector (SIC code 60-67). We then delete 424 observations with fiscal year ends before November 15, 2004 or after February 28, 2005². We then obtain financial data from the *COMPUSTAT* database. There are 37 firms without available data in *COMPUSTAT*, so the sample size drops to 1,243. Finally, we delete 13 observations with CEO tenure and CFO tenure equal to zero. Thus, our final sample consists of 1,230 firms.

**TABLE 1
DERIVATION OF THE SAMPLE**

	No. of observations
Governance data from 2005 Corporate Library database	2043
CEO or CFO data missing	(21)
Observations without SOX 404 filing	(59)
Financial Firms (SIC codes 60-67)	(259)
Firms with fiscal year end before 11-15-04 or after 2-28-05	(424)
Firms missing Compustat variables	(37)
CEO tenure and CFO tenure equal to zero	(13)
Final Sample	1230

RESULTS

Table 2 provides descriptive statistics for two subsets of firms: firms with no material weakness in internal control (MW=0) and firms with material weakness (MW=1). As seen in table 2, 45% of firms with a material weakness in internal controls have a new CFO (*NEWCFOs*), however only 31% of firms without a material weakness in internal controls have a new CFO. We also see slightly higher frequency of new CEOs for material weakness firms (26%) compared to firms with no material weakness (21%). These univariate results are consistent with our hypothesis. The mean sales growth rate for the clean opinion firms is 19%, but the sales growth rate for firms with an adverse SOX 404 report is only 11%. Material weakness firms show more debt equity ratio (3.88 vs. 1.76) and are more likely to have a loss

**TABLE 2
DESCRIPTIVE DATA: MEAN (MEDIAN) VALUES FOR DIFFERENT GROUPS**

Variable	MW=0 (n =1039)	MW=1 (n =191)
<i>NEWCEO</i>	0.11 (0.00)	0.15 (0.00)
<i>NEWCEOs</i>	0.21 (0.00)	0.26 (0.00)
<i>NEWCFO</i>	0.16 (0.00)	0.27 (0.00)
<i>NEWCFOs</i>	0.31 (0.00)	0.45 (0.00)
<i>SqCEOTenure</i>	2.52 (2.45)	2.44 (2.24)
<i>SqCFOTenure</i>	2.08 (2.00)	1.85 (1.73)
<i>LnCEOTenure</i>	1.66 (1.79)	1.56 (1.61)
<i>LnCFOTenure</i>	1.31 (1.39)	1.06 (1.10)
<i>LnMV</i>	7.72 (7.63)	6.88 (6.89)
<i>ROA</i>	0.05 (0.05)	0.00 (0.02)
<i>SGROWTH</i>	0.19 (0.12)	0.11 (0.09)
<i>DE</i>	1.76 (1.12)	3.88 (1.26)
<i>AU</i>	0.97 (1.00)	0.93 (1.00)
<i>RECINV</i>	0.14 (0.12)	0.15 (0.10)
<i>RESTRUCTURE</i>	0.31 (0.00)	0.35 (0.00)
<i>LOSS</i>	0.12 (0.00)	0.36 (0.00)
<i>FOROPS</i>	0.26 (0.00)	0.36 (0.00)
<i>SQSEG</i>	1.47 (1.00)	1.48 (1.41)

The variables are defined as follows:

<i>GOV</i>	=Governance variables (<i>NEWCEO</i> , <i>NEWCEOs</i> , <i>NEWCFO</i> , <i>NEWCFOs</i> , <i>LnCEOTenure</i> , <i>SqCEOTenure</i> , <i>LnCFOTenure</i> and <i>SqCFOTenure</i>).
<i>NEWCFO</i>	= Indicator variable takes a value of 1 if <i>CFOTenure</i> =1, else zero.
<i>NEWCFOs</i>	= Indicator variable takes a value of 1 if <i>CFOTenure</i> =1 or 2, else zero.
<i>LnCFOTenure</i>	= Natural log of CFO tenure.
<i>SqCFOTenure</i>	= Square root of CFO tenure.
<i>NEWCEO</i>	= Indicator variable takes a value of 1 if <i>CEOTenure</i> =1, else zero.
<i>NEWCEOs</i>	= Indicator variable takes a value of 1 if <i>CEOTenure</i> =1 or 2, else zero.
<i>LnCEOTenure</i>	= Natural log of CEO tenure.
<i>SqCEOTenure</i>	= Square root of CEO tenure.
<i>MW</i>	= Indicator variable takes a value of 1 if the firm has a presence of material weakness in Internal control, else zero.
<i>ROA</i>	= Return on assets.
<i>SGROWTH</i>	= Sales growth measured as $(Sales_t - Sales_{t-1}) / Sales_{t-1}$.
<i>DE</i>	= Debt equity ratio.
<i>AU</i>	= Indicator variable takes a value of 1 if the firm is audited by one of the big 4 auditors, else zero.
<i>RECINV</i>	= Receivable plus inventory scaled by total assets.
<i>RESTRUCTURE</i>	= Indicator variable takes a value of 1 if the firm has restructuring charge, else zero.
<i>LOSS</i>	= Indicator variable takes a value of 1 if the firm's income before extraordinary items is negative, else zero.
<i>FOROPS</i>	= Indicator variable takes a value of 1 if the firm has foreign operations, else zero.
<i>SQSEG</i>	= Square root of number of business segments.

(36 percent vs. 12 percent) than firms without material weakness in internal controls. The table also reports that firms with an adverse internal control report are more likely (36% vs. 26%) to have foreign operations than firms with clean internal control reports. These descriptive statistics are consistent with prior studies (viz., Doyle et al. 2007b) that financially weaker firms and more complex firms are more likely to report material weakness in internal control.

The regressions reported in Table 3 present results from the logistic models discussed earlier; in the first regression, we consider the variables *NEWCEO* and *NEWCFO* which refer to the executives in their initial year with a company. In the second regression, we consider *NEWCEOs* and *NEWCFOs* which refer to the executives in their initial one or two years with a company. The overall model is significant in each instance. The significant and negative coefficients for *LnMV* show that adverse SOX 404 reports will be more likely at firms that are smaller (in terms of market value). The significant and positive coefficients for *DE* and *LOSS* show that firms with high debt to equity ratio and firms with negative income are more likely to have a material weakness in internal control. The results related to *SQSEG* and *FOROPS* show that firms with more complex operations are more likely to receive an adverse SOX 404 report. The significant and positive coefficients for *NEWCFO* and *NEWCFOs* indicate that, as expected, adverse SOX 404 reports will be more likely at firms that recently hire a new CFO.

It is interesting to note that neither *NEWCEO* nor *NEWCEOs* is significant in our regressions. The results indicate that the quality of internal control is not dependent on whether the CEO is new. Overall, the results imply that the tenure of CFO has a more important role in the quality of internal control than the tenure of CEO.

**TABLE 3
REGRESSION RESULTS**

	Exp Sign	GOV1= <i>NEWCEO</i> GOV2= <i>NEWCFO</i>		GOV1= <i>NEWCEOs</i> GOV2= <i>NEWCFOs</i>	
		Estimate	Pr > ChiSq	Estimate	Pr > ChiSq
<i>Intercept</i>	+/-	0.77	0.22	0.67	0.28
<i>GOV 1</i>	+	0.19	0.45	0.08	0.67
<i>GOV 2</i>	+	0.51	0.01	0.48	0.01
<i>LnMV</i>	-	-0.35	<.0001	-0.35	<.0001
<i>ROA</i>	-	0.08	0.93	-0.02	0.98
<i>SGROWTH</i>	+/-	-0.66	0.05	-0.63	0.06
<i>DE</i>	+	0.02	0.03	0.02	0.02
<i>AU</i>	+/-	-0.53	0.17	-0.53	0.17
<i>RecInv</i>	+	-0.24	0.72	-0.20	0.76
<i>RETSTRUCTURE</i>	+	-0.24	0.20	-0.26	0.18
<i>LOSS</i>	+	0.86	0.00	0.86	0.00
<i>ForOps</i>	+	0.57	0.00	0.56	0.00
<i>SQSEG</i>	+	0.21	0.20	0.20	0.21
<i>No. observations</i>		1230		1230	
<i>Pseudo R²</i>		0.11		0.11	
<i>Likelihood Ratio</i>		114.17 (p-value <.0001)		115.06 (p-value <.0001)	

CFO (and CEO) Turnover Using Alternative Approaches

Table 4 presents the logistic regression results based on alternative approaches. We use continuous measures of the executives' tenure (either the natural log or square root transformations) to test our hypothesis. The significant and negative coefficient for *LnCFOTenure* and *SqCFOTenure* indicate that, as expected, the possibility of receiving an adverse SOX 404 opinion in the subsequent year is higher in companies with newer executives.

**TABLE 4
REGRESSION RESULTS USING ALTERNATIVE APPROACHES**

	Exp Sign	GOV1= <i>LnCEOTenure</i> GOV2= <i>LnCFOTenure</i>		GOV1= <i>SqCEOTenure</i> GOV2= <i>SqCFOTenure</i>	
		Estimate	Pr > ChiSq	Estimate	Pr > ChiSq
<i>Intercept</i>	+/-	1.36	0.04	1.52	0.03
<i>GOV 1</i>	-	-0.03	0.78	0.00	0.98
<i>GOV 2</i>	-	-0.31	0.00	-0.30	0.01
<i>LnMV</i>	-	-0.35	<.0001	-0.35	<.0001

<i>ROA</i>	-	0.08	0.93	0.01	0.99
<i>SGROWTH</i>	+/-	-0.64	0.06	-0.64	0.06
<i>DE</i>	+	0.02	0.03	0.02	0.03
<i>AU</i>	+/-	-0.57	0.15	-0.56	0.15
<i>RecInv</i>	+	-0.28	0.68	-0.27	0.69
<i>RETSTRUCTURE</i>	+	-0.26	0.17	-0.26	0.17
<i>LOSS</i>	+	0.85	0.00	0.85	0.00
<i>ForOps</i>	+	0.57	0.00	0.57	0.00
<i>SQSEG</i>	+	0.19	0.23	0.19	0.23
<i>No. observations</i>		1230		1230	
<i>Pseudo R²</i>		0.11		0.11	
<i>Likelihood Ratio</i>		115.65 (p-value <.0001)		114.31 (p-value <.0001)	

SUMMARY AND CONCLUSIONS

In this paper, we examine the association between the appointment of new CEOs and CFOs and subsequent SOX 404 opinions. Motivation for this paper comes from the fact that the CEO and CFO of a company play a crucial role in the financial reporting process; in addition, the role played by such executives in the financial reporting process has recently attracted the attention of legislators. For example, Section 302 of SOX requires the CEO and the CFO of each public company to certify the “appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer” (SOX 2002). In addition, Section 404 of SOX requires that management assess and publicly report on the effectiveness of their firm’s internal controls, and that auditors publicly provide an opinion on management’s assessment, as well as on the effectiveness of the internal controls.

Our results show that adverse SOX 404 reports are more likely at firms that have a new CFO. Overall, the paper contributes to the corporate governance and internal control weakness papers by providing direct evidence regarding CFO turnover and subsequent SOX 404 opinions.

Our analyses are subject to the following limitations. First, our analyses are limited to the initial year of SOX 404. For example, it is possible that the relationship between SOX 404 opinions and executives may change in subsequent years. Future research can examine the association between SOX 404 opinions and turnovers of executives in later years. Second, as also noted by prior empirical researchers (e.g., Carcello and Neal 2003; Krishnan 2005), we can only document association not causation. In addition,

there may be omitted unobserved factors that are correlated with SOX 404 opinions and executive turnover. Third, we only examine the relation between the appointment of the new CFO as part of management turnover process and the receipt of subsequent SOX404 opinions. Future research can partition the new CFO sample into internally promoted CFO group and outside recruited CFO group and see whether the significant and positive relation between new CFOs and the receipt of adverse SOX404 opinions still hold under both conditions.

END NOTES

1. Accelerated filers are companies with worldwide market values of at least \$75 million. Our sample consists of only first time filers.
2. Because the SEC granted special permission for delayed filings of 404 reports for registrants with fiscal year ends up to 2-28-05 due to initial year issues. The SEC treated such registrants differently, so we restrict the sample to such firms.

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