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Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members

by Suraj Srinivasan

Abstract

I use a sample of 409 companies that restated their earnings from 1997 to 2001 to examine penalties for outside directors, particularly audit committee members, when their companies experience accounting restatements. Penalties from lawsuits and Securities and Exchange Commission (SEC) actions are limited. However, directors experience significant labor market penalties. In the three years after the restatement, director turnover is 48% for firms that restate earnings downward, 33% for a performance-matched sample, 28% for firms that restate upward, and only 18% for technical restatement firms. For firms that overstate earnings, the likelihood of director departure increases in restatement severity, particularly for audit committee directors. In addition, directors of these firms are no longer present in 25% of their positions on other boards. This loss is greater for audit committee members and for more severe restatements. A matched-sample analysis confirms this result. Overall, the evidence is consistent with outside directors, especially audit committee members, bearing reputational costs for financial reporting failure.

Keywords: Outcome or Result; Business Earnings; Financial Statements; Lawsuits and Litigation; Labor; Markets; Financial Reporting; Accounting Audits; Cost; Reputation;

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