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## ► To cite this version:

Etienne Redor. Market reaction to Audit Committee director departures: Evidence from the post-SOX period. *Economics Bulletin*, *Economics Bulletin*, 2016, 36 (3), pp.1267-1274. <hal-01343678>

**HAL Id: hal-01343678**

**<http://hal-audencia.archives-ouvertes.fr/hal-01343678>**

Submitted on 9 Jul 2016

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## Volume 36, Issue 3

### Market reaction to Audit Committee director departures: Evidence from the post-SOX period

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#### Abstract

Although the Audit Committee is a key component of corporate governance, very few studies have analyzed the market reaction to the departure of an Audit Committee Director. In this paper, we study the market reaction to 90 Audit Committee Director departures between 2004 and 2014. We find no significant market reaction at either the time of a non co-opted directors' departure or at the time of a financial expert directors' departure. Conversely, we show a significant positive market reaction at the announcement of a female Audit Committee member's departure, but no significant market reaction to the announcement of a male Audit Committee member's departure.

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**Citation:** Etienne Redor, (2016) "Market reaction to Audit Committee director departures: Evidence from the post-SOX period", *Economics Bulletin*, Volume 36, Issue 3, pages 1267-1274

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**Submitted:** April 26, 2016. **Published:** July 08, 2016.

## 1. Introduction

The Sarbanes-Oxley Act (herein referred to as either “SOX” or the “Act”) (U.S. House of Representatives, 2002) was undoubtedly a very significant change to federal securities laws in the United States. Enacted as a reaction to several serious corporate scandals (such as, Adelphia, Enron, Global Crossing, Tyco or Worldcom), SOX is aimed at protecting shareholders from fraudulent accounting practices and at the same time improving the accuracy of corporate accounting and related disclosures. The Act, which increased penalties for securities violations, enhanced auditor independence and improved financial disclosures, has had a profound effect on corporate governance in the United States. In particular, SOX augmented both the responsibility and authority of corporate Audit Committees (herein referred to AC or ACs) requiring each member of the committee be “independent” and that each AC have a member who is a “financial expert”.

Even though SOX fundamentally changed the composition and functioning of corporate ACs, research related to AC director turnover is sparse (Singhvi *et al.*, 2013b). Two studies relying on data from the pre-SOX period looked at the appointments of AC directors. The first of these, Davidson *et al.* (2004) examined 136 voluntary announcements of AC appointments and showed a significantly positive market reaction when new members of ACs have “financial expertise”. The second, DeFond *et al.* (2005) studied 702 appointments of outside board members assigned to ACs and found that the market reacts positively to the appointment of accounting financial experts to the AC, but not to the appointment of non-accounting financial experts, nor directors who have no financial expertise. In the post-SOX period, since almost all firms now have financial experts on ACs, the market reaction to the appointment of experts in financial accounting is insignificant (Singhvi *et al.*, 2013a).

While informative, these studies suffer from a methodological problem. As argued by Adams *et al.* (2011), the appointment of a new director is often made at the same time that firms are publishing a lot of other corporate information (e.g. proxy statement or in the annual report). Therefore, it is impossible to isolate the impact of this appointment from the news released by the firm. An effective solution to get around this problem is to analyze the market reaction at the announcement of a director *departure*. Since departures are more likely to be isolated events, the event study methodology should provide more reliable data.

To the best of our knowledge, there is only one other paper that addresses the market reaction to the departure of AC directors. Singhvi *et al.* (2013b) showed a negative stock price reaction to the departure of accounting experts from ACs. By contrast, the market reaction was insignificant for the departures of other types of expert or non-expert directors. Moreover, a subsample of expert directors showed a negative impact for short-tenured director departures, but not for long-tenured director departures. Finally, they were unable to document a relationship between having other board memberships and the market reaction to the departure of an AC director.

The aim of this paper is to reexamine and extend our knowledge of the impact of AC director turnover. This paper proceeds as follows: Section 2 develops our hypotheses about the market reaction to AC director departures; Section 3 describes our data, the sample selection process, and the methodology; Section 4 shows the results; while section 5 provides our conclusions.

## 2. Related research and development of our hypotheses

### 2.1. AC member independence

The independence of AC members is discussed in section 301 of the Act. Moreover, the Securities Exchange Commission (SEC) explains in its final Release on Standards Relating to Listed Company Audit Committees that “an AC comprised of independent directors is better situated to assess objectively the quality of the issuer’s financial disclosure and the adequacy of internal controls than a committee that is affiliated with management. Management may face market pressures for short-term performance and corresponding pressures to satisfy market expectations” (U.S. SEC, 2003).

It is generally acknowledged that outside directors (directors who are not employees or stakeholders of the company) are more independent than inside directors (directors who are also executives at the company) since they are not personally involved in day-to-day management (Johnson *et al.*, 1996). In fact, as early as 1940, the SEC first recommended the establishment of ACs composed of outside directors (U.S. SEC, 1940).

In the post-SOX period, almost all AC directors are outside directors<sup>1</sup>. However, not all outside directors are equally effective in monitoring management (Coles *et al.*, 2014). According to Core *et al.* (1999), outside directors appointed by the CEO are less independent of the CEO and, therefore, less effective monitors. Hence, we conjecture that:

*Hypothesis 1a: If the independence of AC members matters, the market reaction should be negative when a non co-opted AC director (a director who joined the board before the CEO) departure is announced.*

Alternatively, in the post-SOX period, the departure of a non co-opted AC member may not matter if ACs are really independent from management.

*Hypothesis 1b: If AC members are really independent from management, there should be no significant difference in the market reaction between the departure of co-opted and non co-opted directors.*

### 2.2. AC member expert status

The expert status of AC members is discussed in section 407 of the Act. Pursuant to the Act, ACs must have at least one financial expert, or disclose why that role is not filled. To qualify as a financial expert, the director must have five qualifications: (i) an understanding of generally accepted accounting principles and financial statements; (ii) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (iii) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in such activities; (iv) an understanding of internal controls and procedures for financial reporting; and (v) an understanding of AC functions.

Financial experts are supposed to be more capable of overseeing the financial reporting process and ensuring high-quality financial reporting (Defond *et al.*, 2005). As such, the departure of an AC financial expert will weaken corporate governance, and the market reaction should be negative.

*Hypothesis 2a: If financial expertise matters, the market reaction should be negative when an AC financial expert's departure is announced.*

However, as argued by (Singhvi *et al.*, 2013a), ACs are more likely to include financial experts in the post-SOX period. Therefore, the departure of an AC financial expert may not matter.

*Hypothesis 2b: Since ACs are more likely to include financial experts in the post-SOX period, there should be no significant difference in the market reaction to the departures of AC financial experts and non-experts.*

### **2.3. AC member gender**

The impact of female presence on corporate boards has been the subject of much debate amongst practitioners, policy-makers and academics in the past decade (for a meta-analysis, see Post and Byron, 2015). Gul *et al.* (2011) show that gender diversity appears to allow for more public disclosure of information. Thus, it seems that gender-diverse boards make firms more transparent and encourage the incorporation of more firm-specific information into stock prices.

Studies also show that female AC representation brings about positive outcomes in corporate monitoring and oversight (Thiruvadi and Huang, 2011). For instance, Ittonen *et al.* (2010) found that female representation on ACs is negatively related to audit fees and Srinidhi *et al.* (2011) found that firms with female directors in the AC exhibited better reporting discipline by managers.

*Hypothesis 3a: If the presence of female directors in the AC enhances management decision and audit quality, the market reaction should be negative when a female AC member's departure is announced.*

Adams and Ferreira (2009) concluded that women are tougher monitors because gender-diverse boards frequently allocate more effort to monitoring management. While the “toughness” of women could be beneficial for firms that otherwise have weak governance, it could be detrimental for firms with strong governance (i.e., greater gender diversity can lead to over-monitoring and thus decrease shareholder value).

*Hypothesis 3b: If the presence of female director on the AC leads to over-monitoring, the market reaction should be positive when the departure of a female AC member is announced.*

## **3. Sample and data**

Our sample is made up of the announcements of all directors who departed S&P 100 firms between 2004 and 2014. The relevant proxy statements were obtained from the SEC website. We used Forms 8-Ks to obtain the exact date that departures were announced. Multiple departures, CEO departures and anticipated departures (such as mandatory retirements) were systematically excluded from the sample. We focused on S&P 100 firms because the S&P 100 exclusively measures the performance of large cap companies in the United States. Even if the sample selection reduced the number of total potential observations, using the S&P 100 guaranteed a non-biased sample (see Figure 1). This process identified a total of 90 departures.

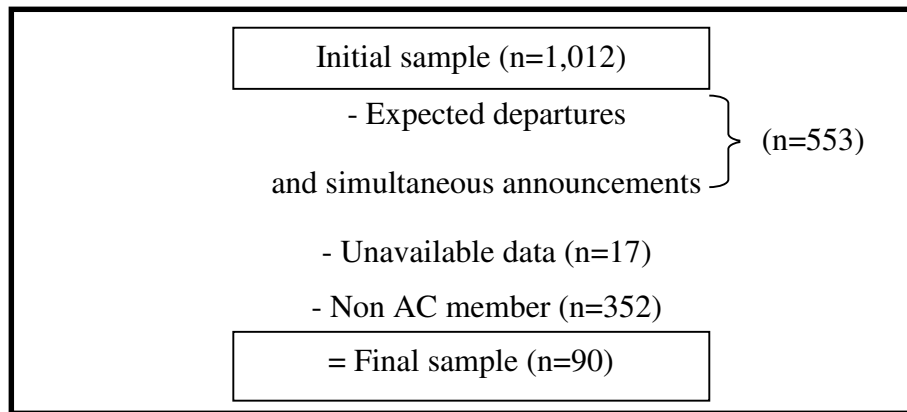


Figure 1 : Diagram of the selection of the sample.

We used an Ordinary Least Square (OLS) Market Model to calculate the market reactions to AC director departures. Similar to Singhvi *et al.* (2013b) we used an eight-day window (-5;+2) where day 0 is the 8-K filing date because Form 8-K can be filed up to four business days after the actual departure of the director<sup>2</sup>. As in many other event studies we use a 100-day estimation window (Campbell and Minguez-Vera, 2010). Statistical significance is based on Z statistics calculated according to the standardized prediction errors method given in the appendix in Dodd and Warner (1983).

#### 4. Results

To test hypothesis 1, we subdivided our sample into two groups depending on whether the departing AC director had been co-opted by the CEO. Our results suggest that there are no significant differences in the market reaction to the departure of co-opted directors and non-co-opted directors. This is consistent with hypothesis 1b. Thus, in the post-SOX period, we cannot conclude that the independence brought to the AC by non co-opted directors is valued by investors. Since almost all AC are made up of outside directors, the departure of a non co-opted director does not appear to weaken corporate governance.

Type of departing director	Eight-Day [-5,2] CAR	Z statistic (p-value)
Co-opted directors (n=40)	0,001	0,181 (0,428)
Non co-opted directors (n=50)	0,006	0,758 (0,224)
Difference Co-opted/Non co-opted (n=90)	0,005	0,444 (0,657)

Table 1 : Market reaction to AC director departures: co-opted directors versus non co-opted directors.

Then, as Davidson *et al.* (2004), DeFond *et al.* (2005) and Singhvi *et al.* (2013a, 2013b), we split our sample into three sub samples. *Accounting experts* are AC financial experts with previous work experience in accounting, finance or auditing (as CFO, CAO, VP-Finance...). *Other financial experts* are AC financial experts with no previous work experience in accounting, finance or auditing. Finally, *non experts* are directors who are not classified as AC financial experts. From Table 2, it can be seen that, in the post-SOX period, the market reaction to the departure of expert and non expert directors is insignificant. Moreover, our results show no significant differences in the market reaction to the departure of different types of expert and non expert directors. This finding is consistent with hypothesis 2b. This result, however,

contradicts Singhvi *et al.* (2013b) that show, in a smaller sample (n=21), a significant negative market reaction resulting from the departure of accounting experts. Their results seem to be specific to their sample and cannot be generalized to our sample of large US firms<sup>3</sup>. On the contrary, our findings are consistent with Singhvi *et al.* (2013a) that documented that the market reaction to the appointment of different type of expert directors was insignificant.

Type of departing director	Eight-Day [-5,2] CAR	Z statistic (p-value)
Accounting expert (n=30)	-0,004	-0,344 (0,634)
Other financial expert (n=21)	0,006	0,573 (0,283)
Non expert (n=39)	0,009	1,255 (0,105)
Difference Expert/Non expert	0,009	0,824 (0,410)
Difference Accounting expert/Non accounting expert	0,012	0,920 (0,358)

Table 2 : Market reaction to AC director departures: Accounting expert versus other expert and non expert.

Table 3 shows a significant positive market reaction (at the 1% level) to the announcement of a female AC member's departure and no significant market reaction to the announcement of a male AC member's departure. The difference between female and male departures is positive and significant at the 5% level. This is consistent with hypothesis 3b. This result is consistent with the view that women tend to increase the level of monitoring, which can lead to over-monitoring and can thus decrease shareholder value (Adams and Ferreira, 2009).

Type of departing director	Eight-Day [-5,2] CAR	Z statistic (p-value)
Men (n=78)	0,000	0,054 (0,478)
Women (n=12)	0,029***	2,422 (0,008)
Difference Men/Women (n=90)	0,028**	2,120 (0,034)

Table 3 : Market reaction to AC director departures: men versus women.

Next, we performed a multiple regression with the 8-day CAR as the dependent variable. Our independent variables were *non co-opted director*, *accounting expert*, *other financial expert* and *gender*. We added various firm level variables as controls. Specifically, we used the following variables: sales, debt to equity ratio and return on assets. Our results are presented in table 4.

Our results confirm hypotheses 1b, 2b and 3b since only one independent variable, *gender*, is significant to explain the market reaction to the announcement of an AC members' departure.

	<b>Eight-Day [-5,2] CAR</b>	<b>Eight-Day [-5,2] CAR</b>	<b>Eight-Day [-5,2] CAR</b>
<b>Intercept</b>	0.041677 (0.582)	0.0269696 (0.725)	0.0403694 (0.582)
<b>Non co-opted director</b>	0.002125 (0.858)		
<b>Accounting expert</b>		-0.0178683 (0.207)	
<b>Other financial expert</b>		-0.008831 (0.566)	
<b>Gender</b>			0.0375384** (0.032)
<b>Ln sales</b>	-0.0044569 (0.535)	-0.002145 (0.773)	-0.0047005 (0.501)
<b>Debt</b>	0.0000439 (0.131)	0.0000488* (0.097)	0.0000504* (0.076)
<b>ROA</b>	0.0001143 (0.903)	0.0000755 (0.936)	0.0000488 (0.958)
<b>Adj. R<sup>2</sup></b>	-0.0145	-0.0073	0.0398
<b>Obs.</b>	88	88	88

Table 4 : Cross-sectional regression analysis.

## 5. Conclusion

This paper examines the market reactions to the departure of AC directors. We failed to find significant market reactions at the time of a non co-opted directors' departure. We also found that the market reaction does not differ based on whether the departing director was a financial expert. This result is important since it contradicts the only study that addresses market reaction to the departure of AC directors (Singhvi *et al.*, 2013b). This tends to show that SOX has achieved its objectives of encouraging the inclusion of financial experts and of independent members on the ACs of large US firms since the departures of non co-opted independent directors and of expert directors have no impact on shareholder wealth.

Conversely, we observe a significant positive market reaction to the announcement of a female AC member's departure but no significant market reaction to the announcement of a male AC member's departure. Moreover, the multivariate analysis confirms that *gender* is the only independent variable which is significant to explain the market reaction to the announcement of an AC members' departure. These results suggest that lower gender diversity can increase shareholder value. This could be due to over-monitoring since women have been shown to spend more efforts to monitor the operation of the firm (Adams and Ferreira, 2009).

It is important to note that our results should not be interpreted as arguments against the SOX and related statutes. While a negative market reaction is an important concern for investors, the primary aim of the legislator was to enhance the long term development of firms. Therefore, many other indicators have to be taken into account to determine SOX's effect<sup>4</sup>.



## Notes

<sup>1</sup> In our sample, all the AC directors were outside directors. Therefore, it was not possible to use the variable “outside directors” as a proxy of independence.

<sup>2</sup> In addition, we used alternative windows and obtain substantively similar results.

<sup>3</sup> Singhvi *et al.* (2013b) themselves acknowledge that their results should be interpreted with caution because (1) of the small size of their sample and (2) their sample is skewed because of the heterogeneity in the firms which constituted the sample.

<sup>4</sup> We would like to thank the anonymous referee for this helpful comment.

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