

## Adverse Section 404 Opinions and Shareholder Dissatisfaction toward Auditors

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**SYNOPSIS:** Auditors issuing adverse Section 404 internal control opinions may be viewed as too conservative, or they may be blamed for being partly responsible for the existence of the internal control material weaknesses. Using a sample of 240 companies with adverse internal control opinions and 240 matched “clean” companies in their first year of Section 404 compliance, we examine how shareholder dissatisfaction with the auditors varies depending on material weakness existence/type (company-level versus noncompany-level) and the presence of recent accounting restatements. In the full sample, we find a significant positive interaction between restatement and company-level material weakness—company-level material weaknesses have a greater effect on shareholder dissatisfaction when a restatement has occurred. To provide insight, we partition our sample based on whether test companies have had recent accounting restatements. In the nonrestatement sample, we find that shareholders are less likely to vote for auditor ratification if the company received an adverse Section 404 internal control opinion because of noncompany-level material weaknesses. Shareholders may view the auditor as being too conservative when no company-level material weaknesses are cited and no recent accounting restatements have been issued. In the restatement sample, we find that shareholders are less likely to vote for auditor ratification if the company received an adverse Section 404 opinion with or without company-level material weaknesses cited—but with shareholder dissatisfaction greater for companies with company-level material weaknesses. Hence, in companies with recent accounting restatements, shareholders may blame the auditor for being partly responsible for the existence of material weaknesses (i.e., low audit quality). Overall, the results provide insights into shareholders’ perceptions of auditing and suggest that existing shareholders may sometimes prefer less conservative auditors. We encourage additional research on the role of auditors in protecting current versus prospective shareholders.

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## INTRODUCTION

This study examines how shareholder voting on management's proposal to reappoint the external auditor is influenced by adverse internal control opinions (i.e., the existence of one or more material weaknesses in internal control) under Section 404 of the Sarbanes-Oxley Act (hereafter SOX; [U.S. House of Representatives, Committee on Financial Services 2002](#)). Our motivation comes from (1) increasing attention paid to shareholder ratification of auditors from policy makers, investors, and researchers, and (2) criticism of auditors in the first year of Section 404 audits.

Public companies are not required by state or federal law to allow shareholders to vote on auditor selection. However, many companies have voluntarily allowed such votes since the pre-SOX period ([Krishnan and Ye 2005](#)). SOX makes the audit committee more responsible for the auditor selection process; however, this has not dampened shareholders' desire to participate in the auditor ratification process. In addition, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession (hereafter, ACAP) recently recommended that all U.S. public companies submit the appointment of the auditor to an advisory shareholder vote each year ([ACAP 2008](#)). The Committee notes that auditor ratification is a mechanism by which shareholders can "voice a view on the audit committee's work" in selecting the auditor ([ACAP 2008](#)).

Section 404 of the Sarbanes-Oxley Act, effective for fiscal years ending on or after November 15, 2004 for accelerated filers (public float of at least \$75 million), requires companies to include in each annual report the auditor's opinion on the effectiveness of internal control over financial reporting. In the first year of SOX Section 404 audits under PCAOB Auditing Standard No. 2 (hereafter AS No. 2; [PCAOB 2004](#)), auditors were criticized as being too conservative in implementing the new requirements ([Reason 2006](#); [Schuman 2006](#)). The PCAOB had concerns that internal control audits should have been more efficient, and "public company executives complained vigorously about rigid and overreaching audits" ([Reason 2006](#)) that contributed to the high cost of Section 404 implementation.<sup>1</sup> In addition, an adverse opinion on internal control can result in a loss of wealth for the shareholders ([De Franco et al. 2005](#); [Cheng et al. 2007](#)). Therefore, shareholders may blame the auditors for issuing an adverse Section 404 opinion, much as a going concern opinion is associated with shareholder dissatisfaction toward the auditor because of the damaging effect of a going concern opinion ([Sainty et al. 2002](#)).

Moreover, while AS No. 2 reaffirms that management, not the auditor, is responsible for the effectiveness of internal control, shareholders may view an adverse opinion on internal control as an indication that the auditors either did not point out the internal control problems in previous periods or did not persuade or help the client to remedy the problems, suggesting low audit quality (see [RiskMetrics Group 2007](#)). Consistent with this notion, [Turner \(2005, 6\)](#) states, "When material weaknesses at companies such as WorldCom and Enron were exposed, investors rightly asked, 'Where were the auditors?'" Institutional Shareholder Services (hereafter, ISS) may also recommend votes against the audit firm when accounting problems, including material weaknesses, are present ([RiskMetrics Group 2007](#)).

Using a sample of 240 companies that received adverse opinions on internal control and a control sample of 240 "clean" companies matched on industry and exchange, we examine the

<sup>1</sup> Such criticism has led to the replacement of AS No. 2 with PCAOB Auditing Standard No. 5 (hereafter AS No. 5; [PCAOB 2007](#)) as the auditing standard related to Section 404, effective for audits of fiscal years ending on or after November 15, 2007.

relation between adverse internal control opinions and shareholder voting on the reappointment of the auditor. We consider material weakness type (company-level versus noncompany-level) because company-level material weaknesses are considered more serious as they are more pervasive and “difficult to audit around” (Doyle et al. 2007). We also conjecture that shareholders’ perceptions of the auditor’s responsibilities may depend on recent accounting restatements. AS No. 2 (para. 140) states that “restatement of previously issued financial statements to reflect the correction of a misstatement” is a strong indicator that a material weakness in internal control exists. Also, an adverse Section 404 opinion with a recent accounting restatement suggests that internal control problems were severe enough to have already caused accounting misstatements.

In the full sample, we find a significant positive interaction between restatement and company-level material weakness—company-level material weaknesses have a greater effect on shareholder dissatisfaction when there has been a restatement. To provide more insight, we partition our sample based on whether test companies have had recent accounting restatements. In the nonrestatement sample, we find that shareholders are less likely to vote for auditor ratification if the company received an adverse opinion on the effectiveness of internal control because of noncompany-level material weaknesses only. In the restatement sample, we find that shareholders are less likely to vote for auditor ratification if the company received an adverse opinion on the effectiveness of internal control with or without company-level material weaknesses cited—but with shareholder dissatisfaction greater for companies with company-level material weaknesses.

Our interpretation of the results is that when no recent accounting restatements have been issued, shareholders may view the auditor as being too conservative when only noncompany-level material weaknesses are cited—the auditor has issued an adverse internal control opinion for a less pervasive weakness, and no error has resulted in the restatement of the financial statements. Without recent accounting restatements, shareholders do not react negatively to company-level material weaknesses, because they may believe that the auditor has identified important problems that must be corrected to prevent future accounting problems.

In the restatement sample, it appears that shareholders may blame the auditor for being partly responsible for the existence of the material weaknesses that already caused accounting misstatements. In this setting, shareholders react more negatively to company-level material weaknesses, which reflect the most fundamental control problems. Failure to detect and help to remediate such problems in the past may signal low audit quality, just as restatements may signal low audit quality (Liu et al. 2009).

Our study adds to recent auditor ratification literature (Sainty et al. 2002; Raghunandan 2003; Raghunandan and Rama 2003; Mishra et al. 2005; Dao et al. 2008; Liu et al. 2009) by providing insights into shareholder voting reactions to material weaknesses in internal control—and how such reactions vary depending on the type of material weakness and whether the company has restated its financial statements. Across the two settings (nonrestatement and restatement), we find evidence consistent with both blaming the auditor for being too conservative and blaming the auditor for not helping to identify and correct important control weaknesses (low audit quality). Overall, the results provide insights into shareholders’ perceptions of auditing and suggest that they may sometimes prefer less conservative auditors (also see Sainty et al. [2002]). We encourage additional research on the role of auditors in protecting current versus prospective shareholders.

We also contribute to the auditor ratification and audit committee literature by documenting that companies with greater audit committee financial expertise obtain more shareholders’ votes for auditor ratification. Raghunandan and Rama (2003) find that the positive relation between high nonaudit fee ratios and shareholders’ votes against auditor reappointment is mitigated if the audit committee has solely independent members and has at least one financial expert. However, we are not aware of any other studies examining the association between audit committee financial

expertise alone and auditor ratification. Our finding suggests that strong audit committees give shareholders more confidence in the auditor selected by the audit committee.

The remainder of the paper is organized as follows. In the next section we provide background information and develop the research question. The following sections present the model, sample and data, results, and conclusion.

## BACKGROUND AND RESEARCH QUESTION

### Shareholder Voting on Auditor Ratification

Many companies have voluntarily sought shareholders' ratification of management's auditor selection proposals since the pre-SOX period. [Krishnan and Ye \(2005\)](#) document that approximately 68 percent of Standard and Poor's 500 companies sought shareholder ratification of the auditor at the shareholders' annual meeting after fiscal year 2001. Section 301 of SOX enhances the audit committee's role in the appointment of the independent auditor. Even so, some shareholder activists still request that companies allow shareholders to vote on auditor selection. For instance, in 2004 the Sheet Metal Workers' National Pension Fund presented a proposal at the annual shareholders' meeting of Cooper Tire & Rubber Co. requesting that "the Board of Directors and its Audit Committee adopt a policy that the selection of the Company's independent auditor be submitted to the Company's shareholders for their ratification at the Company's annual meeting" ([Cooper Tire & Rubber Co. 2004](#)). In its supporting statement this shareholder states, "We acknowledge the positive contributions of the Sarbanes-Oxley Act to protecting auditor independence through the expanded role of the audit committee. However, we believe that shareholders also have a critically important role to play in protecting auditor independence." Approximately 72 percent of voters voted for this proposal.

Research indicates that the percentage typically is quite low of shareholder votes against or abstentions from auditor ratification. [Mishra et al. \(2005\)](#) find that the mean percentage of votes against or abstaining from the appointment of the external auditor was 1.6 percent in 2001, 3.4 percent in 2002, and 4.9 percent in 2003. The years 2002 and 2003 likely reflect the greatest time of crisis in the U.S. auditing profession in many decades, yet the apparent average approval rating of auditors still exceeded 95 percent ([Dao et al. 2008](#)). More recently, [Dao et al. \(2008\)](#) find that the mean percentage of votes against or abstaining from the appointment of the external auditor was 1.6 percent in 2006. Such evidence is consistent with generally passive U.S. shareholders documented in other shareholder voting literature ([Karpoff et al. 1996](#); [Cai et al. 2009](#)).<sup>2</sup> The percentage of negative votes in auditor ratification is low mainly because (1) small shareholders are not motivated to become informed voters because a majority of shareholders must agree on any important investor action ([Shleifer and Vishny 1997](#)); (2) shareholder voting on auditor ratification is nonbinding; and (3) the board of directors always recommends that stockholders vote for auditor ratification. Therefore, the magnitude of actual shareholder dissatisfaction toward the auditor likely is higher than the percentage of negative votes might suggest ([Sainty et al. 2002](#)).

Some recent studies have examined factors that affect shareholder-voting results on auditor ratification. [Sainty et al. \(2002\)](#) find that shareholders are more likely to vote against auditor reappointment after the auditor issues a going concern opinion. They further show that companies with high shareholder dissatisfaction are more likely to change auditors subsequently. [Raghunandan \(2003\)](#) provides evidence that shareholders are more likely to vote against auditor reappointment when the auditor performs a high level of nonaudit services. [Raghunandan and Rama \(2003\)](#) document that shareholders of companies with high nonaudit fee ratios are less likely to vote

<sup>2</sup> [Cai et al. \(2009\)](#) find that on average directors typically are reelected with 97 percent positive votes, and even directors in poorly performing companies typically receive over 90 percent positive votes.

against auditor reappointment if the audit committee has solely independent members and has at least one financial expert. [Mishra et al. \(2005\)](#) provide additional insights into nonaudit fees by examining the separate components of auditor fees. They find that the audit-related fee ratio is negatively associated with shareholder dissatisfaction toward the auditor, while both the tax fee ratio and the other fee ratio are positively related to shareholder dissatisfaction toward the auditor. [Dao et al. \(2008\)](#) find that votes against the appointment of the auditor are positively related to audit firm tenure, suggesting that some shareholders view lengthy auditor tenure as a threat to audit quality. Finally, [Liu et al. \(2009\)](#) find that shareholders are less likely to vote for the reappointment of the auditor following accounting restatements. The authors assert that such restatements signal low audit quality.

The above studies do not examine the association of adverse Section 404 opinions and shareholders' voting behavior on auditor ratification. Our study intends to fill this gap.<sup>3</sup>

### Internal Control Weaknesses and Research Question

Recent studies indicate the disclosure of internal control weaknesses yields negative consequences (see [Schneider et al. \[2009\]](#) for a review of this literature). Material weaknesses in internal control are associated with "poorly estimated accruals" ([Doyle et al. 2007](#), 1141), negative stock market reactions ([De Franco et al. 2005](#); [Cheng et al. 2007](#)), increased audit fees ([Raghunandan and Rama 2006](#); [Hoitash et al. 2008](#)), higher cost of equity ([Ashbaugh-Skaife et al. 2009](#)), and lenders' assessment of credit risk ([Schneider and Church 2008](#)).

An adverse internal control opinion may cause shareholder dissatisfaction with the auditor because the opinion has negative consequences, much as a going concern opinion is associated with shareholder dissatisfaction toward the auditor ([Sainty et al. 2002](#)) because the opinion can lead to damages such as higher costs of debt, negative stock price reactions, and "self-fulfilling prophecies" that can accelerate client failure ([Louwers et al. 1999](#)). This may be especially true when auditors are criticized as being too conservative and inefficient in implementing Section 404, leading to the high cost of Section 404 and allegedly unnecessary adverse Section 404 opinions.

In addition, shareholders may view the auditor as partly to blame for the internal control problems (low-quality auditing). More specifically, shareholders may believe that the auditor should have pointed out the internal control deficiencies earlier and pushed or helped the company to remedy the deficiencies before they resulted in misstatements or other accounting problems. Consistent with this view, [RiskMetrics Group \(2007, 4\)](#) summarizes the ISS 2008 policy position as follows: "ISS may hold auditors and audit committee members accountable for poor accounting practices [defined to include "material weaknesses identified in Section 404 disclosures"] by recommending a withhold/against vote on audit committee members and against the ratification of auditors." Apparently ISS views material weaknesses in internal control as an indicator of poor accounting practices, and thus low audit quality.

In evaluating the effect of adverse internal control opinions on auditor ratification votes, we consider both the arguments above: "the auditor is too conservative" and "the auditor is partly to blame for the control problem." We explore these arguments by examining the type of material weaknesses (company-level versus noncompany-level) and the presence or absence of accounting restatements. Shareholders may view company-level material weaknesses to be especially prob-

<sup>3</sup> [Ye and Krishnan \(2009\)](#) investigate the relation between internal control material weaknesses and shareholders' voting behavior on director election. The authors find that material weaknesses are positively associated with shareholders' votes withheld in director elections. We control for votes withheld from director election in our multivariate models.

lematic, as they reflect pervasive problems and are “difficult to audit around” (Doyle et al. 2007).<sup>4</sup> Noncompany-level weaknesses may reflect less serious problems, and shareholders may not have expected auditors to find all such weaknesses in the past.

In terms of accounting restatements, if the company has not had a restatement, then some shareholders may view an adverse internal control opinion as too conservative or unduly harsh, especially if it is based on less pervasive control weaknesses. However, if the company has disclosed a restatement, then investors already know about the company’s accounting misstatements and the auditor’s potentially suspect quality (see Liu et al. [2009]). As a result, shareholders are quite unlikely to view the auditor as being too conservative by issuing an adverse internal control opinion. In such cases, internal control problems may signal low audit quality, as shareholders view the auditor as jointly responsible, with management, for the control problems.

Based on the above discussion, our research question is stated:

**RQ1:** How does shareholder dissatisfaction with the auditors vary depending on material weakness existence/type (company-level versus noncompany-level) and whether there has been an accounting restatement?

### MODEL

Based on Mishra et al. (2005) and other research, we use the following regression model to address our research question:

$$\begin{aligned} REJECT = & \beta_0 + \beta_1 COMP MW + \beta_2 NOCOMP MW + \beta_3 RESTATE \\ & + \beta_4 RESTATE * COMP MW + \beta_5 RESTATE * NOCOMP MW + \beta_6 NASR \\ & + \beta_7 LOG TA + \beta_8 WHBOARD + \beta_9 CEOCHR + \beta_{10} BLKOWN + \beta_{11} INSIDER \\ & + \beta_{12} INSTIOWN + \beta_{13} ADRET + \beta_{14} LOSS + \beta_{15} ACEXPT + \beta_{16} AUDTEN + \varepsilon, \quad (1) \end{aligned}$$

where *REJECT* is the natural log of the percentage of votes against or abstentions from auditor ratification.<sup>5</sup> Material weaknesses (*MW*) are coded using two variables, *COMP MW* (1 if a company received an adverse opinion on the effectiveness of internal control and the internal control material weaknesses involve company-level material weaknesses; 0 otherwise) and *NOCOMP MW* (1 if a company received an adverse opinion on the effectiveness of internal control and the internal control material weaknesses do not involve company-level material weaknesses; 0 otherwise).<sup>6</sup>

Prior studies show that shareholders are more likely to vote against or abstain from voting on auditor ratification when a restatement occurs (Liu et al. 2009). Hence, we include *RESTATE* (1 if at least one nontechnical restatement disclosure occurs during the fiscal year for which a company received an adverse opinion on the effectiveness of internal control or between the end of this

<sup>4</sup> We coded company-level material weaknesses based on Paragraph 53 of AS No. 2 (PCAOB 2004):

Company-level controls are controls such as the following: Controls within the control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as codes of conduct and fraud prevention, that apply to all locations and business units; Management’s risk assessment process; Centralized processing and controls, including shared service environments; Controls to monitor results of operations; Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; The period-end financial reporting process; and Board-approved policies that address significant business control and risk management practices.

<sup>5</sup> Consistent with Dao et al. (2008) and Liu et al. (2009), we use the natural log because of the high skewness (7.49 in our sample) of the raw *REJECT* percentages.

<sup>6</sup> Thus, if the company has a material weakness ( $MW = 1$ ), then either  $COMP MW = 1$  (if there are any company-level material weaknesses) or  $NOCOMP MW = 1$  (if there are no company-level material weaknesses).

period and the current shareholder annual meeting date, and the auditor in the restated period is the same as the auditor being voted on; 0 otherwise) and expect its coefficient to be positive.<sup>7</sup> The interactions of *RESTATE* and the two *MW* variables (*RESTATE \* COMPMW* and *RESTATE \* NOCOMPMW*) are used to test our research question—whether the effect of material weaknesses on shareholder voting differs depending on restatement status. We do not predict signs for the coefficients of these two interaction variables.

Raghunandan (2003) and Raghunandan and Rama (2003) find that shareholders are more likely to vote against or abstain from voting on auditor ratification when auditors provide high levels of nonaudit services. Other studies (Krishnan et al. 2005; Francis and Ke 2006) document a lower earnings response coefficient (suggesting lower perceived quality of earnings) for companies that purchase high levels of nonaudit services from their auditors. Hence, we control for *NASR* (the ratio of the sum of tax fees and other fees to the sum of audit fees and audit-related fees) and predict its coefficient to be positive.

To control for any potential size differences, we include the natural logarithm of total assets (*LOGTA*). On one hand, large companies are more likely to be the targets of shareholder activism; on the other hand, large companies have more resources to secure votes for the management-initiated proposals (Bethel and Gillan 2002). Therefore, we do not predict a sign for the coefficient of *LOGTA*. Because shareholders' dissatisfaction toward the auditor may be partly influenced by their dissatisfaction with the directors, we include *WHBOARD* (the average percentage of votes withheld for the election of all incumbent director nominees) as a control variable. Its coefficient is expected to be positive. Shareholders are more likely to vote against auditor ratification if the CEO and chairperson positions are held by the same person, possibly because of concerns about lack of independence between directors and officers (Raghunandan 2003). Hence, *CEOCHR* (coded 1 if the CEO also serves as chairperson of the board; 0 otherwise) is expected to have a positive coefficient.

We also include three ownership variables: *BLKOWN* (percentage of shares held by blockholders owning 5 percent or more of the company's stock); *INSIDER* (percentage of shares held by insiders, including officers, directors, beneficial owners, and principal stockholders owning 10 percent or more of the company's stock); and *INSTIOWN* (percentage of shares held by institutional investors). Previous studies on shareholder votes document mixed results for *BLKOWN*, so we do not predict a sign for its coefficient. Although insiders are more likely to vote for proposals initiated by managers, institutional investors seem in recent years to be acting more as activists (Bethel and Gillan 2002). Therefore, the coefficient of *INSIDER* is expected to be negative, and *INSTIOWN* is predicted to have a positive coefficient. Moreover, we include *ADRET* (two-digit SIC industry mean adjusted one-year common stock returns) to control for the stock performance of the company, and its coefficient is expected to be negative.<sup>8</sup> We use *LOSS* (1 if income before extraordinary items is less than zero for the last fiscal year; 0 otherwise) to control for financial performance and predict a positive sign for its coefficient.<sup>9</sup>

We include *ACEXPT* (proportion of audit committee members with financial expertise) because prior research documents that audit committee expertise helps to promote investors' interests (Carcello and Neal 2003; Krishnan and Ye 2005). Also, Raghunandan and Rama (2003) find that the positive association between shareholders' negative votes on auditor reappointment and high nonaudit fee ratios is alleviated by high audit committee quality (defined as having solely inde-

<sup>7</sup> A "technical restatement" is one that does not result from a previous misstatement (e.g., a restatement to reflect a change in accounting principle).

<sup>8</sup> The results are substantially similar if we replace *ADRET* with the one-year raw common stock returns.

<sup>9</sup> The results are substantially similar if we replace *LOSS* with return on assets (ROA) or two-digit SIC industry mean adjusted ROA.

pendent members and at least one financial expert). Therefore, shareholders may be less likely to vote against auditor selection if the audit committee has more financial expertise, because the audit committee is responsible for selecting the auditor. Hence, we predict a negative coefficient on audit committee financial expertise. Following [Beasley et al. \(1999\)](#) and [Krishnan and Ye \(2005\)](#), we define an audit committee member as a financial expert if the individual has a CPA or CFA designation, or has worked as a CFO, VP of finance, controller, treasurer, auditor, banker, investment banker, financial consultant, investment manager, venture capitalist, or in other similar positions.<sup>10</sup>

Finally, following [Dao et al. \(2008\)](#), we include *AUDTEN* (natural logarithm of auditor tenure) and expect its coefficient to be positive. We could not trace the auditor tenure of some companies beyond 10 years, so we winsorize auditor tenure at 10 years before the logarithm transformation. The variable definitions are disclosed in [Table 1](#), and their expected signs are in [Table 4](#) below.

### SAMPLE AND DATA

The sample companies were identified using Audit Analytics. On May 10, 2006, the database included 859 companies with adverse or disclaimer Section 404 opinions. We reduced the sample for companies not publicly traded or not on Compustat ( $n = 13$ ), not having proxy statements about the annual shareholders' meeting ( $n = 63$ ), filing their Section 404 opinions after the annual shareholders' meeting ( $n = 87$ ), not disclosing director election results as of that date ( $n = 274$ ), having different classes of stock with different voting rights ( $n = 11$ ), missing ownership data ( $n = 15$ ), having multiple Section 404 opinion dates ( $n = 6$ ; we keep the most recent opinion before the annual shareholders' meeting), or having only new director nominees ( $n = 1$ ). We also deleted 17 companies with disclaimed opinions and 110 companies that did not seek auditor ratification or did not disclose their voting results. Finally, 22 companies were dropped because they were seeking ratification of a new auditor. The final test sample comprises 240 companies.

The control companies come from the 6,089 companies with unqualified Section 404 opinions on the May 10, 2006, Audit Analytics database. The control companies had to seek shareholder ratification of the auditor after the Section 404 opinion date, disclose the voting results, and have data available for the estimation of our model. We sorted the companies by names and chose the first company that met the data requirements as a control company to match each test company by exchange and industry ([Ge and McVay 2005](#); [Martinek 2005](#)).<sup>11</sup> We used a matched-pairs approach because the data had to be hand-collected. The "full sample" comprises the 240 test companies ( $MW = 1$ ) and their 240 control companies ( $MW = 0$ ).

As discussed above, to provide more insight, we partition the full sample into two subsamples based on whether test companies have had recent accounting restatements (whether *RESTATE* = 1). The test companies with *RESTATE* = 1 and their matched control companies constitute the "restatement sample;" the "nonrestatement sample" has test companies with *RESTATE* = 0 and their matched control companies.

The fiscal year-ends for the 480 sample companies range from November 27, 2004, to October 1, 2005. The sample includes 451 firms with 2004 fiscal year-ends and 29 firms with 2005 fiscal year-ends (all have initial Section 404 opinions). Manufacturing and services companies constitute nearly 59 percent of the sample. Approximately 17 percent of the sample companies are

<sup>10</sup> The results are substantially similar if we use a narrow, accounting-based definition of financial expertise.

<sup>11</sup> We were able to match 230 pairs on both two-digit SIC codes and exchange, 9 pairs on two-digit SIC codes and a different exchange, and 1 pair on 1-digit SIC codes and exchange. Results do not change substantially if we estimate the models using only the 230 pairs matched on both two-digit SIC codes and exchange.



**TABLE 1**  
**Variable Definitions**

<i>REJECT</i>	=	natural logarithm of the percentage of votes against or abstentions from auditor ratification;
<i>MW</i>	=	1 if a company received an adverse opinion on the effectiveness of internal control (existence of one or more material weaknesses), and 0 otherwise;
<i>COMP MW</i>	=	1 if a company received an adverse opinion on the effectiveness of internal control and the internal control material weaknesses involve company-level material weaknesses, and 0 otherwise;
<i>NOCOMP MW</i>	=	1 if a company received an adverse opinion on the effectiveness of internal control and the internal control material weaknesses do not involve company-level material weaknesses, and 0 otherwise;
<i>RESTATE</i>	=	1 if there is at least one nontechnical restatement disclosure during the fiscal year for which a company received an adverse opinion on the effectiveness of internal control or between the end of this period and the current shareholder annual meeting date, and the auditor in the restated period is the same as the auditor being voted on, and 0 otherwise;
<i>NASR</i>	=	the ratio of the sum of tax fees and other fees to the sum of audit fees and audit-related fees;
<i>LOGTA</i>	=	natural logarithm of total assets (in millions) at the end of the fiscal year;
<i>TA</i>	=	total assets (in billions) at the end of the fiscal year;
<i>WHBOARD</i>	=	average percentage of votes withheld from the election of all incumbent director nominees;
<i>CEOCHR</i>	=	1 if the CEO also serves as chairperson of the board, and 0 otherwise;
<i>BLKOWN</i>	=	percentage of shares held by blockholders (owning 5 percent or more of the company's stock);
<i>INSIDER</i>	=	percentage of shares held by insiders, including officers, directors, beneficial owners, and principal stockholders owning 10 percent or more of the company's stock;
<i>INSTIOWN</i>	=	percentage of shares held by institutional investors;
<i>ADRET</i>	=	two-digit SIC industry mean adjusted one-year common stock returns (one-fiscal-year common stock returns of a company minus the mean of one-fiscal-year common stock returns in the same two-digit SIC industry at the same time period) (in percentage);
<i>LOSS</i>	=	1 if income before extraordinary items is less than 0 for the last fiscal year, and 0 otherwise;
<i>ACEXPT</i>	=	proportion of audit committee members with financial expertise; and
<i>AUDTEN</i>	=	natural logarithm of auditor tenure (winsorized at 10 years).

in wholesale and retail, 10 percent in transportation/utilities, and 10 percent in financial services. More than 60 percent of the test and control companies are from NASDAQ, and more than 30 percent are from the NYSE.

The data are collected from various sources. For *REJECT* and *WHBOARD*, we collect voting results mainly from companies' 10-Q filings and in some cases from the 10-K and 8-K filings. We read the auditor's reports available on the Audit Analytics database or in companies' 10-K filings to identify the auditor's opinion on the effectiveness of internal control and code *MW*, *COMP MW*, and *NOCOMP MW*. We retrieve accounting restatement data from the Audit Analytics database. We then read the relevant restatement disclosures from SEC filings to determine whether a restatement is nontechnical (Raghunandan and Rama 2003; Srinivasan 2005).

Auditor fee data are collected from the Audit Analytics database and proxy statements. Financial data (*LOGTA* and *LOSS*) are retrieved from the Compustat database or the EDGAR database. Shareholders' annual meeting date and data relating to *CEOCHR* are obtained from the

proxy statements. Ownership data for *BLKOWN*, *INSIDER*, and *INSTIOWN* are collected from the Compact Disclosure database. Data to compute *ADRET* are obtained from the Compustat Research Insight database. Audit committee data to construct *ACEXPT* are hand collected from the proxy statements or 10-K filings. Auditor tenure data are retrieved from the Audit Analytics database, Compustat database, 10-Ks, 10-Qs, and proxy statements.

## RESULTS

### Descriptive Statistics

Descriptive statistics are provided in Table 2.<sup>12</sup> The dependent variable, *REJECT*, which is the natural log of the percentage of votes against or abstentions from auditor ratification, does not differ between companies with material weaknesses and those without material weaknesses; however, we have not yet considered the types of material weaknesses or the restatement status of the companies. Raw (untransformed) *REJECT* has mean approximately = 2.12 percent and median = 1.04 percent, consistent with Liu et al. (2009), which uses a sample from approximately the same time period. The mean of raw (untransformed) *REJECT* is approximately 2.42 percent for the *MW* sample versus 1.83 percent for the control sample. This difference in means is marginally significant using a one-tailed test ( $p = 0.07$ ).

Restatements are much more likely for the material weakness (*MW*) sample (51.3 percent) than for the control group (6.7 percent).<sup>13</sup> The nonaudit fee ratio (*NASR*) is lower for the *MW* sample than for the control group. Also, compared with the control group, *MW* companies are smaller (see *LOGTA* and *TA*), and have lower institutional ownership (*INSTIOWN*), weaker financial performance (*LOSS*), and shorter auditor tenure (*AUDTEN*). The other control variables are not significantly different between the test and control groups.

Information on the distribution of raw (untransformed) *REJECT* within each sample is presented in Table 3.<sup>14</sup> Within each sample, no significant differences are seen in raw *REJECT* between the *MW* and non-*MW* companies (see Panels A and C).

In Panel B (for the nonrestatement sample with  $MW = 1$ ), the Wilcoxon test suggests that raw *REJECT* has a higher ( $p < 0.05$ ) distribution for companies without company-level weaknesses than for companies with company-level weaknesses. This is consistent with our conjecture that shareholders may view the auditor as being too conservative by issuing an adverse internal control opinion based only on noncompany-level weaknesses.

In Panel D (for the restatement sample), this relation is reversed—both the t-test and Wilcoxon test suggest that raw *REJECT* has a higher ( $p < 0.10$  and  $p < 0.05$ , respectively) distribution for companies with company-level weaknesses than for companies without company-level weaknesses. Mean raw *REJECT* is approximately 4.78 percent (median = 2.55 percent) for  $COMP MW = 1$  versus 2.14 percent (median = 1.27 percent) when  $COMP MW = 0$  (only noncompany-level weaknesses). This is consistent with our conjecture that shareholders blame the auditor for failing to detect and help to correct fundamental internal control problems in prior periods (low audit quality). We caution that these tests are univariate, with other variables not yet controlled. Overall, meaningful variation appears to exist in shareholder dissatisfaction, bearing in mind that many shareholders are quite passive (see Sainty et al. [2002]).

<sup>12</sup> To eliminate the effect of outliers, we winsorized *WHBOARD* at the 1 percent level and 99 percent level, and *ADRET* at the 95 percent level (see Efendi et al. [2007]).

<sup>13</sup> In the full sample, we find the following correlations: *RESTATE* and *MW* 0.491, *RESTATE* and *COMP MW* 0.018, and *RESTATE* and *NOCOMP MW* 0.506. See below for discussion of the potential for multicollinearity.

<sup>14</sup> We present the descriptive statistics of raw *REJECT* in Table 3 because the untransformed numbers are more intuitive. The results of t-tests and Wilcoxon tests with *REJECT* are similar to those reported in Table 3 except that in Panel B the t-statistic is significantly negative ( $p < 0.05$ ) based on *REJECT*.

**TABLE 2**  
**Descriptive Statistics of Variables**

Variable	Group	Mean	Standard Deviation	25th Percentile	Median	75th Percentile	t-statistic	Wilcoxon Z-statistic
REJECT	All	-0.111	1.397	-0.960	0.039	0.754		
	MW = 1	-0.087	1.406	-0.971	-0.033	0.728	0.38	-0.31
	MW = 0	-0.135	1.391	-0.899	0.112	0.840		
Raw REJECT (Untransformed)	All	2.124	4.290	0.383	1.040	2.126		
	MW = 1	2.419	5.483	0.379	0.968	2.071	1.51	-0.31
	MW = 0	1.828	2.578	0.407	1.118	2.317		
RESTATE	All	0.290	0.454	0.000	0.000	1.000		
	MW = 1	0.513	0.501	0.000	1.000	1.000	12.34***	10.76***
	MW = 0	0.067	0.250	0.000	0.000	0.000		
NASR	All	0.160	0.209	0.028	0.095	0.218		
	MW = 1	0.138	0.189	0.023	0.078	0.180	-2.30**	-2.74***
	MW = 0	0.182	0.225	0.038	0.118	0.244		
LOGTA	All	6.610	1.807	5.340	6.245	7.665		
	MW = 1	6.408	1.784	5.175	6.055	7.310	-2.47**	-2.39**
	MW = 0	6.812	1.812	5.485	6.505	7.850		
TA	All	8.347	63.701	0.209	0.515	2.133		
	MW = 1	6.940	53.213	0.177	0.426	1.495	-0.48	-2.39**
	MW = 0	9.753	72.780	0.241	0.669	2.566		
WHBOARD	All	5.640	6.050	1.647	3.599	7.304		
	MW = 1	5.653	6.520	1.517	3.466	6.846	0.05	-0.79
	MW = 0	5.626	5.553	1.978	3.729	7.620		
CEOCHR	All	0.510	0.500	0.000	1.000	1.000		
	MW = 1	0.521	0.501	0.000	1.000	1.000	0.46	0.46
	MW = 0	0.500	0.501	0.000	0.500	1.000		
BLKOWN	All	37.579	21.840	21.545	34.955	50.785		
	MW = 1	38.024	21.336	21.405	37.520	52.560	0.45	0.86
	MW = 0	37.135	22.369	21.765	32.225	50.010		
INSIDER	All	9.138	15.070	0.650	2.720	10.895		
	MW = 1	8.844	14.825	0.605	2.835	10.345	-0.43	-0.19
	MW = 0	9.432	15.337	0.670	2.575	12.570		
INSTIOWN	All	63.712	28.739	42.125	69.645	88.340		
	MW = 1	59.734	30.295	38.085	64.550	85.980	-3.06***	-2.75***
	MW = 0	67.689	26.566	48.535	73.600	89.060		
ADRET	All	3.636	40.125	-23.813	0.049	23.528		
	MW = 1	2.703	45.254	-30.449	0.049	26.909	-0.51	-1.06
	MW = 0	4.568	34.307	-17.268	0.153	22.088		
LOSS	All	0.281	0.450	0.000	0.000	1.000		
	MW = 1	0.388	0.488	0.000	0.000	1.000	5.32***	5.17***
	MW = 0	0.175	0.381	0.000	0.000	0.000		
ACEXPT	All	0.494	0.280	0.333	0.500	0.667		
	MW = 1	0.485	0.269	0.333	0.500	0.667	-0.65	-0.75
	MW = 0	0.502	0.291	0.333	0.500	0.667		
AUDTEN	All	1.715	0.726	1.099	2.079	2.303		
	MW = 1	1.567	0.788	1.099	1.792	2.303	-4.58***	-4.72***
	MW = 0	1.864	0.625	1.386	2.303	2.303		

\*\* , \*\*\* Indicate significance at the 0.05 and 0.01 levels, respectively, two-tailed.

**TABLE 3**  
Distributions of Raw (Untransformed) *REJECT*

**Panel A: Nonrestatement Sample**

<u>Group</u>	<u>n</u>	<u>Mean</u>	<u>Standard Deviation</u>	<u>25th Percentile</u>	<u>Median</u>	<u>75th Percentile</u>	<u>t-statistic</u>	<u>Wilcoxon Z-statistic</u>
<i>MW</i> = 1	117	2.174	6.603	0.278	0.765	1.412	0.97	-0.92
<i>MW</i> = 0	117	1.540	2.580	0.356	0.871	1.650		

**Panel B: Nonrestatement Sample with *MW* = 1**

<u>Group</u>	<u>n</u>	<u>Mean</u>	<u>Standard Deviation</u>	<u>25th Percentile</u>	<u>Median</u>	<u>75th Percentile</u>	<u>t-statistic</u>	<u>Wilcoxon Z-statistic</u>
<i>COMP</i> <i>MW</i> = 1	54	2.650	9.221	0.223	0.492	1.251	0.68	-2.32**
<i>COMP</i> <i>MW</i> = 0	63	1.766	2.920	0.365	0.889	1.524		

**Panel C: Restatement Sample**

<u>Group</u>	<u>n</u>	<u>Mean</u>	<u>Standard Deviation</u>	<u>25th Percentile</u>	<u>Median</u>	<u>75th Percentile</u>	<u>t-statistic</u>	<u>Wilcoxon Z-statistic</u>
<i>MW</i> = 1	123	2.651	4.162	0.584	1.419	2.796	1.25	0.34
<i>MW</i> = 0	123	2.103	2.557	0.505	1.493	2.664		

**Panel D: Restatement Sample with *MW* = 1**

<u>Group</u>	<u>n</u>	<u>Mean</u>	<u>Standard Deviation</u>	<u>25th Percentile</u>	<u>Median</u>	<u>75th Percentile</u>	<u>t-statistic</u>	<u>Wilcoxon Z-statistic</u>
<i>COMP</i> <i>MW</i> = 1	24	4.778	7.106	0.818	2.545	6.274	1.79*	2.03**
<i>COMP</i> <i>MW</i> = 0	99	2.136	2.887	0.577	1.270	2.298		

\*, \*\* Indicate significance at the 0.10 and 0.05 levels, respectively, two-tailed.

### Regression Results

The regression results are reported in Table 4. To provide a comprehensive analysis, we present the results for the full sample ( $n = 480$ ), the nonrestatement sample ( $n = 234$ ; *MW* companies without restatements and their matches), and the restatement sample ( $n = 246$ ; *MW* companies with restatements and their matches).

Each of the three models in Table 4 is significant at  $p < 0.01$ , with adjusted  $R^2$ s ranging from 29 to 33 percent. In Columns 1 and 2 (full sample), the coefficient on *RESTATE* \* *COMP**MW* is positive and significant ( $p < 0.01$ ), and the coefficient on *RESTATE* \* *NOCOMP**MW* is not

**TABLE 4**  
**OLS Regression Results**  
**Dependent Variable = REJECT**

Variable	Pred. Sign	Full Sample		MW Firms Without Restatements and Their Matches		MW Firms With Restatements and Their Matches	
		Coeff. Est.	t-statistic	Coeff. Est.	t-statistic	Coeff. Est.	t-statistic
		(1)	(2)	(3)	(4)	(5)	(6)
Intercept	?	-1.284	-4.11***	-1.019	-2.30**	-1.818	-3.83***
<i>COMP</i> <i>MW</i>	+	-0.170	-0.92	-0.154	-0.73	1.063	2.73***
<i>NOCOMP</i> <i>MW</i>	+	0.257	1.53*	0.327	1.71**	0.584	1.76**
<i>RESTATE</i>	+	-0.004	-0.01	0.416	0.59	-0.210	-0.64
<i>RESTATE</i> * <i>COMP</i> <i>MW</i>	?	1.147	2.75***				
<i>RESTATE</i> * <i>NOCOMP</i> <i>MW</i>	?	0.188	0.53				
<i>NASR</i>	+	1.578	6.12***	1.655	4.79***	1.282	3.11***
<i>LOGTA</i>	?	0.092	2.75***	0.097	1.74*	0.107	2.47**
<i>WHBOARD</i>	+	0.039	4.45***	0.036	2.79***	0.045	3.70***
<i>CEOCHR</i>	+	0.212	1.95**	0.249	1.54*	0.138	0.91
<i>BLKOWN</i>	?	-0.013	-4.85***	-0.013	-2.94***	-0.011	-3.19***
<i>INSIDER</i>	-	-0.010	-2.72***	-0.021	-2.95***	-0.006	-1.39*
<i>INSTIOWN</i>	+	0.004	2.05**	0.002	0.55	0.006	2.19**
<i>ADRET</i>	-	-0.001	-0.96	-0.003	-1.62*	0.001	0.47
<i>LOSS</i>	+	-0.183	-1.40	-0.117	-0.60	-0.261	-1.45
<i>ACEXPT</i>	-	-0.741	-3.81***	-0.741	-2.46***	-0.583	-2.20**
<i>AUDTEN</i>	+	0.325	4.19***	0.215	1.94**	0.474	4.28***
n		480		234		246	
Adj. $R^2$		32.71%		28.79%		33.46%	
F-value		15.56***		7.73***		9.80***	

\*, \*\*, \*\*\* Indicate significance at the 0.10, 0.05, and 0.01 levels, respectively, one-tailed where signs are predicted, two-tailed otherwise.

*RESTATE* is included in the models in Columns 3–6 because matching companies do not always have the same restatement status as the *MW* companies they are matching. The results are similar when the *RESTATE* variable is deleted from the subsample models.

See Table 1 for variable definitions.

significant.<sup>15</sup> This indicates that the effect of *COMPMW* on shareholder voting differs depending on restatement status (there is a greater effect when restatements have been disclosed).<sup>16</sup>

To provide greater insight, we first split the *MW* companies into the restatement and nonrestatement subsamples, and then the matching companies follow their *MW* pairs (but the matching companies do not always have the same restatement status as the *MW* companies they are matching). In the restatement sample, all of the *MW* companies have restatements, but only 13 of the matching companies have restatements. In the nonrestatement sample, none of the *MW* companies has a restatement, but three of the matching companies have restatements. The results are similar when the *RESTATE* variable is deleted from the subsample models.<sup>17</sup>

In the nonrestatement sample (Columns 3 and 4), *NOCOMPMW* is positively significant ( $p < 0.05$ ), while the coefficient on *COMPMW* is not significant. Also, the coefficient on *NOCOMPMW* is greater than the coefficient on *COMPMW* ( $F = 4.51$ ;  $p = 0.03$  [two-tailed]).<sup>18</sup> Hence, when the company has not had a restatement, shareholders react negatively toward the auditor when an adverse Section 404 opinion is issued because of only noncompany-level material weaknesses. Shareholders may view the auditor as being too conservative and penalizing a company that has not experienced significant misstatements. Shareholders do not react negatively toward the auditor for the disclosure of company-level material weaknesses in the Section 404 report, as they may believe that the auditor has identified important problems that need to be corrected.

In the restatement sample (Columns 5 and 6), *COMPMW* and *NOCOMPMW* are both positively significant ( $p < 0.01$  and  $p < 0.05$ , respectively).<sup>19</sup> Hence, when the company has had a restatement, shareholders react negatively toward the auditor when an adverse Section 404 opinion is issued for either company-level or noncompany-level material weaknesses. The coefficient on *COMPMW* is greater than the coefficient on *NOCOMPMW* ( $F = 3.49$ ;  $p = 0.06$  two-tailed), suggesting that shareholders are more dissatisfied with company-level weaknesses. Therefore, shareholders may blame auditors for not identifying and helping to correct material weaknesses in the past, thus providing low-quality audit services.

The control variable results are quite stable across the three models. The coefficient on *NASR* is positive and significant, suggesting that auditors providing more nonaudit services are less likely to receive support from shareholders.<sup>20</sup> Shareholders are more likely to vote against or abstain from the reappointment of auditors when the company is larger (*LOGTA*), shareholders are more dissatisfied with their incumbent directors (*WHBOARD*), and the CEO and chairperson of the board are the same person (*CEOCHR*; significant in two models). Also, blockholders (*BLKOWN*) and insiders (*INSIDER*) are more likely to vote for auditor ratification, while institutional investors (*INSTIOWN*; significant in two models) do the opposite. Finally, shareholders are less likely to

<sup>15</sup> If we replace *COMPMW* and *NOCOMPMW* with *MW* (= 1 if any material weakness; otherwise 0), the interaction term *RESTATE \* MW* is not significant ( $p = 0.16$ , two-tailed).

<sup>16</sup> If we delete the two interaction terms from the model, then *RESTATE* is significant ( $p < 0.01$ ) and positive, consistent with Liu et al. (2009). Both *COMPMW* and *NOCOMPMW* are not significant.

<sup>17</sup> In terms of the subsample analyses below, because only 13 control companies in the restatement sample have restatements, we cannot run a model where the test and control firms have the same restatement status. For the nonrestatement sample, we exclude the three control firms with restatements and their matches ( $n = 228$  after three pairs are deleted). The results are similar (*NOCOMPMW* has  $p = 0.05$ , and *COMPMW* is not significant).

<sup>18</sup> The inclusion of *COMPMW* and *NOCOMPMW* increases the adjusted  $R^2$  of the model from 27.80 percent to 28.79 percent.

<sup>19</sup> The inclusion of *COMPMW* and *NOCOMPMW* increases the adjusted  $R^2$  of the model from 31.84 percent to 33.46 percent.

<sup>20</sup> Our results are similar when we add the magnitude of total auditor fees to the model. This added variable is not significant. Also, following Mishra et al. (2005), we replace the nonaudit fee ratio, *NASR*, with *ARERAT* (ratio of audit-related fees to audit fees), *TXRAT* (ratio of tax fees to audit fees), and *OFRAT* (ratio of other fees to audit fees), with consistent overall results.

vote for auditor ratification if the audit committee has less financial expertise (*ACEXPT*), or auditor tenure is greater (*AUDTEN*).<sup>21</sup>

### Sensitivity Tests

We run some additional sensitivity tests on the three models in Table 4. The full sample results for *RESTATE \* COMPMW* are unaffected ( $p < 0.01$ ) in all of the analyses except as noted below. In the two subsamples, the results for *COMPMW* and *NOCOMPMW* are substantially similar (in some cases the significance of *NOCOMPMW* changes from  $p < 0.05$  to  $p < 0.10$ ) in the following sensitivity tests, except as discussed below.

First, as one may argue that insiders typically do not vote against the auditor, we exclude insider votes (estimated based on votes cast and insider ownership) from the denominator in the *REJECT* calculation and drop *INSIDER* from the main model. Second, some companies such as [Expeditors International of Washington, Inc. \(2006\)](#) state in their proxies that abstentions have the same effect as a vote cast against the auditor. However, one may argue that some investors choose to neglect the voting although they support the auditor selection proposal. Hence, we exclude votes abstained from both the numerator and denominator (or only the numerator) in calculating *REJECT*. In these analyses, the results are similar except that *NOCOMPMW* has  $p = 0.11$  in the nonrestatement sample.

Third, we winsorize *REJECT* at the 1 percent and 99 percent levels. Fourth, we add a dummy variable for Big 4 auditor (there are 60 non-Big 4 clients in the sample). Big 4 is not significant. Fifth, we add individual Big 4 firm dummy variables. The Big 4 variables are not significant. Sixth, because of the unique characteristics of financial institutions, we include a dummy variable for two-digit SIC 60. This dummy variable is not significant.<sup>22</sup> Seventh, six companies in our sample received a going concern opinion. We add an indicator variable for the going concern opinion. The going concern variable is not significant.

Eighth, it is likely that votes against the auditor in the prior year (*PYREJECT*) may be related to shareholder voting in the current year. To address this issue, we gathered data (as possible) on the prior year votes. Among the 240 companies in the test (control) sample, we delete 35 (25) companies that did not seek auditor ratification or did not report the voting results on auditor ratification in the year before, and 12 (2) companies with different auditors selected for ratification at the two shareholders' annual meetings. From the remaining 193 test companies and 213 control companies, we find 190 pairs that can be matched on two-digit SIC codes within the same exchange, where possible, and on one-digit SIC codes and other exchanges when a two-digit SIC code and exchange match is not available (we rematched some companies that lost their original matches because of data availability). Using this sample of  $n = 380$  companies, we find that *PYREJECT* is positive and significant ( $p < 0.001$ ), and *RESTATE \* COMPMW* remains positive

<sup>21</sup> No evidence is seen of heteroscedasticity (White 1980) or multicollinearity (Kennedy 1992) in the models. The highest VIF is less than 7.4 in the full sample, 1.6 in the nonrestatement sample, and 5.5 in the restatement sample. The only correlation between any two variables in the subsample models above 0.50 is *RESTATE* and *NOCOMPMW* ( $r = 0.74$ ) in the restatement sample. For both subsample models, we can drop *RESTATE* from the model, and the results for *COMPMW* and *NOCOMPMW* are similar. Thus, the correlation of *RESTATE* and *NOCOMPMW* does not affect the subsample results.

<sup>22</sup> Including dummy variables for SICs 73 and 36 (the two most prevalent SICs in our sample) also has no effect on the results. The coefficient on SIC 73 is positively significant ( $p = 0.04$  in the full sample and  $p = 0.02$  in the restatement sample).

and significant at  $p < 0.05$ . Thus, controlling for prior year votes (and using a reduced sample) does not affect our full sample conclusions.<sup>23</sup>

Ninth, we use a logit transformation to address the skewness of raw *REJECT*.<sup>24</sup> Finally, we add variables to the models capturing the stock price reaction (value weighted or equally weighted market-adjusted returns, as well as raw returns) to the filing of the 10-K containing the Section 404 internal control opinion (Beneish et al. 2008). Using either day 0 (the filing date or the next trading date if the filing time is after the close of trading) or days  $-1$  to  $+1$  as the event window, we find no evidence that stock price reactions are associated with *REJECT* in the subsamples or the full sample. However, we conjecture that the confounding news (other than the adverse opinion) in 10-Ks or press releases at this time may have prevented us from finding such evidence (Beneish et al. 2008). We encourage additional research into shareholder voting and stock price reactions.

### CONCLUSION

We examine shareholders' dissatisfaction with auditors that have issued adverse internal control opinions in the first year of the Section 404 implementation process. Shareholders could blame the auditor for being too conservative in issuing an adverse Section 404 opinion (see Reason [2006]). In addition, they may view the auditor as partly to blame for internal control weaknesses, a signal of low audit quality (see RiskMetrics Group [2007]).

In our analysis, we consider the type of material weakness and restatement status. In the full sample, we find a significant and positive interaction between restatement and company-level material weakness—company-level material weaknesses have a greater effect on shareholder dissatisfaction when there has been a restatement. In the nonrestatement sample, we find that shareholders are less likely to vote for auditor ratification if the company received an adverse opinion because of only noncompany-level material weaknesses. Hence, shareholders may view the auditor as being too conservative when only noncompany-level material weaknesses are cited and there have been no restatements. Without recent restatements, shareholders do not react negatively to company-level material weaknesses, as they may believe that the auditor has identified an important problem that needs to be corrected. In the restatement sample, we find that shareholders are less likely to vote for auditor ratification if the company received an adverse Section 404 opinion with or without company-level material weaknesses cited—but with shareholder dissatisfaction greater for companies with company-level material weaknesses. Therefore, shareholders may blame the auditor for being partly responsible for material weaknesses.

The results in the nonrestatement sample suggest that some shareholders may prefer less conservative auditors, especially if no misstatements have occurred (also see Sainty et al. [2002] for similar results related to going concern opinions). If so, it may be that auditors' protective efforts sometimes apply to prospective shareholders, rather than to existing shareholders, who may be damaged by the auditor's highlighting of internal control problems. Accordingly, we encourage additional research on the auditor's role in agency frameworks, in particular with respect to the

<sup>23</sup> We also attempted to perform this reduced sample analysis on the two subsamples. In the restatement sample ( $n = 210$ ), *COMP* has  $p = 0.05$ , while *NOCOMP* is not significant. In the nonrestatement sample ( $n = 170$ ), both *COMP* and *NOCOMP* are insignificant. We note that *NOCOMP* becomes insignificant in both subsamples because of the reduced sample size. *NOCOMP* is also not significant when *PYREJECT* is not in the model. Analysis also suggests that the inclusion of *PYREJECT* does not affect the significance level of *COMP* in the restatement sample based on the reduced sample.

<sup>24</sup> We also use ranks of raw *REJECT* as the dependent variable. *RESTATE \* COMP* is significant at  $p = 0.02$  in the full sample. *COMP* remains significant ( $p = 0.03$ ) in the restatement sample. *NOCOMP* is not significant in the nonrestatement sample ( $p = 0.11$ ) or the restatement sample ( $p = 0.27$ ). Note that a rank transformation ignores the distance between values of the variable, and thus is not as reliable as the log transformation or logit transformation.



auditor's protection of existing shareholders and prospective shareholders. Such research may probe more deeply into shareholder voting and stock price reactions as well.

The results in the restatement sample suggest that some shareholders view the auditor and management as jointly responsible for the quality of internal controls and financial reporting. While management is technically responsible for internal controls and the financial statements, our results suggest that shareholder dissatisfaction encompasses the auditor when internal control weaknesses are accompanied by accounting restatements.

We caution the reader about two important limitations of the study. First, we examine only the first year of Section 404 implementation, a period when auditors and managers were struggling under intense time pressure and limited guidance. It is possible that the results would be different in later periods. Second, while we have tried to control for all relevant variables, it is possible that correlated variables were omitted.

Shareholder ratification of the auditor provides investors with one mechanism to express their dissatisfaction toward the auditor (ACAP 2008). From a policy perspective, we believe that it is important for companies to provide investors with such a mechanism, even if the votes against the auditor are quite low (see Dao et al. [2008]; Liu et al. [2009]). We encourage ongoing research into other factors associated with shareholder votes on auditor ratification. Future studies may examine whether auditors' Section 404 opinions issued under AS No. 5 cause different shareholder reactions with respect to auditor ratification, and we encourage research on the reaction of non-accelerated filers' shareholders to the issuance of adverse Section 404 opinions. Research also can be conducted on whether such factors as abnormally high audit fees, abrupt changes in audit fees, or audit firm events (e.g., significant audit failure related to another client) are associated with increased shareholder dissatisfaction with the auditor. Finally, as noted above, we encourage additional consideration of the auditor's role in protecting current versus prospective shareholders in agency frameworks.

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