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WEAK INTERNAL CONTROLS AND SHAREHOLDER DISSATISFACTION

A Dissertation
Submitted to
the Temple University Graduate Board

In Partial Fulfillment
of the Requirements for the Degree
Doctor of Philosophy

By

Zhongxia Ye

August, 2006

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ABSTRACT

Title: Weak Internal Controls and Shareholder Dissatisfaction
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SOX Section 404 requires public companies to include in each annual report the management's assessment on the effectiveness of the internal control and the auditor's attestation opinion. It has been regarded as the most controversial section of SOX. The primary objective of this study is to examine whether the disclosure relating to internal controls under Section 404 affects shareholders' voting decisions in director election.

Based on samples with companies that comply with Section 404 for the first time, I find that an adverse auditor's attestation opinion on internal control is positively associated with shareholders' dissatisfaction toward the management, as measured by votes withheld, but does not affect shareholders' perceptions, of the board of directors or the audit committee. However, shareholders show their dissatisfaction toward the management, the board and the audit committee in the presence of internal control material weaknesses when these weaknesses are accompanied by lower auditor independence (as reflected by total auditor fees), or when they are reported very late.

I also document that non-audit services are positively related to shareholders' dissatisfaction toward the audit committee and the board, but not to shareholders' dissatisfaction toward the management. Moreover, the magnitude of total fees paid to the auditor affects shareholders' dissatisfaction toward the management, the audit committee and the board. In addition, I find that generally independent director nominees are less likely to have votes withheld than affiliated director nominees.

This dissertation adds to recent literature on the benefits of Sections 302 and 404, and the monitoring role of shareholder voting. It also indicates that Sections 201 and 301, and SEC's rules on the disclosure of auditor fees do reflect shareholders' calls for total auditor independence and increasing scrutiny over the relationship between the auditor and its client. In addition, this study lends supports to the requirement of Section 301 that the audit committee consist of totally independent directors and other recent rules to regulate director independence in public companies. It also has implications for researchers, companies, investors and corporate governance activists.

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TABLE OF CONTENTS

LIST OF TABLES

CHAPTER 1

INTRODUCTION

The Sarbanes-Oxley Act of 2002 (SOX hereafter, U.S. House of Representatives 2002) has introduced new disclosure rules relating to corporate internal controls over financial reporting.[1] Under SOX Section 302, principal executive officers and principal financial officers are required to certify in each corporate quarterly and annual report that they have evaluated and presented in a report, their conclusions on the effectiveness of the internal controls as of a date within 90 days prior to the report. Section 404 of SOX requires public companies to include, in their annual reports, their management's assessment of the effectiveness of the internal controls, and their independent auditors' attestation report on management's assessment and the effectiveness of internal controls. The primary purpose of this study is to examine whether the disclosures relating to internal controls affects the perceptions of shareholders when they vote on director election.

Empirical studies show that weak internal controls signal poor earnings quality (e.g., Doyle et al. 2005a) and lower firm market value (e.g., Franco et al. 2005). Weak internal controls are also associated with higher auditor fees (Eldridge and Kealey 2005) and cost of equity (Ogneva et al. 2005), and longer audit report lags (Ettredge et al. 2005). In addition, anecdotal evidence suggests that firms with internal control problems attract more scrutiny from regulators (Martinek 2005a; Martinek 2005b). Clearly, the existence of weak internal controls indicates that

[1] Internal Control – Integrated Framework, known as the COSO report, published by the Committee of0 Sponsoring Organizations ("COSO") of the Treadway Commission, is the framework for purposes of management's assessment and the auditor's attestation of the effectiveness of internal controls (COSO 1992). According to the COSO framework, there are two other primary objectives of internal control: efficiency and effectiveness of operations, and compliance with laws and regulations. In this study I only examine issues related to internal control over financial reporting.

shareholders' interests are not protected. The Foreign Corrupt Practices Act of 1977 (FCPA hereafter) requires all public companies to maintain internal control over accounting and asset protection. Also, SOX Section 302 emphasizes management's responsibility to establish and maintain effective internal controls. Moreover, recent policy changes indicate that the audit committee and the board of directors are responsible for overseeing the entity's internal controls. Hence, weak internal controls signify the failure of management, the audit committee and the board of directors to perform their duties. Consequently, an interesting question is whether shareholders take actions in response to disclosures about internal control deficiencies. Prior work has shown that dissatisfied shareholders are more likely to vote against proposals initiated by management (e.g., Sainty et al. 2002; Raghunandan 2003). Anecdotal evidence also suggests that shareholders express their discontent by withholding votes for the election of incumbent directors (Public Accounting Report 2004, PAR 2004 hereafter). Therefore, I conjecture that shareholders of companies that have disclosed internal control problems may respond by withholding votes for the reelection of incumbent directors.[2]

SOX Section 201 restricts the non-audit services that a public company can purchase from its auditor. Previous studies show that the provision of non-audit services affects shareholders' perceptions of auditor independence (e.g., Raghunandan 2003). Also, Francis (1984) and Ashbaugh et al. (2003) argue that the magnitude of total fees paid to the independent auditor is the more appropriate proxy for the economic dependence of the auditor on its client. However, it is still an open

[2] Dissatisfied shareholders can also sell their shares, and this has been investigated by market reaction studies (e.g. Franco et al. 2005). However, selling shares is not the only action that shareholders (especially large shareholders) take because the selling of a lot of shares can drive the price down (Gillan and Starks 2000). Therefore, exercising their voting rights is one important approach for shareholders to protect their own interests (Shleifer and Vishny 1997).

question as to whether the non-audit fees and the total fees paid to the auditor affect shareholders' perceptions of the board of directors, especially the audit committee, which has now been delegated the job of hiring and determining the compensation of the auditor, and is required to pre-approve all audit and non-audit services provided by the auditor (SOX Section 301; SEC 2003d). The second objective of this study is to test whether the magnitude of non-audit fees and total auditor fees affect shareholders' votes withheld for director election.

The independence of the directors, especially directors on the audit committee, nominating committee and compensation committee[3], has been a great concern of policy makers, researchers and corporate governance activists. For example, the New York Stock Exchange and NASDAQ Stock Exchange maintain that each listed company should consist of a majority of independent directors (SEC 2003g). Moreover, SOX Section 301 requires each member of the audit committee to be independent. Previous studies also document that independent directors are more likely to act in the best interests of shareholders (e.g., Dechow et al. 1996). However, there has been no empirical evidence as to whether shareholders are more likely to vote for independent director nominees in the director election. The third objective of this study is to examine the association between director independence and shareholder voting on director election.

SOX Section 407 requires a public company to disclose whether it has at least one financial expert on the audit committee, but the definition of financial expertise remains controversial. Originally, the SEC proposed a definition of financial expert

[3] For instance, on November 4, 2003, the SEC approved the proposal from the New York Stock Exchange (NYSE) that each company listed on NYSE has a nominating / corporate governance committee, a compensation committee and an audit committee, all of which are composed completely of independent directors.

that emphasizes whether the director has accounting-related experience such as a public accountant, auditor, principal or chief financial officer, controller, or principal or chief accounting officer (accounting financial expert hereafter; SEC 2002). However, this narrow definition was criticized for its unnecessary restriction and limiting the pool of qualified directors. In response, the SEC broadened the definition of financial expert in the final rule. This broadened definition of financial expert includes both accounting financial expert and nonaccounting financial expert which is defined as a director with the experience of "actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions" or "overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements" (SEC 2003e). DeFond et al. (2005) show that the market reaction to the appointment of new audit committee directors is positively associated with the accounting financial expertise of the audit committee directors, but not related to the nonaccounting financial expertise of the audit committee directors. The fourth objective of this study is to investigate, from a different perspective, whether shareholders' votes for the election of audit committee directors are associated with the financial expertise of the audit committee directors and if so, whether they discriminate between different types of expertise.

Based on samples comprising firms that comply with Section 404 for the first time, I find that an adverse auditor's attestation opinion on internal control is positively associated with shareholders' dissatisfaction toward the management, as measured by votes withheld, but does not affect shareholders' perceptions, of the board of directors or the audit committee.

Thus the aggregate results indicate some, but not overwhelming evidence that shareholders express dissatisfaction toward the presence of material weaknesses by withholding votes on director election. However, I do find that, in the presence of some additional conditions, shareholders react more strongly to the presence of material weaknesses. First, shareholders are more dissatisfied with managers, the audit committee and the board of directors if the firms receiving an adverse Section 404 auditor opinion also pay high total fees to the auditor. Second, among the firms with internal control material weaknesses, director nominees are less likely to have votes withheld if they had disclosed the internal control deficiencies according to SOX Section 302 before they received the adverse auditor opinion. Third, I find that shareholders are more likely to withhold their votes for the manager director nominees and director nominees on the board in companies that file their Section 404 reports extremely late. Thus, shareholders play a monitoring role by expressing discontent towards the presence of material weaknesses when these weaknesses are accompanied by lower auditor independence (as reflected by total auditor fees), or when they are reported very late.

In addition to the above findings regarding shareholders' reaction to the presence of material weaknesses, I also document other findings, not reported in prior work, relating to shareholder voting on director election in general. I document that non-audit services are positively related to shareholders' dissatisfaction toward the audit committee and the board of directors, but not to shareholders' dissatisfaction toward the management. Also, the magnitude of total fees paid to the auditor plays a very significant role in affecting shareholders' dissatisfaction toward the management, the audit committee and the board.

Moreover, the results provide empirical evidence on shareholders' perceptions of director independence. Generally independent audit committee director nominees (and other independent director nominees) are less likely to have votes withheld than affiliated director nominees. However, I do not find an association between shareholder voting and audit committee independence in the sample consisting of only firms with internal control material weaknesses. Surprisingly, I do not find any relation between shareholders' voting and audit committee financial expertise. I also do not find, contrary to expectation, any interaction effects between audit committee independence and expertise, and the presence of material weaknesses.

This study makes three major contributions. First, there has been considerable debate over the benefits and costs of Sections 302 and 404 (Eldridge and Kealey 2005).[4] Some recent studies investigate how the disclosure of internal control deficiencies affects investors' evaluation of companies' market value (e.g., Ashbaugh et al. 2005; Franco et al. 2005; Hammersley et al. 2005).[5] However, there is currently no evidence on how the disclosure of internal controls is used by shareholders in casting their votes on director election. This study shows that the disclosure of internal control weaknesses triggers shareholder reaction by causing them to withhold votes against director nominees, although the strength of the response varies across different types of director nominees, and other circumstances accompanying the disclosure of the material weaknesses. Thus, this dissertation adds to recent literature

[4] For example, regulators believe that internal control is critical to improve the accuracy and reliability of financial reporting and protect investors (SEC 2005a, SEC 2005d). Conversely, SOX Section 404 is regarded by some people as the "most expensive and most burdensome piece of Sarbanes-Oxley" (SEC 2005c) and opponents even call for the repeal of this requirement (American Electronics Association 2005; Financial Executives Institute 2005).

[5] Hermanson (2000) also documents that the perception about the value of the disclosures relating to internal control varies across different financial information user groups.

on the benefits of Sections 302 and 404, and the monitoring role of shareholder voting.

Second, this study adds to the recent growing literature on auditor fees (e.g., Raghunandan 2003). It provides additional evidence that the disclosure of auditor fees influences shareholders' voting decisions. In particular, this dissertation shows that generally both the non-audit services and the magnitude of total fees paid to the auditor influence shareholders' perception of directors, although non-audit services do not affect shareholders' perception of manager directors. Therefore, this study lends empirical support to the SEC's rules on the disclosure of auditor fees and SOX Section 201's restriction on the non-audit services that an independent auditor can provide to public companies.

Third, my empirical results show that the requirement of SOX Section 301 that each member of the audit committee be independent is consistent with shareholders' needs.

The rest of the dissertation is organized as follows. First, I provide the background and literature review in Chapter 2, and develop the hypotheses in Chapter 3. Next, in Chapter 4 I present the research design followed by details about sample selection and data sources. The final two chapters contain the discussion of the empirical results and conclusions.

CHAPTER 2

REGULATIONS, PRIOR RESEARCH AND BACKGROUND

2.1 Regulations of Internal Controls

The FCPA, the only statutory regulation of internal controls in the pre-SOX period, requires all public companies to maintain *cost effective* internal control over accounting and asset protection. Kinney et al. (1990) argue that the term "cost-effective" is ambiguous and leads to weak implementation of this rule.

In the pre-SOX period, public companies only needed to disclose the internal control weaknesses reported by their predecessor auditors when they switched auditors (SEC 1988). In addition to reinforcing the requirements of FCPA, SOX enforces stricter disclosure rules. Section 302 requires principal executive officers and principal financial officers to certify in each quarterly and annual report that they are responsible for establishing and maintaining internal controls, and that they have evaluated and presented in the report their conclusions on the effectiveness[6] of the internal controls as of a date within 90 days prior to the report. They are also required to certify that they have disclosed to their auditors and the audit committee all significant deficiencies and material weaknesses in internal controls, and any fraud

[6] "...Maintaining effective internal control over financial reporting means no material weaknesses exist..." [PCAOB Auditing Standard No. 2 (AS2 hereafter), Paragraph 4]. AS2 differentiates three levels of internal control deficiencies based on the severity of the deficiencies: "A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis" (AS2, Paragraph 8). A significant deficiency is defined as "a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected" (AS2, Paragraph 9). A material weakness is defined as "a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected" (AS2, Paragraph 10). Section 302 does not require companies to disclose control deficiencies or significant deficiencies. However, they are obligated to identify and publicly disclose all material weaknesses (SEC 2004b).

that is related to their internal controls. In addition, they must certify that they have disclosed in the report whether there were significant changes in the internal controls or in other factors that could significantly impact internal controls following the date of their previous evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Section 302 applies to all public companies and became effective for quarterly and annual reports covering periods that end after August 29, 2002. According to SOX Section 906, top managers who willfully certify a periodic report that does not comport with the requirements of Section 302 can be fined up to $5,000,000, or imprisoned for up to 20 years, or both.

Section 404 requires the public company to include an internal control report in its annual report. In this internal control report, management must state its responsibility for establishing and maintaining an effective internal control, and include its assessment on the effectiveness of the internal controls as of the end of the most recent fiscal year. Moreover, the auditor that issues the audit report for the company shall attest to, and report on, the assessment made by the management of the company and on the effectiveness of the internal controls.

Section 404 applies to all public companies except registered investment companies and issuers of asset-backed securities (AS2, Paragraph 2). Originally, accelerated filers under SEC Rule 12b-2 (that is, issuers with public float of at least $75 million)[7] were required to begin complying with Section 404 requirements for

[7] More precisely, an accelerated filer is a company that has "met all of the following criteria as of the end of its fiscal year: (1) the issuer had an aggregate market value of voting and non-voting common equity held by non-affiliates of the issuer of $75 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter; (2) the issuer had been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months; (3) the issuer previously had filed at least one annual report; and (4) the issuer was not eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports" (SEC 2005f, Page

first fiscal years ending on or after June 15, 2004, and non-accelerated filers were required to begin complying for first fiscal years ending on or after April 15, 2005 (SEC 2003a). Later, these compliance dates were extended to November 15, 2004 for accelerated filers, and July 15, 2005 for non-accelerated filers and foreign private issuers, respectively (AS2; SEC 2004a). On November 30, 2004, the SEC granted some eligible small accelerated-filers (with public float less than $700 million at the end of the second fiscal quarter of 2004) that have a fiscal year ending between and including November 15, 2004 and February 28, 2005 an additional 45 days to comply with Section 404 (SEC 2004c). Subsequently, the compliance dates for non-accelerated filers and foreign private issuers were extended to July 15, 2006 first (SEC 2005b) and then to July 15, 2007 (SEC 2005e).

In accordance with AS2, the auditor expresses an opinion on management's assessment, as well as an opinion on the effectiveness of the company's internal control. Only when there are no identified material weaknesses and when there have been no scope limitations on the auditor's work, can the auditor issue an unqualified opinion on the effectiveness of the company's internal controls. The auditor must issue an adverse opinion if one or more material weaknesses are found, or if the auditor is aware of any subsequent events that materially and adversely influence the effectiveness of the company's internal controls as of the date specified in the assessment.[8] In the situations of scope limitations, it is recommended that the auditor withdraw from the engagement, or issue a qualified opinion or a disclaimer opinion,

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4). Since December 27, 2005, the SEC has classified accelerated filers into "large accelerated filers" and "accelerated filers" based on a cut-off of public float of $700 million (SEC 2005f).

[8] When an adverse opinion is issued because of material weaknesses, the auditor is required to describe specifically in the auditor's report the nature of any material weaknesses, and their actual and potential effect on the company's financial reports issued during the existence of the material weaknesses.

depending on the significance of the scope limitation. A disclaimer opinion should also be expressed when the auditor cannot determine the influence of subsequent events on the effectiveness of the company's internal controls. Moreover, if the management's assessment report contains additional information such as corrective actions, the auditor should disclaim an opinion on such information. Finally, the principal auditor should modify the standard report when referring to the report of other auditors as a basis, in part, for its report.

2.2 Research on Internal Controls

One stream of studies investigates the determinants of internal control problems. Using samples from firms that changed auditors in the period 1994-2000, Krishnan (2005) finds that the existence of internal control problems[9] is negatively related to the independence and financial expertise of audit committee directors, management quality and auditor tenure, and positively associated with firm size, financial distress of firms and auditor resignation.

A few studies use post-SOX data to examine the determinants of internal control problems disclosed before the effective date of Section 404.[10] Using firms that disclosed material weaknesses from August 2002 to November 2004 as a test sample and firms that did not disclose any material weaknesses during the same period as a control sample, Ge and McVay (2005) document that the probability of reporting material weaknesses increases with business complexity and auditor quality, and decreases with firm size and profitability. Based on samples similar to those in Ge

[9] In the Pre-SOX period internal control deficiencies include reportable conditions and material weaknesses.

[10] Since August 29, 2002, the effective date of Section 302, some companies have disclosed, in accordance with Section 302, in their SEC filings or press releases the material weaknesses identified by the management. Although not mandated by Section 302, some companies even disclosed control deficiencies and significant deficiencies.

and McVay (2005), Doyle et al. (2005b) confirm the findings of Ge and McVay (2005), but add that firms that are younger, growing more rapidly or with restructuring activities, are more likely to have internal control material weaknesses. Similarly, based on a test sample of 342 firms that disclosed internal control deficiencies from November 2003 to December 2004 and a control sample of 5,281 firms that did not disclose internal control deficiencies during the same period, Ashbaugh et al. (2005) show that firms engaged in merger, acquisition or restructuring activities, firms with more complicated operations, firms with more concentrated ownership or greater inventory as a percentage of total assets, growth firms, larger firms, firms that change auditors, firms that restate earnings or have an SEC Accounting and Auditing Enforcement Release (AAER) are more likely to report internal control deficiencies.

Ashbaugh et al. (2005) find, in univariate analysis, that firms that report internal control deficiencies have greater performance adjusted total abnormal accruals and abnormal working capital accruals. Moreover, Doyle et al. (2005a) provide evidence that accrual quality is lower for firms with material weaknesses in internal controls, especially firms with material weaknesses relating to company-level controls. [11] Also, Chan et al. (2005) demonstrate that positive and absolute discretionary accruals are positively related to the existence of internal control material weaknesses.

Another line of current research on internal controls tests market reactions to the disclosure of internal control problems. Franco et al. (2005) find that firms suffered significant negative abnormal returns when they disclosed internal control

[11] Moody's classifies material weaknesses into material weaknesses relating to controls over specific accounts or transactions and company-level material weaknesses (Doss and Jonas 2004).

deficiencies. Similarly, Hammersley et al. (2005) document significant negative returns and increased trading volume surrounding firms' disclosures of internal control material weaknesses. Beneish et al. (2005) confirm the results of these two studies. In addition, they demonstrate that firms that changed auditors or those in high-risk industries experienced more adverse market reactions, and that firms with poorer earnings quality or a higher quality auditor experienced less negative market reactions.

Although Ashbaugh et al. (2005) do not find a significant market reaction to the disclosure of internal control deficiencies, they find that the earnings response coefficients (ERCs) of firms with internal control material weaknesses decline following the disclosures of internal control problems, while ERCs of firms with internal control deficiencies or significant deficiencies remain unchanged. In addition, they find that ERCs of firms with internal control material weaknesses are lower than those of firms with less severe internal control deficiencies. Similarly, Chan et al. (2005) show that firms with internal control material weaknesses have lower return-earnings association.

Other studies relate internal controls to audit fees, audit report lag or cost of equity. Based on a sample from Fortune 1000 companies, Eldridge and Kealey (2005) document that average audit fees increased from 2003 to 2004 by $2.3 million, primarily because of the internal control audit. They find that the increase in audit fees from 2003 to 2004 per dollar of assets is positively associated with the existence of material weaknesses. Ettredge et al. (2005) show that the audit report lag is longer for companies in 2004 than in 2003, and it is longer for companies with internal control material weaknesses, especially company-level material weaknesses. Ogneva et al. (2005) provide weak evidence that firms with internal control material

weaknesses have higher cost of equity. They also find that the cost of equity is significantly higher for firms that delay their Section 404 disclosures.

To summarize, the above studies do not study how the disclosure of internal control problems affects shareholders' voting behavior on director election. This study intends to fill this gap.

2.3 Shareholder Voting

Actual replacement of incumbent directors does not happen frequently, partly because most companies adopt uncontested plurality voting policies for director election. However, the election of directors is the most important device through which manager actions can be influenced, in order to induce them to protect shareholders' interests (Bebchuk 2005). Recently, director election has received increasing attention (SEC 2003b; SEC 2003c). Regulators are considering enhancing "their (investors') ability to participate meaningfully in the proxy process for the nomination and election of directors" (SEC 2003c). For instance, the SEC proposed that companies should include a security holder nominee in their proxy materials if one or more of their nominees for directors received "withhold" votes from more than 35 percent of the votes cast (SEC 2003c). In response, shareholder activists launched "vote-no" campaigns to withhold their votes for the directors that they were not satisfied with.[12] Also, some companies such as Circuit City Stores Inc. and Automatic Data Processing Inc. have voluntarily adopted the majority voting practice for director election (Taub 2005).

[12] For example, 45 percent of shareholders who executed their proxies at the annual shareholders' meeting of the Walt Disney Co, held on March 3, 2004, withheld votes for the election of the CEO Michael Eisner as a director (Lang 2004). In response, the board of directors stripped him of his position as Chairman of the board.

Although managers have firm specific knowledge and can control many issues included on the ballots, recent trends indicate that shareholder voting is playing an increasingly important role in influencing corporate decisions. For example, recent studies show that shareholders are more likely to vote against auditor selection when auditor quality or stock return is lower, when the company receives a going concern audit opinion (Sainty et al. 2002), when the ratio of non-audit fees to audit fees is higher (Raghunandan 2003), or when the company pays more tax fees or other fees[13] to the auditor (Mishra et al. 2005). Also, management is more likely to change the auditor subsequently in response to higher votes against auditor appointment (Sainty et al. 2002). Furthermore, Ferri et al. (2005) demonstrate that shareholders vote in favor of stock option expensing when firms' perceived option compensation is excessive, or the expected impact of expensing on earnings is lower. Shareholders can also play monitoring roles when they are asked to vote on other proposals, such as stock option plans (Thomas and Martin 2000) and proposals initiated by themselves (Gordon and Pound 1993; Smith 1996; Gillan and Starks 2000). An interesting question is whether these trends in shareholder voting extend to situations where companies disclose internal control problems. [14]

[13] The reason is that the provision of tax fees or other fees may be perceived to compromise auditor independence.

[14] Bethel and Gillan (2002) use measures based on shareholders' votes for director election and those for other proposals together as the dependent variable in the model to test when shareholders favor management-initiated proposals and oppose shareholder-initiated proposals. However, they do not investigate the voting outcomes of director election separately.

CHAPTER 3

HYPOTHESES DEVELOPMENT

As discussed earlier, studies show that weak internal controls signal poor earnings quality, lower firms' market value, increase auditor fees, audit report lags and cost of equity, and thus directly or indirectly decrease shareholders' value. Also, anecdotal evidence suggests that regulators are more likely to scrutinize firms with internal control problems (Martinek 2005a; Martinek 2005b). Therefore, shareholders of companies with weak internal controls have reasons to be dissatisfied.

Management may be the first target of shareholders' dissatisfaction, because Section 302 and AS2 maintain that management is responsible for establishing and maintaining effective internal controls. The Committee of Sponsoring Organizations of the Treadway Commission (1992) [COSO (1992) hereafter] also suggests that the CEO is eventually responsible for the internal control system, and that the CEO sets the "tone at the top" that influences integrity, ethics and other factors of a control environment. COSO (1992) also emphasizes the significant role of CFOs in internal controls.[15]

In addition, the audit committee should be held responsible for weak internal controls because it is a direct monitor of management's work. The monitoring role of the audit committee in internal controls has been emphasized by regulators since at least 1979 (SEC 1979; NCFFR 1987; BRC 1999; also see Braiotta 2004 and Krishnan 2005 for more details). Moreover, AS2 (Paragraph 55) stresses, "The company's audit

[15] To maintain the independence of the auditor, the auditor is not allowed to design or implement controls for the company (AS2, Paragraph 32). The auditor can accept an engagement to provide internal control-related services to the company only if it has been pre-approved by the audit committee. However, for "any internal control services the auditor provides, management must be actively involved and cannot delegate responsibility for these matters to the auditor. Management's involvement must be substantive and extensive. Management's acceptance of responsibility for documentation and testing performed by the auditor does not by itself satisfy the independence requirements." (AS2, Paragraph 33).

committee plays an important role within the control environment and monitoring components of internal control over financial reporting. Within the control environment, the existence of an effective audit committee helps to set a positive tone at the top. Within the monitoring component, an effective audit committee challenges the company's activities in the financial arena". AS2 also maintains that the auditor should assess the effectiveness of the audit committee when it attests to the effectiveness of a company's internal control. Recent empirical evidence also suggests that audit committees of poor quality are associated with weak internal controls (Krishnan 2005).[16]

Shareholders can also blame the board of directors for weak internal controls because "The company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee..." (AS2, Paragraph 56). The practices and attitudes of the entire board have a great impact on the performance of the audit committee and thus a dysfunctional board of directors can lead to an ineffective audit committee (BRC 1999). One way that shareholders express their dissatisfaction is to withhold their votes for the election of management directors, audit committee directors and the board of directors (PAR 2004). Therefore, I hypothesize (in the alternative form):

H1: Ceteris paribus, shareholders are more dissatisfied with the management (the audit committee, or the board of directors) of the companies with internal control problems.

Moody's classifies material weaknesses into "Category A" material weaknesses, which relate to controls over specific account balances or transaction-level processes, and "Category B" material weaknesses, which relate to company-

[16] The monitoring role of the audit committee does not suggest that management's responsibility has been transferred to the audit committee (AS2, Paragraph 55).

level controls (Doss and Jonas 2004). According to Paragraph 53 of AS2, company-level controls include, but are not limited to, the following controls:

> *"• 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[17]; and*
>
> *•Board-approved policies that address significant business control and risk management practices."* (PCAOB 2004, Paragraph 53).

Moody's asserts that it is less concerned about "Category A" material weaknesses because it believes that the independent auditor can "audit around" these material weaknesses by performing additional substantive procedures (Doss and Jonas 2004). By contrast, "Category B" material weaknesses have a pervasive effect on a company's financial reporting and thus the auditor may not be able to audit around them. Also, Moody's believes that Category B material weaknesses signify management's failure to control the business and its inability to prepare accurate financial reports. COSO (1992) and Statement on Auditing Standards (SAS hereafter) No. 55 (AICPA 1988a) also emphasize that company-level controls are the foundation for all other components of internal control. Moreover, both AS2 and SAS No. 55 (AICPA 1988a) recommend that auditors test and evaluate the design

[17] The period-end financial reporting process includes: "(a) The procedures used to enter transaction totals into the general ledger; (b) The procedures used to initiate, authorize, record, and process journal entries in the general ledger; (c) Other procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements, such as consolidating adjustments, report combinations, and classifications; and (d) Procedures for drafting annual and quarterly financial statements and related disclosures." (AS2, Paragraph 76).

effectiveness of company-level controls first because weaknesses in the control environment could indicate the need to alter the nature, timing, or extent of the testing of other aspects of internal control. Finally, compared to transaction-level material weaknesses, company-level weaknesses are more likely to result in poor earnings quality and longer audit report lags (Doyle et al. 2005a and Ettredge et al. 2005). Therefore, I hypothesize (in the alternative form):

H2: Ceteris paribus, shareholders are more dissatisfied with the management (the audit committee, or the board of directors) of the companies with company-level internal control material weaknesses.

Deficiencies in controls over revenue recognition are probably most likely to be associated with fraudulent financial reporting and earnings management.[18] For example, Beasley et al. (1999) report that typical financial statement fraud techniques involve the overstatement of revenues. Also, based on investigations of AAERs, Dechow and Shrand (2004) report that the most common type of earnings management results from overstating revenue. Since the purpose of internal controls is to "provide reasonable assurance regarding the reliability of financial reporting" (AS2, Paragraph 7), and fraudulent financial reporting or earnings management reduces the reliability of financial information, I hypothesize (in the alternative form):

H3: Ceteris paribus, shareholders are more dissatisfied with the management (the audit committee, or the board of directors) of the companies with internal control material weaknesses relating to revenue recognition.

Section 302 maintains that principal executive officers and principal financial managers evaluate and present, in each quarterly or annual report, their conclusions on the effectiveness of the internal controls. An interesting question is whether, in situations where the auditors conclude that a company's internal controls are not

[18] Ge and McVay (2005) document that 55% of their sample firms disclosed revenue recognition control deficiencies.

effective (per Section 404), management had disclosed such internal control deficiencies in previous SEC filings in accordance with Section 302. In situations where this did not happen, investors may be more dissatisfied since it suggests that management did not evaluate their internal controls properly or report internal control problems in a timely manner. Hence, I posit (in the alternative form):

H4: Ceteris paribus, shareholders are more dissatisfied with the management (the audit committee, or the board of directors) of the companies that did not disclose internal control problems in accordance with Section 302 before they received an adverse opinion from the auditor on the effectiveness of the internal controls.

Following the effective date of Section 404, more firms than usual delayed their 10-K filings beyond the mandatory period because of Section 404 implementation (Hadi 2005; Ettredge et al. 2005). Delayed disclosure causes information asymmetry among investors and thus damages some investors' interests (e.g., Hakansson 1977; Bamber et al. 1993). Consistent with this, Ogneva et al. (2005) find that firms that delay their Section 404 disclosures have higher costs of equity. Hence, I hypothesize (in the alternative form):

H5: Ceteris paribus, shareholders are more dissatisfied with the management (the audit committee, or the board of directors) of the companies with internal control material weaknesses if companies delay the disclosure of the auditor's attestation report on the effectiveness of the internal control.[19]

In some companies the director nominees include new director nominees and incumbent directors. Shareholders in companies with weak internal controls may hope for some changes in the composition of the board, which may help fix the internal control problems. In comparison, shareholders in companies without internal

[19] Another related hypothesis is: shareholders are less dissatisfied with the management (the audit committee, or the board of directors) of the companies with internal control material weaknesses if the companies disclose remediation plans or progress in addressing the reported material weaknesses. However, my data suggests that almost all of the companies disclose their remediation plans or progress in addressing the reported material weaknesses before the annual shareholders' meeting. Therefore, this hypothesis is not testable.

control problems may not strongly desire changes in the board since changes mean uncertainties. Thus, I hypothesize (in the alternative form):

H6: Ceteris paribus, shareholders in firms with internal control problems are more likely to vote for the election of new director nominees as opposed to incumbent director nominees than shareholders in firms without internal control problems.

To establish and maintain effective internal controls or address internal control material weaknesses requires financial expertise. Hence, firms with weak internal controls may have more demand for new financial experts than firms without internal control problems. Actually some companies that disclosed internal control problems have added financial experts to the board (Fargher and Gramling 2005). If shareholders understand this, I hypothesize (in the alternative form):

H7: Ceteris paribus, shareholders in firms with internal control problems are more likely to vote for the election of new director nominees with financial expertise than shareholders in firms without internal control problems.

CHAPTER 4

RESEARCH DESIGN

4.1 Models

I use the following models to test Hypothesis H1:

Hypothesis H1 relating to shareholders' dissatisfaction toward the management:

$$WHMAN = \alpha_0 + \alpha_1 MW + \alpha_2 TERM + \alpha_3 LOGTA + \alpha_4 CEOCHR + \alpha_5 BLKOWN + \alpha_6 INSIDER + \alpha_7 INSTIOWN + \alpha_8 ADROA + \alpha_9 NASR + \alpha_{10} TOTFEE + \alpha_{11} STOCKTURN + \varepsilon \quad (1)$$

Hypothesis H1 relating to shareholders' dissatisfaction toward the audit committee:

$$WHAUC = \beta_0 + \beta_1 MW + \beta_2 TERM + \beta_3 LOGTA + \beta_4 CEOCHR + \beta_5 BLKOWN + \beta_6 INSIDER + \beta_7 INSTIOWN + \beta_8 ADROA + \beta_9 NASR + \beta_{10} TOTFEE + \beta_{11} STOCKTURN + \beta_{12} ACINDEPEN + \beta_{13} ACFINEXP + \varepsilon \quad (2)$$

Hypothesis H1 relating to shareholders' dissatisfaction toward the board of directors:

$$WHALL = \gamma_0 + \gamma_1 MW + \gamma_2 TERM + \gamma_3 LOGTA + \gamma_4 CEOCHR + \gamma_5 BLKOWN + \gamma_6 INSIDER + \gamma_7 INSTIOWN + \gamma_8 ADROA + \gamma_9 NASR + \gamma_{10} TOTFEE + \gamma_{11} STOCKTURN + \gamma_{12} DIRINDEPEN + \varepsilon \quad (3)$$

where ε is the error term. The variable definitions are as follows:

WHMAN	=	Average percent of votes withheld for the election of all incumbent manager director nominees.
WHAUC	=	Average percent of votes withheld for the election of all incumbent audit committee director nominees.
WHALL	=	Average percent of votes withheld for the election of all incumbent director nominees.
MW	=	1 if a company received an adverse opinion on the effectiveness of the internal control (indicating the existence of material weaknesses), and 0 otherwise.
TERM	=	1 if all of the director nominees are elected to serve for the ensuing year, and 0 otherwise.
LOGTA	=	Natural logarithm of total assets (in millions) at the end of the fiscal year.

CEOCHR	=	1 if the CEO also serves as Chairperson of the board, and 0 otherwise.
BLKOWN	=	Percentage of shares held by block-holders (owning 5% or more of the company's stock).
INSIDER	=	Percentage of shares held by insiders including officers, directors, beneficial owners, and principal stockholders owning ten percent or more of the company's stock.
INSTIOWN	=	Percentage of shares held by institutional investors.
ADROA	=	Two-digit SIC industry adjusted return on assets (income before extraordinary items for the fiscal year divided by total assets at the end of the fiscal year)(in percentage).
NASR	=	Ratio of adjusted non-audit fees (tax fees and other fees) to audit fees in the most recent fiscal year.
TOTFEE	=	Total fees paid to independent auditors in the fiscal year (in millions).
STOCKTURN	=	Natural logarithm of total shares traded between a company's record and meeting dates as a proportion of primary shares outstanding at the record date.
ACINDEPEN	=	The proportion of independent incumbent audit committee director nominees.
ACFINEXP	=	The proportion of incumbent audit committee director nominees with financial expertise.
DIRINDEPEN	=	The proportion of independent incumbent nominee directors on the board.

WHMAN, WHAUC and WHALL measure shareholders' dissatisfaction toward management, the audit committee and the board, respectively. A director nominee should be a manager, an audit committee director, or a director on the board in the most recent fiscal year to be included in the calculations of WHMAN, WHAUC or WHALL, respectively. The rationale is that new director nominees[20] are not responsible for what happened in the company before they are appointed as the company's directors. Shareholders either vote for or withhold their votes on director election[21](Sainty et al. 2002). The percent of votes withheld is computed as votes withheld for the election of a director nominee divided by votes cast (the sum of votes for and votes withheld). While the adoption of other proposals needs approval by a

[20] I classify a director nominee as new instead of incumbent if he/she started to serve on the board after the fiscal year end.

[21] There are no "against" votes in director elections because the SEC believes that "against" votes could be confusing to shareholders (Lang 2004).

majority of shares, under most state laws, the election of directors is uncontested and determined by a plurality of the votes cast, as long as a quorum is present (Lang 2004). Although under this plurality voting system, director nominees are usually elected regardless of the number of votes withheld, withholding votes for director nominees is one opportunity for shareholders to express their dissatisfaction (Lang 2004).

I define companies that receive an adverse auditor opinion on the effectiveness of the internal control as companies with internal control problems.[22] Hypothesis H1 predicts a positive coefficient for MW.

Whether incumbent directors are reelected each year depends on the number of years for which they are elected to serve. This varies across companies. Therefore, one limitation of this study is that the percent of votes withheld is not necessarily based on the voting results for the election of all incumbent directors. However, the choice of incumbent director nominees depends on whether their terms have expired and whether they are willing to stand for reelection. Therefore, it is a random process and should not bias the empirical results of this study. Nevertheless, to mitigate this limitation, I include TERM as a control variable.[23] It has been suggested that it is a best practice to elect all directors of the board annually to provide directors with more

[22] Only 17 companies that received a disclaimer auditor opinion on the effectiveness of the internal control meet the data requirement. Also, receiving a disclaimer auditor's attestation opinion does not necessarily indicate the existence of internal control problems. Therefore, I do not include them in the hypothesis tests.

[23] An examination of the data suggests that one-year term and three-year term are most common. Because the terms of directors being reelected are mixed in some companies, I define TERM as a dummy variable instead of a continuous variable.

incentives to act in the best interests of shareholders[24]. Therefore, I expect the coefficient of TERM to be negative.

Larger firms have more resources to hire proxy solicitors to secure votes for the proposals initiated by management. Bethel and Gillan (2002) find that shareholders in larger companies are more likely to favor proposals initiated by managers and oppose proposals initiated by shareholders. Hence, the coefficient of LOGTA, the measure of firm size, is expected to be negative.

The responsibility to oversee the work of management requires the directors of the board, and especially the Chairperson of the board, to be independent. Therefore, CEO duality (CEO also serves as the Chairperson of the board) is against the independence principle (Jensen 1993). Dechow et al. (1996) report that companies with CEO duality are more likely to manage earnings. Raghunandan and Rama (2003) show that companies with CEO duality are more likely to face shareholders' votes against auditor selection. Also, separating the positions of CEO and Chairperson has been regarded as one of the most important steps to improve corporate governance (Imhoff 2003). Therefore, I predict a positive sign for the coefficient of CEOCHR.

Some studies suggest that block-holders are more likely to favor management's decision (e.g., Dann and DeAngelo 1988; Bethel and Gillan 2002), but others show that they pressure managers to change corporate decisions (e.g., Barclay

[24] For example, as one of the steps to promote shareholders' interests, in 2005 Raytheon Company asked shareholders to approve the board's recommendation that the entire board stand for election each year (Raytheon Co/. 2005). Also, at the 2003 annual shareholders' meeting, Evelyn Y. Davis, a shareholder of Merck & Co Inc, initiated a proposal recommending the board to reinstate the annual election of directors in order to ensure "that ALL directors will be more accountable to ALL shareholders each year and to a certain extent prevents the self-perpetuation of the Board" (Merck & Co Inc. 2003). She also states that "The great majority of New York Stock Exchange listed corporations elect all their directors each year." (Merck & Co Inc. 2003). (Currently some companies such as IBM and Verizon elect directors for a term of only one year.)

and Holderness 1991; Bethel et al. 1998). Therefore, I do not predict a sign for the coefficient of BLKOWN.

Insiders are more likely to vote for proposals initiated by management (Bethel and Gillan 2002). Hence, I expect the coefficient of INSIDER to be negative.

Evidence on whether institutional investors vote for proposals initiated by management is also mixed. Historically they have sided with managers. However, recent evidence suggests that they are more likely to act as activists (e.g., Smith 1996; Gillan and Starks 2000; Bethel and Gillan 2002). Therefore, I do not have an expected sign for the coefficient of INSTIOWN.

Poorly performing firms tend to receive proposals on corporate governance issues from shareholders (Karpoff et al. 1996), and are more likely to have shareholders' votes against management's decisions and in favor of shareholder-initiated proposals (Gillan and Starks 2000; Sainty et al. 2002). I use ADROA to proxy for firm performance and the expected sign for its coefficient is negative.[25]

Prior studies show that shareholders' perceptions of auditor independence are affected by the provision of non-audit services (Raghunandan 2003; Krishnan et al. 2005; Francis and Ke 2006). In addition, the magnitude of total fees paid to the auditor has been argued as the more appropriate proxy for the economic dependence of the auditor on its client (Francis 1984; Ashbaugh et al. 2003). The audit committee is delegated with the responsibility of hiring and compensating the auditor (SOX Section 301), and pre-approving all audit and non-audit services provided by the auditor (SEC 2003d). Also, the board is the monitor of the audit committee.

[25] There are some extreme observations with very low return on assets (ROA) in two industries (SIC codes 78 and 79). I winsorized the industry ROA for these two industries at the 5th percentile. After that, there are still some outliers in ADROA, so I winsorized all of the observations at the 1st percentile and 99th percentile.

Therefore, I expect that shareholders are dissatisfied with the directors when the perceived independence of the auditor is compromised.[26] Hence, I expect the coefficients of NASR and TOTFEE to be positive. The SEC requires public companies to disclose auditor fees in four categories: audit fee, audit-related fees, tax fees and other fees for fiscal years ending after December 15, 2003 (SEC 2003d). Audit-related fees, tax fees and other fees are all non-audit fees. However, whether non-audit services are perceived to compromise auditors' independence varies with the types of non-audit services. Mishra et al. (2005) show that shareholders' dissatisfaction toward auditors is positively related to the magnitude of tax fees and other fees, but not related to the magnitude of audit-related fees. Therefore, I do not include audit-related fees in the non-audit fees to construct NASR and define NASR as the ratio of the sum of tax fees and other fees to audit fees.

Unhappy shareholders may sell their shares after a company's record date. However, these shareholders are still allowed to participate in voting. Bethel and Gillan (2002) find that the proportion of shares traded between a company's record and meeting dates is negatively associated with the votes for management-initiated proposals. Thus, I expect the coefficient of STOCKTURN to be positive.[27]

The independence of directors and financial expertise of audit committee directors affect their abilities to monitor management. Dechow et al. (1996) document that firms with lower proportions of independent directors are more likely to manage earnings. Raghunandan and Rama (2003) show that the independence and financial expertise of the audit committee have an impact on shareholders' perception of

[26] For example, CALPERS withheld votes for five Hewlett Packard audit committee members because the directors authorized the auditor Ernst & Young to provide non-audit services for the company (PAR 2004).

[27] There are some outliers in STOCKTURN, so I winsorized all of the observations at the 1st percentile and the 99th percentile.

auditors in firms with high non-audit fee ratios. Krishnan (2005) finds that the incidence of internal control problems is negatively related to the proportion of independent audit committee directors and the number of audit committee directors with financial expertise. DeFond et al. (2005) demonstrate that the market reacts favorably to the appointment of outside audit committee directors with accounting financial expertise. Therefore, I expect the coefficients of ACINDEPEN, ACFINEXP and DIRINDEPEN to be negative.

I use two ways to define the director independence:

(1) Based on Carcello and Neal (2003), Raghunandan and Rama (2003), Krishnan and Ye (2005), SOX Section 301, SEC (2003f)[28] and SEC (2003g)[29], I regard a director as not independent if he or she has familial or economic relationships with the company such as: (a) being an employee, or having a family member who is an employee, of the company, its parent companies or subsidiaries within the last three years; (b) employed, or having a family member who is employed, by the company's internal or external auditor within the last three years; (c) having economic relationships, or having a family member who has economic relationships, with the company within the last three years directly or through an entity, including being suppliers or customers of the company, providing service to the company, etc.; and (d) within the last three years being an executive officer, or having a family member being an executive officer, of another company where any of the company's present executives serve on that company's compensation committee.

[28] SOX Section 301 and SEC (2003f) provide guidelines for public companies on determining the independence of audit committee directors. Public companies, other than foreign private issuers and small business issuers, are required to comply with these rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004, or (2) October 31, 2004.

[29] NYSE and NASDAQ require their public companies that are not foreign private issuers or small business issuers to comply with SEC (2003g) on determining the independence of directors that are elected at the annual meeting after January 15, 2004 or October 31, 2004.

(2) The regulations cited above only provide guidelines as to what disqualifies someone from being an independent director. McLane et al. (2004) suggest that those bright-line guidelines are not a replacement for practical standards in companies and the standards adopted for determining director independence vary with companies.[30] Therefore, I define a director as independent if a company identifies him/her as independent.

How to define the financial expertise of an audit committee director is controversial (DeFond et al. 2005). I use four ways to define the audit committee financial expert:

(1) Following Beasley et al. (1999) and Krishnan and Ye (2005), an audit committee director is a financial expert if he/she 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.

(2) SOX requires a public company to disclose whether it has at least one financial expert serving on its audit committee (SEC 2003e). Therefore, I define an audit committee director as a financial expert if a company discloses him/her as a financial expert.

(3) Following the financial expert definition proposed by SEC (SEC 2002), DeFond et al. (2005) define an *accounting financial expert* as a director with experience as a public accountant, auditor, principal or chief financial officer, controller, or principal or chief accounting officer. Therefore, I define an audit committee director as a financial expert if he/she is an accounting financial expert as defined in DeFond et al. (2005).

[30] I also noticed this phenomenon when collecting the data.

(4) In the final rule, the SEC broadened the definition of audit committee financial expert to include a director with experience of "actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions" or "overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements" (SEC 2003e). Hence, DeFond et al. (2005) define a *nonaccounting financial expert* as a director with experience as the CEO or president of a for-profit company.[31] Therefore, I designate an audit committee director as a financial expert if he/she is an accounting financial expert or nonaccounting financial expert as defined in DeFond et al. (2005)[32].

I use Models (4)-(6) to test Hypotheses H2-H5:[33]

Hypotheses H2-H5 relating to shareholders' dissatisfaction toward the management:

$$WHMAN = \phi_0 + \phi_1 COMMW + \phi_2 REVMW + \phi_3 MWDIS1 + \phi_4 MWDIS2 + \phi_5 LATE + \phi_6 TERM + \phi_7 LOGTA + \phi_8 CEOCHR + \phi_9 BLKOWN + \phi_{10} INSIDER + \phi_{11} INSTIOWN + \phi_{12} ADROA + \phi_{13} NASR + \phi_{14} TOTFEE + \phi_{15} STOCKTURN + \varepsilon \quad (4)$$

Hypotheses H2-H5 relating to shareholders' dissatisfaction toward the audit committee:

[31] They find that the market reacted favorably to the appointment of accounting financial experts assigned to the audit committees, but did not react to the appointment of nonaccounting financial experts assigned to the audit committees.

[32] My data suggests that companies do not always define a financial expert in accordance with the SEC requirements possibly because the application of the SEC final rule requires a good deal of judgment (SEC 2003e; DeFond et al. 2005).

[33] Another way to test Hypotheses H2-H5 is to include the interactions between MW and test variables for Hypotheses H2-H5 in Models (1)-(3). I do not do this because too many interactions may cause multicollinearity problems. Also, Hypotheses H2-H5 do not depend on whether Hypothesis H1 is supported.

$$WHAUC = \lambda_0 + \lambda_1 COMMW + \lambda_2 REVMW + \lambda_3 MWDIS1 + \lambda_4 MWDIS2 + \lambda_5 LATE + \lambda_6 TERM + \lambda_7 LOGTA + \lambda_8 CEOCHR + \lambda_9 BLKOWN + \lambda_{10} INSIDER + \lambda_{11} INSTIOWN + \lambda_{12} ADROA + \lambda_{13} NASR + \lambda_{14} TOTFEE + \lambda_{15} STOCKTURN + \lambda_{16} ACINDEPEN + \lambda_{17} ACFINEXP + \varepsilon \quad (5)$$

Hypotheses H2-H5 relating to shareholders' dissatisfaction toward the board of directors:

$$WHALL = \omega_0 + \omega_1 COMMW + \omega_2 REVMW + \omega_3 MWDIS1 + \omega_4 MWDIS2 + \omega_5 LATE + \omega_6 TERM + \omega_7 LOGTA + \omega_8 CEOCHR + \omega_9 BLKOWN + \omega_{10} INSIDER + \omega_{11} INSTIOWN + \omega_{12} ADROA + \omega_{13} NASR + \omega_{14} TOTFEE + \omega_{15} STOCKTURN + \omega_{16} DIRINDEPEN + \varepsilon \quad (6)$$

where ε is the error term. Definitions for variables not defined before are as follows:

COMMW	=	1 if company-level material weakness(es) exist according to the auditor's report, and 0 otherwise.
REVMW	=	1 if material weakness(es) relating to revenue recognition exist according to the auditor's report, and 0 otherwise.
MWDIS1	=	1 if a company complied with SOX Section 302 by disclosing internal control material weaknesses after August 29, 2002 and before the end of the fiscal year in which the internal control is not effective, and 0 otherwise.
MWDIS2	=	1 if a company disclosed internal control deficiencies after August 29, 2002 and before the end of the fiscal year in which the internal control is not effective, but did not classify them as material weaknesses, and 0 otherwise.
LATE	=	1 if a company files the auditor's attestation report 240 days beyond its fiscal year end, and 0 otherwise.

Hypotheses H2 and H3 predict the coefficients of COMMW and REVMW to be positive. MWDIS1 and MWDIS2 are test variables for Hypothesis H4 and the expected signs for their coefficients are negative. The sample to test Hypotheses H2-H5 consists of companies that received an adverse auditor opinion on the effectiveness of the internal controls. In other words, these companies have internal control material weaknesses. MWDIS1 equal to 1 is a situation where a company had

completely disclosed the internal control problems, while MWDIS2 equal to 1 is a situation where a company had under-evaluated or not completely disclosed the internal control problems before it received the adverse auditor opinion. Therefore, I expect the coefficient for MWDIS1 to be more negative than that for MWDIS2.

Accelerated filers are required to file their 10-K reports with the SEC within 75 days of the fiscal year end. As discussed earlier, the SEC allowed some eligible small accelerated-filers an additional 45 days to comply with Section 404. Therefore, a strict way to define a late filer is to use 120 days as a cut-off. However, the documentation and testing of internal control is very new for many companies and this was the reason that the SEC extended the Section 404 compliance date again and again for public companies. Therefore, shareholders may be relatively tolerable in such a circumstance and deem the filing of the Section 404 reports several months after the deadline as late. As such, I use 240 days after the fiscal year end as the cut off to define LATE. Hypothesis H5 predicts a positive coefficient for LATE. The expected signs of other variables are the same as discussed above.

I use Model (7) to test Hypotheses H6 and H7:

$$R = \pi_0 + \pi_1 MW + \pi_2 \text{FINEXP} + \pi_3 MW * \text{FINEXP} + \pi_4 \text{INDEPEN} + \pi_5 TERM + \pi_6 LOGTA + \pi_7 CEOCHR + \pi_8 BLKOWN + \pi_9 INSIDER + \pi_{10} INSTIOWN + \pi_{11} ADROA + \pi_{12} NASR + \pi_{13} TOTFEE + \pi_{16} STOCKTURN + \varepsilon \quad (7)$$

where ε is the error term. Definitions for variables not defined before are as follows:

R	=	The average percent of votes for the election of all new director nominees divided by the average percent of votes for the election of all incumbent director nominees.
FINEXP	=	The proportion of new director nominees with financial expertise.
INDEPEN	=	The proportion of independent new director nominees on the board.

Hypothesis H6 predicts a positive coefficient for MW. Also, Hypothesis H7 predicts a positive coefficient for MW*FINEXP.[34] The coefficients of FINEXP and INDEPEN are expected to be both positive as their higher value means the higher quality of new director nominees. I expect that bad corporate governance, poor firm performance and low perceived auditor independence lead to shareholders' dissatisfaction toward the incumbent directors, and thus shareholders would favor new director nominees over incumbent director nominees hoping that new directors will bring good changes to the company. Therefore, the coefficients of TERM and ADROA are expected to be negative, while the coefficients of CEOCHR, NASR, TOTFEE and STOCKTURN are expected to be positive. I do not predict the directions for the coefficients of BLKOWN, INSIDER and INSTIOWN since I am not aware of any theories or prior literature on whether block-holders, insiders or institutional investors favor new director nominees or incumbent director nominees. The definitions of all the variables for this dissertation are shown in Table 1.

4.2 Sample

4.2.1 To Test Hypothesis H1

The internal control data set of the *AuditAnalytics* database consists of firms that have filed Section 404 reports with the SEC. My test sample selection started from 859 firms available on the internal control data set of the *Audit Analytics* database on May 10, 2006 that received an adverse or disclaimer opinion on the

[34] A new director can be nominated by managers, gray directors, independent directors, the nominating committee, shareholders or a third-party search firm. Since managers and gray directors are not independent, I expect that shareholders are more likely to vote for directors nominated by independent directors, the nominating committee or shareholders than those nominated by management or gray directors. Although since January 1, 2004, the SEC requires public companies to disclose the categories of persons or entities that recommended the nominees included in the company's proxy card: "security holder, non-management director, chief executive officer, other executive officer, third-party search firm, or other, specified source" (SEC 2003h), only about half of the companies in my sample disclose who recommended the new director nominees. Therefore, I do not include this factor as a control variable.

TABLE 1. Variable Definitions

Variable	Predicted Sign	Definition
Dependent Variables:		
WHMAN	NA	Average percent of votes withheld for the election of all incumbent manager director nominees.
WHAUC	NA	Average percent of votes withheld for the election of all incumbent audit committee director nominees.
WHALL	NA	Average percent of votes withheld for the election of all incumbent director nominees.
R	NA	The average percent of votes for the election of all new director nominees divided by the average percent of votes for the election of all incumbent director nominees.
Independent Variables:		
MW	+	1 if a company received an adverse opinion on the effectiveness of the internal control (indicating the existence of material weaknesses), and 0 otherwise.
TERM	-	1 if all of the director nominees are elected to serve for the ensuing year, and 0 otherwise.
LOGTA	-	Natural logarithm of total assets (in millions) at the end of the fiscal year.
CEOCHR	+	1 if the CEO also serves as Chairperson of the board, and 0 otherwise.
BLKOWN	?	Percentage of shares held by block-holders (owning 5% or more of the company's stock).
INSIDER	-	Percentage of shares held by insiders including officers, directors, beneficial owners, and principal stockholders owning ten percent or more of the company's stock.
INSTIOWN	?	Percentage of shares held by institutional investors.
ADROA	-	Two-digit SIC industry adjusted return on assets (income before extraordinary items for the fiscal year divided by total assets at the end of the fiscal year)(in percentage).
NASR	+	Ratio of adjusted non-audit fees (tax fees and other fees) to audit fees in the most recent fiscal year.
TOTFEE	+	Total fees paid to independent auditors in the fiscal year (in millions).
STOCKTURN	+	Natural logarithm of total shares traded between a company's record and meeting dates as a proportion of primary shares outstanding at the record date.

Table 1. (continued)

Variable	Predicted Sign	Definition
ACINDEPEN	-	The proportion of independent incumbent audit committee director nominees.
ACINDEPEN(1)	-	ACINDEPEN based on the first definition of independence. (see text, page 28).
ACINDEPEN(2)	-	ACINDEPEN based on the second definition of independence. (see text, page 29).
ACFINEXP	- -	The proportion of incumbent audit committee director nominees with financial expertise.
ACFINEXP(1)	-	ACFINEXP based on the first definition of financial expertise. (see text, page 29).
ACFINEXP(2)	-	ACFINEXP based on the second definition of financial expertise. (see text, page 29).
ACFINEXP(3)	-	ACFINEXP based on the third definition of financial expertise. (see text, page 29).
ACFINEXP(4)	-	ACFINEXP based on the fourth definition of financial expertise. (see text, page 30).
DIRINDEPEN	-	The proportion of independent incumbent nominee directors on the board.
DIRINDEPEN(1)	-	DIRINDEPEN based on the first definition of independence. (see text, page 28).
DIRINDEPEN(2)	-	DIRINDEPEN based on the second definition of independence. (see text, page 29).
COMMW	+	1 if company-level material weakness(es) exist according to the auditor's report, and 0 otherwise.
REVMW	+	1 if material weakness(es) relating to revenue recognition exist according to the auditor's report, and 0 otherwise.
MWDIS1	-	1 if a company complied with SOX Section 302 by disclosing internal control material weaknesses after August 29, 2002 and before the end of the fiscal year in which the internal control is not effective, and 0 otherwise.
MWDIS2	-	1 if a company disclosed internal control deficiencies after August 29, 2002 and before the end of the fiscal year in which the internal control is not effective, but did not classify them as material weaknesses, and 0 otherwise.
LATE	+	1 if a company files the auditor's attestation report 240 days beyond its fiscal year end, and 0 otherwise.
FINEXP	+	The proportion of new director nominees with financial expertise.
INDEPEN	+	The proportion of independent new director nominees on the board.

effectiveness of the internal control.[35] I dropped 13 firms that are not on the Compustat database or whose shares are not publicly traded. 63 firms were lost because they do not have proxy statements containing information on director election. Since shareholders cast their votes for director election by the annual shareholders' meeting date, the disclosure relating to the effectiveness of the internal control is useful in this context only when it is available to shareholders by the annual shareholders' meeting date. Hence, I deleted 87 firms which filed their auditor's attestation reports after the annual shareholders' meetings, and whose management did not disclose any internal control material weaknesses in the 10-K filings before the annual shareholders' meeting, or the material weaknesses disclosed were less severe than those identified in the auditor's attestation reports that were filed after the annual shareholders' meetings.[36] I eliminated 274 firms because their voting results on director election were not available by May 10, 2006. 11 firms were excluded because they have more than one class of stocks whose holders have different voting rights and the director nominees are classified and elected by holders of different classes of stocks. The rationale for this is that the voting results for the election of different directors in the same company are not comparable in such circumstances. I lost 15 firms for which data of block-holder ownership, insider ownership or institutional ownership are not available on the Compact Disclosure database. In

[35] To facilitate cross-sectional comparisons, I rely on Section 404 auditor opinion on the effectiveness of the internal control instead of the management's reports under Section 302. The reason is that auditors are more professional and objective since they have AS2 as their evaluation criteria. For example, there is some anecdotal evidence that managers in some companies certified their controls as effective not long before they received an adverse opinion on the effectiveness of their internal controls (Aguilar 2005). Moreover, the report of material weaknesses by the management may not lead to auditor's adverse opinion on the effectiveness of the internal control if management implements changes sufficiently in advance of the "as of" date.

[36] In the final sample only 4 firms filed the auditor's attestation reports after the annual shareholders' meeting and the material weaknesses disclosed in the 10-Ks before the annual shareholders' meeting are similar to those identified in the auditor's attestation reports that were filed after the annual shareholders' meeting.

cases where a company has more than one observation with different auditor's attestation report filing dates, I only kept the observation with the most recent auditor's attestation report filing date before the annual shareholders' meeting and deleted the others. 6 firms were dropped for this reason. I also eliminated 1 firm because it has only new director nominees. Among the firms left after the above screening process, 17 firms received a disclaimer opinion from the auditor. Since this is a small sample size and receiving a disclaimer opinion from the auditor on the effectiveness of the internal control does not necessarily mean that the internal control is not effective, I did not include them in the final sample. This yielded a test sample of 372 firms for testing the hypotheses relating to the board of directors ("board MW sample", hereafter). Among these 372 firms, 260 firms have manager director nominees and thus are kept as the test sample for testing the hypotheses relating to manager directors ("manager MW sample", hereafter). Similarly, 346 firms have audit committee director nominees among the board MW sample and hence are retained as the test sample for testing the hypotheses relating to audit committee directors ("audit committee MW sample", hereafter). The above sample selection procedure is presented in Table 2.

A control firm without any internal control problems was then generated to match each firm in the board MW sample. The initial control firms were obtained from 6089 companies available on the internal control data set of the *AuditAnalytics* database by May 10, 2006, that received an unqualified opinion from the auditor on the effectiveness of the internal control. Companies in the control sample should also meet the following criteria:

(a) availability of financial data on the Compustat or EDGAR database;

(b) availability of ownership data on the Compact Disclosure database;

TABLE 2. Sample Selection

Sample Selection Procedure	
Firms available on the *Audit Analytics* database on May 10, 2006 that received an adverse or disclaimer auditor opinion on the effectiveness of the internal control.	859
Less:	
(1) Firms not on the Compustat database or not publicly traded.	13
(2) Firms without proxy statements containing information on director election.	63
(3) Firms which filed their auditor' attestation report with adverse or disclaimer auditor opinion after the annual shareholders' meeting, and whose management did not disclose any internal control material weaknesses in the 10-K before the annual shareholders' meeting, or the material weaknesses disclosed are less severe than those disclosed in the auditor's attestation report.	87
(4) Firms without voting results on director election by May 10, 2006.	274
(5) Firms having more than one class of stocks whose holders have different voting rights, and the director nominees are classified and elected by holders of different classes of stocks.	11
(6) Firms for which data of block-holder ownership, insider ownership or institutional ownership are not available on the Compact Disclosure database.	15
(7) Repetitive firm observations with the auditor' attestation report filing dates earlier than the most recent one before shareholders' annual meeting.	6
(8) Firms with only new director nominees.	1
(9) Firms with a disclaimer auditor opinion on the effectiveness of the internal control.	17
MW Test Sample for Models (3) and (6) (board of directors)	**372**
MW Test Sample for Models (1) and (4) (Firms with manager director nominees among the 372 firms)	**260**
MW Test Sample for Models (2) and (5) (Firms with audit committee director nominees among the 372 firms)	**346**

(c) availability of the proxy statement for the annual shareholders' meeting containing information about director election;

(d) availability of the 10-K containing an unqualified Section 404 auditor opinion, filed before the annual shareholders' meeting date;

(e) the company disclosed voting results for director election in 10-Q, 10-K or 8-K by May 10, 2006;

(f) the company does not have director nominees that are classified and elected by the holders of different stocks;

(g) the company has not disclosed any control deficiencies, significant deficiencies or material weaknesses from August 2002 to the date of annual shareholders' meeting.[37]

From the firms identified through the above screening process, a random choice for the control firm is made to match each firm in the test sample by the exchange on which the firm is listed and the industry in which it operates. Matching on exchange is necessary because the rules pertaining to directors vary with different stock exchanges (Krishnan 2005; SEC 2003g). In addition, listing requirements for companies with internal control problems differ across the exchanges.[38] Matching on industry is also necessary because the industry distribution of firms with internal control material weaknesses is different from that of firms on the Compustat database (Ge and McVay 2005). Also, investors' perceptions of internal control deficiencies

[37] This requirement is to make the distinctions between the test sample and control sample more obvious, because investors may not be aware of the rules about different levels of internal control deficiencies.

[38] For example, although SEC stated that receiving a disclaimer Section 404 auditor opinion is acceptable, Nasdaq sent out delisting notices to some public companies for getting a disclaimer opinion on the effectiveness of the internal control (Martinek 2005a). However, I am not aware of such actions taken by other stock exchanges.

vary with industries (Beneish et al. 2005). Where possible, industry matching was based on four-digit SIC codes within the same exchange. Three digits or two digits were used if it was not possible to match on four digits. If a control firm was not available for any of these SIC levels, I matched on industry in another exchange. Therefore, for testing Hypothesis H1 relating to shareholders' dissatisfaction toward the board of directors, I have 744 firms ("board sample", hereafter)[39], which consists of 372 test firms (board MW sample) and 372 control firms.

Among the 372 control firms, 252 firms have incumbent manager director nominees and thus are kept as the control sample for testing Hypothesis H1 relating to manager directors. In other words, the sample for testing Hypothesis H1 relating to manager directors ("manager sample", hereafter) includes 260 test firms (manager MW sample) and 252 control firms.[40] Similarly, 349 firms have incumbent audit committee director nominees among the board 372 control firms and hence are kept as control firms for testing Hypothesis H1 relating to audit committee directors. Hence, the sample for testing Hypothesis H1 relating to the audit committee ("audit committee sample", hereafter) consists of 346 test firms (audit committee MW sample) and 349 control firms. [41]

4.2.2 To Test Hypotheses H2-H5

The manager MW sample of 260 firms, audit committee MW sample of 346 firms and the board MW sample of 372 firms yielded through above procedure are

[39] The fiscal year end of the 744 board sample ranges from November 27, 2004 to October 2, 2005.

[40] Among the manager sample, 212 pairs can be matched on at least two-digit SIC industry. Empirical results based on only the 212 pairs are substantially unaltered.

[41] Among the audit committee sample, 323 pairs can be matched on at least two-digit SIC industry. Empirical results based on only the 323 pairs are qualitatively unchanged.

used to test Hypotheses H2-H5 relating to shareholders' dissatisfaction toward the management, the audit committee and the board of directors, respectively.

4.2.3 To Test Hypotheses H6 and H7

Firms whose director nominees include at least one new director nominee from the board MW sample of 372 firms and their 372 control firms are used as the sample to test Hypotheses H6 and H7. The final sample comprises 167 observations, of which 87 firms received an adverse auditor opinion and 80 received an unqualified auditor opinion on the effectiveness of the internal control.

4.3 Sources of Data

The data were collected from various sources. I constructed the dependent variables WHMAN, WHAUC, WHALL and R based on the voting results for the election of each director nominee. I collected the voting results mainly from firms' 10-Q filings and in some cases from the 10-K and 8-K filings. I read the auditor's attestation reports available on the *AuditAnalytics* database or in firms' 10-K filings to identify MW and COMMW. Data relating to TERM and CEOCHR were obtained from the proxy statements. Financial data for constructing LOGTA and ADROA were retrieved from the Compustat database or the EDGAR database. Ownership data for BLKOWN, INSIDER and INSTIOWN were collected from Compact Disclosure database. Auditor fees data, REVMW, and the fiscal year end date and filing date of the auditor's attestation report for calculating LATE were retrieved from the *AuditAnalytics* database. To construct STOCKTURN, I obtained trading volume and shares outstanding from the CRSP database or the *yahoo.com* website, and the record date and annual shareholders' meeting date from the proxy statements.

The independence of the directors was based on the following information in the proxy statements: (a) information included in the proxy statements in sections

with titles such as "board independence" or "director independence". When such sections are not available, I searched the proxy statements for the paragraphs that describe companies' identification of the independence of directors; (b) the reports of the committees for which an incumbent director served in the last fiscal year; (c) the biography of each director nominee; (d) information contained in the proxy statements in sections with titles such as "certain relationship and related transactions". When this section was not found or for other reasons I deemed necessary, I searched the proxy statements for the last name of each director to obtain related information; (e) I also searched under the key word "interlock" for compensation committee interlocking cases. Before deciding the independence of a Chairperson or Vice Chairperson of the board, when necessary, I searched the proxy statements for the last name of the Chairperson or Vice Chairperson to get related disclosure relating to his/her relationships with the company because these relationships can be complicated in some circumstances.

The information about the financial expertise of audit committee directors is obtained from the biographies of the audit committee directors and the related paragraphs containing the word "expert".

To construct MWDIS1 and MWDIS2, I used key words such as "deficiency", "deficiencies", "weakness", and "reportable condition"[42] to search in firms' 10-Ks, 10-Qs, 8-Ks and proxy statements on the Lexis/Nexis database for companies' disclosure about the deficiencies in internal controls between August 29, 2002 and the

[42]In the Pre-SOX period internal control problems were classified as reportable conditions and material weaknesses. PCAOB uses the term "significant deficiency" instead of "reportable condition" as in SAS No. 60 (AICPA 1988b), because the latter was solely a matter of the auditor's judgment and it is not sufficient for purposes of SOX. "...management also needs a definition to determine whether a deficiency is significant, and that definition should be the same as the definition used by the auditor" (PCAOB 2004, E75). However, because AS2 was issued on June 17, 2004, many companies use the term "reportable conditions" in the Section 302 certification from 2002 to early 2004 (Ashbaugh et al. 2005).

fiscal year end. Similarly, to make sure that the control firms have not disclosed any levels of internal control deficiencies between August 29, 2002 and the annual shareholders' meeting, I used the same key words to search in the same filings on the Lexis/Nexis database and Factiva database.

CHAPTER 5

EMPIRICAL RESULTS

5.1 Results for Testing Hypothesis H1 Relating to the Management

Table 3, Panels A and B present the sample composition by year and stock exchange for the manager sample, which includes 260 MW test firms and 252 control firms. Similar to what is reported in Krishnan (2005), the incidence of internal control material weaknesses is mostly concentrated (15%) in the two-digit SIC industry of 73 (business services), followed by 36 (electronic and other electric equipment), 35 (industrial machinery and equipment) and 38 (instruments and related products). While a majority of test firms with internal control problems in Krishnan (2005) are over-the-counter companies, firms with internal control material weaknesses in my sample are mostly likely listed on the Nasdaq Stock Exchange (NASDAQ), followed by the New York Stock Exchange (NYSE). Firms listed on the American Stcok Exchange (AMEX) and over-the-counter companies (OTCBB) account for only 6.54 percent of the MW sample.

Since the manager sample firms come from the board sample firms that have incumbent manager director nominees, the matching is less than perfect. However, I still have 212 pairs that are matched on at least two-digit SIC industry and they account for about 83 percent of the firms.[43]

Table 4 reports descriptive statistics for the manager sample, the manager MW test sample and the manager control sample. WHMAN, the dependent variable, is significantly higher for the MW test sample than for the control sample. LOGTA, INSTIOWN and NASR are significantly lower for the MW test sample than for the

[43] Empirical results based on only the 212 pairs are substantially unaltered.

TABLE 3. Sample Composition—Manager Sample for H1-Model (1)

Panel A: Sample Composition, By Industry

Two-Digit SIC	MW Test Sample		Control Sample	
	Frequency (1)	Percentage (2)	Frequency (3)	Percentage (4)
100-199	1	0.38	1	0.40
1000-1099	3	1.15	4	1.59
1300-1399	8	3.08	4	1.59
1400-1499	1	0.38	3	1.19
1500-1599	1	0.38	1	0.40
1600-1699	2	0.77	0	0.00
1700-1799	1	0.38	1	0.40
2000-2099	1	0.38	1	0.40
2300-2399	3	1.15	3	1.19
2400-2499	2	0.77	2	0.79
2500-2599	1	0.38	1	0.40
2600-2699	0	0.00	1	0.40
2700-2799	1	0.38	2	0.79
2800-2899	13	5.00	11	4.37
3000-3099	2	0.77	3	1.19
3100-3199	1	0.38	1	0.40
3300-3399	3	1.15	2	0.79
3400-3499	4	1.54	1	0.40
3500-3599	17	6.54	16	6.35
3600-3699	26	10.00	31	12.30
3700-3799	2	0.77	3	1.19
3800-3899	16	6.15	9	3.57
3900-3999	1	0.38	2	0.79
4100-4199	0	0.00	2	0.79
4200-4299	2	0.77	3	1.19
4500-4599	2	0.77	1	0.40
4700-4799	1	0.38	0	0.00
4800-4899	11	4.23	11	4.37
4900-4999	9	3.46	8	3.17
5000-5099	6	2.31	5	1.98
5100-5199	2	0.77	2	0.79
5200-5299	1	0.38	1	0.40
5300-5399	3	1.15	2	0.79
5400-5499	0	0.00	2	0.79
5500-5599	3	1.15	3	1.19

TABLE 3. (continued)

Panel A: (continued)

Two-Digit SIC	MW Test Sample		Control Sample	
	Frequency (1)	Percentage (2)	Frequency (3)	Percentage (4)
5600-5699	11	4.23	11	4.37
5700-5799	1	0.38	3	1.19
5800-5899	10	3.85	9	3.57
5900-5999	5	1.92	6	2.38
6000-6099	13	5.00	12	4.76
6100-6199	4	1.54	4	1.59
6200-6299	0	0.00	1	0.40
6300-6399	3	1.15	3	1.19
6400-6499	2	0.77	2	0.79
6500-6599	1	0.38	0	0.00
6700-6799	3	1.15	1	0.40
7200-7299	3	1.15	2	0.79
7300-7399	39	15.00	40	15.87
7500-7599	1	0.38	0	0.00
7800-7899	4	1.54	3	1.19
7900-7999	1	0.38	1	0.40
8000-8099	1	0.38	2	0.79
8200-8299	4	1.54	3	1.19
8300-8399	1	0.38	1	0.40
8700-8799	3	1.15	5	1.98
Total	260	100	252	100

Panel B: Sample Composition, By Exchange

Exchange	MW Test Sample		Control Sample	
	Frequency (1)	Percentage (2)	Frequency (3)	Percentage (4)
AMEX	15	5.77	10	3.97
NYSE	80	30.77	92	36.51
NASDAQ	163	62.69	149	59.12
OTCBB	2	0.77	1	0.40
Total	260	100	252	100

TABLE 4. Descriptive Statistics of Variables—Manager Sample for H1-Model (1)
(n=512: 260 MW=1 firms and 252 MW=0 firms)
(See table 1 for variable definitions)

Variable	Group	Mean	Standard Deviation	25th Percentile	Median	75th Percentile	t-statistic
WHMAN	All	5.45	7.46	1.34	2.75	6.08	
	MW=1	6.07	8.49	1.46	2.84	6.56	1.90*
	MW=0	4.82	6.18	1.23	2.65	5.28	
TERM	All	0.60	0.49	0.00	1.00	1.00	
	MW=1	0.60	0.49	0.00	1.00	1.00	-0.35
	MW=0	0.61	0.49	0.00	1.00	1.00	
LOGTA	All	6.47	1.75	5.27	6.19	7.44	
	MW=1	6.24	1.69	5.07	6.01	7.16	-3.09***
	MW=0	6.71	1.78	5.51	6.34	7.77	
CEOCHR	All	0.52	0.50	0.00	1.00	1.00	
	MW=1	0.52	0.50	0.00	1.00	1.00	0.17
	MW=0	0.51	0.50	0.00	1.00	1.00	
BLKOWN	All	38.74	22.39	21.84	36.84	52.59	
	MW=1	39.61	22.63	21.59	37.66	55.23	0.89
	MW=0	37.84	22.14	22.03	35.66	50.59	
INSIDER	All	10.09	16.27	0.66	3.20	12.94	
	MW=1	9.62	16.11	0.65	3.37	11.13	-0.66
	MW=0	10.57	16.45	0.66	2.95	14.35	
INSTIOWN	All	63.67	27.47	43.41	67.76	86.43	
	MW=1	59.73	28.69	39.38	63.53	83.67	-3.33***
	MW=0	67.73	25.57	50.82	72.17	88.69	
ADROA	All	67.97	70.52	11.94	39.74	122.84	
	MW=1	64.17	69.79	9.64	37.18	120.50	-1.24
	MW=0	71.89	71.19	12.89	43.44	125.56	
NASR	All	0.17	0.26	0.02	0.08	0.22	
	MW=1	0.14	0.24	0.01	0.06	0.17	-2.82***
	MW=0	0.20	0.27	0.03	0.11	0.26	
TOTFEE	All	3.16	6.63	0.77	1.38	2.82	
	MW=1	3.28	7.32	0.82	1.50	2.91	0.42
	MW=0	3.03	5.85	0.68	1.29	2.63	
STOCKTURN	All	-1.56	0.97	-2.09	-1.47	-0.88	
	MW=1	-1.62	1.01	-2.14	-1.51	-0.90	-1.51
	MW=0	-1.49	0.92	-2.03	-1.38	-0.85	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

control sample. Also, it is noteworthy that TERM has a mean of 0.6 in the manager sample, suggesting that about 60 percent of firms allow shareholders to elect all of their directors on the board every year.

Table 5 presents the correlations. WHMAN is positively correlated with MW and TOTFEE*MW, the interaction between TOTFEE and MW, and negatively correlated with TERM and LOGTA, consistent with some of my predictions. The correlation between LOGTA and TOTFEE, and that between TOTFEE*MW and TOTFEE are the only correlations that are above 0.50.

Columns (1) and (2) in Table 6 show the OLS estimates for Model (1). The adjusted R-square is 3.63% and the F-value is significant. The highest VIF among the independent variables is 1.89, suggesting that multicollinearity is not a problem. The coefficient for MW is positive and significant ($p = 0.069$). Therefore, as expected, shareholders are more likely to withhold their votes for the election of manager directors in companies with internal control material weaknesses. The coefficient of TERM is significantly negative ($p < 0.01$). Hence, as I expected, shareholders favor director nominees in companies promoting good corporate governance in director election. The coefficient of LOGTA is significant and negative ($p < 0.01$), consistent with the finding in Bethel and Gillan (2002) that larger firms get more votes for the proposals initiated by the management. The coefficient of INSTIOWN is significant and positive ($p < 0.1$), indicating that institutional investors are generally more critical than other shareholders. The coefficient of TOTFEE is significant and positive ($p < 0.01$), supporting my prediction that shareholders blame the management for the high auditor fees paid to the auditor.

TABLE 5. Pearson Correlations Matrix—Manager Sample for H1-Model (1)
(n=512)
(See table 1 for variable definitions)

	MW	TERM	LOGTA	CEOCHR	BLKOWN	INSIDER	INSTIOWN	ADROA	NASR	TOTFEE	STOCK-TURN	TOTFEE *MW
WHMAN	0.084*	-0.123***	-0.089**	0.021	0.030	0.028	0.050	-0.011	0.010	0.033	0.043	0.108**
MW		-0.015	-0.136***	0.007	0.039	-0.029	-0.146***	-0.055	-0.124***	0.019	-0.067	0.300***
TERM			-0.041	-0.043	0.035	0.065	0.032	0.122***	0.066	0.071	0.042	0.031
LOGTA				0.147***	-0.142***	-0.113**	0.248***	-0.191***	0.056	0.597***	0.105**	0.333***
CEOCHR					-0.052	-0.079*	0.173***	0.087**	-0.001	0.036	0.129***	-0.011
BLKOWN						0.276***	0.190***	0.031	0.009	-0.169***	-0.044	-0.100**
INSIDER							-0.098	-0.016	0.035	-0.069	-0.102**	-0.010
INSTIOWN								0.058	0.033	0.073*	0.407***	0.016
ADROA									0.043	-0.040	0.088**	-0.067
NASR										0.044	0.020	-0.038
TOTFEE											0.030	0.755***
STOCKTURN												0.025

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 6. OLS Regression Results for H1-Model (1)—Based on Manager Sample
(See table 1 for variable definitions)

Variable	Predicted Sign	Without TOTFEE*MW		With TOTFEE*MW	
		Coefficient Estimate (1)	t-statistics (2)	Coefficient Estimate (3)	t-statistics (4)
INTERCEPT	?	10.275	4.90***	10.065	4.8***
MW	+	0.999	1.48*	0.543	0.74
TERM	-	-2.222	-3.29***	-2.172	-3.22***
LOGTA	-	-0.927	-3.65***	-0.858	-3.34***
CEOCHR	+	0.389	0.58	0.433	0.64
BLKOWN	?	0.002	0.13	0.002	0.14
INSIDER	-	0.017	0.81	0.015	0.69
INSTIOWN	?	0.024	1.73*	0.023	1.66*
ADROA	-	-0.004	-0.79	-0.003	-0.68
NASR	+	0.858	0.68	0.970	0.76
TOTFEE	+	0.185	2.95***	0.078	0.82
STOCKTURN	+	0.299	0.80	0.269	0.72
TOTFEE*MW	+			0.156	1.52*
Observations		512		512	
Adj-R Square		3.63%		3.88%	
F-Value		2.75		2.72	
Prob>F		0.0018		0.0014	
Highest VIF		1.89		3.78	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
WHMAN= Average percent of votes withheld for the election of all incumbent manager director nominees.

To test whether MW interacts with other factors that may affect shareholders' voting, I add the interactions of MW and other independent variables as independent variables, and run the regressions. The results indicate that the VIF is higher than the critical value of 10 when all of the interactions are included. Hence, I run the regressions with the interaction of MW and each of other independent variables added as an independent variable at a time. The only interaction with a significant coefficient is TOTFEE*MW. Therefore, I present the OLS estimates of Model (1) with TOTFEE*MW in columns (3) and (4). The adjusted R-square is 3.88% and the F-value is significant. The highest VIF among the independent variables is 3.78. Hence, multicollinearity is not a problem. The coefficients for MW and TOTFEE are not significant any more, but the coefficient of TOTFEE*MW is positive and statistically significant ($p = 0.065$). Therefore, shareholders are more likely to withhold their votes for the election of manager directors in companies with both internal control material weaknesses and high total auditor fees. The results of other variables are similar as those reported in Columns (1) and (2).

5.2 Results for Testing Hypothesis H1 Relating to the Audit Committee

Panels A and B in Table 7 present the sample composition by year and stock exchange for the audit committee sample, which includes 346 MW test firms and 349 control firms. The incidence of internal control material weaknesses is mostly concentrated (16.47%) in the two-digit SIC industry of 73 (business services), followed by 36 (electronic and other electric equipment), 60 (commercial banks and savings institution), 35 (industrial machinery and equipment), 38 (instruments and related products) and 28 (chemical products). As for the exchange distribution, firms from NASDAQ and NYSE account for 63.87 percent and 29.19 percent of the firms with internal control material weaknesses in the MW test sample, respectively.

TABLE 7. Sample Composition—Audit Committee Sample for H1-Model (2)

Panel A: Sample Composition, By Industry

Two-Digit SIC	MW Test Sample		Control Sample	
	Frequency (1)	Percentage (2)	Frequency (3)	Percentage (4)
100-199	1	0.29	1	0.29
1000-1099	3	0.87	4	1.15
1300-1399	8	2.31	8	2.29
1400-1499	2	0.58	2	0.57
1500-1599	1	0.29	1	0.29
1600-1699	2	0.58	2	0.57
1700-1799	1	0.29	0	0
2000-2099	3	0.87	3	0.86
2300-2399	4	1.16	2	0.57
2400-2499	3	0.87	3	0.86
2500-2599	1	0.29	0	0
2600-2699	2	0.58	2	0.57
2700-2799	1	0.29	1	0.29
2800-2899	18	5.2	17	4.87
3000-3099	2	0.58	3	0.86
3100-3199	1	0.29	1	0.29
3200-3299	0	0	1	0.29
3300-3399	3	0.87	4	1.15
3400-3499	4	1.16	4	1.15
3500-3599	19	5.49	20	5.73
3600-3699	36	10.4	38	10.89
3700-3799	3	0.87	3	0.86
3800-3899	19	5.49	21	6.02
3900-3999	2	0.58	1	0.29
4100-4199	1	0.29	2	0.57
4200-4299	2	0.58	3	0.86
4500-4599	2	0.58	2	0.57
4700-4799	1	0.29	1	0.29
4800-4899	17	4.91	18	5.16
4900-4999	12	3.47	13	3.72
5000-5099	8	2.31	7	2.01
5100-5199	3	0.87	2	0.57
5200-5299	1	0.29	1	0.29
5300-5399	3	0.87	3	0.86

TABLE 7. (continued)

Panel A: (continued)

Two-Digit SIC	MW Test Sample		Control Sample	
	Frequency (1)	Percentage (2)	Frequency (3)	Percentage (4)
5400-5499	3	0.87	2	0.57
5500-5599	3	0.87	3	0.86
5600-5699	11	3.18	12	3.44
5700-5799	3	0.87	4	1.15
5800-5899	13	3.76	11	3.15
5900-5999	8	2.31	7	2.01
6000-6099	22	6.36	24	6.88
6100-6199	3	0.87	4	1.15
6200-6299	1	0.29	1	0.29
6300-6399	5	1.45	4	1.15
6400-6499	2	0.58	2	0.57
6500-6599	1	0.29	1	0.29
6700-6799	3	0.87	3	0.86
7200-7299	3	0.87	3	0.86
7300-7399	57	16.47	54	15.47
7500-7599	1	0.29	1	0.29
7800-7899	4	1.16	2	0.57
7900-7999	2	0.58	1	0.29
8000-8099	1	0.29	2	0.57
8100-8199	0	0	1	0.29
8200-8299	5	1.45	5	1.43
8300-8399	1	0.29	1	0.29
8700-8799	5	1.45	7	2.01
Total	346	100	349	100

Panel B: Sample Composition, By Exchange

Exchange	MW Test Sample		Control Sample	
	Frequency (1)	Percentage (2)	Frequency (3)	Percentage (4)
AMEX	21	6.07	17	4.87
NYSE	101	29.19	112	32.09
NASDAQ	221	63.87	217	62.18
OTCBB	3	0.87	3	0.86
Total	346	100	349	100

Since the audit committee sample firms are derived from the board sample firms that have incumbent audit committee director nominees, the matching is less than perfect. However, I still have 323 pairs that are matched on at least two-digit SIC industry and they account for about 93 percent of the sample firms.[44]

Table 8 presents descriptive statistics of the audit committee sample, the MW test sample and the control sample. LOGTA, INSTIOWN and NASR are significantly lower for the MW test sample than for the control sample. ACFINEXP(3), the proportion of incumbent audit committee director nominees with *accounting* financial expertise, is significantly higher for the MW test sample than for the control sample. This should be interpreted with caution because not all of the audit committee directors are included in calculating ACFINEXP in companies with TERM not equal to 1. Interestingly, the mean of ACINDPEN(1) for the sample is 0.94 and the mean of ACINDPEN(2) for the sample is 0.99. Therefore, not all of the audit committee directors are independent although SOX 301 requires each member of the audit committee to be independent. Also, the mean of ACINDPEN(2) is higher than that of ACINDPEN(1), suggesting that the criteria of independence set by companies are less stringent than those I use for the definition of director independence.

Table 9 presents the correlations. WHAUC, the dependent variable, is positively correlated with INSTIOWN, ADROA, NASR, TOTFEE, STOCKTURN, TOTFEE*MW and ACFINEXP(4), the proportion of incumbent audit committee director nominees with financial expertise based on the fourth definition of financial expertise, and negatively correlated with TERM and ACINDEPEN(1), the proportion of independent incumbent audit committee director nominees based on the first

[44] Empirical results based on only the 323 pairs are qualitatively unchanged.

TABLE 8. Descriptive Statistics of Variables—Audit Committee Sample for H1-Model (2)
(n=695: 346 MW=1 firms and 349 MW=0 firms)
(See table 1 for variable definitions)

Variable	Group	Mean	Standard Deviation	25th Percentile	Median	75th Percentile	t-statistic
WHAUC	ALL	5.17	6.65	1.34	2.86	6.31	
	MW=1	5.20	7.10	1.29	2.82	6.37	0.08
	MW=0	5.15	6.17	1.50	2.93	6.22	
TERM	ALL	0.46	0.50	0.00	0.00	1.00	
	MW=1	0.47	0.50	0.00	0.00	1.00	0.49
	MW=0	0.45	0.50	0.00	0.00	1.00	
LOGTA	ALL	6.43	1.71	5.26	6.20	7.33	
	MW=1	6.24	1.70	5.08	6.01	7.20	-2.98***
	MW=0	6.62	1.69	5.49	6.34	7.53	
CEOCHR	ALL	0.51	0.50	0.00	1.00	1.00	
	MW=1	0.52	0.50	0.00	1.00	1.00	0.57
	MW=0	0.50	0.50	0.00	0.00	1.00	
BLKOWN	ALL	37.86	22.09	21.45	36.37	51.75	
	MW=1	38.44	22.10	21.36	37.26	52.57	0.69
	MW=0	37.28	22.09	21.77	34.89	50.57	
INSIDER	ALL	9.51	15.51	0.73	3.06	11.53	
	MW=1	9.29	15.27	0.63	3.18	11.25	-0.37
	MW=0	9.72	15.76	0.77	2.95	11.79	
INSTIOWN	ALL	61.96	28.25	41.69	66.20	86.00	
	MW=1	58.09	29.26	37.42	61.56	83.17	-3.63***
	MW=0	65.79	26.71	48.08	69.90	88.16	
ADROA	ALL	66.33	70.67	10.72	38.41	121.96	
	MW=1	65.44	71.34	9.67	35.94	121.84	-0.33
	MW=0	67.22	70.08	12.09	41.28	122.64	
NASR	ALL	0.17	0.24	0.02	0.09	0.24	
	MW=1	0.14	0.23	0.02	0.07	0.18	-3.24***
	MW=0	0.20	0.24	0.03	0.12	0.29	
TOTFEE	ALL	3.00	6.05	0.73	1.36	2.82	
	MW=1	3.24	6.72	0.82	1.50	2.91	1.04
	MW=0	2.76	5.29	0.63	1.20	2.63	
STOCKTURN	ALL	-1.60	0.97	-2.16	-1.50	-0.94	
	MW=1	-1.62	0.98	-2.15	-1.55	-0.93	-0.56
	MW=0	-1.58	0.96	-2.16	-1.46	-0.95	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 8. (continued)

Variable	Group	Mean	Standard Deviation	25th Percentile	Median	75th Percentile	t-statistic
ACINDEPEN(1)	ALL	0.94	0.20	1.00	1.00	1.00	
	MW=1	0.95	0.20	1.00	1.00	1.00	0.59
	MW=0	0.94	0.20	1.00	1.00	1.00	
ACINDEPEN(2)	ALL	0.99	0.06	1.00	1.00	1.00	
	MW=1	0.99	0.07	1.00	1.00	1.00	-0.80
	MW=0	1.00	0.04	1.00	1.00	1.00	
ACFINEXP(1)	ALL	0.48	0.39	0.00	0.50	1.00	
	MW=1	0.49	0.39	0.00	0.50	1.00	0.56
	MW=0	0.48	0.38	0.00	0.50	1.00	
ACFINEXP(2)	ALL	0.43	0.38	0.00	0.33	0.75	
	MW=1	0.45	0.38	0.00	0.33	1.00	1.33
	MW=0	0.41	0.38	0.00	0.33	0.67	
ACFINEXP(3)	ALL	0.25	0.33	0.00	0.00	0.40	
	MW=1	0.27	0.34	0.00	0.00	0.50	1.72*
	MW=0	0.23	0.32	0.00	0.00	0.33	
ACFINEXP(4)	ALL	0.49	0.39	0.00	0.50	1.00	
	MW=1	0.50	0.38	0.00	0.50	1.00	0.22
	MW=0	0.49	0.40	0.00	0.50	1.00	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 9. Pearson Correlations Matrix—Audit Committee Sample for H1-Model (2)
(n=695)
(See table 1 for variable definitions)

	MW	TERM	LOGTA	CEOCHR	BLKOWN	INSIDER	INSTIOWN	ADROA	NASR	TOTFEE	STOCKTURN
WHAUC	0.003	-0.071*	0.014	0.025	0.020	-0.045	0.117***	0.064*	0.081**	0.083**	0.126***
MW		0.018	-0.112***	0.022	0.026	-0.014	-0.136***	-0.013	-0.122***	0.039	-0.021
TERM			-0.021	-0.050	0.066*	0.079**	0.046	0.114***	0.039	0.075**	0.061
LOGTA				0.165***	-0.159***	-0.134***	0.273***	-0.176***	0.104***	0.587***	0.127***
CEOCHR					-0.045	-0.079**	0.185***	0.055	-0.015	0.069*	0.104***
BLKOWN						0.303***	0.214***	0.057	-0.006	-0.160***	-0.022
INSIDER							-0.111***	0.036	0.005	-0.081**	-0.126***
INSTIOWN								0.062	0.045	0.105***	0.446***
ADROA									0.036	-0.025	0.128***
NASR										0.069*	0.046
TOTFEE											0.078**

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 9. (continued)
(See table 1 for variable definitions)

	TOTFEE *MW	ACINDEPEN(1)	ACINDEPEN(2)	ACFINEXP(1)	ACFINEXP(2)	ACFINEXP(3)	ACFINEXP(4)
WHAUC	0.130***	-0.074**	0.027	-0.008	-0.020	-0.029	0.087**
MW	0.323***	0.022	-0.030	0.021	0.051	0.065*	0.008
TERM	0.034	0.027	-0.009	0.043	0.085**	0.026	0.049
LOGTA	0.339***	0.015	-0.010	0.005	0.128***	-0.036	0.017
CEOCHR	0.022	0.019	0.040	-0.016	0.042	-0.046	0.007
BLKOWN	-0.081**	0.005	-0.048	0.095***	-0.023	0.045	0.060
INSIDER	-0.021	-0.028	-0.072	0.131***	-0.046	0.055	-0.034
INSTIOWN	0.030	0.062*	0.095***	0.031	0.094***	-0.009	0.101***
ADROA	-0.047	0.005	0.043	0.046	0.055	0.041	0.088**
NASR	-0.031	0.081**	0.046	-0.060	0.003	-0.041	0.028
TOTFEE	0.755***	0.055	0.030	-0.042	0.122***	-0.024	0.061
STOCKTURN	0.056	0.082**	0.121***	0.084**	0.081**	0.083**	0.160***
TOTFEE*MW		0.051	0.019	0.011	0.080**	0.027	0.071*
ACINDEPEN(1)			0.305***	0.049	0.048	0.047	0.032
ACINDEPEN(2)				0.038	0.039	0.030	0.062*
ACFINEXP(1)					0.349***	0.574***	0.308***
ACFINEXP(2)						0.431***	0.383***
ACFINEXP(3)							0.587***

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

definition of director independence. The correlation between the two definitions of ACINDEPEN is only 0.305 and the correlations between any two of the four definitions of ACFINEXP are all below 0.6.

Table 10 reports the OLS regression results for Model (2) with ACINDEPEN(1) and ACFINEXP(1). Columns (1) and (2) present the estimates for the model without TOTFEE*MW. The adjusted R-square is 3.91% and the F-value is highly significant. The highest VIF among the independent variables is 1.85, suggesting that multicollinearity is not a problem. The coefficient of TERM is significantly negative ($p < 0.01$). The coefficient of LOGTA, the measure of firm size, is negative and significant ($p < 0.05$). The coefficient of INSTIOWN is significant and positive ($p = 0.056$). The coefficient of NASR, the non-audit fee ratio, is significant and positive ($p < 0.05$). The coefficient of TOTFEE is significantly positive ($p < 0.01$). Therefore, shareholders care about both the non-audit fees and the magnitude of total fees paid to the auditor when they vote for the audit committee director nominees. The coefficient of STOCKTURN is significant and has the expected sign ($p < 0.05$). The coefficient of ACINDEPEN(1) is significant and negative, supporting my expectation that independent audit committee directors get more favorable votes from the shareholders in the director election than affiliated audit committee directors. Surprisingly, the coefficient of ACFINEXP(1) is not significant. Results after replacing ACFINEXP(1) with the other three definitions of ACFINEXP are similar except that the coefficient of ACFINEXP(4) is marginally significant but positive (not tabulated). One possible explanation for the insignificance is that usually a director serves on more than one committee and a director without financial expertise may have other expertise that qualifies him/her for serving on committees other than the audit committee. Columns (3) and (4) show the

TABLE 10. OLS Regression Results for H1-Model (2)—Based on Audit Committee Sample—Models with ACINDEPEN(1) and ACFINEXP(1)
(See table 1 for variable definitions)

Variable	Predicted Sign	Without TOTFEE*MW		With TOTFEE*MW	
		Coefficient Estimate (1)	t-statistics (2)	Coefficient Estimate (3)	t-statistics (4)
INTERCEPT	?	9.826	4.88***	9.707	4.85***
MW	+	0.190	0.37	-0.521	-0.93
TERM	-	-1.300	-2.57***	-1.207	-2.40***
LOGTA	-	-0.400	-2.03**	-0.317	-1.60*
CEOCHR	+	0.015	0.03	0.073	0.14
BLKOWN	?	0.007	0.53	0.006	0.47
INSIDER	-	-0.013	-0.74	-0.016	-0.91
INSTIOWN	?	0.021	1.91*	0.020	1.87*
ADROA	-	0.004	1.03	0.005	1.24
NASR	+	2.448	2.28**	2.666	2.50***
TOTFEE	+	0.149	2.86***	-0.025	-0.33
STOCKTURN	+	0.616	2.11**	0.589	2.03**
ACINDEPEN(1)	-	-3.343	-2.61***	-3.360	-2.64***
ACFINEXP(1)	-	0.032	0.05	-0.080	-0.12
TOTFEE*MW	+			0.257	3.01***
Observations		695		695	
Adj-R Square		3.91%		5.03%	
F-Value		3.17		3.63	
Prob>F		0.0001		<.0001	
Highest VIF		1.85		3.65	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
WHAUC = Average percent of votes withheld for the election of all incumbent audit committee director nominees.

results for the OLS regression with TOTFEE*MW. The adjusted R-square is 5.03% and the F-value is highly significant. The highest VIF among the independent variables is 3.63, much lower than the critical value of 10 for the existence of multicollinearity. The coefficient of TOTFEE*MW is positive and very significant ($p < 0.01$), while the coefficient of TOTFEE itself is not significant. The estimates of coefficients for other variables are similar to those reported in Columns (1) and (2). Therefore, internal control material weakness itself does not cause shareholders' dissatisfaction toward the audit committee, but it leads to shareholder dissatisfaction toward the audit committee when the magnitude of total auditor fees is high.

Table 11 reports the OLS regression results for Model (2) with ACINDEPEN(2) and ACFINEXP(1). ACINDEPEN(2) is based on the independence definitions used by the companies. The results are similar to those presented in Table 10, except that the coefficient of ACINDEPEN(2) is not significant. The difference in the estimates for the coefficients of ACINDEPEN(1) and ACINDEPEN(2) indicates that when voting for the audit committee director nominees, shareholders use more information than companies' classification of director independence to identify the independence of audit committee director nominees.

5.3 Results for Testing Hypothesis H1 Relating to the Board of Directors

Panels A and B in Table 12 present the sample composition by year and stock exchange for the board sample, which includes 372 MW test firms and 372 control firms. The incidence of internal control material weaknesses is mostly concentrated (16.13%) in the two-digit SIC industry of 73 (business services), followed by 36 (electronic and other electric equipment), 60 (commercial banks and savings institution), 35 (industrial machinery and equipment), 28 (chemical products) and 38 (instruments and related products). Firms from NASDAQ and NYSE account for

TABLE 11. OLS Regression Results for H1-Model (2)—Based on Audit Committee Sample—Models with ACINDEPEN(2) and ACFINEXP(1)
(See table 1 for variable definitions)

VARIABLE	Predicted Sign	Without TOTFEE*MW		With TOTFEE*MW	
		Coefficient Estimate (1)	t-statistics (2)	Coefficient Estimate (3)	t-statistics (4)
INTERCEPT	?	7.006	1.48	6.961	1.48
MW	+	0.153	0.30	-0.555	-0.98
TERM	-	-1.318	-2.59***	-1.226	-2.42***
LOGTA	-	-0.379	-1.90**	-0.296	-1.48*
CEOCHR	+	-0.001	0.00	0.057	0.11
BLKOWN	?	0.007	0.51	0.006	0.46
INSIDER	-	-0.012	-0.68	-0.015	-0.84
INSTIOWN	?	0.020	1.82*	0.019	1.78*
ADROA	-	0.004	1.08	0.005	1.29
NASR	+	2.218	2.06**	2.435	2.27**
TOTFEE	+	0.141	2.70***	-0.032	-0.41
STOCKTURN	+	0.580	1.98**	0.554	1.90**
ACINDEPEN(2)	-	-0.348	-0.08	-0.436	-0.10
ACFINEXP(1)	-	-0.057	-0.09	-0.169	-0.26
TOTFEE*MW	+			0.256	2.98***
Observations		695		695	
Adj-R Square		2.95%		6%	
F-Value		2.62		3.10	
Prob>F		0.0014		0.0001	
Highest VIF		1.86		3.65	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
WHAUC = Average percent of votes withheld for the election of all incumbent audit committee director nominees.

TABLE 12. Sample Composition—Board Sample for H1-Model (3)

Panel A: Sample Composition, By Industry

Two-Digit SIC	MW Test Sample		Control Sample	
	Frequency (1)	Percentage (2)	Frequency (3)	Percentage (4)
100-199	1	0.27	1	0.27
1000-1099	4	1.08	4	1.08
1300-1399	9	2.42	9	2.42
1400-1499	2	0.54	2	0.54
1500-1599	1	0.27	1	0.27
1600-1699	2	0.54	2	0.54
1700-1799	1	0.27	1	0.27
2000-2099	3	0.81	3	0.81
2300-2399	4	1.08	3	0.81
2400-2499	3	0.81	3	0.81
2500-2599	1	0.27	1	0.27
2600-2699	2	0.54	2	0.54
2700-2799	1	0.27	1	0.27
2800-2899	19	5.11	19	5.11
3000-3099	3	0.81	3	0.81
3100-3199	1	0.27	1	0.27
3200-3299	0	0.00	1	0.27
3300-3399	4	1.08	4	1.08
3400-3499	4	1.08	4	1.08
3500-3599	21	5.65	21	5.65
3600-3699	40	10.75	40	10.75
3700-3799	4	1.08	4	1.08
3800-3899	19	5.11	19	5.11
3900-3999	2	0.54	2	0.54
4100-4199	1	0.27	1	0.27
4200-4299	2	0.54	3	0.81
4500-4599	2	0.54	2	0.54
4700-4799	1	0.27	1	0.27
4800-4899	18	4.84	18	4.84
4900-4999	13	3.49	13	3.49
5000-5099	8	2.15	8	2.15
5100-5199	3	0.81	3	0.81
5200-5299	1	0.27	1	0.27
5300-5399	3	0.81	3	0.81
5400-5499	3	0.81	2	0.54

TABLE 12. (continued)

Panel A: (continued)

Two-Digit SIC	MW Test Sample		Control Sample	
	Frequency (1)	Percentage (2)	Frequency (3)	Percentage (4)
5500-5599	3	0.81	3	0.81
5600-5699	13	3.49	13	3.49
5700-5799	3	0.81	3	0.81
5800-5899	13	3.49	13	3.49
5900-5999	8	2.15	8	2.15
6000-6099	26	6.99	26	6.99
6100-6199	4	1.08	4	1.08
6200-6299	1	0.27	1	0.27
6300-6399	5	1.34	5	1.34
6400-6499	2	0.54	2	0.54
6500-6599	1	0.27	1	0.27
6700-6799	3	0.81	3	0.81
7200-7299	3	0.81	3	0.81
7300-7399	60	16.13	60	16.13
7500-7599	1	0.27	1	0.27
7800-7899	4	1.08	4	1.08
7900-7999	2	0.54	2	0.54
8000-8099	1	0.27	2	0.54
8200-8299	6	1.61	5	1.34
8300-8399	1	0.27	1	0.27
8700-8799	6	1.61	6	1.61
Total	372	100	372	100

Panel B: Sample Composition, By Exchange

Exchange	MW Test Sample		Control Sample	
	Frequency (1)	Percentage (2)	Frequency (3)	Percentage (4)
AMEX	23	6.18	13	3.49
NYSE	108	29.03	123	33.06
NASDAQ	238	63.98	233	62.63
OTCBB	3	0.81	3	0.81
Total	372	100	372	100

63.98 percent and 29.03 percent of the firms, respectively, with internal control material weaknesses in the board MW sample. I was able to identify control firms for all but 3 test firms based on the at least 2-digit SIC industry matching criteria. Although the matching on exchange is a little less perfect than the matching on industry, the percentage of firms in each stock exchange is not very different among the test firms and control firms.

Table 13 reports descriptive statistics of the board sample, the MW test sample and the control sample. LOGTA, INSTIOWN and NASR are significantly lower for the MW test sample than for the control sample. Also, the mean of DIRINDEPEN(1) is 0.64 and the mean of DIRINDEPEN(2) is 0.69, indicating that on average a majority of directors in my sample are independent. In addition, the mean of DIRINDEPEN(2) is higher than that of DIRINDEPEN(1), suggesting that the criteria of director independence used by companies is less stringent than those I use in defining DIRINDEPEN(2).

Table 14 reports the correlations. WHALL, the dependent variable, is positively correlated with BLKOWN, INSTIOWN, TOTFEE, STOCKTURN and TOTFEE*MW, and negatively correlated with TERM and DIRINDEPEN(1). The correlation between DIRINDEPEN(1) and DIRINDEPEN(2) is 0.844, suggesting that there is some difference between the classification of director independence in these two definitions.

Table 15 presents the OLS regression results for Model (3) with DIRINDEPEN(1). Columns (1) and (2) show the estimates for the model without TOTFEE*MW. The adjusted R-square is 4.95% and the F-value is highly significant. The highest VIF among the independent variables is 1.82. Thus, multicollinearity is not an issue. The coefficients of both TERM and LOGTA are significantly negative

TABLE 13. Descriptive Statistics of Variables—Board Sample for H1-Model (3)
(n=744: 372 MW=1 firms and 372 MW=0 firms)
(See table 1 for variable definitions)

Variable	Group	Mean	Standard Deviation	25th Percentile	Median	75th Percentile	t-statistic
WHALL	ALL	5.86	6.69	1.81	3.59	7.56	
	MW=1	5.88	7.06	1.74	3.54	7.48	0.07
	MW=0	5.85	6.30	1.91	3.62	7.78	
TERM	ALL	0.42	0.49	0.00	0.00	1.00	
	MW=1	0.44	0.50	0.00	0.00	1.00	1.11
	MW=0	0.40	0.49	0.00	0.00	1.00	
LOGTA	ALL	6.43	1.70	5.25	6.21	7.33	
	MW=1	6.25	1.67	5.08	6.02	7.20	-3.02***
	MW=0	6.62	1.70	5.48	6.38	7.61	
CEOCHR	ALL	0.51	0.50	0.00	1.00	1.00	
	MW=1	0.51	0.50	0.00	1.00	1.00	-0.15
	MW=0	0.51	0.50	0.00	1.00	1.00	
BLKOWN	ALL	38.34	22.42	21.75	36.65	52.36	
	MW=1	38.47	22.17	21.41	37.26	52.55	0.17
	MW=0	38.20	22.69	22.29	35.66	51.59	
INSIDER	ALL	9.79	15.57	0.78	3.21	12.01	
	MW=1	9.42	15.43	0.67	3.21	11.15	-0.65
	MW=0	10.16	15.72	0.79	3.20	13.05	
INSTIOWN	ALL	62.19	28.14	41.88	66.55	85.95	
	MW=1	58.47	29.06	37.55	61.91	83.26	-3.64***
	MW=0	65.91	26.71	47.98	70.48	88.41	
ADROA	ALL	67.60	71.43	10.42	39.52	123.00	
	MW=1	65.06	70.78	9.30	36.33	121.29	-0.97
	MW=0	70.14	72.07	12.12	42.41	125.44	
NASR	ALL	0.17	0.24	0.03	0.09	0.24	
	MW=1	0.14	0.23	0.02	0.07	0.18	-3.44***
	MW=0	0.20	0.25	0.04	0.13	0.28	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 13. (continued)
(n=744: 372 MW=1 firms and 372 MW=0 firms)
(See table 1 for variable definitions)

Variable	Group	Mean	Standard Deviation	25th Percentile	Median	75th Percentile	t-statistic
TOTFEE	ALL	2.90	5.85	0.75	1.32	2.72	
	MW=1	3.15	6.51	0.82	1.50	2.90	1.13
	MW=0	2.66	5.11	0.64	1.16	2.47	
STOCKTURN	ALL	-1.60	0.99	-2.17	-1.50	-0.93	
	MW=1	-1.63	0.99	-2.18	-1.54	-0.93	-0.63
	MW=0	-1.58	1.00	-2.15	-1.46	-0.94	
DIRINDEPEN(1)	ALL	0.64	0.25	0.50	0.67	0.83	
	MW=1	0.64	0.25	0.50	0.67	0.83	-0.01
	MW=0	0.64	0.26	0.50	0.67	0.83	
DIRINDEPEN(2)	ALL	0.69	0.23	0.50	0.67	0.86	
	MW=1	0.68	0.23	0.50	0.67	0.83	-1.59
	MW=0	0.71	0.23	0.50	0.71	0.89	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

($p < 0.01$). The coefficient of INSTIOWN is significant and positive ($p < 0.01$). As to the measures of the auditor's dependence on its client, both NASR and TOTFEE have a significant and positive coefficient ($p < 0.05$ and $p < 0.01$, respectively). The coefficient of STOCKTURN is significant and positive ($p = 0.095$). The coefficient of DIRINDEPEN(1) is highly significant and negative ($p < 0.01$), indicating that shareholders favor independent director nominees. Columns (3) and (4) present the results for the model with TOTFEE*MW. The adjusted R-square is 5.63% and the F-value is highly significant. The highest VIF among the independent variables is 4.41, lower than the critical value of 10 for the presence of multicollinearity. The coefficient of TOTFEE*MW is positive and very significant ($p < 0.01$), while the coefficient of TOTFEE itself is not significant. The estimates of other variables are

TABLE 14. Pearson Correlations Matrix—Board Sample for H1-Model (3)
(n=744)
(See table 1 for variable definitions)

	MW	TERM	LOGTA	CEOCHR	BLKOWN	INSIDER	INSTI-OWN	ADROA
WHALL	0.003	-0.083**	-0.037	0.010	0.069*	-0.010	0.119***	0.025
MW		0.041	-0.110***	-0.005	0.006	-0.024	-0.132***	-0.036
TERM			-0.020	-0.037	0.050	0.061*	0.028	0.085**
LOGTA				0.166***	-0.173***	-0.140***	0.259***	-0.185***
CEOCHR					-0.051	-0.090**	0.187***	0.051
BLKOWN						0.302***	0.216***	0.076**
INSIDER							-0.114***	0.032
INSTIOWN								0.056

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 14. (continued)
(n=744)
(See table 1 for variable definitions)

	NASR	TOTFEE	STOCKTURN	TOTFEE *MW	DIRIND-EPEN(1)	DIRIND-EPEN(2)
WHALL	0.052	0.061*	0.089**	0.111***	-0.108***	-0.056
MW	-0.125***	0.041	-0.023	0.324***	0.000	-0.058
TERM	0.025	0.082**	0.051	0.048	-0.021	-0.022
LOGTA	0.099***	0.580***	0.127***	0.330***	0.025	0.045
CEOCHR	-0.002	0.063*	0.114***	0.015	0.078**	0.080**
BLKOWN	-0.009	-0.147***	-0.014	-0.083**	-0.087**	-0.110***
INSIDER	-0.005	-0.083**	-0.128***	-0.025	-0.098***	-0.122***
INSTIOWN	0.038	0.095***	0.463***	0.030	0.070*	0.071*
ADROA	0.030	-0.043	0.111***	-0.050	-0.020	-0.010
NASR		0.059	0.032	-0.034	0.077**	0.053
TOTFEE			0.081**	0.757***	0.048	0.040
STOCKTURN				0.055	0.079**	0.086**
TOTFEE*MW					0.023	0.003
DIRINDEPEN(1)						0.844***

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 15. OLS Regression Results for H1-Model (3)—Based on Board Sample—Models with DIRINDEPEN(1)
(See table 1 for variable definitions)

VARIABLE	Predicted Sign	Without TOTFEE*MW		With TOTFEE*MW	
		Coefficient Estimate (1)	t-statistics (2)	Coefficient Estimate (3)	t-statistics (4)
INTERCEPT	?	10.540	6.23***	10.392	6.17***
MW	+	0.093	0.19	-0.486	-0.89
TERM	-	-1.487	-3.03***	-1.415	-2.88***
LOGTA	-	-0.674	-3.54***	-0.603	-3.14***
CEOCHR	+	0.082	0.17	0.121	0.24
BLKOWN	?	0.011	0.92	0.011	0.92
INSIDER	-	-0.007	-0.4	-0.009	-0.56
INSTIOWN	?	0.029	2.77***	0.029	2.69***
ADROA	-	-0.001	-0.28	-0.001	-0.17
NASR	+	1.877	1.86**	2.031	2.02**
TOTFEE	+	0.181	3.52***	0.035	0.45
STOCKTURN	+	0.365	1.31*	0.351	1.27*
DIRINDEPEN(1)	-	-3.429	-3.59***	-3.389	-3.56***
TOTFEE*MW	+			0.215	2.51***
Observations		744		744	
Adj-R Square		4.95%		5.63%	
F-Value		4.22		4.41	
Prob>F		<.0001		<.0001	
Highest VIF		1.82		3.61	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
WHALL= Average percent of votes withheld for the election of all incumbent director nominees.

similar to those reported in Columns (1) and (2). Therefore, the disclosure of internal control material weakness does not cause shareholders' dissatisfaction toward the board of directors, but triggers shareholders' dissatisfaction toward the board when the magnitude of total auditor fees is high.

Table 16 reports the OLS regression results for Model (3) with DIRINDEPEN(2). The results are similar to those presented in Table 15, except that the coefficient of DIRINDEPEN(2) is less significant than that of DIRINDEPEN(1) as reported in Table 15, suggesting that generally shareholders rely on more stringent standards in determining the independence of director nominees than those adopted by the companies when voting on director election.

5.4 Results for Testing Hypotheses H2-H5 Relating to the Management

Table 17 reports descriptive statistics of the manager MW sample, which is used to estimate Model (4). The mean of COMMW is 0.36, indicating that 36 percent of the firms have company-level material weaknesses in internal control. REVMW has a mean of 0.32, suggesting that 32 percent of the firms have internal control material weaknesses relating to revenue recognition. The mean of MWDIS1 is 0.25 and MWDIS2 has a mean of 0.09. Hence, 25 percent of the firms reported their internal control material weaknesses before the fiscal year end according to the requirement of SOX Section 302, and 9 percent of firms reported their internal control problems before the fiscal year end but only identified them as deficiencies or significant deficiencies. The other 66 percent of firms did not comply with Section 302 by evaluating and reporting the effectiveness of internal control properly and timely. The mean of LATE is 0.02, suggesting that only 2 percent of firms filed their auditor's attestation report 8 months after their fiscal year end.

TABLE 16. OLS Regression Results for H1-Model (3) —Based on Board Sample— Models with DIRINDEPEN(2)
(See table 1 for variable definitions)

VARIABLE	Predicted Sign	Without TOTFEE*MW		With TOTFEE*MW	
		Coefficient Estimate (1)	t-statistics (2)	Coefficient Estimate (3)	t-statistics (4)
INTERCEPT	?	9.668	5.49***	9.532	5.43***
MW	+	0.032	0.06	-0.557	-1.02
TERM	-	-1.464	-2.96***	-1.391	-2.82***
LOGTA	-	-0.647	-3.38***	-0.575	-2.98***
CEOCHR	+	0.029	0.06	0.069	0.14
BLKOWN	?	0.012	0.99	0.012	0.99
INSIDER	-	-0.006	-0.34	-0.008	-0.50
INSTIOWN	?	0.028	2.65***	0.027	2.57***
ADROA	-	-0.001	-0.19	0.000	-0.08
NASR	+	1.679	1.66**	1.838	1.82**
TOTFEE	+	0.175	3.38***	0.026	0.34
STOCKTURN	+	0.350	1.25	0.337	1.21
DIRINDEPEN(2)	-	-2.039	-1.91**	-2.020	-1.90**
TOTFEE*MW	+			0.219	2.54***
Observations		744		744	
Adj-R Square		3.75%		4.46%	
F-Value		3.41		3.67	
Prob>F		<.0001		<.0001	
Highest VIF		1.82		3.61	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
WHALL= Average percent of votes withheld for the election of all incumbent director nominees.

TABLE 17. Descriptive Statistics of Variables—Manager MW Sample for Model (4) (n=260)
(See table 1 for variable definitions)

Variable	Mean	Standard Deviation	25th Percentile	Median	75th Percentile
WHMAN	6.07	8.49	1.46	2.84	6.56
COMMW	0.36	0.48	0.00	0.00	1.00
REVMW	0.32	0.47	0.00	0.00	1.00
MWDIS1	0.25	0.43	0.00	0.00	0.50
MWDIS2	0.09	0.29	0.00	0.00	0.00
LATE	0.02	0.12	0.00	0.00	0.00
TERM	0.60	0.49	0.00	1.00	1.00
LOGTA	6.24	1.69	5.07	6.01	7.16
CEOCHR	0.52	0.50	0.00	1.00	1.00
BLKOWN	39.61	22.63	21.59	37.66	55.23
INSIDER	9.62	16.11	0.65	3.37	11.13
INSTIOWN	59.73	28.69	39.38	63.53	83.67
ADROA	64.05	69.97	9.64	37.18	120.50
NASR	0.14	0.24	0.01	0.06	0.17
TOTFEE	3.28	7.32	0.82	1.50	2.91
STOCKTURN	-1.68	1.44	-2.14	-1.51	-0.90

Table 18 shows the correlations among the dependent variable and independent variables for Model (4). WHMAN, the dependent variable, is positively correlated with LATE and TOTFEE, and negatively correlated with TERM. The only correlation that is above 0.50 is that between TOTFEE and LOGTA.

Table 19 presents the OLS estimates for Model (4). The adjusted R-square is 6.07% and the F-value is significant. The highest VIF among the independent variables is 1.84. Hence, multicollinearity is not a problem. As I expected, the coefficient of MWDIS1 is significantly negative ($p < 0.05$), suggesting that shareholders are less dissatisfied with the managers in companies that comply with the disclosure rule of SOX section 302. The coefficient for MWDIS2 is not significant, suggesting that disclosing the internal control problems before they received the

TABLE 18. Pearson Correlations Matrix—Manager MW Sample for Model (4)
(n=260)
(See table 1 for variable definitions)

	COMMW	REVMW	MWDIS1	MWDIS2	LATE	TERM	LOGTA	CEO-CHR
WHMAN	-0.014	0.051	-0.086	-0.047	0.144**	-0.126**	-0.034	0.073
COMMW		0.291***	0.181***	0.039	0.168***	0.025	-0.119*	0.027
REVMW			0.057	0.035	0.181***	-0.001	-0.048	-0.010
MWDIS1				-0.184***	0.072	-0.014	-0.027	-0.067
MWDIS2					-0.040	-0.062	0.007	-0.039
LATE						-0.088	-0.054	-0.067
TERM							-0.105*	-0.039
LOGTA								0.081

TABLE 18. (continued)
(n=260)
(See table 1 for variable definitions)

	BLKOWN	INSIDER	INSTIOWN	ADROA	NASR	TOTFEE	STOCK-TURN
WHMAN	0.013	0.014	0.089	0.034	0.046	0.107*	0.054
COMMW	-0.010	0.049	-0.067	0.024	-0.007	0.043	-0.055
REVMW	0.058	-0.072	0.031	0.145**	-0.069	0.115*	0.035
MWDIS1	-0.171***	-0.036	-0.146**	0.057	-0.103*	0.147**	0.034
MWDIS2	0.015	-0.027	-0.003	0.006	-0.095	-0.011	-0.002
LATE	0.022	-0.050	0.020	-0.030	-0.048	-0.028	-0.047
TERM	0.052	0.130**	0.050	0.126**	0.005	0.052	0.008
LOGTA	-0.057	0.008	0.280***	-0.214***	0.025	0.569***	0.167***
CEOCHR	-0.039	-0.020	0.116*	0.117*	-0.022	-0.019	0.070
BLKOWN		0.265***	0.216***	0.023	-0.023	-0.163***	-0.018
INSIDER			-0.070	-0.013	0.018	-0.002	-0.051
INSTIOWN				-0.017	-0.019	0.084	0.324***
ADROA					0.055	-0.075	0.056
NASR						-0.001	-0.011
TOTFEE							0.058

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 19. OLS Regression Results for Model (4)—Based on Manager MW Sample
(See table 1 for variable definitions)

Variable	Predicted Sign	Coefficient Estimate	t-statistics
INTERCEPT	?	12.858	4.08***
COMMW	+	-0.817	-0.70
REVMW	+	0.064	0.05
MWDIS1	-	-2.477	-1.93**
MWDIS2	-	-1.748	-0.96
LATE	+	10.198	2.36***
TERM	-	-2.922	-2.69***
LOGTA	-	-1.229	-3.00***
CEOCHR	+	1.292	1.22
BLKOWN	?	-0.002	-0.06
INSIDER	-	0.029	0.85
INSTIOWN	?	0.029	1.41
ADROA	-	0.003	0.37
NASR	+	1.530	0.70
TOTFEE	+	0.313	3.46***
STOCKTURN	+	0.315	0.82
Observations		260	
Adj-R Square		6.07%	
F-Value		2.12	
Prob>F		0.0099	
Highest VIF		1.84	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
WHMAN= Average percent of votes withheld for the election of all incumbent manager director nominees.

adverse auditor's opinion, but not identifying them as material weaknesses does not affect shareholders' voting on the election of manager director nominees. Therefore, as I expected, MWDIS1 has more influence than MWDIS2 on shareholder voting. The coefficient of LATE is significant and positive ($p < 0.01$), consistent with my prediction. The coefficients of TERM and LOGTA are both significant and negative ($p < 0.01$). The coefficient of TOTFEE is significant and positive ($p < 0.01$). The coefficients of other variables are not significant.

5.5 Results for Testing Hypotheses H2-H5 Relating to the Audit Committee

Table 20 reports descriptive statistics of the audit committee MW sample, which is used to estimate Model (5). Interestingly, the mean of WHAUC is 5.2, lower than that of WHMAN (6.07) as reported in Table 17. Hence, on average audit committee director nominees have more favorable votes than manager director nominees.

Table 21 presents the correlations among the dependent variable and independent variables for Model (5). WHAUC, the dependent variable, is positively correlated with INSTIOWN and TOTFEE, and negatively correlated with MWDIS2. Disregarding the correlations among the four definitions of ACFINEXP, the only correlation that is above 0.50 is that between TOTFEE and LOGTA.

Table 22 reports the OLS estimates for Model (5). Columns (1) and (2) show the OLS estimates for the model with ACINDEPEN(1). The adjusted R-square is 3.93% and the F-value is significant. The highest VIF among the independent variables is 1.86, indicating that multicollinearity is not an issue here. The coefficient of COMMW is significant but has the unexpected sign ($p = 0.059$). One explanation for this is that companies with company-level internal control material weaknesses are more likely to have managers with less integrity and such managers may be more

TABLE 20. Descriptive Statistics of Variables—Audit Committee MW Sample for Model (5)
(n=346)
(See table 1 for variable definitions)

Variable	Mean	Standard Deviation	25th Percentile	Median	75th Percentile
WHAUC	5.20	7.10	1.29	2.82	6.37
COMMW	0.35	0.48	0	0	1
REVMW	0.30	0.46	0	0	1
MWDIS1	0.24	0.43	0	0	0
MWDIS2	0.11	0.32	0	0	0
LATE	0.01	0.09	0	0	0
TERM	0.47	0.50	0	0	1
LOGTA	6.24	1.70	5.08	6.01	7.2
CEOCHR	0.52	0.50	0	1	1
BLKOWN	38.44	22.10	21.36	37.26	52.57
INSIDER	9.29	15.27	0.63	3.18	11.25
INSTIOWN	58.09	29.26	37.42	61.56	83.17
ADROA	65.34	71.50	9.67	35.94	121.84
NASR	0.14	0.23	0.02	0.07	0.18
TOTFEE	3.24	6.72	0.82	1.5	2.91
STOCKTURN	-1.67	1.32	-2.15	-1.55	-0.93
ACINDEPEN(1)	0.95	0.20	1	1	1
ACINDEPEN(2)	0.99	0.07	1	1	1
ACFINEXP(1)	0.49	0.39	0	0.5	1
ACFINEXP(2)	0.45	0.38	0	0.33	1
ACFINEXP(3)	0.27	0.34	0	0	0.5
ACFINEXP(4)	0.50	0.38	0	0.5	1

TABLE 21. Pearson Correlations Matrix—Audit Committee MW Sample for Model (5)
(n=346)
(See table 1 for variable definitions)

	COMMW	REVMW	MWDIS1	MWDIS2	LATE	TERM	LOGTA	CEOCHR
WHAUC	-0.071	0.031	0.009	-0.094*	0.028	-0.064	0.081	0.019
COMMW		0.251***	0.140***	0.086	0.128**	0.030	-0.110**	0.023
REVMW			0.055	0.065	0.143***	0.025	-0.058	0.002
MWDIS1				-0.202***	0.020	-0.008	0.002	-0.033
MWDIS2					-0.033	-0.062	0.013	-0.076
LATE						-0.026	-0.031	-0.034
TERM							-0.087	-0.073
LOGTA								0.120**

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 21. (continued)
(n=346)
(See table 1 for variable definitions)

	BLKOWN	INSIDER	INSTIOWN	ADROA	NASR	TOTFEE	STOCKTURN
WHAUC	-0.018	-0.086	0.118**	0.031	0.078	0.180***	0.077
COMMW	-0.031	0.024	-0.102*	0.084	0.034	0.074	-0.037
REVMW	-0.006	-0.023	-0.004	0.204***	-0.058	0.117**	0.053
MWDIS1	-0.107**	-0.014	-0.043	0.043	-0.057	0.163***	0.021
MWDIS2	-0.014	-0.016	-0.076	0.062	-0.080	0.027	0.025
LATE	0.024	-0.044	0.014	-0.040	-0.035	-0.023	-0.044
TERM	0.084	0.098*	0.052	0.069	-0.017	0.042	-0.004
LOGTA	-0.031	-0.030	0.311***	-0.208***	0.048	0.565***	0.156***
CEOCHR	-0.051	-0.043	0.176***	0.092*	-0.028	0.023	0.085
BLKOWN		0.247***	0.277***	0.017	-0.019	-0.135**	-0.001
INSIDER			-0.047	0.009	0.004	-0.025	-0.054
INSTIOWN				-0.032	-0.032	0.107**	0.323***
ADROA					0.044	-0.062	0.060
NASR						0.012	0.005
TOTFEE							0.082

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 21. (continued)
(n=346)
(See table 1 for variable definitions)

	ACINDE-PEN(1)	ACINDE-PEN(2)	ACFIN-EXP(1)	ACFIN-EXP(2)	ACFIN-EXP(3)	ACFIN-EXP(4)
WHAUC	0.014	0.033	-0.044	-0.013	-0.006	0.083
COMMW	-0.078	-0.071	-0.038	-0.106**	-0.061	-0.006
REVMW	0.009	0.069	0.111**	0.042	0.137**	0.182***
MWDIS1	-0.016	0.036	-0.067	-0.013	-0.041	-0.019
MWDIS2	0.015	0.038	0.008	0.141***	0.101*	0.069
LATE	0.026	0.010	0.082	0.012	0.064	0.042
TERM	0.043	0.009	0.040	0.019	-0.003	0.010
LOGTA	0.036	-0.020	0.104*	0.151***	0.049	0.100*
CEOCHR	-0.007	0.008	0.023	0.087	-0.027	0.016
BLKOWN	-0.007	-0.080	-0.004	-0.028	0.017	0.061
INSIDER	-0.037	-0.132**	0.100*	-0.049	0.049	-0.046
INSTIOWN	0.051	0.137**	0.029	0.108**	0.022	0.104*
ADROA	0.025	0.049	0.037	-0.001	0.048	0.032
NASR	0.063	0.041	-0.055	-0.012	-0.035	0.007
TOTFEE	0.065	0.035	0.007	0.096*	0.008	0.105**
STOCKTURN	0.118**	0.165***	0.071	0.050	0.130	0.112**
ACINDEPEN(1)		0.402***	0.002	0.013	0.025	-0.011
ACINDEPEN(2)			0.092*	0.088	0.067	0.092*
ACFINEXP(1)				0.364***	0.610***	0.384***
ACFINEXP(2)					0.482***	0.441***
ACFINEXP(3)						0.611***

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 22. OLS Regression Results for Model (5)—Based on Audit Committee MW Sample
(See table 1 for variable definitions)

VARIABLE	Predicted Sign	With ACINDEPEN(1)		With ACINDEPEN(2)	
		Coefficient Estimate (1)	t-statistics (2)	Coefficient Estimate (3)	t-statistics (4)
INTERCEPT	?	7.874	2.67***	8.237	1.37
COMMW	+	-1.331	-1.57*	-1.318	-1.55*
REVMW	+	0.335	0.38	0.342	0.39
MWDIS1	-	-0.634	-0.68	-0.621	-0.67
MWDIS2	-	-2.161	-1.73**	-2.156	-1.73**
LATE	+	3.080	0.74	3.015	0.73
TERM	-	-1.196	-1.55*	-1.207	-1.56*
LOGTA	-	-0.393	-1.30*	-0.397	-1.31*
CEOCHR	+	-0.165	-0.21	-0.164	-0.21
BLKOWN	?	-0.001	-0.06	-0.001	-0.08
INSIDER	-	-0.029	-1.12	-0.029	-1.13
INSTIOWN	?	0.024	1.60	0.025	1.61
ADROA	-	0.005	0.82	0.005	0.81
NASR	+	2.292	1.38*	2.273	1.36*
TOTFEE	+	0.252	3.49***	0.251	3.48***
STOCKTURN	+	0.213	0.69	0.208	0.67
ACINDEPEN(1)	-	-0.710	-0.36		
ACINDEPEN(2)	-			-1.041	-0.19
ACFINEXP(1)	-	-0.745	-0.74	-0.723	-0.72
Observations		346		346	
Adj-R Square		3.93%		3.90%	
F-Value		1.83		1.82	
Prob>F		0.0237		0.0243	
Highest VIF		1.86		1.89	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
WHAUC = Average percent of votes withheld for the election of all incumbent audit committee director nominees.

likely to hire proxy solicitors to secure votes for the director election. Contrary to my expectation, the coefficient of MWDIS1 is not significant, but the coefficient of MWDIS2 is significant and negative ($p < 0.05$). The coefficients of TERM and LOGTA are both significant and negative ($p = 0.061$ and $p = 0.097$, respectively). Also, the coefficient for NASR is significantly positive ($p = 0.085$) and the coefficient of TOTFEE is positive and highly significant ($p < 0.01$). Surprisingly, the coefficients of ACINDEPEN(1) and ACFINEXP(1), the measures of the independence and expertise of the audit committee director nominees, are both insignificant. Columns (3) and (4) report the OLS estimates for the model with ACINDEPEN (2). The results are qualitatively similar to those reported in Columns (1) and (2).

5.6 Results for Testing Hypotheses H2-H5 Relating to the Board of Directors

Table 23 reports descriptive statistics for the board MW sample, which is used to estimate Model (6). The mean of COMMW is 0.35, indicating that 35 percent of the firms have company-level material weaknesses in internal control. REVMW has a mean of 0.30, suggesting that 30 percent of the firms have internal control material weaknesses relating to revenue recognition. The mean of MWDIS1 is 0.24 and MWDIS2 has a mean of 0.10. Hence, 34 percent of the firms reported their internal control problems before they received the adverse auditor's attestation opinion. The mean of LATE is 0.01, suggesting that only about 1 percent of board MW sample firms filed their auditor's attestation reports 8 months after their fiscal year end.

Table 24 shows the correlations among the dependent variable and independent variables for Model (6). The dependent variable, WHALL, is positively correlated with LATE, INSTIOWN and TOTFEE, and negatively correlated with DIRINDEPEN(1).

TABLE 23. Descriptive Statistics of Variables—Board MW Sample for Model (6)
(n=372)
(See table 1 for variable definitions)

Variable	Mean	Standard Deviation	25th Percentile	Median	75th Percentile
WHALL	5.88	7.06	1.74	3.54	7.48
COMMW	0.35	0.48	0.00	0.00	1.00
REVMW	0.30	0.46	0.00	0.00	1.00
MWDIS1	0.24	0.43	0.00	0.00	0.00
MWDIS2	0.10	0.31	0.00	0.00	0.00
LATE	0.01	0.10	0.00	0.00	0.00
TERM	0.44	0.50	0.00	0.00	1.00
LOGTA	6.25	1.67	5.08	6.02	7.20
CEOCHR	0.51	0.50	0.00	1.00	1.00
BLKOWN	38.47	22.17	21.41	37.26	52.55
INSIDER	9.42	15.43	0.67	3.21	11.15
INSTIOWN	58.47	29.06	37.55	61.91	83.26
ADROA	64.98	70.93	9.30	36.33	121.29
NASR	0.14	0.23	0.02	0.07	0.18
TOTFEE	3.15	6.51	0.82	1.50	2.90
STOCKTURN	-1.67	1.30	-2.18	-1.54	-0.93
DIRINDEPEN(1)	0.64	0.25	0.50	0.67	0.83
DIRINDEPENC(2)	0.68	0.23	0.50	0.67	0.83

TABLE 24. Pearson Correlations Matrix—Board MW Sample for Model (6)
(n=372)
(See table 1 for variable definitions)

	COMMW	REVMW	MWDIS1	MWDIS2	LATE	TERM	LOGTA	CEOCHR	BLKOWN
WHALL	-0.043	0.019	-0.018	-0.067	0.101**	-0.056	0.041	0.020	0.017
COMMW		0.240***	0.154***	0.078	0.141***	0.014	-0.108**	0.005	-0.019
REVMW			0.071	0.062	0.159***	0.019	-0.087*	-0.011	0.021
MWDIS1				-0.192***	0.064	-0.003	0.000	-0.041	-0.104**
MWDIS2					-0.036	-0.039	0.011	-0.067	-0.014
LATE						-0.040	-0.046	-0.054	0.024
TERM							-0.091*	-0.058	0.070
LOGTA								0.122**	-0.054
CEOCHR									-0.045

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 24. (continued)
(n=372)
(See table 1 for variable definitions)

	INSIDER	INSTIOWN	ADROA	NASR	TOTFEE	STOCK - TURN	DIRIN-DEPEN(1)	DIRIN-DEPEN(1)
WHALL	-0.035	0.128**	0.008	0.040	0.156***	0.071	-0.090*	-0.066
COMMW	0.025	-0.091*	0.092*	0.028	0.071	-0.035	-0.127**	-0.134**
REVMW	-0.041	0.000	0.218***	-0.055	0.112**	0.040	-0.036	-0.030
MWDIS1	-0.012	-0.063	0.050	-0.050	0.159***	0.018	-0.037	-0.035
MWDIS2	-0.018	-0.078	0.062	-0.080	0.031	0.025	0.048	0.022
LATE	-0.042	0.021	-0.026	-0.046	-0.024	-0.045	-0.130**	-0.125**
TERM	0.081	0.028	0.071	-0.024	0.051	-0.003	-0.008	-0.015
LOGTA	-0.029	0.298***	-0.215***	0.056	0.555***	0.162***	0.021	0.020
CEOCHR	-0.045	0.186***	0.076	-0.039	0.024	0.097*	0.102**	0.111**
BLKOWN	0.269***	0.273***	0.035	-0.025	-0.129**	-0.015	-0.110**	-0.145***
INSIDER		-0.053	0.015	-0.003	-0.026	-0.061	-0.110**	-0.138***
INSTIOWN			-0.030	-0.033	0.105**	0.331***	0.054	0.049
ADROA				0.041	-0.058	0.052	0.030	0.032
NASR					0.010	0.008	0.043	0.029
TOTFEE						0.083	0.034	0.033
STOCKTURN							0.100	0.092**
DIRINDEPEN(1)								0.885***

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

Table 25 presents the OLS estimates for Model (6). Columns (1) and (2) have the results for the model with DIRINDEPEN(1). The adjusted R-square is 4.7% and the F-value is significant. The highest VIF among the independent variables is 2.14, indicating that multicollinearity is not a problem. The coefficient of COMMW is significant but negative ($p = 0.082$), consistent with what is reported in Table 22 for the audit committee MW sample. The coefficient of LATE is significant and positive ($p < 0.05$). The coefficients of TERM and LOGTA are both significantly negative ($p = 0.057$ and $p < 0.05$, respectively). The coefficients of INSTIOWN and TOTFEE are both significant and positive ($p < 0.05$ and $p < 0.01$, respectively). The coefficient of DIRINDEPEN (1) is significantly negative. Columns (3) and (4) show the OLS estimates for the model with DIRINDEPEN(2). The results are not substantially different from those reported in Columns (1) and (2).

5.7 Results for Testing Hypotheses H6-H7

Table 26 reports descriptive statistics of the whole sample, the MW test sample and the control sample with new director nominees, which are used to estimate Model (7).[45] R has a mean of 1.03, suggesting that on average new director nominees get 3 percent more favorable votes more than incumbent director nominees. INSTIOWN is significantly lower for the MW firms than for the control firms.

Table 27 presents the correlations. R, the dependent variable, is positively correlated with INSTIOWN and NASR. The only correlations that are above 0.50 are those between MW*FINEXP and its two separate variables (MW and FINEXP), and that between TOTFEE and LOGTA.

[45] FINEXP and INDEPEN are based on the first definition of financial expertise and first definition of independence, respectively. Results using FINEXP and INDEPEN based on other definitions are qualitatively similar.

TABLE 25. OLS Regression Results for Model (6)—Based on Board MW Sample
(See table 1 for variable definitions)

VARIABLE	Predicted Sign	With DIRINDEPEN(1)		With DIRINDEPEN(2)	
		Coefficient Estimate (1)	t-statistics (2)	Coefficient Estimate (3)	t-statistics (4)
INTERCEPT	?	10.742	4.46***	10.584	4.22***
COMMW	+	-1.121	-1.39*	-1.087	-1.35*
REVMW	+	-0.283	-0.34	-0.268	-0.32
MWDIS1	-	-0.984	-1.10	-0.990	-1.11
MWDIS2	-	-1.400	-1.14	-1.490	-1.21
LATE	+	6.819	1.90**	6.997	1.94**
TERM	-	-1.167	-1.58*	-1.172	-1.59*
LOGTA	-	-0.652	-2.26**	-0.643	-2.23**
CEOCHR	+	0.144	0.19	0.120	0.16
BLKOWN	?	0.000	-0.01	0.000	-0.02
INSIDER	-	-0.011	-0.46	-0.011	-0.46
INSTIOWN	?	0.030	2.01**	0.029	1.99**
ADROA	-	0.002	0.33	0.002	0.33
NASR	+	1.574	0.97	1.493	0.92
TOTFEE	+	0.275	3.92***	0.273	3.88***
STOCKTURN	+	0.257	0.86	0.244	0.82
DIRINDEPEN(1)	-	-3.059	-2.10**		
DIRINDEPEN(2)	-			-2.681	-1.64**
Observations		372		372	
Adj-R Square		4.7%		4.25%	
F-Value		2.14		2.03	
Prob>F		0.0066		0.011	
Highest VIF		1.80		1.80	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
WHALL= Average percent of votes withheld for the election of all incumbent director nominees.

TABLE 26. Descriptive Statistics of Variables—Sample for Model (7)
(n=167: 87 MW=1 firms and 80 MW=0 firms)
(See table 1 for variable definitions)

Variable	Group	Mean	Standard Deviation	25th Percentile	Median	75th Percentile	t-statistic
R	ALL	1.03	0.08	1.00	1.01	1.04	
	MW=1	1.02	0.09	1.00	1.01	1.04	-0.38
	MW=0	1.03	0.05	1.00	1.01	1.03	
FINEXP	ALL	0.36	0.44	0.00	0.00	1.00	
	MW=1	0.36	0.42	0.00	0.00	1.00	-0.18
	MW=0	0.37	0.47	0.00	0.00	1.00	
INDEPEN	ALL	0.76	0.41	0.67	1.00	1.00	
	MW=1	0.76	0.40	0.50	1.00	1.00	-0.22
	MW=0	0.77	0.42	1.00	1.00	1.00	
TERM	ALL	0.53	0.50	0.00	1.00	1.00	
	MW=1	0.54	0.50	0.00	1.00	1.00	0.36
	MW=0	0.51	0.50	0.00	1.00	1.00	
LOGTA	ALL	6.76	1.84	5.52	6.63	7.79	
	MW=1	6.59	1.82	5.37	6.57	7.32	-1.26
	MW=0	6.95	1.86	5.69	6.80	8.30	
CEOCHR	ALL	0.44	0.50	0.00	0.00	1.00	
	MW=1	0.41	0.50	0.00	0.00	1.00	-0.79
	MW=0	0.48	0.50	0.00	0.00	1.00	
BLKOWN	ALL	39.79	24.49	20.95	34.21	56.44	
	MW=1	39.80	24.69	18.23	37.97	54.92	0.01
	MW=0	39.78	24.43	22.07	32.07	56.72	
INSIDER	ALL	10.34	17.07	0.78	2.76	13.01	
	MW=1	11.12	18.83	0.46	2.76	13.70	0.62
	MW=0	9.48	15.01	0.81	2.75	12.49	
INSTIOWN	ALL	60.68	29.26	36.75	63.70	86.59	
	MW=1	57.11	30.76	30.26	61.53	85.08	-1.65*
	MW=0	64.57	27.20	44.85	72.02	87.78	
ADROA	ALL	62.49	67.37	9.43	35.17	115.00	
	MW=1	60.08	66.77	6.68	32.97	119.66	-0.48
	MW=0	65.11	68.35	11.81	38.26	113.14	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 26 (continued)
(n=167: 87 MW=1 firms and 80 MW=0 firms)
(See table 1 for variable definitions)

Variable	Group	Mean	Standard Deviation	25th Percentile	Median	75th Percentile	t-statistic
NASR	ALL	0.18	0.21	0.03	0.11	0.27	
	MW=1	0.15	0.19	0.03	0.07	0.22	-1.59
	MW=0	0.21	0.23	0.04	0.13	0.3	
TOTFEE	ALL	3.95	8.95	0.77	1.55	3.26	
	MW=1	4.53	10.77	0.82	1.54	3.05	0.88
	MW=0	3.31	6.44	0.65	1.57	3.47	
STOCKTURN	ALL	-1.76	1.53	-2.31	-1.55	-0.98	
	MW=1	-1.83	1.92	-2.32	-1.57	-0.92	-0.58
	MW=0	-1.69	0.96	-2.28	-1.53	-1.09	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 27. Pearson Correlations Matrix—Sample for Model (7)
(n=167)
(See table 1 for variable definitions)

	MW	FINEXP	MW* FINEXP	INDEPEN	TERM	LOGTA	CEOCHR	BLKOWN
R	-0.030	-0.017	-0.028	0.014	0.038	0.035	-0.003	-0.055
MW		-0.014	0.505***	-0.017	0.028	-0.098	-0.062	0.000
FINEXP			0.585***	0.004	0.071	-0.115	-0.106	-0.026
MW*FINEXP				0.003	0.023	-0.088	-0.097	0.062
INDEPEN					-0.047	0.094	0.191***	-0.084
TERM						-0.073	-0.217***	0.135*
LOGTA							0.167**	-0.210***
CEOCHR								-0.167**

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

TABLE 27. (continued)
(n=167)
(See table 1 for variable definitions)

	BLKOWN	INSIDER	INSTI-OWN	ADROA	NASR	TOTFEE	STOCK-TURN
R	-0.055	-0.002	0.132*	-0.043	0.301***	0.068	0.088
MW	0.000	0.048	-0.128*	-0.037	-0.123	0.068	-0.045
FINEXP	-0.026	0.053	-0.040	0.066	0.030	-0.074	0.075
MWFINEXP	0.062	-0.001	-0.021	-0.010	-0.050	0.020	0.062
INDEPEN	-0.084	-0.140**	0.141*	-0.073	-0.032	0.121	0.078
TERM	0.135*	0.117	-0.121	0.085	-0.038	0.113	-0.048
LOGTA	-0.210***	-0.071	0.272***	-0.142*	0.198***	0.627***	0.224***
CEOCHR	-0.167**	-0.126	0.201***	0.004	0.002	0.023	0.046
BLKOWN		0.287***	0.215***	0.125	-0.017	-0.191***	0.008
INSIDER			-0.124	0.114	0.069	0.012	-0.039
INSTIOWN				0.053	0.074	0.053	0.358***
ADROA					0.057	-0.050	0.072
NASR						0.065	0.106
TOTFEE							0.058

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels respectively, two-tailed.

Table 28 reports the OLS regression results for Model (7). The adjusted R-square is 5.93% and the F-value is significant ($p < 0.1$). The highest VIF among the independent variables is 2.67, suggesting that multicollinearity is not a problem. Neither MW nor MW*FINEXP are significant. Hence, I cannot find evidence to support Hypotheses H6 and H7. This can be because the sample size is small or I cannot control for factors such as who recommend the new director nominees to the board. The coefficient of LOGTA is significant and negative ($p = 0.08$). The coefficient of INSTIOWN is positively significant ($p < 0.05$), suggesting that institutional investors prefer changes in the composition of the board. The coefficient of NASR is positive and highly significant ($p < 0.01$). Therefore, firms with higher non-audit fees are more likely to favor new director nominees over incumbent director nominees.

5.8 Additional Tests

The results after winsorizing the dependent variables at the 1st percentile and the 99th percentile are not substantially different from those reported earlier. Also, instead of using votes withheld divided by votes cast to construct the dependent variables, I used votes withheld divided by the difference between votes cast and votes insiders are entitled to [46] to calculate the percent of votes withheld and reran the regressions. The major inferences are similar. It is noteworthy that this way of constructing the dependent variables has more noise than the way I reported earlier. While insiders are more likely to vote for proposals initiated by the management than other investors, it is not necessarily true that all of the insiders vote for all of the director nominees. In addition, I used the sum of votes withheld and non-vote shares

[46] Votes entitled to insiders are equal to votes entitled to be cast for director election multiplied by insider ownership.

TABLE 28. OLS Regression Results for Model (7)
(See table 1 for variable definitions)

VARIABLE	Predicted Sign	Coefficient Estimate	t-statistics
INTERCEPT	?	1.050	26.20***
MW	+	0.001	0.05
FINEXP	+	-0.006	-0.32
MW*FINEXP	+	-0.002	-0.08
INDEPEN	+	-0.001	-0.10
TERM	-	0.010	0.82
LOGTA	?	-0.008	-1.76*
CEOCHR	+	-0.003	-0.22
BLKOWN	?	0.000	-1.28
INSIDER	?	0.000	0.23
INSTIOWN	?	0.000	2.01**
ADROA	-	0.000	-1.11
NASR	+	0.117	4.08***
TOTFEE	+	0.001	1.19
STOCKTURN	+	0.002	0.49
Observations		167	
Adj-R Square		5.93%	
F-Value		1.75	
Prob>F		0.0516	
Highest VIF		2.67	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
R= The average percent of votes for the election of all new director nominees divided by the average percent of votes for the election of all incumbent director nominees.

divided by votes entitled to be cast to compute dependent variables and re-estimated the models. The main results are similar. Similarly, this measure of shareholders' dissatisfaction has some noise because dissatisfaction is not the only reason that shareholders do not vote.

Moreover, for ACFINEXP and FINEXP, I only report the results of the regressions using the first definition. The results of using other definitions are similar.

Furthermore, I defined a new indicator variable that is equal to 1 if MWDIS1=1 or MWDIS2=1 and 0 otherwise. I then used this new indicator variable to replace MWDIS1 and MWDIS2 in all of the three models to test Hypotheses H2-H5. The coefficient for this new variable is significant and negative in all of the three regressions.

In addition, I used the 212 pairs among the manager sample that are matched on at least two-digit SIC industry to re-estimate Model (1). The results are substantially similar. In the regression without the interaction term, the coefficient for MW is positive and more significant ($p = 0.038$) than that reported earlier in Table 6. Also, the coefficient of STOCKTURN is significant in the regression with or without the interaction term. Similarly, I used the 323 pairs among the audit committee sample that are matched on at least two-digit SIC industry to re-estimate Model (2). The results are qualitatively unchanged.

I also conducted White's (1980) test for heteroskedasticity on all regressions reported earlier. The test suggests that heteroskedasticity possibly exists only in the regression to test H1 relating to shareholders' dissatisfaction toward the board of directors. Conclusions based on White's heteroskedasticity corrected t statistics are unaltered.

Finally, since the total votes withheld for the election of all incumbent director nominees in a company (r) among the total votes cast for all incumbent director nominees in the same company (n) has the binomial distribution, I used the logit models to re-test hypotheses H1-H5.[47] The results are reported in Tables 29-34. The major references are qualitatively similar to those based on OLS regressions. However, there are some small differences that deserve attention. For instance, as reported in Table 29, in the logistic regression to test Hypothesis H1 relating to shareholders' dissatisfaction toward the management, the coefficient of MW is more significant ($p = 0.048$), but the coefficient for the interaction term TOTFEE*MW is not significant. Also, as reported in Table 32, in the logistic regression to test Hypotheses H2-H5 relating to shareholders' dissatisfaction toward the management, the coefficient for CEOCHR, the measure of CEO duality, is significant and has the expected sign ($p = 0.95$). Moreover, as reported in Table 33, in the logistic regression to test Hypotheses H2-H5 relating to shareholders' dissatisfaction toward the audit committee, the coefficient of INSIDER is significant and has the expected sign ($p = 0.95$).

[47] Data analysis suggests that the data has overdispersion, so I used the Williams' (1982) method to estimate the logistic regressions.

TABLE 29. Logistic Regression Results for H1—Based on Manager Sample
(See table 1 for variable definitions)

Variable	Predicted Sign	Without TOTFEE*MW		With TOTFEE*MW	
		Coefficient Estimate (1)	t-statistics (2)	Coefficient Estimate (3)	t-statistics (4)
INTERCEPT	?	-1.952	-5.13***	-1.999	-5.25***
MW	+	0.207	1.66**	0.134	1.00
TERM	-	-0.430	-3.54***	-0.421	-3.47***
LOGTA	-	-0.189	-3.87***	-0.173	-3.47***
CEOCHR	+	0.072	0.59	0.081	0.67
BLKOWN	?	0.000	0.12	0.000	0.12
INSIDER	-	0.003	0.91	0.003	0.77
INSTIOWN	?	0.005	1.96**	0.005	1.92*
ADROA	-	-0.001	-0.81	-0.001	-0.70
NASR	+	0.186	0.85	0.199	0.92
TOTFEE	+	0.033	3.45***	0.008	0.33
STOCKTURN	+	0.060	0.85	0.055	0.78
TOTFEE*MW	+			0.028	1.23
Observations		512		512	
Pseudo R Square		1.47%		1.55%	
Likelihood Ratio χ^2		34.686***		36.670***	
Highest VIF		1.89		3.78	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
Prob(r out of n), where
r = total votes withheld for the election of all incumbent manager director nominees for each firm; and
n= total votes cast for the election of all incumbent manager director nominees for the same firm.

TABLE 30. Logistic Regression Results for H1—Based on Audit Committee Sample
(See table 1 for variable definitions)

Variable	Predicted Sign	Without TOTFEE*MW		With TOTFEE*MW	
		Coefficient Estimate (1)	t-statistics (2)	Coefficient Estimate (3)	t-statistics (4)
INTERCEPT	?	-2.065	-5.45***	-2.123	-5.66***
MW	+	0.042	0.42	-0.076	-0.69
TERM	-	-0.269	-2.67***	-0.257	-2.57***
LOGTA	-	-0.083	-2.07**	-0.060	-1.47*
CEOCHR	+	-0.002	-0.02	0.011	0.11
BLKOWN	?	0.002	0.63	0.001	0.55
INSIDER	-	-0.003	-0.75	-0.003	-0.92
INSTIOWN	?	0.005	2.08**	0.005	2.05**
ADROA	-	0.001	1.17	0.001	1.39
NASR	+	0.468	2.54***	0.494	2.74***
TOTFEE	+	0.027	3.23***	-0.010	-0.51
STOCKTURN	+	0.142	2.33***	0.137	2.27**
ACINDEPEN(1)	-	-0.597	-2.75***	-0.593	-2.77***
ACFINEXP(1)	-	0.003	0.02	-0.016	-0.13
TOTFEE*MW	+			0.042	2.24**
Observations		695		695	
Pseudo R Square		1.26%		1.44%	
Likelihood Ratio $\chi 2$		44.721***		52.001***	
Highest VIF		1.85		3.65	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
Prob(r out of n), where
r = total votes withheld for the election of all incumbent audit committee director nominees for each firm; and
n= total votes cast for the election of all incumbent audit committee director nominees for the same firm.

TABLE 31. Logistic Regression Results for H1—Based on Board Sample
(See table 1 for variable definitions)

VARIABLE	Predicted Sign	Without TOTFEE*MW		With TOTFEE*MW	
		Coefficient Estimate (1)	t-statistics (2)	Coefficient Estimate (3)	t-statistics (4)
INTERCEPT	?	-1.987	-6.60***	-2.036	-6.80***
MW	+	0.020	0.23	-0.058	-0.60
TERM	-	-0.267	-2.97***	-0.258	-2.88***
LOGTA	-	-0.126	-3.56***	-0.109	-3.04***
CEOCHR	+	0.012	0.13	0.019	0.21
BLKOWN	?	0.002	1.00	0.002	1.00
INSIDER	-	-0.001	-0.38	-0.002	-0.53
INSTIOWN	?	0.006	2.88***	0.006	2.83***
ADROA	-	0.000	-0.18	0.000	-0.08
NASR	+	0.338	2.06**	0.355	2.19**
TOTFEE	+	0.030	3.97***	0.003	0.19
STOCKTURN	+	0.074	1.42*	0.072	1.39*
DIRINDEPEN(1)	-	-0.584	-3.57***	-0.571	-3.52***
TOTFEE*MW	+			0.030	1.80**
Observations		744		744	
Pseudo R Square		1.17%		1.26%	
Likelihood Ratio $\chi 2$		52.193***		56.8929***	
Highest VIF		1.82		3.61	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
Prob(r out of n), where
r = total votes withheld for the election of all incumbent director nominees for each firm; and
n= total votes cast for the election of all incumbent director nominees for the same firm.

TABLE 32. Logistic Regression Results for H2-H5—Based on Manager MW Sample
(See table 1 for variable definitions)

Variable	Predicted Sign	Coefficient Estimate	t-statistics
INTERCEPT	?	-1.597	-3.09***
COMMW	+	-0.167	-0.85
REVMW	+	0.033	0.17
MWDIS1	-	-0.440	-1.95**
MWDIS2	-	-0.330	-1.01
LATE	+	1.195	2.44***
TERM	-	-0.496	-2.85***
LOGTA	-	-0.221	-3.09***
CEOCHR	+	0.228	1.32*
BLKOWN	?	-0.001	-0.22
INSIDER	-	0.006	1.02
INSTIOWN	?	0.006	1.57
ADROA	-	0.001	0.46
NASR	+	0.287	0.92
TOTFEE	+	0.045	3.98***
STOCKTURN	+	0.061	0.85
Observations		260	
Pseudo R Square		2.93%	
Likelihood Ratio $\chi 2$		34.759***	
Highest VIF		1.84	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
Prob(r out of n), where
r = total votes withheld for the election of all incumbent manager director nominees for each firm; and
n= total votes cast for the election of all incumbent manager director nominees for the same firm.

TABLE 33. Logistic Regression Results for H2-H5—Based on Audit Committee MW Sample
(See table 1 for variable definitions)

VARIABLE	Predicted Sign	Coefficient Estimate	t-statistics
INTERCEPT	?	-2.468	-4.41***
COMMW	+	-0.296	-1.76**
REVMW	+	0.100	0.59
MWDIS1	-	-0.091	-0.53
MWDIS2	-	-0.493	-1.77**
LATE	+	0.571	0.85
TERM	-	-0.263	-1.77**
LOGTA	-	-0.068	-1.16
CEOCHR	+	-0.037	-0.25
BLKOWN	?	-0.001	-0.15
INSIDER	-	-0.008	-1.31*
INSTIOWN	?	0.005	1.76*
ADROA	-	0.001	0.98
NASR	+	0.424	1.61**
TOTFEE	+	0.034	3.43***
STOCKTURN	+	0.055	0.78
ACINDEPEN(1)	-	-0.099	-0.27
ACFINEXP(1)	-	-0.141	-0.74
Observations		346	
Pseudo R Square		1.99%	
Likelihood Ratio $\chi 2$		33.449***	
Highest VIF		1.86	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
Prob(r out of n), where
r = total votes withheld for the election of all incumbent audit committee director nominees for each firm; and
n= total votes cast for the election of all incumbent audit committee director nominees for the same firm.

TABLE 34. Logistic Regression Results for H1—Based on Board MW Sample
(See table 1 for variable definitions)

VARIABLE	Predicted Sign	Coefficient Estimate	t-statistics
INTERCEPT	?	-2.006	-4.65***
COMMW	+	-0.211	-1.42*
REVMW	+	-0.038	-0.25
MWDIS1	-	-0.147	-0.91
MWDIS2	-	-0.250	-1.03
LATE	+	0.866	1.84**
TERM	-	-0.214	-1.59**
LOGTA	-	-0.108	-2.03**
CEOCHR	+	0.026	0.20
BLKOWN	?	0.000	0.02
INSIDER	-	-0.002	-0.48
INSTIOWN	?	0.006	2.03**
ADROA	-	0.000	0.37
NASR	+	0.282	1.06
TOTFEE	+	0.035	3.84***
STOCKTURN	+	0.054	0.88
DIRINDEPEN(1)	-	-0.506	-2.00**
Observations		372	
Pseudo R Square		1.56%	
Likelihood Ratio $\chi 2$		31.135**	
Highest VIF		1.8	

***, **, and * indicate significance at the 0.01, 0.05 and 0.1 levels, respectively; one-tailed where signs are predicted, two-tailed otherwise.

Dependent Variable:
Prob(r out of n), where
r = total votes withheld for the election of all incumbent director nominees for each firm; and
n= total votes cast for the election of all incumbent director nominees for the same firm.

CHAPTER 6

CONCLUSIONS

SOX Section 404 requires public companies to include in each annual report the management's assessment on the effectiveness of the internal control and the auditor's attestation opinion. It has been regarded as the most controversial section of SOX. Hence, research is needed to investigate the benefits and costs of Section 404. The primary objective of this study is to examine whether the disclosure relating to internal controls under Section 404 affects shareholders' voting decisions in director election.

According to SOX Section 302 and PCAOB Auditing Standard No. 2, managers are responsible for the effectiveness of the internal control. Also, the audit committee and the board are expected to oversee management's work in establishing and maintaining effective internal controls. Internal controls have been shown to be associated with poor earnings quality, lower firm market value and higher cost of equity. Hence, the existence of ineffective internal controls means that shareholders' interests are not protected. Therefore, I hypothesize that shareholders are dissatisfied with the management, the audit committee and the board of directors in companies with weak internal controls. In addition, I expect that shareholders in companies with internal control material weaknesses are more dissatisfied if the companies have company-level material weaknesses or material weaknesses relating to revenue recognition, do not disclose internal control problems early, or do not file the auditor's attestation reports in a timely manner. I use shareholders' votes withheld for director election to proxy for shareholders' dissatisfaction. I also test the associations between votes withheld for director election and other factors such as non-audit fees,

total auditor fees, director independence and financial expertise of audit committee directors.

Based on different samples of companies that comply with Section 404 for the first time, I test the hypotheses relating to shareholders' dissatisfaction toward the management, the audit committee and the board of directors separately. I find that the disclosure of internal control material weaknesses is positively related to shareholders' dissatisfaction toward the management. Moreover, shareholders' dissatisfaction toward the management is lessened when companies disclosed the internal control material weaknesses in its SOX Section 302 disclosures prior to receiving the auditor's adverse opinion, or filed the auditor's attestation report within 8 months of the fiscal year end. In addition, shareholders' dissatisfaction toward the management is positively related to the magnitude of total fees, institutional ownership and the term of directors, and negatively associated with firm size. I also document an interaction effect between the magnitude of total fees and the existence of ineffective internal controls. That is, shareholder dissatisfaction is greater when the material weaknesses are accompanied by greater auditor fees.

I do not find an association between shareholders' dissatisfaction toward the audit committee and the disclosure of internal control material weaknesses. However, under some circumstances, shareholders do show their discontent toward the audit committee in the presence of material weaknesses. Shareholders are more dissatisfied with the audit committee if firms with internal control material weaknesses also pay high total fees to the independent auditor, or had not disclosed the internal control problems (for example, in section 302 disclosures) before they received the adverse auditor's opinion. Contrary to my expectation, audit committee director nominees have fewer votes withheld in the director election if a company has company-level

internal control material weaknesses. This may be because company-level internal control material weaknesses are usually related to integrity problems of the management and opportunistic managers may be more likely to obtain votes through unusual approaches such as hiring proxy solicitors. I also find that shareholders' votes withheld for the election of audit committee director nominees increase with non-audit fees, total auditor fees, the term of directors, institutional ownership and the trading volume between the record date and annual shareholders' meeting date, and decrease with firm size and the proportion of independent audit committee director nominees. However, I do not find an association between the shareholders' voting in director election and the financial expertise of audit committee director nominees.

I find that votes withheld for the director nominees on the board indicate no association with the existence of internal control material weaknesses as well. Nevertheless, under some conditions, shareholders do express their dissatisfaction toward the board when there are material weaknesses. Shareholders show their discontent toward the board if the firms that have internal control material weaknesses also pay high total fees to the independent auditor, or file their the auditor's attestation reports extremely late. Surprisingly, director nominees on the board are less likely to have votes withheld if a company has company-level internal control material weakness. I also document that shareholders' votes withheld for the election of director nominees on the board is positively related to non-audit fees, total auditor fees, the term of directors, institutional ownership, and the trading volume between the record date and annual shareholders' meeting date, and decrease with director independence and firm size.

To summarize, my empirical results suggest that shareholders play a monitoring role by expressing dissatisfaction in the director election when a company

has weak internal controls or does not disclose the internal control problems in a timely manner, when the auditor's perceived independence is low, when the directors are not independent, or when a company's corporate governance is poor.

The objective of SOX is to "protect investors by improving the accuracy and reliability of corporate disclosures..." (SOX). This study lends support to the requirements of Sections 302, 404, 201 and 301 and related rules from the perspective of investors. Specifically, the findings about shareholders' discontent toward the disclosure of internal control material weaknesses shed light on the benefits of Sections 302 and 404. Moreover, Section 201 restricts the non-audit services that a listed company can purchase from the independent auditor. Also, Section 301 holds the audit committee responsible for the appointment and compensation of the independent auditor. The empirical evidence on shareholders' dissatisfaction toward the disclosure of high non-audit fees and high total auditor fees indicates that Sections 201 and 301, and SEC's rules on the disclosure of auditor fees do reflect shareholders' calls for total auditor independence and increasing scrutiny over the relationship between the auditor and its client. Furthermore, I document that shareholders favor independent director nominees (including the audit committee director nominees), thus supporting the requirement of Section 301 that the audit committee consist of totally independent directors and other recent rules issued by the SEC and stock exchanges to regulate director independence in public companies.

This dissertation also has implications for companies, investors and corporate governance activists. For instance, recently some companies have promoted good corporate governance by declassifying the directors and allowing shareholders to elect all of the directors on the board each year. My empirical results suggest that companies are rewarded by practicing such good corporate governance.

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