Auditor-provided nonpublic signals of misreporting and CFO dismissal

Phillip T. Lamoreaux
Arizona State University, Tempe, AZ, USA

Summer Zhujun Liu
Texas A&M University, College Station, TX, USA
sliu@mays.tamu.edu

Nathan J. Newton
Florida State University, Tallahassee, FL, USA

Min Zhang
Renmin University of China, Beijing, China

Abstract
Research suggests that board members value financial reporting quality because executive dismissal often follows low reporting quality events. However, inferences about the board's demand for reporting quality in these studies are confounded by board members' reputation incentives because the events examined are public (e.g., restatements). We investigate boards' demand for reporting quality by exploiting a *private* signal of misreporting: audit adjustments communicated to the board by the external auditor. We first survey 29 audit committee chairs to understand whether boards use audit adjustments in their oversight of management and then conduct an empirical investigation to answer our research question. We find an increased likelihood of CFO dismissal following audit adjustments. This association is driven by adjustments that reduce income and by firms with better board oversight. These findings suggest that boards proactively use nonpublic signals of reporting quality and incorporate information from auditors into their monitoring function.

Key words: Private signals; audit adjustments; reporting quality; executive turnover; CFO dismissal

JEL Codes: G34; L84; M41; M42

1 Introduction

An extensive literature investigates the board of directors' oversight of management. One theoretical argument and finding of these studies is that boards reduce agency conflicts between shareholders and managers by constraining managers' discretion in financial reporting. For example, research finds that boards dismiss executives in connection with earnings management, restatements, and financial-statement fraud (Arthaud-Day et al. 2006; Desai et al. 2006; Hennes et al. 2008; Leone and Liu 2010; Hazarika et al. 2012; Agrawal and Cooper 2017). These studies show that boards react to signals of low-quality financial reporting but that the public disclosure of these signals also hurts the reputations of both managers and board members (Srinivasan 2005; Fich and Shivdasani 2007; Firth et al. 2016; Street and Hermanson, 2019). Thus, boards are incentivized to publicly demonstrate that they actively monitor management in those settings. As a result, research provides little insight into whether boards fulfill their fiduciary responsibilities over financial reporting absent public pressure. Given that boards have access to private signals of financial reporting quality, it is important to investigate whether and to what extent boards actually use these nonpublic signals. Therefore, this study examines whether boards of directors proactively discipline managers for low-quality financial reporting that is privately revealed to the board.

This study is also motivated by the fact that, while external auditors communicate privately with boards, we know little about whether boards use auditor-provided, private information in their oversight. In general, a key role of the board is to ensure that managers act for the benefit of shareholders. However, directors, especially independent directors, have significant information disadvantages because their primary information source is management (Verrecchia 2001; Armstrong et al. 2010), such that some private signals about managers' performance can be kept not only from the public but from the board as well. In the context of financial reporting, this

means that boards may not become aware of low-quality reporting until public revelation is imminent, for example, in a restatement. One information source available to boards to reduce information asymmetry between themselves and management is direct communication with the external auditor.[1] Information from the external auditor is independent and revealed directly to the audit committee of the board but not to shareholders, giving directors incremental information that they can use to evaluate management's performance. Therefore, we focus on nonpublic signals provided by external auditors to study our research question.

Specifically, we exploit audit adjustments communicated by the auditors to the board. During the conduct of an audit, auditors must communicate certain matters to the board, including information about adjustments the auditors require to ensure the financial statements are fairly presented. These adjustments identify necessary corrections of financial reporting mistakes or, at the extreme, managers' attempts at fraudulent reporting that the auditors have discovered. Audit adjustments are not revealed publicly, so stakeholders see only financial statements that incorporate these adjustments. However, auditing standards require auditors to communicate these necessary adjustments to the audit committee, which provides the board with private information about the quality of managers' pre-audited financial reports. Because the public, or shareholders, are not informed whether the auditor has identified any misstatements, board members would not experience public pressure to respond to this misreporting. Thus, disciplinary actions taken by the board in connection with privately communicated audit adjustments would demonstrate that boards are proactive in their oversight of management, in addition to the reactive oversight related

[1] James Doty, former chair of the PCAOB, noted that auditors "ask for and see anything they think they need in order to assure themselves that there are no material misstatements ... Boards don't do that, but they and their shareholders sure can benefit from knowing what the auditor has learned" (Doty 2016).

to public signals from earnings management, misstatements, and fraud documented in prior studies.

To this end, we obtain a proprietary dataset of recorded audit adjustments from the Ministry of Finance (MOF) in China.[2] To provide information on the institutional environment and ensure a proper understanding of the use of audit adjustments by corporate boards, we surveyed 29 board members serving as audit committee chairs of Chinese public companies.[3] The survey reveals that audit committee members meet with external auditors and discuss audit findings. The respondents also indicate they perceive that audit adjustments convey relevant information about management's integrity, competence, and earnings management attempts. Collectively, the survey participants believe that audit adjustments help them evaluate company executives.

Based on information from surveyed audit committee chairs and findings from the literature, we measure the board's disciplinary efforts by examining the relation between audit adjustments and dismissal of executives for the period of 2010–2019.[4] Our survey respondents suggest that audit adjustments are useful in evaluating both the chief financial officer (CFO) and the chief executive officer (CEO), though we observe a statistically greater importance assigned to CFOs, consistent with CFOs overseeing the financial reporting process. Thus, we focus on the consequences of audit adjustments for CFOs. We model the likelihood of CFO dismissal following

[2] This dataset consists of a listing of public company identifying information along with pre- and post-audit financial numbers for several accounts. One co-author obtained the data directly from the MOF on the condition that the data be used only for academic research and not shared with others. These data have been used in recent literature to investigate mandatory internal control audits (Lennox and Wu 2022), auditor incentives for equity ownership (Lennox et al. 2020), auditor early-career experiences (He et al. 2018), reporting irregularities around acquisitions (Lennox et al. 2018), earnings quality (Lennox et al. 2016), and auditor rotation (Lennox et al. 2014).

[3] The survey was approved by the institutional review boards of all participating universities.

[4] Boards of directors have various disciplinary tools, including informal discipline, increasing scrutiny of the executives' decisions, adjusting executives' compensation, and dismissing executives. While we anticipate that boards are willing to take various disciplinary actions other than executive dismissal, consistent with the literature (e.g., Desai et al. 2006; Hazarika et al. 2012), we focus on dismissals in our main tests. We examine executive compensation in an additional test.

notification of audit adjustments to the board and find that the likelihood of CFO dismissal increases with the magnitude of audit adjustments. Economically, a one-standard-deviation increase in audit adjustment magnitude (the presence of a material audit adjustment) increases the likelihood of CFO dismissal by 8.7% (17.4%) relative to the unconditional probability of CFO dismissal. These effects suggest that boards view audit adjustments as a negative signal of management quality. Finally, we note that our results are concentrated among audit adjustments that correct an overstatement of company earnings (income-reducing adjustments), suggesting boards appear to be more tolerant of misreporting when an audit adjustment indicates overly conservative financial reporting.

We next investigate how the quality of the company's monitoring impacts the relation between audit adjustments and CFO dismissal. We use characteristics of the board of directors as proxies for monitoring quality. First, we find that better-informed boards, as proxied by the size of the audit committee relative to the overall board, are more likely to dismiss the CFO following audit adjustments, consistent with larger audit committees ensuring that a larger share of the board learns about the severity of misstatements directly from the auditor. Second, we find that a higher likelihood of CFO dismissal occurs only in firms where the CEO does not also chair the board. This finding is consistent with greater managerial entrenchment when the CEO also serves as the board chair, inhibiting the board's removal of a top executive. Collectively, these tests indicate that boards respond more to private signals of low-quality reporting when they have greater incentives and abilities to discipline top executives.

We conduct several tests to address alternative explanations that might influence our inferences. First, we include firm fixed effects to ensure our results are not driven by time-invariant firm characteristics and find consistent results. Second, although we control for restatements in all

models, we add additional controls for various other public signals, including reported material weaknesses in internal control, regulatory sanctions, discretionary accruals, management forecast errors, earnings announcement errors, and going concern opinions. These public signals have fairly low correlation with audit adjustments, and, accordingly, we continue to find a positive association between audit adjustments and CFO dismissal. Finally, because boards' decisions to discipline CFOs would be reflected in *dismissal* rather than voluntary departure, we do not expect audit adjustments will result in a higher likelihood of *voluntary* CFO turnovers. Consistent with our expectations, we find no association between audit adjustments and voluntary CFO turnover.

We also conduct several analyses to provide further insights regarding our main findings. First, if boards view current-year audit adjustments negatively, we expect that they will view a pattern of audit adjustments even more severely. We find that the likelihood of CFO dismissal increases when the CFO is associated with audit adjustments in previous years, when the average adjustment magnitude throughout the CFO's term is high, and when the pattern of audit adjustments indicates worse financial reporting quality in the current year relative to the prior year. The finding that multiple years of adjustments influence CFO dismissal also mitigates reverse causality concerns that the decision to dismiss the CFO reduces the CFO's power, increasing the likelihood of audit adjustments in the final year of the CFO's tenure. Second, we find that audit adjustments and the board's responses to them appear to have other consequences, as most CFOs dismissed in connection with material audit adjustments obtain less prestigious roles in subsequent jobs. Third, dismissal is a severe consequence, so we expect that boards will also employ other tools in their oversight of executives. We find that audit adjustments are negatively associated with CFO compensation, which suggests that boards exercise oversight of executives using various tools.

Finally, as revealed by the survey, audit adjustments provide relevant information about the CEO in addition to the CFO. As such, we investigate whether boards incorporate audit adjustments into CEO dismissal decisions. We find that CEOs are dismissed in connection with audit adjustments but *only if* the CFO is also dismissed. This finding suggests that CEOs appear to deflect responsibility for audit adjustments to CFOs. Furthermore, we find that factors affecting the power dynamic between the CEO and CFO influence whether CFOs are held accountable for audit adjustments. These results indicate that the CEO plays a role in CFO dismissal but the board exercises oversight over both executives.

Our study makes several contributions to the literature. First, it contributes by showing that boards use information from the external audit in their governance decisions. Former PCAOB chair, James Doty, stated that "auditors were intended to be the eyes through which both investors and directors look for the truth" but "we don't hear about boards using the audit to obtain more insight into fraud risk or management integrity" (Doty 2016). Our study suggests that directors use information from the external audit to carry out their fiduciary duty.

Second, our study contributes by providing evidence that boards proactively demand reporting quality in the absence of public signals. The literature clearly documents that boards dismiss executives in connection with public signals of low-quality reporting of varying severity, such as earnings management, misstatements, and fraud, which indicates boards are reactive to negative events under potential public scrutiny (Arthaud-Day et al. 2006; Desai et al. 2006; Hennes et al. 2008; Leone and Liu 2010; Hazarika et al. 2012; Lee et al. 2012; Agrawal and Cooper 2017; Haislip et al. 2017). Our use of privately communicated audit adjustments represents a fundamentally different type of information, and our results hold after controlling for various public signals. Thus, our study provides evidence that boards hold executives responsible for

private low-quality reporting in a setting where public pressure to act is significantly lower or even absent.

Lastly and importantly, we contribute to the understanding of corporate governance in China. Although boards of directors in China have historically been viewed as less effective than those in western economies, due to concentrated ownership and government involvement, their monitoring incentives and the quality of corporate governance in China have been improving over time (Mutlu et al. 2018; Jiang and Kim 2020). Both our survey and findings reveal that Chinese boards of directors appear to discipline managers for low financial reporting quality. Due to China's growing influence in the world economy, understanding its governance environment and the corresponding implications for financial reporting quality and auditing is important. Because boards in western countries are typically seen as more effective, the governance mechanisms we document in China may be even more relevant or pronounced in those settings.

2 Background and related literature

2.1 Board monitoring responsibilities

A primary function of the board of directors is to ensure that managers act for the benefit of the shareholders. Because shareholders do not directly oversee managers, they rely on the board of directors to reduce agency problems arising from managers acting in their own interests (Weisbach 1988; Jensen 1993; Shleifer and Vishny 1997; Core et al. 1999; Bushman and Smith 2001; Armstrong et al. 2010). Boards can employ various tools in their oversight of management ranging from setting compensation contracts to dismissing executives for undesirable performance. In addition, governance systems include incentives to ensure board members fulfill their oversight obligations, with studies noting that board members experience negative

reputational consequences following negative publicity for a firm (Wu 2004; Srinivasan 2005; Fich and Shivdasani 2007; Firth et al. 2016; Street and Hermanson 2019).

2.2 Executive turnover

The literature has investigated boards' use of dismissal in their oversight of executives. Early studies document an inverse relation between firm performance and management changes (Coughlan and Schmidt 1985; Warner et al. 1988; Weisbach 1988; Mian 2001), and this relation has held over time, despite changes to governance environments (Huson et al. 2001), and in international settings (DeFond and Hung 2004; Wu and Zhang 2019), including in China (Kato and Long 2006; Chang and Wong 2009; Cao et al. 2017).[5]

Boards also appear to dismiss executives in connection with poor financial reporting quality. Providing accurate financial reporting is a responsibility of management, and financial reporting quality presumably serves as a separate metric that boards use to evaluate the quality of executives' performance. In general, studies focusing on the U.S. setting find that earnings management, restatements, financial statement fraud, and internal control weaknesses lead to executive turnover (Arthaud-Day et al. 2006; Desai et al. 2006; Hennes et al. 2008; Li et al. 2010; Hazarika et al. 2012; Agrawal and Cooper 2017). This is also true in the Chinese setting, where Firth et al. (2011) find that there is greater CEO turnover after restatement announcements. Our focus is on nonpublic signals of misreporting, so we control for restatements in our models because restatements are a prominent public signal that can occur from intentional earnings management or unintentional errors due to deficiencies in the internal control system.

2.3 Public versus private signals of low-quality financial reporting

[5] Since we focus on executive turnover unrelated to firm performance, our models control for several measures of firm performance, including ROA and positive and negative stock returns.

The board's decision to dismiss an executive for low-quality financial reporting involves multiple considerations, including how financial misreporting will impact board members themselves. While prior research consistently finds that executives are disciplined for low financial reporting quality, the signals of low-quality financial reporting examined in the literature are public revelations of reporting failures. When a company restates its financial statements, shareholders are alerted to the reporting failures of management and an oversight failure of *the board*. Thus, when a financial reporting fraud is revealed, shareholders may be as likely to hold the board responsible as they are to hold management responsible.[6] Even in less egregious instances, where publicly filed financial statements indicate some level of earnings management, stakeholders can observe that financial reporting quality was low.[7] In these scenarios, board members—subject to external pressures and with their own reputations to protect—are incentivized to deflect blame from themselves by disciplining executives, due to the public nature of these signals.[8]

In contrast, this study examines a nonpublic signal of low reporting quality that is provided to board members near the completion of an audit and never disclosed publicly. Audit adjustments reveal the quality of management's pre-audit financial reporting to the board without revealing the information to shareholders. In fact, because audit adjustments improve earnings quality, increase earnings smoothness, and reduce the likelihood of restatement (Lennox et al. 2016; Lennox and Wu 2022), the signal itself mitigates management's misreporting that might have otherwise been later revealed publicly.

2.4 Institutional background and setting

[6] This notion is consistent with directors voluntarily departing during a fraud-committing period but before the fraud is publicly revealed to protect their reputations (Gao et al. 2017).
[7] For example, Haw et al. (2005) note that regulators and investors in China adjust their behavior in response to financial statements that are suspected of earnings management.
[8] In our setting, restatement announcements are significantly positively associated with executive dismissal, showing that boards in China react to public signals of misreporting.

Despite some unique institutional features, such as significant state ownership of firms and concentrated ownership among controlling shareholders, from a corporate governance standpoint, China shares many institutional attributes with other countries. Many of these similarities have emerged because the Chinese government has instituted regulatory changes in recent decades to improve corporate governance of Chinese companies. Included in these changes are greater institutional ownership, the implementation of corporate governance codes, stronger regulatory oversight, and conversion of nontradable shares to tradable shares of public companies (Jiang and Kim 2015).

These changes have resulted in many Chinese corporate governance characteristics consistent with other jurisdictions around the world, including the U.S., regarding board oversight of executives. Chinese boards meet regularly throughout the year, make important decisions about firm operations, and oversee and evaluate the firm's executives on behalf of shareholders (Jiang and Kim 2020). In addition, Chinese boards are structured like U.S. boards.[9] For example, a board in China must consist of at least one-third independent directors, and independent directors chair the audit committee (Jiang and Kim 2015).[10] Also like the U.S. setting, Chinese auditing standards require external auditors to report directly to the audit committee, and the audit committee communicates important audit findings to the remaining board members.

Directors also have clear incentives to monitor managers. While the labor market for independent directors is less developed in China (Firth et al. 2016), both the Shanghai (SHSE) and Shenzhen (SZSE) stock exchanges have disciplinary authority over directors, such as preventing

[9] Chinese listed firms also must have a board of supervisors to oversee directors and senior managers. However, the board of directors performs the firm's key governance responsibilities and outranks the supervisory board due to participation of controlling shareholders as directors such that "in most cases, the supervisory board may be redundant or pointless." (Jiang and Kim 2020, p. 743).

[10] In 2002, the CSRC and State Economic and Trade Commission jointly issued the *Code of Corporate Governance for Listed Companies in China*, outlining basic rules for boards in China. As noted in this code, the primary responsibilities of boards in China resemble those of U.S. boards.

directors from being nominated for directorships. In addition, regulators and these exchanges closely monitor directors and have sanctioned independent directors in connection with financial misreporting (Firth et al. 2016). For example, five independent directors were fined by the CSRC in 2019 and then judged liable in 2021 in a securities class action lawsuit against the company in connection with fraudulent financial reports (Yang 2021). Independent directors in China have other reputation incentives as well. Jiang et al. (2016) find that independent directors who dissent on board proposals gain more outside directorships and are less likely to be sanctioned by regulators. Thus, while agency problems in China are not identical to those in the U.S. or other jurisdictions, directors have similar responsibilities and clear incentives to fulfill their fiduciary duties, which include monitoring managers.

2.5 Survey evidence on the institutional setting

To further understand the institutional environment surrounding board oversight of executives and the relevance of auditor-provided information, we surveyed audit committee chairs of listed Chinese companies. We first held informal discussions with several audit committee chairs to better understand boards' communication with auditors, the manner in which audit adjustments are shared with boards, and the board's use of audit adjustments. We then surveyed 29 audit committee chairs to determine the prevalence and application of these views. We used Wenjuanxing (wjx.cn), a Chinese survey platform similar to Qualtrics, to deliver the survey. Survey respondents were contacted through the personal connections of one of the authors and were informed that their responses would be anonymous and reported only in aggregate. The recruitment procedures and the survey instrument were approved by our universities' IRBs. Among the respondents, the median number of boards they have served on is five, and the median number of years they have served on a board is seven.

The survey questions and the summarized responses are displayed in Table 1. The majority of respondents (89.7 percent) indicate that they meet with auditors during an audit to discuss procedures and findings. Most respondents (86 percent) note some experience with auditors informing them of audit adjustments. While experiences of these board members vary, their responses suggest that audit committee-auditor interactions are common, and, on average, audit committee members are familiar with and regularly become aware of audit adjustments.

The next series of questions asks about the information conveyed by audit adjustments and the potential usefulness of the information for the board in overseeing management. First, respondents indicated that they view audit adjustments as a relatively important input in their assessment of financial reporting quality (mean=5.07 on a seven-point scale). Next, when asked about characteristics of the audit adjustments, respondents assigned the highest importance to audit adjustments that correct overstatements (mean=5.9) and that are material (mean=5.72), although they viewed audit adjustments with other characteristics as important as well (i.e., all mean responses exceed the midpoint of the scale). When comparing characteristics, a *t*-test between responses suggests that respondents view the magnitude of adjustments as more important than the mere occurrence ($p<0.01$). A subsequent question asked respondents what information audit adjustments convey about managers. Respondents indicated that audit adjustments have implications for the perception of management's integrity (mean=5.14) and their attempts to manage earnings (mean=5.41).

The survey also asks about the member of management to which respondents attribute audit adjustments. Interestingly, respondents answered that audit adjustments matter to their evaluation of both the CFO and the CEO. The CFO has direct responsibilities over financial reporting, so it is unsurprising that board members attribute audit adjustments to the CFO. On the

other hand, CEOs do not directly deal with financial reporting, but they do have ultimate responsibility for public financial disclosures. While respondents indicated that audit adjustments are useful in evaluating both executives, a *t*-test indicates that the mean response regarding CFOs is higher than that for CEOs ($p<0.01$). As such, we focus our empirical analyses on the dismissal of CFOs. However, we also investigate the implications of audit adjustments for CEOs in additional analyses.

Overall, the survey responses demonstrate agreement between the institutional background suggested in prior literature and current audit committee members' experiences and perceptions of practices in China. Respondents indicate that boards interact with auditors and that auditors communicate important audit adjustments to the audit committee. Furthermore, audit committee members view audit adjustments as relevant in their oversight of management.

3 Hypothesis development

The board of directors, specifically its audit committee, hires the external auditor, and the external auditor reports directly to the committee. Near the completion of an audit, external auditors must communicate certain information to the audit committee, including necessary adjustments to the financial statements.[11] If the auditor identifies misstatements and proposes audit adjustments, it signals to the audit committee that (1) the *unaudited* financial statements are of lower quality, which reflects the quality of executives' management of the financial reporting process, and (2) the external auditor is in a sense an effective oversight mechanism to aid the audit

[11] Since 2005, the Chinese Institute of Certified Public Accountants (CICPA) has been working to converge Chinese Standards on Auditing (CSA) with International Standards on Auditing (ISA) as released by the International Auditing and Assurance Standards Board (IAASB 2010). These auditing standards, consistent with PCAOB auditing standards, require that auditors communicate with those charged with governance (e.g., board or audit committee) regarding significant matters relevant to financial reporting, including material misstatements that have been corrected (ISA 260.16 and A27 (IAASB, 2009); CSA 1151.17 and CSA 1151 Guidelines No. 27 (CICPA, 2010; MOF, 2010); AS 1301.19 (PCAOB, 2012)).

committee in its fiduciary duty. Therefore, audit adjustments provide a *nonpublic* signal to the board that the quality of executives' execution of the financial reporting function is low.

While we expect boards to view audit adjustments as a signal of low reporting quality, this signal still may not result in a measurable board response. Audit adjustments correct financial statements before public release, and evidence suggests that audit adjustments reduce the likelihood of subsequent restatements (Lennox and Wu 2022). Thus, board members would have little reason to expect that audit adjustments indicate the potential for a restatement of current financial statements and related public scrutiny. Board members may also view the external audit as part of their oversight function such that they consider audit adjustments as evidence that they (the board) are fulfilling their oversight responsibilities rather than that management has failed to report correctly. However, despite these factors and consistent with our survey results, directors may view audit adjustments as an indicator of management's integrity or aggressiveness. Given boards' responses to public signals and the opportunity audit adjustments provide to boards to be proactive in fulfilling their oversight responsibilities, we expect boards will respond to audit adjustments via increased likelihood of CFO dismissal. This discussion is formalized in the following hypothesis:

H1: Audit adjustments are positively associated with CFO dismissal.

While our primary prediction is that a private signal of low reporting quality will increase the likelihood of CFO dismissal, we expect that board characteristics are likely to influence how the board responds to signals of financial reporting quality. Greater monitoring incentives or independence from management suggest the board will have a greater ability to discipline executives. For example, Beck and Mauldin (2014) find that the board can better influence the audit when the audit committee is more powerful, and Klein (2002) finds that greater board independence is associated with better monitoring of financial reporting. Conversely, CEO-chair

duality reduces boards' allocation of attention to monitoring, increases the likelihood of fraudulent financial reporting, and shields the CEO from dismissal following poor performance, suggesting greater managerial entrenchment and weaker governance (Goyal and Park 2002; O'Connor et al. 2006; Tuggle et al. 2010). These studies indicate that board characteristics contribute to the board's ability to fulfill its oversight responsibilities. Collectively, we anticipate that the likelihood of CFO dismissal following audit adjustments will be greater in the presence of higher governance quality, as indicated by board characteristics that create greater incentives and ability to monitor management. Our expectation is formalized as follows:

H2: Audit adjustments are positively associated with CFO dismissal when firm governance quality is higher.

4 Research methods

4.1 Forced CFO turnovers

We obtain 5,705 CFO turnovers in the period of 2010 to 2019 from the RESSET database, a widely used database for Chinese research.[12] For firm-years with multiple CFO turnovers, we retain the turnover record of the CFO who has the longest tenure. We then exclude firms trading on the over-the-counter market, without a matchable stock identifier, financial firms, and B-shares.[13] Because we examine whether the board of directors disciplines financial officers who provide low-quality financial reporting, distinguishing between forced and voluntary turnovers is necessary. Building on the literature, such as the work of Parrino (1997) and Fisman et al. (2014), who identify CEO dismissal versus voluntary turnover, we classify a CFO turnover as voluntary if any of the following conditions are met: (1) the departure is due to health issues or change in

[12] The CFO in our study refers to the individual who holds the title of "chief financial officer," "general accountant," or "financial administrator."

[13] We exclude B-shares because they are a special type of stock class traded in foreign currency. Studies using the Chinese setting focus on A-shares and exclude B-shares (e.g., Giannetti et al. 2015; Chen et al. 2020).

controlling shareholders; (2) the departing CFO is 60 or older in age; (3) the departing acting CFO is promoted to official CFO or later re-hired as the CFO; (4) the departing CFO is promoted to CEO or stays on as the board chair; or (5) the departing CFO becomes the CFO, CEO, or board chair of another listed firm. After removing voluntary turnovers, the remaining 3,948 cases are classified as forced CFO turnovers (i.e., dismissals).[14]

Next, we consider the timing of CFO dismissal. If CFOs are disciplined for poor reporting quality as a result of audit adjustments, we would not expect a significant delay from the time the board becomes aware of audit adjustments to the dismissal of the executive. Thus, we focus on CFO dismissals occurring within a 180-day window beginning at the approximate time when the board becomes aware of the adjustments. Auditing standards indicate that auditors should communicate important audit findings, including audit adjustments, to the audit committee near the completion of the audit in preparation to file the final financial statements. As such, we begin the 180-day window during the approximate timeframe of this communication, commencing one week prior to the annual report filing date (i.e., [-7, +172]).[15] After further removing observations with missing data for necessary control variables, the final number of forced turnovers used in the main analysis is 1,212. The detailed procedures for identifying these dismissals are shown in Table 2 panel A.

4.2 Audit adjustments

We obtain proprietary data on audit adjustments from the MOF in China. Since 2006, the MOF has required audit firms to privately submit their public clients' pre-audit annual profits to

[14] Our results are robust to adding back turnovers defined as voluntary under each of these criteria, one at a time or collectively (untabulated).

[15] In some cases, auditors may inform the board about audit adjustments at an earlier date, such as when they are discovered. Our results are consistent (untabulated) when we begin the 180-day window four weeks before the filing date (i.e., [-28, +151]). Alternatively, the process of dismissing a CFO may take some time, so we extend the dismissal window through the end of the calendar year (i.e., [-7, Dec 31]) and find consistent results (untabulated).

the Ministry's Inspection Bureau. This requirement resembles U.S. auditors submitting information about their audits, including proposed and recorded adjustments, to the PCAOB. The MOF uses these adjustments to oversee audit firms, but this information is not shared with the public or with the regulatory agency that oversees companies and boards (Lennox et al. 2018). We independently confirmed this policy with two employees at the MOF. Thus, any board response to audit adjustments is unlikely due to actual or perceived pressure from regulators.[16] In a typical audit engagement, an adjustment occurs when the pre-audit financial statements provided by the client firm are misstated, and the misstatements are detected and corrected.[17] Therefore, audit adjustments clearly signal low-reporting quality.[18]

4.3 Sample selection

We start with all firms listed on the SHSE and SZSE between 2010 and 2019.[19] This gives us an initial sample of 29,939 firm-year observations obtained from the China Stock Market and Accounting Research (CSMAR) database. We delete 608 observations of financial firms and exclude 1,037 observations of B-shares. As noted previously, we exclude voluntary CFO turnovers and forced CFO turnovers that occur outside of our defined turnover window (716 and 1,799 firm-

[16] If the MOF uses audit adjustments (or audit committee members believe the MOF uses audit adjustments) for company oversight, audit adjustments would likely be associated with director dismissals (voluntary director turnover) when the board fails to discipline the CFO. In untabulated analyses, we find no association between audit adjustments and audit committee member dismissal or voluntary turnover among a sample of firms that did not dismiss the CFO, consistent with audit adjustments playing no actual or perceived role in regulatory oversight of boards of directors.

[17] Management may waive auditor-proposed adjustments rather than record them. Throughout this study, we focus on recorded adjustments, while Choudhary et al. (2022) investigate waived adjustments.

[18] Audit adjustments may reflect executive optimism, which has been shown to influence the likelihood of executive turnover (Campbell et al. 2011). To address this possibility, we categorize CFOs into high- and low-optimism groups based on firm investment levels and CFO net stock purchases, following the approach outlined by Campbell et al. (2011). The correlations between audit adjustments and the optimism measures are low, and our main results hold after controlling for them (untabulated).

[19] CFO dismissals occurring from 2010 to 2019 correspond to audit adjustments of the 2009 to 2018 financial statements. We have access to audit adjustments data from 2006 to 2018, but we begin our sample period after the global financial crisis because the association between management performance and turnover may differ during this period. Our inferences are consistent when including 2006 to 2008 (i.e., executive dismissals from 2007 to 2009, untabulated).

years, respectively). In addition, we drop 8,885 observations missing data for control variables. We further lose 3,701 observations after merging with audit adjustments data. Our final sample includes 13,193 firm-year observations for 2,792 unique firms. Table 2 panel B shows the detailed sample selection procedures.

We report the number of observations and forced CFO turnovers by year in panel C of Table 2. The number of firms gradually increases in the early years of the sample and is fairly consistent thereafter except for 2017. In 2017, the MOF eliminated the requirement that audit firms submit audit adjustment information for fiscal year 2016; however, the MOF reinstated the requirement in 2018.[20] The number of forced CFO turnovers is shown in the third column and follows a similar pattern over time. The final column of panel C shows the percentage of firm-years with forced CFO turnovers, which ranges from 6.5% to 12.2% over the sample period.

4.4 Empirical models

To test our first hypothesis, we estimate the following linear probability models:[21]

$$CFO\ Dismissal = \alpha_0 + \alpha_1\, Adjust\_Mag + Controls + FEs + \varepsilon; \quad (1)$$

$$CFO\ Dismissal = \beta_0 + \beta_1\, Adjust\_Mag\_Pos + \beta_2\, Adjust\_Mag\_Neg + Controls + FEs + u; \quad (2)$$

where the dependent variable (*CFO Dismissal*) equals one if there is a forced CFO turnover of a firm in year *t* during the 180-day window starting one week prior to the annual report filing date for fiscal year *t*-1 (i.e., [-7, +172]) and zero otherwise. Our independent variables are generally measured in year *t*-1 to reflect the most recent annual information available at the time of the CFO dismissal decision. In equation 1, *Adjust_Mag* is the absolute magnitude of the audit adjustments

[20] Of the 3,701 observations missing audit adjustment data shown in Table 2 panel B, 1,680 are due to missing data for fiscal year 2016. However, some audit firms voluntarily reported 2016 audit adjustment information. We obtain similar results if we exclude the voluntary reporters (untabulated).

[21] We use a linear probability model to avoid the incidental parameters problem that can occur with a significant number of fixed effects in a logistic model, but our results are robust to estimating logistic models (untabulated).

made to a firm's pre-audit profits divided by the absolute pre-audit profits (i.e., $|Profits_{post} - Profits_{pre}| / |Profits_{pre}|$). The coefficient on *Adjust_Mag* is expected to be significantly positive if boards of directors punish CFOs for low-quality financial reporting. In equation 2, we replace *Adjust_Mag* with *Adjust_Mag_Pos* and *Adjust_Mag_Neg* to investigate whether the likelihood of dismissal is influenced by the nature of misstatements identified by auditors. *Adjust_Mag_Pos* equals the magnitude of audit adjustments made to pre-audit profits divided by the absolute pre-audit profits (i.e., $(Profits_{post} - Profits_{pre}) / |Profits_{pre}|$) when profits are adjusted upward ($Profits_{post} > Profits_{pre}$) and zero otherwise ($Profits_{post} \leq Profits_{pre}$); *Adjust_Mag_Neg* is measured similarly but for downward adjustments to profits and takes the absolute value.

Our first set of control variables includes four measures of firm performance: post-audit return on assets (*ROA*) for both year *t*-1 and year *t*-2 as well as positive and absolute values of negative stock returns (*Ret_Pos* and *Ret_Neg*).[22] We include these firm performance variables to ensure the association between audit adjustments and executive turnover is not driven by firm performance, which has been shown to influence executive turnover (e.g., Warner et al. 1988; Weisbach 1988; Huson et al. 2001; Mian 2001).[23] Moreover, controlling for operational and market performance ensures that audit adjustments capture something distinct from poor-performing managers. We also control for corporate governance variables used in the literature (e.g., Weisbach 1988; Srivastav et al. 2017), including the number of directors on the board (*Board Size*), whether the CEO also chairs the board (*Duality*), the percentage of independent directors on the board (*Independence*), and the percentage of common shares outstanding held by the board

[22] We partition stock returns because Dikolli et al. (2014) and Minutti-Meza et al. (2022) find that executive turnover models exhibit greater explanatory power when performance is separated into its positive and negative components. In untabulated tests, we also partition ROA_{t-1} and ROA_{t-2} into their positive and negative components and find consistent results.

[23] Our results are also robust to using industry-adjusted performance measures (untabulated).

(*Director Ownership*), executives (*Executive Ownership*), and institutional investors (*Institutional Ownership*). In addition, we control for firm size (*Size*), the public signal of low-quality financial reporting quality indicated by restatement announcements (*Restate*), and two ownership characteristics, that is, whether the firm is a state-owned enterprise (*SOE*) and the ownership of the largest shareholder (*Largest Shareholder*). [24] Lastly, we control for CFOs' personal characteristics that might be associated with dismissal likelihood, including their age (*CFO Age*), gender (*CFO Gender*), and tenure (*CFO Tenure*) (Chen et al. 2013; Dikolli et al. 2014). The Appendix provides detailed variable definitions.

To test Hypothesis 2, we partition the sample based on governance quality and estimate regressions separately for each group. We elaborate on the partitioning variables in Section 5. We include year, industry, and audit firm fixed effects in all analyses unless otherwise specified and cluster standard errors by company to address potential serial correlation (Petersen 2009).[25,26] All continuous variables are winsorized at the first and 99th percentiles to mitigate the impact of outliers.

4.5 Descriptive statistics and correlations

Table 3 presents descriptive statistics for our main estimation sample. Over the sample period, 9.2% of firm-year observations have a forced CFO turnover event within the 180-day window [-7, +172]. Audit adjustments are common in the sample, with 41.64% (15.84%) of observations having negative-effect (positive-effect) audit adjustments (untabulated). Thus, the adjustment magnitude provides greater variation in a firm's degree of misstatement. As shown in

[24] Our results are also robust to a sample that excludes SOEs (untabulated).
[25] Our inclusion of audit firm fixed effects captures the average quality of each audit firm and results in our models using within-audit firm variation in adjustments. In an untabulated analysis, we also add a control for auditor switches. Inferences are consistent under this specification, and the auditor switch variable is insignificant.
[26] Industry classification is based on the industry classification code issued by the CSRC in 2012.

Table 3, external auditors have adjusted pre-audit profits by 7.4% on average during the audit process, of which 1.6% (5.8%) is due to audit adjustments that adjust pre-audit profits upward (downward). Turning to other control variables, the median value of ROA in year *t*-1 is 0.042, suggesting that most observations are profitable, though they experience a slight decline in ROA compared to that of the prior year. Consistent with the profitability of these firms, the average and median positive stock returns exceed the average and median negative stock returns in magnitude. With respect to CFO personal characteristics, the average age of CFOs in our sample is about 45 years old, 68.7% are male, and their average tenure is about 3.7 years. Finally, the largest shareholder has significant ownership of firms in our sample, consistent with prior research (Jiang and Kim 2015).

We also examine correlations (untabulated) among variables used in equations 1 and 2. Forced CFO turnover is positively correlated with the absolute magnitude of audit adjustments, especially with the absolute magnitude of downward audit adjustments. Consistent with prior research, forced CFO turnover is positively correlated with a restatement and negatively correlated with the earnings performance (ROA) of the firm. Forced turnover is also negatively associated with firms' state-owned nature and CFO tenure. Other correlations are as expected. For example, ROA_{t-1} is positively correlated with contemporaneous stock returns, and firm size is positively correlated with board size and institutional ownership.

5 Empirical results

5.1 Main results

Table 4 column 1 reports the results of estimating equation 1. *Adjust_Mag* is positive and statistically significant (p<0.01), suggesting that CFOs who provide lower-quality financial

reporting are more likely to be dismissed, supporting our first hypothesis.[27] Economically, a one-standard-deviation increase in the absolute magnitude of audit adjustments is associated with an 8.7% higher likelihood of forced CFO turnovers relative to the unconditional probability of CFO dismissal. Therefore, the impact of audit adjustments on CFO dismissal is both economically and statistically significant.

Turning to our control variables, we find a significant negative coefficient on ROA_{t-1} and a significant positive coefficient on the absolute magnitude of negative stock returns Ret_Neg_{t-1}, consistent with the literature that finds that executives are more likely to be fired if the firm performs poorly (Coughlan and Schmidt 1985; Warner et al. 1988; Huson et al. 2001; Mian 2001; DeFond and Hung 2004; Kato and Long 2006). The coefficient on *SOE* is significantly negative, indicating that firms with state ownership on average are less likely to dismiss CFOs. In addition, the coefficient on *Restate* is significantly positive, consistent with CFO dismissal following public signals of misreporting (Arthaud-Day et al. 2006; Desai et al. 2006; Hennes et al. 2008; Agrawal and Cooper 2017).[28]

Column 2 of Table 4 shows the results of estimating equation 2. We find that the coefficient on *Adjust_Mag_Neg* is positive and statistically significant (p<0.01), while the coefficient on *Adjust_Mag_Pos* is statistically insignificant, indicating that only the magnitude of audit adjustments that correct an overstatement of firm profits is associated with a higher likelihood of CFO dismissal.

[27] Our results are robust to using the natural log transformation of (one plus) *Adjust_Mag* following Lennox et al. (2020) and Lennox and Wu (2022).

[28] In addition to controlling for restatements, we conduct a robustness test by dropping observations with *Restate* equal to one. The coefficient on *Adjust_Mag* is significant and positive (p<0.01, untabulated), indicating that the board responds to audit adjustments, even in the absence of public signals of low financial reporting quality.

Our adjustment variables capture the magnitude of adjustments, but the mere presence of large adjustments likely serves as a signaling role to the board. To investigate how the presence of adjustments affects turnover decisions, we create separate indicators for any adjustment, negative adjustments, and positive adjustments that exceed 5 percent of pre-audit profits because this cutoff is often used as a rule of thumb by auditors to identify *material* misstatements. Using indicator variables also enables us to employ entropy balancing, which addresses fundamental, observable differences in company and auditor characteristics between firms with and without audit adjustments (Hainmueller 2012). We balance based on the presence of any large audit adjustment that exceeds 5 percent of pre-audit profits when the indicator for large adjustments (*Adjust_Large*) is the variable of interest and on large, negative adjustments when the indicator for large, negative adjustments (*Adjust_Large_Neg*) is included in the model. As shown in Table 4, columns 3 and 4, results resemble those using continuous measures of audit adjustments. These results suggest that a material (negative) audit adjustment increases the likelihood of CFO dismissal by 17.4% (18.5%) relative to the unconditional probability. In contrast, the coefficient on large, positive adjustments is insignificant (p>0.10).

Collectively, the results in Table 4 suggest that boards dismiss CFOs following nonpublic signals of low reporting quality and their willingness to do so is influenced by the nature of the audit adjustment. Research indicates that the market penalizes companies for overstating earnings more than for understating earnings (Palmrose et al. 2004) and that auditors also are more focused on overstatements (Nelson et al. 2002; Ke et al. 2015). Our results suggest that boards react to audit adjustments similarly in that they factor negative adjustments (i.e., overstatements) into CFO dismissal decisions but not positive ones (i.e., understatements). One reason for this asymmetric treatment may be that positive audit adjustments increase firm profits relative to management's

initially reported amounts, and the board might view this favorably because it reflects conservatism on the part of the managers. In contrast, a negative audit adjustment informs the board that management may have attempted to report aggressively and was prevented from doing so by the auditor. In addition, if management has provided performance results to the board throughout the year (e.g., quarterly or monthly operating reports), a negative adjustment, which occurs at year-end, also results in lower operating performance relative to the board's expectations developed over the course of the year. In subsequent tests, we focus on the magnitude of audit adjustments and evaluate positive and negative adjustments separately.

5.2 Cross-sectional evidence

In this section, we investigate whether a company's governance quality impacts the relation between audit adjustments and CFO dismissal as predicted in Hypothesis 2. We measure governance quality using two board characteristics that reflect the board of directors' ability and incentives to monitor the company's executives. First, we expect that a board with a relatively more informed audit committee will better enable the board to execute its oversight responsibilities. We use the size of the audit committee relative to the size of the board to measure audit committee influence because a larger committee implies that a greater percentage of the board learns about the audit adjustments directly from the auditor. Further, a board with a greater proportion of audit committee members also has more independent directors. We categorize an audit committee as large (small) if the percentage of audit committee members on the board of a firm in year *t*-1 equals or exceeds (is less than) the median within the firm size quintile. In column 2 of Table 5, we find a significantly positive coefficient on *Adjust_Mag_Neg* ($p<0.01$) for the subsample of firms with a large audit committee. The coefficient on *Adjust_Mag_Neg* also differs

significantly between small and large audit committee groups (p<0.10).[29] This result is consistent with management having greater difficulty influencing a larger audit committee and with more of the board being more likely to be informed about audit adjustments.

Second, we examine whether the CEO serving as board chair affects the association between audit adjustments and CFO dismissal. Boards with CEO-chair duality typically have less oversight and reduced ability to remove a top executive. Our partitioning variable is whether the CEO is also the board chair in year t-1. Columns 3 and 4 of Table 5 show the results from estimating equation 2 for each group. We find that the likelihood of CFO dismissal increases with the magnitude of negative audit adjustments only in the group of firms without CEO-chair duality (p<0.05), suggesting that greater managerial entrenchment and weaker governance lessens CFOs' accountability for low reporting quality.

6 Additional analyses

6.1 History of audit adjustments

Our results suggest that, when auditors prevent financial reporting misstatements, boards view this information as relevant to their decisions about CFO retention. While we do not expect CFO dismissal to necessarily be the average response to an audit adjustment, boards are more likely to dismiss CFOs when audit adjustments indicate more material misstatements. Therefore, we test whether dismissal is more evident in the presence of a pattern of audit adjustments. To do so, we perform two sets of additional tests that incorporate the history of audit adjustments. The first set of tests focuses on the moderating effect of existence and magnitude of *prior* audit adjustments, that is, whether there is any prior audit adjustment during the CFO's tenure, and

[29] For all cross-sectional analyses, we compare coefficients between subsamples using Fisher's permutation test with bootstrapping (Efron and Tibshirani 1993; Hsu et al. 2022), where p-values are based on one-tailed levels of significance because of our directional prediction regarding the tests.

whether the average absolute magnitude of prior audit adjustments over the CFO's tenure equals or exceeds the sample mean. In panel A of Table 6, we divide our sample based on these two measures respectively and re-estimate equation 2 for each group. We find that CFO dismissal is positively associated with negative-effect adjustments only when prior audit adjustments exist and when prior audit adjustments on average have a large magnitude (p<0.01). Moreover, the coefficient on *Adjust_Mag_Neg* is significantly larger for the group with a greater average prior adjustment magnitude (p<0.10).

Our second test investigates the change in the direction and magnitude of audit adjustments relative to the prior year. In this test, we identify firms in which pre-audit financial reporting quality is improving or declining. We define firms' reporting quality as worsening (improving) when current-year (prior-year) adjustments are negative and the absolute magnitude of current-year adjustments is greater (smaller) than that of prior-year. Firms not fitting in either of these categories (e.g., no audit adjustments in either year) are the base condition. In panel B of Table 6, we find that CFO dismissal is positively associated with the change in audit adjustment magnitude only when pre-audit financial reporting quality worsens (p<0.05). Overall, these results suggest that boards consider the pattern of misreporting in determining whether to dismiss CFOs.

6.2 Addressing alternative explanations

Our models control for predictors of dismissal, including measures of firm performance and publicly revealed misreporting, and employ a lagged specification, but unobserved company characteristics may still affect our results. To address this concern, we control for the effect of time-invariant company characteristics by estimating a linear probability model that includes company fixed effects. As shown in Table 7 panel A column 1, inferences from this specification

are consistent with our main results (p<0.05).[30]

Another potential concern with our main findings is that a CFO who knows of impending dismissal has declining power and therefore cannot push back against auditor-proposed adjustments, resulting in more audit adjustments in the CFO's final year (i.e., reverse causality). Our previous results in Table 6 suggest that reverse causality is unlikely because audit adjustments occurring over multiple years are associated with CFO dismissal. Furthermore, if reverse causality is an explanation, the association between CFO dismissal and audit adjustments should exist for both dismissal and voluntary turnover because a decline in CFO power would occur in both cases. In contrast, CFO dismissal decisions influenced by audit adjustments would be associated with dismissal but not with voluntary turnover. Thus, we conduct a placebo test by replacing the dependent variable in our primary tests (forced CFO turnover) with a measure of voluntary CFO turnover, defined as CFOs leaving the company within the 180-day window due to health or age.[31] Consistent with our expectation, we find no association between audit adjustments and voluntary CFO turnover (Table 7 panel A column 2, p>0.10). This result suggests that reverse causality is not a primary driver of our results.

We also consider public signals examined in the literature that are associated with low financial reporting quality. Note that audit adjustments correct low-quality reporting before such misreporting becomes public, so the correlation between audit adjustments and public signals of misreporting (i.e., misstatements not identified by auditors) is low both theoretically and in practice (Lennox et al. 2016). As our variable of interest represents a unique construct distinct

[30] We also estimate all other tabulated regressions after including company fixed effects (untabulated). Results are generally consistent, with 26 of 31 regressions producing the same inferences as those tabulated. The other five regressions produce weaker results on the variable of interest than those tabulated.

[31] There are other reasons an executive would voluntarily leave, including accepting an equivalent or better position (e.g., CEO, CFO, or board chair) elsewhere. However, CFOs departing for these reasons would likely retain a certain amount of power. Because we are interested in situations in which a departing CFO has limited power, we focus only on CFOs leaving without an equivalent or better opportunity.

from public signals documented in the literature, we use a carefully designed parsimonious model in our main regressions that includes controls for actual confounds in accordance with the guidance of Whited et al. (2022). Additionally, we control for restatement announcements throughout the paper, as a restatement is a prominent public signal of low-quality financial reporting that reflects both intentional earnings management and unintentional errors occurring through failures of internal control. Nevertheless, we conduct additional tests to demonstrate that other public signals of low reporting quality are not correlated omitted variables. First, we confirm that the correlations between audit adjustments and various public signals, including earnings management, material weakness in internal controls, regulatory sanctions, management forecast errors, earnings announcement errors, and uncertainties about going concern (Arthaud-Day et al. 2006; Desai et al. 2006; Hennes et al. 2008; Hazarika et al. 2012; Lee et al. 2012; Agrawal and Cooper 2017; Haislip et al. 2017) are fairly low, ranging from 5 percent to 12 percent. Then, we add controls for these public signals (*Material Weakness*$_{t-1}$, *Sanction*$_{t-1}$, *Discretionary Accruals*$_{t-1}$, *Management Forecast Error*$_{t-1}$, *Earnings Announcement Error*$_{t-1}$, and *Going Concern*$_{t-1}$) into our main regressions both one signal at a time and collectively.[32] In Table 7 panel B, we continue to find a positive association between audit adjustments and CFO dismissal (p<0.05 or lower) across all columns. While we have included a robust set of signals, one limitation of our study is that other signals could exist that we cannot include in our models. Nevertheless, our results suggest that

[32] The material weaknesses, regulatory sanctions, discretionary accruals, and going concerns data are from CSMAR, and data on management earnings forecasts and earnings announcements are from the RESSET database. For regulatory sanctions, we follow Lennox et al. (2018) and include sanctions related to financial reporting or disclosure irregularities.

audit adjustments convey different information to the board than other signals and that this information influences CFO dismissal decisions.[33]

6.3 Audit adjustments and CFO compensation

The results of our tests indicate that boards' demand for financial reporting quality influences decisions regarding CFO employment. However, dismissal is not the only way to incentivize quality reporting. One other tool is the use of compensation contracts with managers. The literature finds that boards use compensation to motivate CFOs to avoid low reporting quality in public disclosures (e.g., Hoitash et al. 2012; Hui and Matsunaga 2015), so we expect boards will similarly use CFOs' compensation in connection with private signals of low reporting quality.

To examine the effect of audit adjustments on CFO compensation, we exclude firm-years with CFO turnovers and modify equations 1 and 2 by replacing *CFO Dismissal* with a measure of compensation.[34] *CFO Compensation* is the natural logarithm of a CFO's cash compensation, including base salary, bonus, stipends, and other benefits.[35] Table 8 presents the results. In column 1, we find that the magnitude of audit adjustments in year *t*-1 is associated with lower CFO compensation in year *t* ($p<0.05$). Column 2 documents that negative audit adjustments are associated with lower CFO compensation ($p<0.01$), while positive audit adjustments are not associated with compensation ($p>0.10$). These results are consistent with our main findings

[33] We also conduct two additional untabulated tests. First, we control for sanctions occurring in year *t*+1 because the board may be aware of investigations in year *t* that are eventually made public in subsequent years. Results are consistent in this test. Second, we control for misstatements that are excluded from audit adjustments but later revealed through a restatement. The correlation between audit adjustments and concurrent remaining misstatements is low (~3.5 percent), and we find consistent results while simultaneously controlling for misstatements and restatement announcements. This test demonstrates that audit adjustments are a distinct construct from concurrent misstatements.
[34] The annual compensation for departing CFOs is likely to be uninformative, as the departing CFO typically works only a portion of the year. Including CFO turnover years could bias the results toward finding an effect. In addition, in years when a CFO is dismissed, boards are unlikely to take two disciplinary actions by decreasing compensation and terminating the CFO simultaneously. Thus, we examine compensation effects in the years where there are no CFO turnovers. In an untabulated analysis, we include and control for CFO turnover firm-years and find consistent results.
[35] We do not have access to data on the various components of cash compensation or to equity-based compensation.

regarding CFO dismissal and indicate that boards of directors use multiple methods to discipline CFOs for low-quality financial reporting.

6.4 Audit adjustments and CEO involvement in CFO dismissal

Although CFOs directly oversee financial reporting, CEOs have ultimate management responsibility over the company and other executives. Research indicates that CEOs may pressure CFOs to act in certain ways (Feng et al. 2011), and our survey of audit committee chairs indicates that boards evaluate both CEOs and CFOs using audit adjustments. Thus, we expect that boards will also incorporate reporting quality into their evaluation of CEOs. In addition, the CEO can make independent decisions about the CFO's employment or seek to influence the board either in favor of or against the CFO, given management is the primary provider of information to the board. These factors suggest that the dynamics of the relationship among the board, the CEO, and the CFO likely contribute to the party or parties who are held accountable for errors in financial reporting. In this section, we examine factors that influence employment decisions about CEOs and CFOs in connection with audit adjustments.

Our first consideration is whether the CEO is also held accountable for audit adjustments. We identify CEO turnovers from the CSMAR database and impose criteria like those used in Section 4 to identify forced CFO turnovers.[36] We are interested in whether CEOs are dismissed following audit adjustments or whether CEOs can protect themselves by deflecting blame to CFOs. To examine this question, we create three separate indicator variables: dismissal of the CEO (*CEO Dismissal*), dismissal of the CEO without dismissing the CFO (*CEO Only Dismissal*), and dismissal of both executives (*CEO & CFO Dismissal*). If the CEO deflects responsibility, we

[36] Like prior studies, we consider a CEO as the manager who has the job title of "chief executive officer" or "general manager" (e.g., Yan and Gray 1994; Tan and Tan 2005; Chang and Wong 2009). When the chief executive officer or general manager is unidentifiable for a firm-year, we use the individual who holds the "acting chief executive officer" or "acting general manager" title.

would not expect to find that audit adjustments are associated with CEO dismissal in the absence of CFO dismissal. We follow equation 2, except that we replace the dependent variable with one of these indicators and include personal characteristics for the corresponding executive(s) (i.e., either CEO or CFO characteristics or both).

Table 9 panel A reports the results on the relation between the magnitude of audit adjustments and CEO dismissal. In column 1, we find a positive and statistically significant association ($p<0.01$) between negative audit adjustments and CEO dismissal, suggesting that CEOs are held accountable for low-quality financial reporting, on average. In column 2, we find a significantly positive association ($p<0.05$) between negative audit adjustments and dismissal of both executives, indicating that boards hold both executives accountable for audit adjustments. However, in column 3, we find no evidence that CEOs are dismissed *without* the CFO also being dismissed ($p>0.10$). Collectively, the results in panel A indicate that boards hold both executives accountable for lapses in financial reporting but that the CEO can deflect some of the blame.

Given that our results suggest that the CEO has some influence over accountability for audit adjustments, our next consideration is how the relationship between the CEO and the CFO factors into that accountability. First, we expect that a more powerful CFO (compared to the CEO) will be able to temper potential personal consequences for financial reporting errors. As compensation reflects executive power (Song and Wan 2019), we proxy for the CFO's power using the ratio of the CFO's cash compensation to the CEO's cash compensation. Second, we expect that CEOs would prefer to have more power than the CFO. Research indicates that CFOs often act under pressure from CEOs (Feng et al. 2011), and Dikolli et al. (2021) note that a CEO who influenced the hire of a CFO (i.e., a co-opted CFO) benefits from the ability to pressure the CFO. Thus, we predict that the CEO is more likely to protect a co-opted CFO from the

consequences of audit adjustments. We also expect that a CEO would be more likely to coordinate with the board to dismiss a non-co-opted CFO in connection with financial misreporting, in an attempt to hire a new, co-opted CFO to increase the CEO's relative power.

Table 9 panel B reports the results on CEO/CFO relationship dynamics and CFO dismissal. In columns 1 and 2, we partition the sample based on the median value of CFO power and find a significant coefficient on *Adjust_Mag_Neg* ($p<0.05$) for the group with lower CFO compensation, while the coefficient on *Adjust_Mag_Neg* for the highly paid CFO group is insignificant. These coefficients differ statistically ($p<0.01$), suggesting that CFOs are more likely to face dismissal for audit adjustments when they are less powerful than the CEO. In columns 3 and 4, we partition the sample on whether the CFO is co-opted and find a significant coefficient on *Adjust_Mag_Neg* ($p<0.01$) only for the group in which the CFO is not co-opted, and the coefficients differ statistically ($p<0.01$). This suggests the CEO protects a co-opted CFO. Overall, the evidence in panel B suggests that the relationship between the CEO and the CFO impacts the effect of private signals of low reporting quality on CFO dismissal.

6.5 Consequences of audit adjustments and CFO dismissal

Given the association between audit adjustments and CFO dismissal, we consider how a dismissal decision in the presence of audit adjustments affects the company and the dismissed CFO. To do so, we identify 286 CFOs who were dismissed when their companies had material, negative-effect audit adjustments. Among these CFOs, 78 percent subsequently disappear from the dataset, suggesting they were no longer an executive or a board member for a public company in subsequent years. Of the 22 percent of these CFOs who continue to appear in the dataset, nearly all of them obtained subsequent positions that would be considered less prestigious (e.g., vice president). Regarding the company consequences, we examine subsequent financial reporting

quality after CFO dismissal and find that 79 percent of these companies experienced improved financial reporting quality in the following year, with the average magnitude of audit adjustment dropping by about half. These analyses suggest that board actions in response to material audit adjustments have significant consequences for companies and the dismissed CFOs.

7 Conclusion

Research documents that boards dismiss executives in connection with publicly revealed financial misreporting. Because these public signals may also reflect poorly on board members, studies provide inferences about the joint reaction to low financial reporting quality and to reputation protection of boards. We use a unique dataset of audit adjustments to investigate whether board members discipline CFOs for poor financial reporting quality when there is no public signal. Because our data represent a setting where the public does not know about the misreporting, we can document boards' responses to lapses in financial reporting when they face reduced reputational threats.

Using a survey of audit committee chairs, we find that auditors regularly communicate their audit findings to audit committee members, who in turn find the information useful in their evaluation of management. In subsequent empirical analyses, we document employment and compensation consequences for CFOs when auditors identify misstatements in the pre-audited financial statements. These consequences occur when the auditors propose corrections that result in a reduction in the firm's income, suggesting that boards react to an unexpected decrease in the firm's profits. We also find that firm governance quality and relationship dynamics between the CEO and the CFO impact the board's response to audit adjustments.

Our study makes several contributions to the literature. First, we document that boards of directors appear to use private information communicated by the auditor in their oversight of

management. Second, because our signal of financial misreporting is not associated with public pressure or immediate reputational implications for board members, our tests directly investigate whether boards proactively demand higher reporting quality. Finally, we contribute evidence concerning the governance environment in China. Our results provide evidence consistent with independent directors of the audit committee engaging in their fiduciary duty to demand reporting quality. Due to China's growing influence in the world economy, understanding its evolving governance environment and the corresponding implications for financial reporting quality and auditing in China is important. Moreover, the governance mechanisms we document in China may be even more relevant or pronounced in other settings where boards are seen as more effective.

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Appendix Variable definitions

CFO Dismissal	Equals one if there is a forced turnover of CFO during the 180-day window starting one week prior to the annual report filing date for fiscal year *t*-1 (i.e., [-7, +172]) and zero otherwise.
Adjust_Mag	The absolute magnitude of audit adjustments made to pre-audit profits divided by the absolute value of pre-audit profits (i.e., $\|Profits_{post} - Profits_{pre}\| / \|Profits_{pre}\|$).
Adjust_Mag_Pos	Equals the magnitude of audit adjustments made to pre-audit profits divided by the absolute value of pre-audit profits (i.e., $(Profits_{post} - Profits_{pre}) / \|Profits_{pre}\|$) when profits are adjusted upward ($Profits_{post} > Profits_{pre}$), and zero otherwise ($Profits_{post} \leq Profits_{pre}$).
Adjust_Mag_Neg	Equals the absolute magnitude of audit adjustments made to pre-audit profits divided by the absolute value of pre-audit profits (i.e., $\|Profits_{post} - Profits_{pre}\| / \|Profits_{pre}\|$) when profits are adjusted downward ($Profits_{post} < Profits_{pre}$) and zero otherwise ($Profits_{post} \geq Profits_{pre}$).
ROA	Net income before extraordinary items divided by total assets at the beginning of the fiscal year, based on post-audit financial numbers reported in the financial statements.
Ret_Pos	Equals buy-and-hold monthly stock returns during the fiscal year if it is positive and zero otherwise.
Ret_Neg	Equals the absolute value of buy-and-hold monthly stock returns during the fiscal year if it is negative and zero otherwise.
Size	Natural logarithm of total assets.
Board Size	The number of directors on the board.
Duality	Equals one if the positions of board chair and CEO are held by the same individual and zero otherwise.
Independence	The percentage of independent directors on the board.
Director Ownership	Percentage of common shares outstanding held by directors.
Executive Ownership	Percentage of common shares outstanding held by executives.
Institutional Ownership	Percentage of common shares outstanding held by institutional investors.
Largest Shareholder	Percentage of common shares outstanding held by the largest shareholder.
SOE	Equals one if one of the firm's controlling shareholders is a Chinese government agency or a state-owned company and zero otherwise.
Restate	Equals one if any irregularity restatements are announced in the 24-month period leading up to the financial statement filing date and zero otherwise. Irregularity restatements include "material," "fraud," "stock exchange," or "securities regulatory commission" in the description and often involve media coverage or regulator intervention. They do *not* involve clerical errors, adoption of new accounting principles, or amended reports for supplemental information or business changes (e.g., mergers, stock splits).
CFO Age	Age of the CFO in the corresponding fiscal year.
CFO Gender	Equals one if the CFO is a male and zero otherwise.
CFO Tenure	The number of years the CFO has been in office.

Table 1 Survey results

Question 1: As a member of an audit committee, to what extent do you meet with external auditors to discuss their procedures and findings during an audit?	
Regularly throughout the year	13.79%
Several times or more throughout the annual audit	34.48%
Once at the end of the annual audit	34.48%
Never	10.34%
Other	6.90%
Question 2: When auditors identify material misstatements during an audit of the financial statements, they propose adjustments to correct the misstatements. How often do you as an audit committee member become aware of these adjustments or the net effect of these adjustments on earnings?	
Most of the time	17.24%
Sometimes	41.38%
Rarely	27.59%
Never	13.79%
Question 3: On a scale of 1 (not at all important) to 7 (very important), how important are audit adjustments to earnings for your evaluation of the company's financial reporting quality?	
Mean	5.07
Median	5.00
Question 4: On a scale of 1 (not useful) to 7 (very useful), how useful are audit adjustments in evaluating management's financial reporting quality in the following scenarios?	
Any time there are audit adjustments regardless of their materiality	Mean: 4.48
When audit adjustments result in material changes to pre-audited earnings	Mean: 5.72
When there is a pattern of audit adjustments across several years	Mean: 5.34
When audit adjustments correct material overstatements of pre-audited earnings	Mean: 5.90
When audit adjustments correct material understatements of pre-audited earnings	Mean: 5.28
Question 5: On a scale of 1 (not at all informative) to 7 (very informative), to what extent do audit adjustments convey information to the audit committee about the following:	
Management's integrity	Mean: 5.14
Management's competence	Mean: 4.86
Management's attempts to manage earnings	Mean: 5.41

(Continued)

Table 1 (continued)

Question 6: On a scale of 1 (not at all important) to 7 (very important), how important are audit adjustments to your evaluation of the following managers:	
The chief executive officer (CEO), or equivalent, e.g., general manager	Mean: 5.07
The chief financial officer (CFO)	Mean: 5.52
Question 7: Including current board assignments, approximately how many boards have you served on?	
Mean	4.9
High	10
Low	1
Median	5
Question 8: How many years have you been an audit committee member since first being appointed to a board?	
Mean	7.62
High	15
Low	1
Median	7
Demographics	
Gender:	
Male	72.41%
Female	27.59%
Age:	
40 or younger	10.34%
41–50	72.41%
51–60	13.79%
61 or older	3.45%

This table provides results from a survey of 29 audit committee chairs of listed companies in China.

Table 2 Sample selection

Panel A: Procedures to identify forced CFO turnovers

	No. of Turnovers
Initial CFO Turnovers during 2010–2019 in RESSET	5,705
Less: Duplicate turnovers of a firm-year	(349)
Less: Observations of firms trading on over-the-counter market	(568)
Less: Observations without a matchable stock identifier	(43)
Less: Observations of financial firms and B-shares	(81)
Less: Voluntary CFO turnovers, including each of the following six categories:	
(1) Turnovers due to health issues or change in controlling shareholders	(15)
(2) Departing CFO whose age is 60 or older	(234)
(3) Departing acting CFO who is promoted to official CFO or is re-hired as CFO within our sample period	(145)
(4) Departing CFO who is promoted to CEO or stays on as board chair	(238)
(5) Departing CFO who becomes the CFO of another listed firm	(72)
(6) Departing CFO who becomes the CEO or board chair of another listed firm	(12)
Total available forced CFO turnovers	3,948
Less: Turnovers outside the [-7, +172] window	(1,799)
Less: Observations missing other information needed in main analysis	(937)
Final number of forced CFO turnovers in regression sample	1,212

Panel B: Sample selection procedures

	Firm-Year	Unique Firms
Full Sample during 2010–2019 in CSMAR	29,939	3,953
Less: Observations of financial firms	(608)	(82)
Less: Observations of B-shares	(1,037)	(109)
Less: Firm-years with voluntary CFO turnovers	(716)	(2)
Less: Firm-years with CFO turnovers outside of the [-7, +172] window	(1,799)	(4)
Less: Observations missing data for control variables	(8,885)	(777)
Less: Observations missing information on audit adjustments to profits	(3,701)	(187)
Final Sample	13,193	2,792

(Continued)

Table 2 (continued)

Panel C: Number of observations by year			
Year	N	No. of forced CFO turnovers	%
2010	973	69	7.1%
2011	1,039	85	8.2%
2012	1,223	80	6.5%
2013	1,521	126	8.3%
2014	1,759	149	8.5%
2015	1,700	149	8.8%
2016	1,741	167	9.6%
2017	309	31	10.0%
2018	1,479	179	12.1%
2019	1,449	177	12.2%
Total	13,193	1,212	9.2%

This table presents the sample used in our main analysis. Panel A shows how we identify forced CFO turnovers. Panel B shows the sample selection procedures. Panel C presents the number of observations and the percentage of forced CFO turnovers in each year.

Table 3 Descriptive statistics

	Mean	S.D.	P25	Median	P75
CFO Dismissal	0.092	0.289	0.000	0.000	0.000
Adjust_Mag	0.074	0.195	0.000	0.004	0.047
Adjust_Mag_Pos	0.016	0.092	0.000	0.000	0.000
Adjust_Mag_Neg	0.058	0.177	0.000	0.000	0.027
ROA_{t-1}	0.051	0.081	0.012	0.042	0.084
ROA_{t-2}	0.056	0.082	0.014	0.045	0.088
Ret_Pos	0.368	0.600	0.000	0.063	0.518
Ret_Neg	0.118	0.166	0.000	0.000	0.228
Size	22.079	1.304	21.181	21.919	22.815
Board Size	8.761	1.765	8.000	9.000	9.000
Duality	0.237	0.425	0.000	0.000	0.000
Independence	0.372	0.053	0.333	0.333	0.417
Director Ownership	0.100	0.175	0.000	0.000	0.129
Executive Ownership	0.054	0.122	0.000	0.000	0.024
Institutional Ownership	0.066	0.074	0.010	0.039	0.096
Largest Shareholder	0.348	0.150	0.229	0.327	0.450
SOE	0.424	0.494	0.000	0.000	1.000
Restate	0.088	0.283	0.000	0.000	0.000
CFO Age	45.016	6.175	41.000	45.000	49.000
CFO Gender	0.687	0.464	0.000	1.000	1.000
CFO Tenure	3.686	3.034	1.200	3.000	5.500

This table shows the descriptive statistics of the variables used in our main analysis. All variables are defined in the appendix. All continuous variables are winsorized at the first and 99^{th} percentiles. The number of firm-years for all variables is 13,193.

Table 4 Audit adjustment magnitude and CFO dismissal

	Dependent variable: CFO Dismissal			
	Continuous Variables		Indicators with Entropy Balancing	
	(1)	(2)	(3)	(4)
$Adjust\_Mag_{t-1}$	**0.041*** **			
	(2.62)			
$Adjust\_Mag\_Pos_{t-1}$		0.000		
		(0.01)		
$Adjust\_Mag\_Neg_{t-1}$		**0.052*** **		
		(2.87)		
$Adjust\_Large_{t-1}$			**0.016** **	
			(2.41)	
$Adjust\_Large\_Pos_{t-1}$				-0.002
				(-0.14)
$Adjust\_Large\_Neg_{t-1}$				**0.017** **
				(2.21)
ROA_{t-1}	-0.182***	-0.178***	-0.225***	-0.281***
	(-4.16)	(-4.09)	(-3.22)	(-4.00)
ROA_{t-2}	-0.062	-0.063	-0.121**	-0.108*
	(-1.51)	(-1.55)	(-1.99)	(-1.69)
Ret_Post_{t-1}	0.006	0.006	0.009	0.011
	(0.97)	(0.95)	(1.09)	(1.16)
Ret_Neg_{t-1}	0.047**	0.046**	0.032	0.037
	(2.01)	(1.99)	(1.00)	(1.10)
$Size_{t-1}$	0.001	0.001	-0.002	-0.005
	(0.23)	(0.23)	(-0.55)	(-1.21)
Board $Size_{t-1}$	-0.002	-0.002	-0.001	-0.001
	(-0.91)	(-0.93)	(-0.54)	(-0.40)
$Duality_{t-1}$	0.002	0.002	-0.003	-0.002
	(0.29)	(0.26)	(-0.33)	(-0.19)
$Independence_{t-1}$	0.019	0.019	0.105	0.102
	(0.35)	(0.35)	(1.34)	(1.21)
Director $Ownership_{t-1}$	0.014	0.014	-0.001	0.003
	(0.53)	(0.53)	(-0.03)	(0.08)
Executive $Ownership_{t-1}$	-0.005	-0.005	0.037	0.032
	(-0.12)	(-0.12)	(0.70)	(0.59)
Institutional $Ownership_{t-1}$	-0.009	-0.008	0.045	0.061
	(-0.25)	(-0.23)	(0.85)	(1.06)
Largest $Shareholder_{t-1}$	0.005	0.005	-0.005	0.002
	(0.25)	(0.26)	(-0.19)	(0.08)
SOE_{t-1}	-0.023***	-0.023***	-0.026***	-0.026***
	(-3.51)	(-3.51)	(-3.04)	(-2.74)
$Restate_{t-1}$	0.022**	0.022**	0.017	0.018
	(2.12)	(2.12)	(1.33)	(1.29)
CFO Age_{t-1}	0.000	0.000	-0.001	-0.001
	(0.24)	(0.25)	(-0.95)	(-1.09)
CFO $Gender_{t-1}$	0.013**	0.013**	0.020***	0.022***
	(2.40)	(2.41)	(2.73)	(2.92)
CFO $Tenure_{t-1}$	-0.001	-0.001	-0.002	-0.002*
	(-1.58)	(-1.58)	(-1.38)	(-1.82)
Constant	0.084	0.084	0.133	0.192**
	(1.43)	(1.43)	(1.61)	(2.15)

(*Continued*)

Table 4 (continued)

Year FEs	Yes	Yes	Yes	Yes
Industry FEs	Yes	Yes	Yes	Yes
Audit Firm FEs	Yes	Yes	Yes	Yes
N	13,193	13,193	13,193	13,193
Adj. R^2	0.009	0.010	0.023	0.026

This table reports the results of testing H1. Column 1 presents the results of estimating equation 1, and column 2 reports the results of estimating equation 2. Columns 3 and 4 present results employing entropy balancing based on *Adjust_Large* and *Adjust_Large_Neg*, respectively. $Adjust\_Large_{t-1}$ equals one if the magnitude of audit adjustment exceeds 5% of pre-audit profits of year *t*-1 and zero otherwise. $Adjust\_Large\_Neg_{t-1}$ ($Adjust\_Large\_Pos_{t-1}$) equals one if the audit adjustment decreases (increases) pre-audit profits of year *t*-1 by more than 5% and zero otherwise. *t*-statistics in parentheses are based on standard errors clustered by firm. All variables are defined in the appendix. ∗∗∗, ∗∗, and ∗ denote significance at the 1%, 5%, and 10% levels, respectively.

Table 5 Effect of governance quality

	Dependent Variable: CFO Dismissal			
	(1)	(2)	(3)	(4)
	Small AC	Large AC	Duality=1	Duality=0
Adjust_Mag_Pos$_{t-1}$	-0.033	0.029	0.042	-0.009
	(-0.98)	(0.67)	(0.60)	(-0.29)
Adjust_Mag_Neg$_{t-1}$	0.033	**0.069*****	0.039	**0.053****
	(1.30)	(2.62)	(0.99)	(2.54)
Controls	Included	Included	Included	Included
Year FEs	Yes	Yes	Yes	Yes
Industry FEs	Yes	Yes	Yes	Yes
Audit Firm FEs	Yes	Yes	Yes	Yes
N	7,164	6,022	3,120	10,061
Adj. R^2	0.006	0.011	0.016	0.007
Test of coefficients	*p*-value=0.058		*p*-value=0.132	

This table reports the results of testing H2. An audit committee is classified as large (small) if the percentage of audit committee members on the board of a firm at the end of year *t*-1 equals or exceeds (is less than) the median within the firm size quintile. *Duality* equals one if the CEO is also the board chair and zero otherwise. *t*-statistics in parentheses are based on standard errors clustered by firm. Definitions of remaining variables are in the appendix. ∗∗∗, ∗∗, and ∗ denote significance at the 1%, 5%, and 10% levels, respectively.

Table 6 History of audit adjustments and CFO dismissal

Panel A: Effect of prior audit adjustments				
	Dependent Variable: CFO Dismissal			
	(1)	(2)	(3)	(4)
	Prior_Adjust =1	Prior_Adjust =0	Avg_Adjust_Mag is High	Avg_Adjust_Mag is Low
$Adjust\_Mag\_Pos_{t-1}$	0.011	-0.039	0.016	-0.028
	(0.31)	(-0.84)	(0.53)	(-0.39)
$Adjust\_Mag\_Neg_{t-1}$	**0.061*****	0.047	**0.064*****	0.047
	(2.76)	(1.41)	(2.98)	(1.08)
Controls	Included	Included	Included	Included
Year FEs	Yes	Yes	Yes	Yes
Industry FEs	Yes	Yes	Yes	Yes
Audit Firm FEs	Yes	Yes	Yes	Yes
N	7,612	5,576	2,557	10,578
Adj. R^2	0.014	0.008	0.021	0.008
Test of coefficients	*p*-value=0.180		*p*-value=0.092	

Panel B: Change in severity of audit adjustments	
	Dependent Variable: CFO Dismissal
$Get\_Better\_Mag_{t-1}$	0.031
	(1.53)
$Get\_Worse\_Mag_{t-1}$	**0.053****
	(2.43)
Controls	Included
Year FEs	Yes
Industry FEs	Yes
Audit Firm FEs	Yes
N	10,522
Adj. R^2	0.007

This table displays the results of examining the effect of the history of audit adjustments on CFO dismissal. *Prior_Adjust* equals one if there are any audit adjustments prior to fiscal year *t*-1 during the CFO's tenure and zero otherwise. *Avg_Adjust_Mag* is high (low) if the average magnitude of audit adjustments prior to fiscal year *t*-1 during the CFO's tenure equals or exceeds (is lower than) the sample mean. $Get\_Better\_Mag_{t-1}$ ($Get\_Worse\_Mag_{t-1}$) equals the absolute difference between the signed magnitude of audit adjustment in year *t*-1 and year *t*-2 for the same CFO if pre-audit financial reporting quality improves (worsens) in year *t*-1 compared to year *t*-2 and zero otherwise. Pre-audit financial reporting quality is classified as improving if year *t*-2 has negative audit adjustments and year *t*-1 has no adjustments or adjustments are smaller than in year *t*-2. Pre-audit financial reporting quality is classified as worsening if the adjustments in year *t*-1 are negative and are greater than adjustments in year *t*-2. *t*-statistics in parentheses are based on standard errors clustered by firm. Definitions of remaining variables are in the appendix. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

Table 7 Addressing alternative explanations

Panel A: Alternative specifications		
	Dependent variable	
	CFO Dismissal	Voluntary CFO Turnover
	(1)	(2)
	Company FEs	Placebo Test
$Adjust\_Mag\_Pos_{t-1}$	0.025	0.002
	(0.80)	(0.21)
$Adjust\_Mag\_Neg_{t-1}$	**0.043****	0.002
	(2.13)	(0.41)
Controls	Included	Included
Year FEs	Yes	Yes
Industry FEs	No	Yes
Audit Firm FEs	Yes	Yes
Company FEs	Yes	No
N	12,835	12,059
Adj. R^2	0.047	0.037

(Continued)

Table 7 (continued)

Panel B: Control for other public signals

	Dependent Variable: CFO Dismissal						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Adjust_Mag_Pos$_{t-1}$	-0.000	0.001	0.013	0.000	-0.000	0.000	0.012
	(-0.01)	(0.04)	(0.43)	(0.01)	(-0.01)	(0.01)	(0.39)
Adjust_Mag_Neg$_{t-1}$	**0.049*****	**0.050*****	**0.045****	**0.051*****	**0.048*****	**0.052*****	**0.038****
	(2.75)	(2.75)	(2.39)	(2.81)	(2.68)	(2.90)	(2.00)
Material Weakness$_{t-1}$	0.099***						0.078**
	(2.68)						(2.03)
Sanction$_{t-1}$		0.030***					0.027***
		(3.72)					(3.28)
Discretionary Accruals$_{t-1}$			0.017				0.018
			(0.57)				(0.59)
Management Forecast Error$_{t-1}$				0.027			-0.007
				(0.87)			(-0.23)
Earnings Announcement Error$_{t-1}$					0.251		0.297*
					(1.51)		(1.70)
Going Concern$_{t-1}$						-0.020	-0.030
						(-0.98)	(-0.97)
Controls	Included	Included	Included	Included	Included	Included	Included
Year FEs	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry FEs	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Audit Firm FEs	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	13,193	13,193	12,498	13,193	13,193	13,193	12,498
Adj. R^2	0.011	0.011	0.008	0.010	0.010	0.010	0.010

This table reports the results of analyses addressing alternative explanations. In panel A, column 1 presents a linear probability model that includes company fixed effects. Column 2 presents results after replacing CFO dismissal with voluntary CFO turnover, defined as CFOs leaving the company within the 180-day window due to health or age. In panel B, the models include various public signals. *Material Weakness$_{t-1}$* equals one if there are any disclosed material weaknesses in internal control for fiscal year *t*-1 and zero otherwise. *Sanction$_{t-1}$* equals one if there is any regulatory sanction announced during the 24-month period leading up to the financial statement filing date of year *t*-1 and zero otherwise. *Discretionary Accruals$_{t-1}$* is the absolute value of abnormal accruals for year *t*-1 obtained from the modified Jones model (Dechow et al. 1995). *Management Forecast Error$_{t-1}$* is the absolute value of the difference between management's earnings forecast and reported earnings for year *t*-1, scaled by the number of shares outstanding at the beginning of the year. This variable is set to zero if the company had no management forecasts. *Earnings Announcement Error$_{t-1}$*

is the absolute value of the difference between the earnings per share in the earnings announcement and the earnings per share reported in the year t-1 annual report. If the company made no earnings announcement, this variable is set to zero. *Going Concern*$_{t-1}$ equals one if auditors identify going-concern uncertainties during the year t-1 audit and zero otherwise. t-statistics in parentheses are based on standard errors clustered by firm. ∗∗∗, ∗∗, and ∗ denote significance at the 1%, 5%, and 10% levels, respectively.

Table 8 Audit adjustments and CFO compensation

	Dependent Variable: CFO Compensation	
	(1)	(2)
$Adjust\_Mag_{t-1}$	**-0.138****	
	(-2.50)	
$Adjust\_Mag\_Pos_{t-1}$		-0.070
		(-0.59)
$Adjust\_Mag\_Neg_{t-1}$		**-0.157*****
		(-2.65)
ROA_{t-1}	1.253***	1.248***
	(6.07)	(6.05)
ROA_{t-2}	0.975***	0.977***
	(6.47)	(6.47)
Ret_Pos_{t-1}	0.036*	0.036*
	(1.85)	(1.86)
Ret_Neg_{t-1}	0.006	0.007
	(0.08)	(0.09)
$Size_{t-1}$	0.181***	0.181***
	(13.45)	(13.46)
Board $Size_{t-1}$	0.025***	0.025***
	(2.60)	(2.61)
$Duality_{t-1}$	-0.024	-0.023
	(-0.72)	(-0.70)
$Independence_{t-1}$	-0.042	-0.042
	(-0.15)	(-0.15)
Director $Ownership_{t-1}$	-0.333***	-0.333***
	(-3.28)	(-3.28)
Executive $Ownership_{t-1}$	0.350***	0.350***
	(2.65)	(2.65)
Institutional $Ownership_{t-1}$	0.391**	0.388**
	(2.41)	(2.39)
Largest $Shareholder_{t-1}$	-0.191**	-0.191**
	(-2.04)	(-2.05)
SOE_{t-1}	0.030	0.030
	(0.89)	(0.89)
$Restate_{t-1}$	-0.082*	-0.082*
	(-1.83)	(-1.83)
CFO Age_{t-1}	-0.001	-0.001
	(-0.53)	(-0.53)
CFO $Gender_{t-1}$	0.092***	0.092***
	(3.73)	(3.73)
CFO $Tenure_{t-1}$	0.014***	0.014***
	(3.33)	(3.33)
Constant	8.523***	8.523***
	(25.81)	(25.80)
Year FEs	Yes	Yes
Industry FEs	Yes	Yes
Audit Firm FEs	Yes	Yes
N	11,962	11,962
Adj. R^2	0.210	0.210

This table reports the effect of audit adjustments on CFO compensation. *CFO Compensation* is the natural logarithm of the CFOs' cash compensation, including base salary, bonus, stipends, and other benefits. *t*-statistics in parentheses are based on standard errors clustered by firm. All other variables are defined in the appendix. ∗∗∗, ∗∗, and ∗ denote significance at the 1%, 5%, and 10% levels, respectively.

Table 9 Audit adjustments and the involvement of CEOs in CFO dismissal

Panel A: CEO and CFO dismissal

	Dependent Variable		
	CEO Dismissal	CEO & CFO Dismissal	CEO Only Dismissal
	(1)	(2)	(3)
$Adjust\_Mag\_Pos_{t-1}$	0.028	0.008	0.014
	(0.99)	(0.43)	(0.64)
$Adjust\_Mag\_Neg_{t-1}$	**0.044*****	**0.026****	0.019
	(2.68)	(2.22)	(1.39)
Controls	Included	Included	Included
Year FEs	Yes	Yes	Yes
Industry FEs	Yes	Yes	Yes
Audit Firm FEs	Yes	Yes	Yes
N	13,690	11,640	13,778
Adj. R^2	0.023	0.013	0.013

Panel B: Relationship dynamics between CEOs and CFOs

	Dependent Variable: CFO Dismissal			
	(1)	(2)	(3)	(4)
	Highly Paid CFO=1	Highly Paid CFO=0	CFO Co-Opt=1	CFO Co-Opt=0
$Adjust\_Mag\_Pos_{t-1}$	0.001	-0.023	-0.019	0.006
	(0.04)	(-0.54)	(-0.43)	(0.16)
$Adjust\_Mag\_Neg_{t-1}$	-0.013	**0.070****	-0.005	**0.089*****
	(-0.84)	(2.33)	(-0.16)	(3.88)
Controls	Included	Included	Included	Included
Year FEs	Yes	Yes	Yes	Yes
Industry FEs	Yes	Yes	Yes	Yes
Audit Firm FEs	Yes	Yes	Yes	Yes
N	6,679	5,948	4,092	8,974
Adj. R^2	0.013	0.023	0.023	0.021
Test of coefficients	*p*-value=0.007		*p*-value=0.000	

This table reports results from tests involving CEO turnover and the relationship between the CEO and CFO. *CEO Dismissal* equals one if there is a forced CEO turnover of firm *i* during the 180-day window starting one week prior to the annual report filing date of fiscal year *t*-1 (i.e., [-7, +172]) and zero otherwise. *CEO & CFO Dismissal* equals one if there is forced turnover of both the CEO and the CFO and zero otherwise. *CEO Only Dismissal* equals one if there is forced turnover of the CEO but no forced turnover of the CFO. *Highly Paid CFO* represents above-median values of the ratio of CFO cash compensation to CEO cash compensation. *CFO Co-Opt* is set to one when the CFO was hired any time after the CEO was hired and zero otherwise. Sample sizes vary from prior tests due to additional data availability. *t*-statistics in parentheses are based on standard errors clustered by firm. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.