

# How Do Companies Adjust their Independent Directors after a Mishap

—Evidence from Independent Directors' Background

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## ABSTRACT

*Selection of independent directors in China's listed companies is a two-way choice dominated by listed companies. Thereafter, most companies adjust their independent directors after a mishap (e.g. receiving qualified audit opinions or punished by regulatory authorities). This paper investigates the behavior of how companies adjust their independent directors from the perspective of independent directors' background, by using data of Chinese listed companies to which a mishap happened between 2002 and 2004 as our target sample. Evidence shows that listed companies will increase independent directors with accounting background significantly after receiving qualified audit opinions or punished by regulatory authorities, for the purpose of mitigating distress from capital market and medium and minority shareholders, which highlights the supervising role of independent directors with accounting background. Besides, these companies enjoy significantly contemporaneous return after the adjustment.*

**Keywords:** Independent Directors, Adjust, Background, Corporate Governance

## 1. Introduction

Independent director system is widely believed as an important action to improve corporate governance and now becomes the common choice among different corporate governance patterns [1]. In China, the system comprised of three parties (*i.e.* China Securities Regulatory Commission, listed companies and independent directors) was enforced as a “life saving straw” in 2001 when reform on non-tradable shares encounters a variety of difficulties. To better protect interests of medium and minority shareholders, China Securities Regulatory Commission (CSRC thereafter), one of the most important regulatory authorities in China's capital market, issued guidance on establishing independent directors system in listed companies (the Guidance thereafter) on August 16, 2001, which gave birth to China's independent directors system.

In consequence, a huge “blind date” between listed companies and independent directors carries on amid fire and thunder. In reality, listed companies have made sufficient comparison and consideration among different candidates before formal invitations and employment. A

person who is assigned to be an independent director must have some strength which is favored by companies, such as social status, professional skills, networking resources or just easy to be controlled [2]. Meanwhile, independent directors can not only get paid, but also reputation, which was deemed as the “fame and fortune” appointment. Therefore, selection of independent directors in Chinese listed companies is a two-way choice dominated by listed companies. What's the motivation of listed companies in the selections? Do they have adequate incentives to choose independent directors for supervising? This is the main question we are going to answer first.

However, whether the system is perfect designed need further investigation. The collapse of Enron, WorldCom, and similar but less catastrophic disclosure failures vividly demonstrated weaknesses in the board governance system produced by the 1990s and pointed the way towards new roles for independent directors and standards of independence [3]. At the end of 1997, Zhengbaiwen was operating at a loss, and so falsified its financial report to make stockholders believe that the company was doing well. This caused stockholders a 98.79% loss in

1998. Listed companies have autonomies in initial selections; however, they will be challenged by medium and minority shareholders or even punished by law when mishap happens. Besides, mass media functions as a “watch dog” on shareholders’ interest in the whole process. As we all see that independent director Jiahao Lu was fined RMB 100,000 in “Zhengbaiwen Event”, for failing to take action when the company submitted a false financial report. Thus, the question arises: will listed companies adjust independent directors as a means to mitigate pressures from regulatory authorities, capital market and medium and minority shareholder? How do market participants react to different adjustment of independent directors? In this paper, we are trying to address these questions.

We motivate this work by investigating the behavior of how companies adjust their independent directors from the perspective of independent directors’ background. We find that percentages of independent directors with accounting background increase significantly in mishap companies. We found that 67% of companies’ independent directors have accounting background in the event year, while increasing to 78% in the subsequent year. Besides, adding accounting professionals after a mishap can help companies mitigate distress from capital market and medium and minority shareholders, which highlights the supervising role of independent directors with accounting background.

The remaining of this paper is organized as follows. The second section provides institutional background and hypothesis. The third section is data and variables description. The fourth section lists descriptive statistics. The fifth section offers empirical test and explanation. The sixth section concludes the paper.

## 2. Institutional Background and Hypothesis

### 2.1. Institutional Background

To put forward in order to further improve the corporate governance structures and promote the standardized operation of listed companies, on August 16, 2001 CSRC issued the guiding opinion on establishment of independent director systems by listed companies, which gave birth to China’s independent directors system.

The Guidance requires independent directors with strong economics and law background. In particular, one of them should be accounting expert. Nevertheless, little rigid requirement is addressed on the specific background of independent directors; people who can satisfy as an independent director are not rare. Thus, independent directors can be from various industries with different background, playing their own distinct role in companies.

The Guidance requires listed companies should establish independent director systems. Besides, CSRS address that an independent director should have the qualifications required to exercise his functions and powers as such a person holding the position of independent director, independent directors must be independent. The nomination, election and replacement of independent directors should be conducted in a legal and standardized manner [4].

Lou [5] documented foreign researches and found that independent directors work as supervisors, strategy designers and politicians in companies. Research Center of Shanghai Security Exchange [6] believed that functions of independent directors are supervision, assistance and networking. Zhou [7] considers independent directors serve as supervisors and consultants for listed companies. Due to the inconsistency of original intention on establishing independent system among CSRC, listed companies and independent directors, whether independent directors are competent and willing to work as a supervisor and consultant need further consideration. This paper uses incentive compatibility theory to analyze incentive incompatibility in initial selections of independent directors and incentive compatibility in adjusting after a mishap.

### 2.2. Incentive Incompatibility: In Initial Selections

Incentive incompatibility is a mechanism design in which conflicting objects exists in principal and agent. Under certain circumstance, agents have no incentive working hard to fulfill principal’s goals; what is more serious, agents may choose behaving negligence and profusion in hopes of self-interest maximization.

The controller of such [joint-stock] companies, however, being the managers of other people’s money rather than of their own, cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honor, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company [8]. China’s independent directors system was created from a mandatory institutional change led by CSRC, which gave birth to a special principal-agent relationship — CSRC delegate listed companies to employ independent directors. In this case, CSRC is the principal, listed companies are agent. CSRC, listed companies and independent directors, as the main parties in this mechanism, have different incentive and opinions in the implementation, therefore, Qingquan Tang [9] analyze the three incentives. CSRC’s

incentive is optimizing board structures in listed companies, protecting interest of medium and minority shareholders, improving information disclosure and internationalization. From the view of listed companies, they induct independent directors in hopes of improving company's image and decision-making ability, dealing with challenges and conquering financial stress. Speaking of independent directors, this invitation means not only get paid and easier to fetch resources, but also reputation and self-fulfillment.

Obviously, incentive conflictions among CSRC, listed companies and independent directors bring disagreement to the establishment of independent directors system. Referring to the consultant role, incentive confliction doesn't exist. In detail, independent directors provide listed companies with strategic, political and networking assistance by using "knowledge capital" of their own, which creates promotion to company's performance. As a result of that, independent directors will enjoy higher reputation and compensation. Here is a "trilateral win contract", which indicates the realization of incentive compatibility. There are conflict incentives of the three parties in independent director's "supervision role". For one thing, there is incentive conflictions originated from the selection mechanism. The reality that independent directors are nominated by majority shareholders in most Chinese listed companies determines that independent directors cannot stand in medium and minority shareholder's shoes as CSRC expected, otherwise incentive incompatibility will come into being. Secondly, the compensation mechanism in independent directors system brings incentive conflictions. It is the listed company controlled by the first majority shareholder and management who pays for independent directors, but the main duty them is supervising the company. In conclusion, regulatory authorities expect independent directors serve as a compatible supervisor; nevertheless listed companies don't want to see that condition happens by no means, they hope independent directors are only consultant rather than watchdog, which shows the incentive incompatible in the selection of independent directors between the principal (regulatory authorities) and agent (listed companies).

### 2.3. Incentive Compatibility: Adjustment after the Mishap

In mechanism design, a process is said to be incentive compatible if all of the participants fare best when they truthfully reveal any private information asked for by the mechanism. As an illustration, voting systems which create incentives to vote dishonestly lack the property of incentive compatibility. In the absence of dummy bidders

or collusion, a second price auction is an example of mechanism that is incentive compatible.

Listed companies wish independent directors to be consultant rather than supervisor. This intention is one-sided romance to some degree because the Guidance requires at least one accounting professionals should be presented as an independent director. What's more, listed companies cannot dominate the selection confronting with pressures from medium and minority shareholders, regulatory authorities and capital market. More and more challenges are heard these days focusing on the issue independent directors are not independent, with little awareness neither. The emergence of independent directors system is to protect medium and minority shareholders, but what we can see is quite different from what we hoped. Lack of independence means independent directors are controlled and manipulated by majority shareholders. Meanwhile, lack of awareness means they cannot satisfy the general public as integrity and competent professionals. Anecdotal evidence shows that independent directors will not only be challenged medium and minority shareholders, regulatory authorities, but also punished by law in serious circumstance after a mishap. Thus, listed companies will adjust independent directors after a mishap hoping to mitigate distress from capital market and medium and minority shareholders, hence, incentive compatibility happens.

### 2.4. Hypothesis

As the independence of independent directors is difficult to measure, this paper mainly test the awareness of them (*i.e.* competence and motivation of independent directors). Jensen and Meckling [10] analyze how the cost of transferring specific knowledge encourages the decentralization of decision rights and how this decentralization generates the rights assignment and control problems. They pointed out that ignoring agency problem, assigning decisions rights to individuals who have the decision-relevant knowledge and abilities increases efficiency. Self-interest on the part of individual decision makers, however, requires a control system to motivate individuals to use their decision rights optimally. This paper uses professional knowledge as a proxy to measure occupational competency of independent directors [7].

We believe that independent directors with accounting background are accomplished in solving financial problems, while management and technical knowledge will provide companies with helpful suggestions on operating performance. A body of foreign researches supports that independent directors with accounting background play a vital role in eliminating earnings management and fraud [11-13]. The Sarbanes-Oxley Act of 2002 and the Guidance emphasize the importance of independent directors

with financial background. Johnson [14], Anderson and Bizjick [15] and Zhao *et al* [16] find independent directors with management background will improve companies operating performance. Therefore, this study empirically tests the following hypothesis:

**Hypothesis 1: listed companies will increase the number of independent directors with accounting background after a mishap.**

Fama and Jensen [17] argue that outside directors tend to be more effective monitors of management than inside directors because they are generally key decision makers at other organizations who are concerned about their reputations in the managerial-labor market. According to their argument, outside directors signal their abilities as key decision makers through their board decisions. This study uses reputation to proxy independent director's occupational motivation and will empirically tests the following hypothesis:

**Hypothesis 2: listed companies will increase the number of independent directors with higher reputation after a mishap.**

Gordon [3] point out that independent directors as developed in the U.S. context solve three different problems: First, they enhance the fidelity of managers to shareholder objectives, as opposed to managerial interests or stakeholder interests. Second, they enhance the reliability of the firm's public disclosure, which makes stock market prices a more reliable signal for capital allocation and for the monitoring of managers at other firms as well as their own. Third, and more controversially, they provide a mechanism that binds the responsiveness of firms to stock market signals but in a bounded way. The turn to independent directors serves a view that stock market signals are the most reliable measure of firm performance and the best guide to allocation of capital in the economy, but that a "visible hand," namely, the independent board, is needed to balance the tendency of markets to overshoot.

How do investors react to adjustment to independent directors after a mishap, to specify, increasing the number of independent directors with accounting background or increasing the number of independent directors with higher reputation? In this paper, we will empirically test this question. Thus, we develop the following hypothesis on firm's market performance.

**Hypothesis 3: listed companies will enjoy positive contemporaneous return after adjusting independent directors after a mishap.**

### 3. Data and Variables

This part is organized as follows. First of all we will provide an introduction to the types of independent directors

listed companies appointed, and then we will empirically test how companies adjust independent directors after a mishap. Different independent directors play various roles due from their functions and positions. Our test focuses on the background of independent directors.

#### 3.1. Sample

In this paper, our mishap companies during the year 2002 to 2004 are selected according to companies' annual report, announcement and other information. Independent directors' background and characters of companies (especially for important bad news) are obtained from WIND and CSMAR database. Other data are collected by hand.

#### 3.2. Variables

Our empirical study comprises three groups of variables: independent directors' specialties, reputation and companies' mishap.

##### 3.2.1. Variables about Independent Directors' Specialties

Independent directors' majors can be divided into four categories: economics and management, accounting, law and technique, which correspond to four dummies in our paper. The Guidance requires at least one accounting professionals should be presented as an independent director. To better investigate the adjusting of accounting professionals in listed companies, we design a continuous variable to depict percentage of accounting professionals. Panel A in **Table 1** presents variables about independent directors' background.

##### 3.2.2. Reputation Variables of Independent Directors

Reputation is hard to be quantified. Some scholars use the average number of companies in which a person serve as an independent director as a proxy for reputation [16,18,19]. Actually, some prestigious independent directors are reluctant to accept more invitations, which highlight the deficiency to this method. To be objective, we use Xia *et al.* [20] and Wei [21] for reference and add some improvement to the method. We use expert assessment to evaluate independent directors' reputation. Panel B in **Table 1** presents variables about independent directors' reputation.

##### 3.2.3. Mishap Variables

Different kinds of mishap can be invasion to medium and minority shareholders interest. This paper chooses punishment from regulatory authorities and qualified audit opinions as proxy for important mishap. The former indicates fraud in listed companies while the latter means problems in financial reports. Two types of mishap are closely related to companies' financial reports, which

**Table 1. Variable definitions.**

Variable Name	Abbreviate	Definition
<b>Panel A: variables about independent directors' knowledge background</b>		
Accounting	ACCO1	If an accounting professional is appointed, ACCO1=1, otherwise ACCO1=0
Percentage of accounting	ACCO2	Number of independent directors with accounting background/Number of independent directors
Law	LAW	If a law professional is appointed, LAW=1, otherwise LAW=0
Economics and management	ECON	If an economics and management is appointed, ECON=1, otherwise ECON=0
Technical	TECON	If a technical professional is appointed, TECON=1, otherwise TECON=0
<b>Panel B: variables about independent directors' reputation</b>		
Reputation	REPUT	Average score, calculating process: how many companies a person serves as an independent director (40%), reputation of his afflation (20%), position (20%), professional title (10%) and education degree (10%)
<b>Panel C: Definition of conviction events in mishap companies</b>		
Conviction	UNRULE	Punished by regulatory authorities or receiving qualified audit opinions

have a name “conviction events”. Panel C in **Table 1** presents variables about mishap.

#### 4. Descriptive Statistics

##### 4.1. Status Quo of Independent Directors

The independent director system in China is basically driven by mandatory rules rather than spontaneous institutional change promoted by listed companies and general public. Therefore, majorities of listed companies carry it into execution by “the last bus”. **Table 2** reports the general situation of independent directors in China’s listed companies. Only 325 companies have independent directors in 2001, covering 28.56% of China’s listed companies. From 2002 on majorities of China’s listed companies put the system into practice. On average, Boards are reelected every three years. **Table 2** shows that the number of independent directors decreased in 2005 compared to 2004, indicating that a body of listed companies reelected during 2004 and 2005. Therefore, we restricted our target sample mishap companies from 2002 to 2004, corresponding to reelection year. Data

related to independent directors’ background spans from 2002 to 2005.

##### 4.2. Statistics Relating to Independent Directors’ Background

Our data covers independent directors’ background from 2002 to 2005.

###### 4.2.1. Statistics of Independent Directors’ Specialties

**Table 3** reports distribution of independent directors’ specialties. Independent directors with economics and management specialties represent 27% of all directors, while technicians cover 23% and 11% for that of law in 2002. Obviously, the phenomenon that independent directors with economics and management majors or with accounting background holding concurrent posts in different companies is not rare. Accounting professionals and law experts are increasing year by year; percentage grows from 27% in 2002 to 28% in 2005 for accounting professionals, from 11% in 2002 to 13% in 2003 for law experts respectively.

###### 4.2.2. Statistics of Independent Directors’ Reputation

This paper uses expert assessment to evaluate independent directors’ reputation. How many companies a person serves as an independent director, reputation of his own afflation, position, professional title (or education degree) are four proxies for reputation, each of them has their own weight, which are 40%, 20%, 20%,10% and 10% respectively. Full mark is 5 points. **Table 4** reports scores of independent directors’ scores. On average all of them are larger than 1, [1,2) covers 8.4% of the whole sample, [2,3) covers 65.0% , [3,4) covers 22.0%, while [4,5] covers 5.7%. Due to strict assessment, few independent directors’ reputation scores [4,5], which doesn’t influence the accuracy of the final result.

**Table 2. Status quo of independent directors.**

Year	Listed companies			Independent directors	
	Number	Appointing independent directors	Percentage	Number	Average <sup>1</sup>
2001	1140	325	28.56%	741	2.28
2002	1204	1175	97.59%	2679	2.28
2003	1267	1261	99.53%	4035	3.20
2004	1354	1353	99.93%	4506	3.33
2005	1351	1351	100.00%	4461	3.30
Total	6316	5465	86.52%	16422	3.00

**Table 3. Independent directors' specialties.**

Year	2002		2003		2004		2005		Total	
Acc	727	27%	1092	27%	1236	27%	1249	28%	4304	27%
Law	295	11%	525	13%	582	13%	608	14%	2010	13%
Econ	1035	39%	1500	37%	1681	37%	1646	37%	5862	37%
Tecon	622	23%	918	23%	1007	23%	958	21%	3505	22%
Total	2679	100%	4035	100%	4506	100%	4461	100%	15681	100%

**Table 4. Distribution of independent directors' reputation.**

Reputation \ Year	2002		2003		2004		2005		Total	
Missing	11	0.40%	5	0.10%	5	0.10%	5	0.10%	26	0.20%
[0, 1)	0	0.00%	0	0.00%	0	0.00%	0	0.00%	0	0.00%
[1, 2)	218	8.1%	335	8.3%	380	8.4%	381	8.5%	1314	8.4%
[2, 3)	1769	66.1%	2592	64.3%	2884	64.0%	2936	65.8%	10181	65.0%
[3, 4)	571	21.3%	929	23.0%	1013	22.5%	932	20.9%	3445	22.0%
[4, 5]	108	4.0%	352	8.7%	221	4.9%	206	4.6%	887	5.7%
Total	2677	100%	4033	100%	4503	100%	4460	100%	15673	100%

### 4.2.3. Statistics of Conviction Event

As is known to all, China's stock market is still in the infancy period and institution investors need great improvement in the days to come. Thus, irregular events are not rare. Punishment from regulatory authorities and qualified audit opinions from public accounting firm can be seen each year in capital market, which indicates serious financial problems in listed companies. **Table 5** presents conviction events (*i.e.* punishment from regulatory authorities and qualified audit opinions from public accounting firm) in listed companies.

## 5. Empirical Test and Explanation

### 5.1. Descriptive Statistics of Adjustment

We develop T-test and Z-test to find the difference of independent directors in event year and subsequent year. Panel A of **Table 6** reports the results. Percentages of independent directors with accounting background increase significantly in mishap companies. 67% of companies' independent directors have accounting background in the event year, while increases to 78% in the subsequent year, which is significant at 1% level. Accounting directors covers 26.63% of all external directors in the conviction year, while increases by 2.57% to 29.2% in the subsequent year, significant at 10% level. Results indicate that companies increase accounting professional as independent directors after a mishap. However, empi-

rical results indicate that listed companies donot increase independent directors with other background (e.g. economics and management, law and technology). Accounting professionals are exerted in figuring out financial problems. Companies appoint them to mitigate distress between regulatory authorities and minority shareholders, providing positive signals to the general public. Actually, foreign and domestic researches emphasize the importance of accounting independent directors. Xie *et al.* [11], Bedard *et al.* [12] and Bryan [13] find that independent directors with financial background play a vital role in supervision and restriction of management earnings management.

Besides, statistics shows that average score of independent directors' reputation in mishap companies is 2.5646 in the conviction year, while decreases to 2.55 in the subsequent year. No statistic evidence supports our second hypothesis. The reason listed companies don't increase the number of independent directors with higher reputation after a mishap is two folded. For one thing, higher reputation doesn't predict more competence. Anecdotal events in capital market show that "vase directors" not only means incompetence but also dereliction of duty. Lu Jiahao in "Zhengbaiwen Event" is a persuasive and vivid example for us. Wang *et al.* [19] finds independent directors' reputation improves company's performance significantly but Zhao *et al.* [22] supports that independent directors' reputation doesn't improve family firm's performance significantly. No evidence shows that reputation backs up independent directors as a competent supervisor. Zhou [7] and Zhou *et al.* [23] are motivated by their reputation, rather than restricted.

**Table 5. Conviction event in China's listed companies.**

Variable	2002	2003	2004	Total
UNRULE	157	111	164	432

**Table 6. Independent director adjustment in event year and subsequent year.**

Variable	Event year			Subsequent year			T-test	Z-test
	N	Mean	Median	N	Mean	Median		
<b>Panel A: background of specialties</b>								
ACCO1	432	0.6728	1	423	0.7801	1	-3.54***	3.51***
ACCO2	432	0.2663	0.33	423	0.2920	0.33	-1.75*	1.83*
LAW	432	0.3921	0	423	0.4397	0	-1.41	1.41
ECON	432	0.7517	1	423	0.7683	1	-0.57	0.64
TECON	432	0.4316	0	423	0.4704	0	-1.14	0.57
<b>Panel B: background of Reputation</b>								
REPUT	432	2.5646	2.55	423	2.5613	2.55	0.12	-0.98

\*\*\*, \*\*, and \* represent significance levels at the 1%, 5%, and 10% levels, two-tailed, respectively. Independent directors' specialties data are unavailable for 9 mishap companies.

**Table 7. Descriptive statistics of accounting independent directors by year.**

Year	N	ACCO1		ACCO2		T-test	Z-test	T-test	Z-test	
		Mean	Median	Mean	Median					
2002	1135	0.59	1.0	0.26	0.33					
2003	1248	0.76	1.0	0.27	0.33	02&03	-9.15***	-8.99***	0.02	-0.96
2004	1347	0.79	1.0	0.27	0.33	03&04	-1.42	-1.42	-0.65	-0.35
2005	1329	0.78	1.0	0.28	0.33	04&05	-1.02	1.02	-0.93	0.89

\*\*\*, \*\*, and \* represent significance levels at the 1%, 5%, and 10% levels, two-tailed, respectively.

Secondly, unqualified opinions from external auditors indicate deficient in companies, therefore, there is no reason for prestigious people to accept invitation from mishap companies for the sake of avoiding risk.

## 5.2. Robust Tests: Is That Resulted from Institutional Change

Implementation of independent directors system in China is a progressive process. The Guidance requires independent directors should be included in the board before July 30, 2002. Besides, at least one third directors in the board should be external directors, one of whom should be accounting expert. Obviously, companies increase accounting directors to meet the mandatory requirement from 2002 to 2003. Does the increase result from institutional change? We will develop additional test in the following. **Table 7** reports descriptive statistics on independent directors' accounting background. Result shows that percentage of companies in which accounting experts present as an independent directors are 59% in 2002, while 76%, 79% and 80% for the year 2003, 2004 and 2005 respectively. Besides, empirical evidence point out that percentage of companies in which accounting experts present as an independent directors increases from 2002 to 2003 significantly in 1% level. However, the

percentage increases insignificantly by year from 2003 to 2005. Thus, listed companies appoint more accounting expert as independent directors not only because of their own demand, but also consequence from institutional change. Besides, nonparametric test shows that percentage of independent directors with accounting background in companies doesn't increase year by year from 2002 to 2005, which indicates that the increase in mishap companies are not resulted from institutional change. In conclusion, our result is robust.

## 5.3. Adding Accounting Independent Directors is Helpful for Market Performance

Empirical evidence shows that China's listed companies will add accounting professionals as their independent directors, however, whether they can benefit from this choice need further investigation. We use market adjusted model to calculate cumulated abnormal return (CAR thereafter), which are computed as the stock's raw return over the interval minus the corresponding equally-weighted market return. We selected 70 companies which add accounting independent directors after the mishap. **Table 8** shows that they experienced negative CAR 2 years before the conviction and significant in 1% level, but CAR is negative but insignificant during the convic-

tion year. After the mishap, market performance increase year by year. We may infer that mishap companies enjoy market performance improvement by adding accounting independent directors. Accounting professionals are favored by market participants.

Barth *et al.* [24] developed a cross-sectional model to test whether improvement in company's market performance benefits from increasing in brand value. To investigate correlations between market return and change in brand value, company's contemporaneous return is regressed on net income, change in net income compare to last year and change in brand value. The coefficient of change in brand value defines the correlation between market return and change in brand value.

We are trying to investigate the correlation between market return and whether mishap company adding accounting independent directors, so we introduce a new dummy *addacco*. New model is shown as follows.

$$RETURN_{it} = \delta_1 NI_{it} + \delta_2 \Delta NI_{it} + \delta_3 addacco_{it} + \varepsilon_{i,t} \quad (1)$$

$RETURN_{i,t}$  denotes firm  $i$ 's contemporaneous return in year  $t$ . The deadline of China's listed companies' annual report is April 30th in the subsequent fiscal year, therefore, we use the first trading day in May in the fiscal year as our beginning date for contemporaneous return.  $NI_{i,t}$  is net income per share (extraordinary items are excluded), and  $\Delta NI_{i,t}$  denotes change in net income compare to last year. *Addacco* is a dummy, which equals 1 if mishap company adding an accounting independent director, 0 otherwise.

**Table 9** reports our OLS regression result. Empirical result shows that net income per share (extraordinary items are excluded) is highly correlated with contemporaneous return, adding accounting independent director help companies improve their market performance significantly (the coefficient of *addacco* is 0.2179, significant at 0.01 level). Accounting professionals can help mishap companies mitigate distress from capital market and medium and minority shareholders, which highlights the supervising role of independent directors with accounting background.

**Table 8. Descriptive statistics of car around the mishap.**

	N	Mean	Min	Max
CAR[-750, -500]	70	-0.0739**	-1.1414	0.4204
CAR[-500, -250]	70	-0.1837***	-0.9635	0.3005
CAR[-250,0]	70	-0.3021***	-1.0568	0.7177
CAR[0,250]	70	-0.0890	-1.8013	1.8653
CAR[250,500]	70	0.0894*	-0.8915	0.9016
CAR[500,750]	70	0.6382***	-0.5249	3.9936
CAR[-750, -500]	70	-0.0739**	-1.1414	0.4204

\*\*\*, \*\*, and \* represent significance levels at the 1%, 5%, and 10% levels, two-tailed, respectively.

**Table 9. OLS regression examining whether market approves adding accounting independent directors.**

Independent Variable	Dependent Variable		
	Predicted sign	Coeff.	t-Stat.
Intercept	?	-.6109	-13.53***
NI	+	.4665	4.58***
$\Delta$ NI	+	.0019	1.36
Addacco	+	.2179	2.63***
Number		417	
Adjusted R <sup>2</sup>		0.24	

\*\*\*, \*\*, and \* represent significance levels at the 1%, 5%, and 10% levels, two-tailed, respectively.

## 6. Conclusions

This paper investigates the behavior of how companies adjust their independent directors from the perspective of independent directors' background, by using data of Chinese listed companies to which a mishap happened between 2002 and 2004 as our target sample. Evidence shows that listed companies will increase independent directors with accounting background significantly after a mishap (*i.e.* receiving qualified audit opinions or punished by regulatory authorities). Nevertheless, listed companies don't increase the number of independent directors with higher reputation after a mishap. On one hand companies don't resort to prestigious independent directors for assistance, and on the other hand prestigious independent directors don't want to work for mishap companies. Empirical evidence shows that listed companies will increase independent directors with accounting background after a mishap for the purpose of mitigating agent distress between majority shareholders and minority shareholders, enjoying significantly positive cumulative abnormal return after the adjustment in the long window. Our result indicates that listed companies will increase accounting independent directors for the purpose of mitigating distress from capital market and medium and minority shareholders, which highlights the supervising role of independent directors with accounting background.

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