

Effects of financial restatements on top management team dismissal

Stefano Azzali and Tatiana Mazza

Abstract

Purpose – The purpose of this paper is to analyze the effects of financial restatements (FRs) on the likelihood of the top management team (TMT) dismissal. It investigates the effects of types of FRs [corrective note and reissuance of financial statement (RFS)], of FR severity and of FR related to international financial reporting standards (IFRSs) easy or difficult-to-estimate.

Design/methodology/approach – The authors hand-collect: data about 96 FRs from the Italian public oversight board documents; chief executive officer (CEO) name, chairman name, year of the financial statement under investigation, total assets and operating income, from their financial statement. The authors use multivariate regression to test the effects of FRs on the probability of TMT dismissal.

Findings – The authors find that the RFS leads to a higher likelihood of chairman dismissal. A greater magnitude of misrepresentation on income statements, and FRs, which decrease net income, increase the likelihood of CEO dismissal. Difficult-to-estimate IFRSs increases the likelihood of CEO dismissal.

Originality/value – FRs are significant determinants of the CEO/chairman dismissal. The authors show that FRs directly involving shareholders (RFS) have negative consequences on the chairman of the board of directors, while the CEO is more affected by FRs that involve technical factors (FR severity or financial statement associated with difficult-to-estimate IFRSs).

Keywords Financial restatements, Chief executive officer dismissal, Chairman dismissal, Financial reporting

Paper type Research paper

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1. Introduction

A financial restatement (FR) refers to the revision of a prior financial statement as required by a public oversight board (POB)[1]. It is required whenever a financial statement is found to contain one or more material misstatements[2]. FRs are bad news for investors, creditors, analysts and auditors (Mao, 2018), and the literature finds that incentive compensation, firm characteristics and auditor attributes are determinants of FRs (Fountaine and Phillips, 2018) and that FRs can have several effects. They can:

- Decrease expected future earnings and stock prices.
- Increase the firm's cost of equity capital (Hribar and Jenkins, 2004; Kasznik, 2004; Kravet and Shevlin, 2010).
- Have a contagion effect on non-restating firms[3] in the same industry causing share prices to decline (Gleason et al., 2008).

Most of the literature investigates the USA or China while Italian studies have focused on type, severity and international financial reporting standard (IFRS) FRs, but to date, no empirical studies have analyzed the effects of FR on top management team (TMT) dismissal taking into account of different types of FR [corrective note (CN) and reissuance of the financial statement (RFS)], FR severity and FR from easy or difficult-to-estimate IFRS. We expect FR to be negative for chief executive officers (CEO) and chairman of the board of

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directors, given that a consequence of FR is often dismissal (Agrawal and Cooper, 2017; Desai *et al.*, 2006; Srinivasan, 2005).

CEO dismissal is defined as the *ad hoc* departure of the CEO, not part of a mandatory retirement policy, and against her or his will (Fredrickson *et al.*, 1988, p. 255). CEO dismissal depends on organizational performance and on four main types of social and political factors as follows: board expectations and attributions, board allegiances, alternatives to the incumbent and the incumbent's power (Fredrickson *et al.*, 1988, pp. 257-259). These factors affect CEO dismissal and interact with a number of objective variables pertaining to the characteristics of the board, the organization, the industry, the CEO and the preceding CEO (Fredrickson *et al.*, 1988). This model of CEO dismissal is based on upper echelons theory (UET) (Hambrick and Mason, 1984) and its updated version (Abatecola and Cristofaro, 2020), where organizational outcomes, strategic choices and performances are partially predicted by TMT characteristics. CEO/chairman are the main roles in a company and, together with the chief financial officer (CFO), audit committee and auditors, they are mainly responsible for the company's financial statement. Hennes *et al.* (2008) investigate the effect of different types of restatement (errors vs irregularities) on CEO/CFO turnover in the USA but to date, no studies have investigated the effects of FR in Italy using the CEO/chairman dismissal model of Fredrickson *et al.* (1988).

The analysis of the effects of FR on TMT dismissal is important because neither the CEO dismissal model nor UET directly considers the risks brought by FR. This research aims to show that FR is a significant factor to be included in the CEO dismissal model linked to the updated version of UET.

TMT dismissal and FR are linked because the chairman and CEO are chiefly responsible for the company and, together with CFO, audit committee and auditors, for the financial statement. Material misstatement in the financial statement increases the risks of FR and the likelihood of manager dismissal. However, it is an empirical question of whether FR impact integrates the CEO dismissal model used in prior literature. We analyze the effects of following two types of FR:

1. FR relating to non-compliance with financial reporting, which requires a CN to be published on the internet site of the company.
2. FR requiring the RFS, which needs re-approval by shareholders.

Using a unique bank of data hand-collected directly from Commissione Nazionale per le Società e la Borsa (CONSOB), the Italian POB, which includes information on 96 FR (51 CN and 45 RFS), our research aims to investigate the effects on TMT dismissal of different types of FR (CN and RFS), according to FR severity and according to whether FR is caused by easy or difficult-to-estimate IFRS. Using logit regression models to compare companies with and without FR, we first test the probability of TMT dismissal, separating the effect of CR and RFS. We also analyze the effect of FR severity and of FR associated with difficult-to-estimate IFRS on the probability of TMT dismissal.

The main results are that:

- FR increases the likelihood of chairman dismissal;
- The severity of the FR is a significant determinant of the probability of CEO dismissal. The likelihood of CEO dismissal is significantly higher for more severe income statement restatements and for restatements that decrease income, compared with restatements that do not affect income; and
- The likelihood of CEO dismissal increases when FR is associated with more difficult-to-estimate IFRS.

We contribute to the literature in several ways. First, we show that chairman dismissal is more probable for RFS than for CN. This may reflect that RFS is more severe and requires

approval by shareholders. Of the two types of management involved, the chairman bears greater responsibility for FR. Secondly, we contribute to the literature regarding the severity of FR, suggesting that the magnitude of FR significantly affects the likelihood of CEO dismissal. Thirdly, we contribute to the literature on accounting standards, showing that the higher level of difficulty in estimating the flouted IFRS increases the likelihood of CEO dismissal.

Our findings have several implications for theory and practice. The model of CEO dismissal suggested by prior literature ([Fredrickson et al., 1988](#)) can be integrated with further variables, in addition to CEO characteristics: the effect of FR, FR severity and FR associated with IFRS more difficult to estimate, which are one of the responsibilities of the CEO and chairman. FR is associated with two determinants that affect CEO dismissal as follows:

1. Board expectations and attributions.
2. Board allegiances and values.

Board members disappointed by firm performance may favor the dismissal of managers. Conversely, board members in a conflict of interest with the organization (relatives of CEO and chairman or those involved in related-party transactions) may support the CEO and chairman. Our study finds that FR that directly involves shareholders (RFS) has negative consequences on the chairman of the board of directors, while for FR, which involves technical factors (FR severity and non-compliance with easy or difficult-to-estimate IFRS) the risk of dismissal is run mainly by the CEO. TMT need to be aware that FR, FR severity and FR associated with more difficult to estimate IFRS increase the likelihood of their dismissal, and where appropriate take steps to avoid these risky events.

2. Regulation background

For the purpose of this research, we analyze two types of FR, which Italian POB can require in the case of material misstatement. The first type of FR follows the detection of non-compliance[4] and requires a CN[5]. CN is published in Italian POB resolutions, published on Italian POB website when the inspection is completed and the firm under investigation informed. These resolutions may relate to separate, consolidated or interim financial statements. After the POB resolution, firms are required to issue a press release with the restated financial statement. The press release is a “pro-forma” financial statement and does not require the approval of shareholders. The second type of FR comes from appeals that require RFS[6]. RFS are published in POB annual reports, which cover its entire oversight activity and include appeals in which POB takes part in civil litigation to request a firm under investigation to change its financial statement. If the civil litigation finds in favor of POB, approval of the financial statement is canceled and the board of directors prepares a new financial statement to be approved by the shareholders. These appeals can be made for separate and consolidated financial statements.

FR is the consequence of material misstatements in financial statements, which can be associated with the accounting standards used in the preparation of the financial statements. In Italy, as a member of the EU, there is the mandatory use of IFRS for public interest entities (EU Regulation 1606/2002).

In international literature ([Agrawal and Cooper, 2017](#); [Desai et al., 2006](#); [Leone and Liu, 2010](#); [Srinivasan, 2005](#)), responsibility for drawing up financial statements and consequences related to FR is found to lie with TMT, including the board of directors, the chairman, the CEO, the CFO, the audit committee and the auditors. This is also the case in Italy. This research focuses on the CEO and chairman, given that they are mainly responsible for the company as a whole.

3. Literature review and hypothesis development

Fredrickson *et al.* (1988) suggest a model of CEO dismissal where the main determinants are company performance (Assenga *et al.*, 2018; Al-Matari, 2019; Kao *et al.*, 2019; Merendino and Melville, 2019; Vieira, 2018; Wang *et al.*, 2019), and four classes of social and political factors as follows: board expectations and attributions, board allegiances, alternatives to incumbent and power of incumbent. These factors affect CEO dismissal and interact with a number of objective variables, grouped as characteristic of board, organization, industry, CEO and predecessor. This model of CEO dismissal is based on UET, where organizational outcomes, strategic choices and performances are partially predicted by TMT characteristics (Hambrick and Mason, 1984; Morais *et al.*, 2018). An updated version of UET (Abatecola and Cristofaro, 2020), improved the model, specifying different environmental factors (organization environmental, industrial environmental and institutional environmental), moderators (managerial discretions, distribution of power and executive job demands) and TMT composition (heterogeneity/homogeneity and structure). These models of CEO dismissal and UET do not include FR, and one contribution made by this study is the suggestion that this factor is considered as a determinant of CEO/chairman turnover. FR affects company financial performance derives from the institutional environment of the company, in our study from the national POB. However, it is an empirical question of whether TMT discretion and the remuneration of the dominant coalition affects the likelihood of FR and of CEO/chairman dismissal.

A great deal of prior literature explores the relationship between FR (Schäuble, 2019) and management turnover. Agrawal and Cooper (2017) find strong evidence of greater turnover of top management in restating than non-restating firms. Srinivasan (2005) finds that the CEO of companies, which make severe income-decreasing restatements, faces a high risk of turnover. He also finds that the likelihood of departure is higher for audit committee members, who have direct responsibility for overseeing the financial reporting process than for non-audit committee directors. Leone and Liu (2010) show that the probability of CEO (CFO) turnover in the wake of an accounting irregularity is lower when the firm's CEO is also a founder. Arthaud-Day *et al.* (2006) find that dismissals of CEO, CFO and audit committee of restating firms are more than twice as high as in a matched firm sample. Desai *et al.* (2006) find that at least one senior manager (chairman and CEO) loses her/his job within 24 months of the announcement of restating in 60 per cent of firms. Gleason *et al.* (2008) find that FR has a contagion effect on non-restating firms in the same industry, and that share price declines. New management is normally capable of carrying high value reputational capital and experience to avoid FR. Chi and Sun, (2014), for example, find a negative association between the probability of reoccurrence of firm FR and replacement of CEO/CFO.

Following the model of CEO dismissal (Fredrickson *et al.*, 1988) linked to UET (Abatecola and Cristofaro, 2020) and most of FR literature (Desai *et al.*, 2006; Gleason *et al.*, 2008; Agrawal and Cooper, 2017), we investigate the reputational penalties of FR, which include CEO/chairman dismissal. Board expectations and attributions are mainly based on organizational performance, with an increase in CEO dismissal when the board includes dissenting expectations and attributions. Board members with betrayed expectations in terms of performance because of FR (e.g. lower benefits and compensation) may be in favor of CEO/chairman dismissal. Moreover, board allegiances and values are also associated with FR. Board members who are friends of the CEO/chairman or have a conflict of interest (e.g. related party transactions) may hold less neutral positions on CEO/chairman dismissal than other board members in the case of FR.

We develop our hypothesis by analyzing the effect of different types of FR, namely, CN and RFS. CN may have less effect on management dismissal because, unlike RFS, it does not involve shareholders in the approval of the restated financial statement. For CN, companies are required only to issue a press release with a “pro-forma” restated financial statement,

while for RFS they have to approve and publish a new financial statement. CN can be considered a less severe type of restatement than RFS and may be associated with a lower likelihood of management dismissal. We expect that:

H1. CNs have a significantly lower effect on the likelihood of CEO/chairman dismissal than the RFSs.

[Palmrose and Scholz \(2004\)](#) analyze the FR severity distinguishing between FR, which involves or does not involve fraud. They show that market reaction to FR involving fraud is higher because:

- the risk of fraud is likely to increase levels of uncertainty in that it harms the reliability of management disclosures; and
- the revelation of fraud leads to increased costs related to contemporaneous litigation and regulatory actions, additional future monitoring and future regulatory scrutiny.

[Hennes et al. \(2008\)](#) investigate the effect of FR severity (separating errors and irregularities) on CEO/CFO turnover: they find that the severity increases the likelihood of external auditor dismissal. [Hennes et al. \(2014\)](#) use severity as a proxy of monitoring failure, monitoring being the responsibility of auditors. Auditors are responsible for providing an opinion on the reliability of financial statements and assure the absence of material misstatements. In the case of FR, auditors too can be held responsible and risk audit sanctions, in terms, e.g. of pecuniary sanctions or temporary prohibitions in the profession. [Wang and Chou \(2010\)](#) find that the likelihood of CEO or CFO turnover significantly increases for companies with higher restatement severity. [Burks \(2010\)](#) finds that CEO turnover is less sensitive than before the Sarbanes–Oxley Act, given the decline of the severity of FR after the Act. [Srinivasan \(2005\)](#) finds that a director making severe income-decreasing restatements face a high risk of turnover. Furthermore, for severe FR, the likelihood of departure is higher for audit committee members, who have direct responsibility for overseeing the financial reporting process, than for non-audit committee directors. He uses FR severity as a proxy for the extent of monitoring failure, arguing that if boards are accountable for reporting failure, the likelihood of director departure should depend primarily on the severity of the problem and the responsibility that specific directors bear for the failure. [Acito et al. \(2009\)](#) analyze FR related to leasing operations and support the notion that materiality judgments reflect both quantitative and qualitative considerations.

Most prior literature shows the negative consequences of severe FR on management dismissal. However, the literature provides no explanation of how FR severity relates to CEO/chairman dismissal. We hypothesize a link with the CEO dismissal model ([Fredrickson et al., 1988](#)) and UET ([Abatecola and Cristofaro, 2020](#)). *H1* reflects that we do not find it sufficient to include FR in the CEO dismissal model; it is also important to take into account FR severity. We predict that FR severity is significantly associated with CEO/chairman dismissal, through the role played by TMT discretion, the institutional environment and the remuneration of the dominant coalition. Given that the CEO and chairman are evaluated overall on their performances, we expect that:

H2. Greater FR severity increases the likelihood of CEO/chairman dismissal.

FR is a result of material misstatements in financial reporting. In Italy, as in all EU countries, public interest entities are required to draw up financial statements following IFRS. Prior literature has extensively studied these accounting standards ([De George et al., 2016](#)), in settings where their use is both mandatory and voluntary, and investigated underlying costs and benefits in terms of earnings quality and comparability.

Some studies analyze specific attributes of IFRS. [Armstrong et al. \(2010\)](#), for example, conjecture that IFRS's emphasis on fair value accounting leads to an improvement in information quality. On the other hand, [Ball et al. \(2015\)](#), argue that fair values are not useful

for debt contracting. IFRS mainly based on fair values – e.g. international accounting standard (IAS) 39 and IFRS 7 – are considered more complex and difficult-to-estimate. [Cheung et al. \(2008\)](#) show that IFRS principles for intangible assets are more stringent than previous Australian accounting standards; thus, the accounting standards for intangibles are also considered more complex and difficult. There are several studies mainly based on data analysis of the effects of IFRS on earnings and audit quality. However, there are very few studies of the effects of IFRS on CEO/chairman dismissal, comparing financial statements with and without FR. [Salavei \(2010\)](#) classifies easy-to-estimate items and difficult-to-estimate items of US accounting standards. Revenue and expense items are mainly based on transaction data and rely less on estimation, and are easy to estimate. Fair value items and intangible assets, however, can be evaluated by parameters set by management and are difficult to estimate. However, no research yet has applied this categorization to IFRS accounting standards or the analysis of possible effects on CEO/chairman dismissal.

The literature investigates IFRS extensively, but no studies as yet have been made on the relationship between FR, IFRS and management dismissal. Here, we link FR from IFRS with the CEO dismissal model ([Fredrickson et al., 1988](#)) and UET ([Abatecola and Cristofaro, 2020](#)). FR and IFRS are in fact environmental factors in UET and are underpinned by the institutional environment, given that the national POB and the EU impose mandatory IFRS. We predict that TMT discretion in the application of IFRS (difficult and easy to estimate) may justify different effects on CEO/chairman dismissal. Following prior literature about IFRS and categorizing them as easy or difficult-to-estimate ([Salavei, 2010](#)), we investigate the effect that IFRS have on TMT dismissal comparing financial statements with and without FR. Several IFRS require assumptions and estimations based on models prepared by TMT (e.g. measurement of intangible assets with IAS 38, measurement and the disclosure of information with IAS 39 and IFRS 7). We expect that:

- H3.* FR from difficult-to-estimate IFRS leads to a higher likelihood of CEO/chairman dismissal than FR from easy-to-estimate IFRS.

4. Method

We collected information on FR from the website of the Italian POB. We downloaded CONSOB annual reports and resolutions and identified all the listed companies on the Italian Stock Exchange that were subject to a FR by the Italian POB in connection with their interim, annual or consolidated accounts. We identified 51 CN and 45 RFS of Italian listed companies (total in [Tables I and II](#)). CN was disclosed from 2010 to 2018

Table I FR by year							
Year of financial statement	CN		N	Year of CN disclosure	RFS		N
	N				N	Year of RFS disclosure	
2008	6		9		2001	2	8
2009	3		0		2002	12	6
2010	0		8		2003	4	8
2011	15		14		2004	11	7
2012	13		10		2005	2	5
2013	4		3		2006	3	3
2014	2		0		2007	5	2
2015	5		3		2009	2	2
2016	3		4		2011	2	2
					2013	2	2
Total	51		51		Total	45	45

Table II FR by financial statement					
CN			RFS		
	N	(%)		N	(%)
Separate financial statement	17	33	Separate financial statement	23	51
Consolidate financial statement	20	39	Consolidate financial statement	22	49
Interim financial statement	14	28			
Total	51	100		45	100

(Table I, Column 2) for financial statements from 2008 to 2016 (Table I, Column 1). RFS was disclosed from 2003 to 2014 (Table I, Column 4) for financial statements from 2001 to 2013 (Table I, Column 3). Differences in the first year of FR disclosure (2010 for CN and 2003 for RFS) depend on the time-gap of nine years between their introductions; CN was introduced in 2007 and RFS in 1998. The year showing financial statements with the highest number of CN is 2011 (15), and the year showing with the highest number of RFS is 2002 (12). We hand-collected data for CEO name, chairman name, year of the financial statement under investigation, total assets and operating income, from the financial reporting of listed companies. We also hand-collected press releases from company or Italian Stock Exchange websites. We hand-collected the net income and total assets to see whether there is an increase, no change or a decrease in these figures. From these press releases, we also compute the severity of the change in total assets and net income. We, finally, hand-collected the number of IFRS flouted from CONSOB resolutions.

CN are related to separate financial statements (33 per cent), consolidated financial statements (39 per cent) and interim financial statements (28 per cent). RFS are related to separate financial statements (51 per cent) and consolidated financial statements (49 per cent) (Table II). The most frequent easy-to-estimate IFRS, which is flouted, is IAS 36 (32 FR) and the most frequent difficult-to-estimate IFRS, which is flouted is IAS 39 (23 FR in Table III).

Table III FR by IFRS		
IAS/IFRS	Description	Number
<i>Easy to estimate</i>		
IAS 2	Inventory	2
IAS 8	Accounting policies and changes in accounting estimates and errors	9
IAS 10	Events after the reporting period	3
IAS 11	Construction contracts	2
IAS 12	Income taxes	7
IFRS 13	Fair value measurement	1
IAS 16	Property, plant and equipment	2
IAS 18	Revenue	3
IAS 27	Consolidate and separate financial statements	7
IAS 28	Investments in associates and joint ventures	5
IAS 36	Impairment of assets	32
IFRS 3	Business combinations	3
IFRS 4	Insurance contracts	2
<i>Difficult-to-estimate</i>		
IAS 37	Provisions, contingent liabilities and contingent assets	14
IAS 38	Intangible assets	6
IAS 39	Financial instruments: recognition and measurement	23
IFRS 7	Financial instruments: disclosures	7

We use the following multivariate regression model to test our three hypotheses:

$$\text{Prob}(\text{CEO/chairman dismissal}) = \beta_0 + \beta_1 \text{variable of interest} + \text{control variables} \\ + \text{industry fixed effect} + \text{year fixed effect}$$

See [Table IV](#) for the definition of variables.

Our dependent variable is a dummy, which takes value 1 if the CEO/chairman is dismissed after 24 months from FR disclosure. We use a logit regression given that the dependent variable is a dummy[7].

For the three hypotheses, the respective variables of interest are as follows. CN is used to test *H1*. FR severity is used to test *H2*. FR is calculated with two continuous variables for the percentage of balance sheet or income statement severity, a dummy variable of high versus low severity and three dummy variables for income increasing, income-decreasing or no income change. The variable difficult-to-estimate IFRS is used to test *H3*. It is calculated with two variable as follows:

1. First, with a dummy variable to consider if at least one difficult-to-estimate IFRS is associated with FR.
2. Second, with a continuous variable for a number of difficult-to-estimate IFRS associated with FR.

Prior literature shows that firms take more actions and/or face greater punishments as the severity of the restatement increases, so we expect that management is more likely to be dismissed after more severe restatements ([Amoah, 2013](#); [Hennes et al., 2014](#)). We also expect that the CEO/chairman is more likely to be dismissed after a more difficult-to-estimate IFRS.

Control variables are the size and the profitability [return on assets (ROA)] of the financial statement under investigation, and these controls for an information environment, capital market pressure and financial resources ([Dechow et al., 2010](#)). ROA is frequently used to represent firm performance in previous studies of CEO turnover ([Rachpradit et al., 2012](#)). Given the high frequency of bankruptcy in cases where CONSOB finds a material error in a financial statement, we also control for bankruptcy. Moreover, we control for the time-lapse from the publication of the CONSOB decision to ask for a restatement and the year of the FR with an error, because this can influence the timing of CEO change. We also control for the number of IFRS not corrected, and for the decision of firms not to disclose pro-forma restated financial statement. These are also possible determinants of CEO dismissal because if a firm maintains that the financial statement is correct and does not restate it; this can be interpreted as confidence in the CEO.

Following the existing literature ([Beasley, 1996](#); [Dechow et al., 1996](#); [Abbott et al., 2004](#); [Carcello and Nagy, 2004](#); [Song and Windram, 2004](#)), we use a statistical model, which compares “treated observations” with “control-matched observations.” For “treated observations,” we consider a FR, which is a financial statement with material errors. The financial statement can be interim, separate or consolidated and can be related to different years for the same firm. The “control matched observations” are financial statements, which have never had a material misstatement identified by CONSOB from Italian listed companies in the same industry, with the same type of financial statement and the same year of treated observations. This model, as built in the literature and widely used for the analysis of FR, makes it possible to isolate the effect of FR in a regression for 192 observations (45 + 51 = 96 financial statements of treated observations and 96 financial statements of control observations).

Table IV Variable definitions*Corporate governance change*

CEO/chairman dismissal 1 if the CEO/chairman was dismissed within 24 months from CONSOB disclosure; 0 otherwise

Variable of interests – H1 FR type

CN 1 if the restatement is a CN; 0 if the restatement is a RFS and 0 if there is not a restatement

Variable of interests – H2 FR severity

Severity of balance sheet (BS) FR Absolute value of (total asset with errors – total asset restated)/(total asset restated)

Data from the restated financial statement in the press release

0 if the restatement is a RFS

0 if the restatement is a CN with press release not available

0 if there is no restatement

Severity of income statement (IS) FR Absolute value of (net income with errors – net income restated)/(net income restated)

Data from the restated financial statement in the press release

0 if the restatement is a RFS

0 if the restatement is a CN with press release not available

0 if there is not a restatement

Great severity of FR 1 if at least one of severity BS or severity IS is above the median (2% for change in total assets and 17% for change in net income) and 0 otherwise

0 if the restatement is a RFS

0 if the restatement is a CN with press release not available

0 if there is not a restatement

FR, which increases income 1 if there is an increase in the net income in the restated financial statement; 0 otherwise

Data from the restated financial statement in the press release

0 if the restatement is a CN with a decrease, non-variation of the net income in the press release

0 if the restatement is a RFS

0 if the restatement is a CN with press release not available

0 if there is not a restatement

FR, which decreases income 1 if there is a decrease in the net income in the restated financial statement; 0 otherwise

Data from the restated financial statement in the press release

0 if the restatement is a CN with an increase, non-variation of the net income in the press release

0 if the restatement is a RFS

0 if the restatement is a CN with press release not available

0 if there is not a restatement

FR, which does not change income 1 if there is not a variation in the net income in the restated financial statement; 0 otherwise

Data from the restated financial statement in the press release

0 if the restatement is a CN with a decrease, increase of the net income in the press release

0 if the restatement is a RFS

0 if the restatement is a CN with press release not available

0 if there is not a restatement

Variable of interests – H3 IFRS difficult-to-estimate

Difficult-to-estimate IFRS 1 if there is the indication of at least one difficult IAS not respected in the CONSOB resolution (difficult: IAS 37, IAS 38, IAS 39 and IFRS 7)

0 if there is not the indication of at least one difficult IAS not respected in the CONSOB resolution (easy: IAS 2, IAS 8, IAS 10, IAS 11, IAS 12, IAS 16, IAS 18, IAS 27, IAS 28, IAS 36 and IFRS 4; and IFRS 13)

0 if the restatement is a RFS

0 if there is not a restatement

Number of difficult-to-estimate IFRS Number of difficult-to-estimate IFRS (based on above definition) included in the CONSOB resolution and considered with errors; 0 if there are not difficult-to-estimate IFRS included in the CONSOB resolution

0 if the restatement is a RFS

0 if there is not a restatement

Control variables

Type of financial statement Dummy variable for each type of financial statement: separate, consolidate or interim

Number of IFRS Number of IFRS included in the CONSOB resolution and considered with errors

0 if the restatement is a RFS, and 0 if there is no restatement

No press release 1 if the company's does not have available a press release with the restated financial statement; 0 if there is a press release, and 0 if the restatement is a RFS

0 if there is not a restatement

(continued)

Table IV

Time resolution_FS	(Year of CONSOB resolution or annual report – year of the financial statement with errors)
Size	Natural logarithm of total assets from the financial statement under investigation
ROA	Operating income/total assets from the financial statement under investigation
Bankruptcy	1 if the company has been declared bankrupt in the year; 0 otherwise
Industry	Industry fixed effect
FR	1 if the financial statement is a financial statement where CONSOB discovers material misstatements; and 0 if it is a financial statement of a control firm that have never had a FR (matched by industry-year-type of FS)
Year of FS	Year fixed effect

5. Descriptive statistics and correlation matrix

Table V shows that CN is slightly more frequent as a type of restatement (53.1 per cent) than RFS. Analyzing difficulty-in-estimation of IFRS leading to errors in the financial statement, we see that 25 per cent of the restatements have at least one difficult-to-estimate IFRS with errors and the average number of difficult-to-estimate IFRS flouted is 0.521. Untabulated results show that firms fail to comply with a maximum of 3 difficult-to-estimate IFRS in the same restatement decision. The magnitude of the severity of the income statement is much higher than the magnitude of the severity of the balance sheet. Moreover, 45.8 per cent of the sample has a restatement with a high level of severity above the materiality threshold. The most frequent restatements are those, which decrease income, (compared to restatements, which increase or do not change income) and errors in consolidated financial statements (compared to separate or interim ones). The average number of IFRS misstated is about two, but there can be a maximum of nine standards wrongly applied in one restatement (untabulated).

Focusing on the timing of publication, CONSOB takes time in discovering the error. For our sample of restated firms, it takes on average one and a half years (1.531) to publish a resolution and ask for a FR. This timing implies that the press release with the restatement usually covers financial statements restated for two consecutive years. Other control variables, such as size and ROA, show firm characteristics and performance. The mean of

Table V Descriptive statistics

<i>Variables (N = 96 FR)</i>	<i>Mean</i>	<i>SD</i>
CEO dismissal	0.490	0.503
chairman dismissal	0.500	0.503
CN	0.531	0.502
Difficult-to-estimate IFRS	0.250	0.435
Number of difficult IFRS	0.521	1.026
Severity of BS FR	0.050	0.136
Severity of IS FR	0.524	2.042
Great severity of FR	0.458	0.501
FR, which increases income	0.063	0.243
FR, which does not change income	0.042	0.201
FR, which decreases income	0.302	0.462
Separate	0.146	0.355
Interim	0.417	0.496
Consolidate	0.438	0.499
Number of IFRS	1.906	2.108
No press release	0.115	0.320
Time resolution_FS	1.531	0.580
Size	20.096	2.796
ROA	−0.039	0.094
Bankruptcy	0.479	0.502

bankruptcy is 47 per cent. On untabulated statistics, 23.53 per cent of CN went into bankruptcy after the CONSOB decision, and the percentage was much higher (75.60 per cent) for RFS.

6. Results

Table VI shows the results for *H1*: the coefficient of our variable of interest (CN) is negative and statistically significant (-0.292). Comparing CN and RFS, CN brings a lower likelihood of chairman dismissal. The same coefficient for CEO is not significant (untabulated). *H1* is confirmed for the chairman but not for the CEO. In other words, given that RFS is much more severe and requires re-approval of the financial statement by shareholders, it leads to a higher likelihood of chairman dismissal. When the FR involves the shareholders, it is thus the chairman who pays for its negative effect. Table IV reports further findings. First, our data confirm results found by prior literature (Desai *et al.*, 2006; Gleason *et al.*, 2008; Agrawal and Cooper, 2017): the coefficient of FR is negative and statistically significant (-0.666). Without distinguishing between CN and RFS, we confirm that FR increases the probability of chairman dismissal. Secondly, among control variables, size, bankruptcy and the number of IFRS show significant coefficients. Larger company size is negatively associated (-0.030) with chairman dismissal, which shows that bigger firms have a lower likelihood of chairman dismissal. The bankruptcy coefficient is negative (-0.402): when a company is no longer a going concern and enters bankruptcy proceedings, a change of chairman is not a voluntary shareholder decision. Finally, the coefficient of the number of IFRS is negative (-0.062). The increase of IFRS associated with FR is negatively associated with the likelihood of chairman dismissal.

Table VII shows the results for *H2* regarding the effects of FR severity. It includes three models. The first tests the effects of the severity of the income statement and balance sheet FR. The second tests the effect of great severity FR. The third model tests the effect of the severity of restatement dividing restatements, which lead to an increase in net income from restatements, which lead to no change in net income: both are compared with restatements that lead to a decrease of the net income. First, we find that FRs increase the likelihood of CEO dismissal when the restatement has greater severity related to income statement errors (positive regression coefficient, 1.136, in Table VII, Model 1). Conversely, when restatements are related to balance sheet errors, the coefficient that measures the effect of the severity is not significant. Secondly, analyzing high FR severity, we find no significant results. Thirdly, we find a negative and significant coefficient (-0.421) for the variable “restatement no-change” (Table VII, Model 3): FR with no change of the net income brings a

Table VI Analysis of CEO dismissal – *H1*

<i>Chairman dismissal</i>		<i>Model 1</i>	
		<i>Estimate</i>	<i>p-value</i>
CN	<i>H1</i>	-0.292	0.067
Separate		-0.057	0.643
Interim		0.004	0.955
Number of IFRS		-0.062	0.033
No press release		-0.018	0.904
Time resolution_FS		0.011	0.897
Size		-0.030	0.020
ROA		-0.304	0.453
Bankruptcy		-0.402	0.000
FR		-0.666	0.000
Constant		1.333	0.000
Year fixed effect		Yes	
Observations		192	

Table VII Analysis of CEO dismissal – H2

CEO dismissal		Model 1		Model 2		Model 3	
		Estimate	p-value	Estimate	p-value	Estimate	p-value
Severity of BS FR	H2	0.868	0.438				
Severity of IS FR	H2	1.136	0.017				
Great severity of FR	H2			0.063	0.688		
FR, which increases income	H2					−0.255	0.184
FR, which does not change income	H2					−0.421	0.045
Separate		0.026	0.813	0.019	0.863	0.028	0.799
Interim		0.036	0.556	0.040	0.518	0.035	0.575
Number of IFRS		−0.097	0.006	−0.046	0.198	−0.035	0.209
No press release		0.106	0.553	−0.212	0.162	−0.231	0.113
Time resolution_FS		0.069	0.408	0.072	0.391	0.039	0.657
Size		−0.001	0.951	−0.004	0.773	−0.003	0.785
ROA		0.603	0.132	0.621	0.125	0.579	0.149
Bankruptcy		−0.276	0.010	−0.351	0.002	−0.414	0.000
FR		0.474	0.002	0.552	0.000	0.674	0.000
Constant		0.783	0.069	0.749	0.037	0.919	0.034
Year fixed effect	Yes			Yes		Yes	
Observations		192		192		192	

lower likelihood of CEO dismissal than FR, which lead to a decrease in net income. In other words, the effects of FR on CEO dismissal are significant when they lead to a reduction in the net income of the company. Untabulated results show non-significant results for chairman dismissal.

Table VIII shows the results for H3. It includes two different models for the evaluation of difficulties in the estimation of financial statement items. The first model compares FR with at least one difficult-to-estimate IFRS flouted with FR with easy-to-estimate IFRS flouted. The following standards are considered difficult to estimate: IAS 37, IAS 38, IAS 39 and IFRS 7. The following standards are considered easy-to-estimate IAS 2, IAS 8, IAS 10, IAS 11, IAS 12, IAS 16, IAS 18, IAS 27, IAS 28, IAS 36 and IFRS 4; and IFRS 13. The second model takes into account the number of difficult-to-estimate IFRS flouted included in the enforcement actions. We find that restatements involving at least one difficult-to-estimate IFRS lead to higher reputational penalties, including CEO dismissal (positive coefficient in

Table VIII Analysis of CEO dismissal – H3

CEO dismissal		Model 1		Model 2	
		Estimate	p-value	Estimate	p-value
Difficult-to-estimate IFRS	H3	0.301	0.049		
Number of difficult IFRS	H3			0.184	0.013
Separate		0.028	0.802	0.053	0.632
Interim		0.045	0.471	0.052	0.400
Number of IFRS		−0.085	0.022	−0.110	0.007
No press release		−0.214	0.140	−0.247	0.090
Time resolution_FS		0.103	0.222	0.085	0.303
Size		−0.008	0.509	−0.006	0.628
ROA		0.614	0.125	0.588	0.139
Bankruptcy		−0.413	0.000	−0.472	0.000
FR		0.562	0.000	0.647	0.000
Constant		0.802	0.024	0.923	0.032
Year fixed effect	Yes			Yes	
Observations		192		192	

Model 1, [Table VIII](#)). We also find the same effect for restatement with a high number of difficult-to-estimate IFRS flouted (positive regression coefficient in Model 2, [Table VIII](#)).

7. Discussion

This paper contributes to enriching the current model(s) of CEO dismissal ([Fredrickson et al., 1988](#)). Our variables of interest from *H1*, *H2* and *H3* (respectively FR, FR severity and FR from IFRS) can be usefully added to CEO characteristics identified in prior research ([Fredrickson et al., 1988, Table I](#), p. 261), as we find evidence that they are associated with board's expectations and attribution and board's allegiances and value.

Specifically, our first finding, that chairman dismissal is more probable when the FR is a RFS than a CN, makes the following contributions.

- Because FR leads to reputational penalties and FRs are responsibility of the CEO, the high risk of CEO dismissal is a disincentive for the CEO to make material misstatement in the financial statement. Board member expectations, mainly based on organizational performance, can lead to an increase in chairman dismissal when FR leads to a reduction in benefits for shareholders or the other board members. The reputational penalties for FR increase the likelihood of chairman dismissal, especially when board members have dissenting expectations. Moreover, board members who are relatives of the chairman or who have a conflict of interests with the company or other stakeholders, for example, when they have the power to affect transfer prices, can be less neutral than other board members with regard to chairman dismissal in the case of FR.
- We also contribute to the literature by analyzing the effect of different types of FRs: public CN and RFS. We find that the benefits of CN, which is that it has a smaller effect on chairman dismissal because CN has a lower level of involvement of shareholders than RFS, are lower than costs associated with the greater severity of RFS. The final effect is an increased likelihood of chairman dismissal in the case of RFS. This result extends the strand of research on the determinants of top manager dismissal, and the strand of research on the effects of FR ([Desai et al., 2006](#); [Gleason et al., 2008](#); [Agrawal and Cooper, 2017](#)).

The second result, that the severity of FR increases the likelihood of CEO dismissal, makes the following contributions.

- Not only does the FR *per se* affect CEO dismissal but also its severity is an important factor. CEO's characteristics in the model by [Fredrickson et al. \(1988\)](#) can be supplemented with this variable as we find clearly that more severe FR increases the risk of manager dismissal;
- Among FRs, those that reduce net income are important variables, which increase the likelihood of CEO dismissal. We also contribute to this strand of research: consistently with the evaluation of CEO according to organization performance, CEO dismissal is more probable in case of a severe reduction of net income ([Srinivasan, 2005](#); [Wang and Chou, 2010](#); [Burks, 2010](#)); and
- The magnitude of FR in the income statement (and not the magnitude of FR in the balance sheet or the magnitude of FR over the median amount) increases the likelihood of CEO dismissal. Our third contribution here is the suggestion of this original way of evaluating FR severity.

The third finding, that the likelihood of CEO dismissal is higher where more difficult-to-estimate IFRS are flouted, contributes to the literature in the following ways:

- Not only does FR *per se* affect CEO dismissal but also does FR associated with more difficulty to estimate IFRS. CEO characteristics in [Fredrickson et al. \(1988\)](#) model can

be integrated with this variable, given that we find evidence that FR associated with more difficult to estimate IFRS increases the risk of manager dismissal. As FR and IFRS are environmental factors in UET, underpinned by the institutional environment, we find that TMT discretion used in the application of IFRS (difficult and easy to estimate) may account for different effects of the related FR on CEO/chairman dismissal;

- We extend the application of [Salavei's \(2010\)](#) classification to IFRS accounting standards. Classifying them as easy or difficult-to-estimate is useful for the evaluation of the probability of CEO dismissal, and FR is linked to difficult-to-estimate IFRS. We also extend the findings of [Cheung, et al.\(2008\)](#) and [Armstrong et al. \(2010\)](#) on more complex and difficult-to-estimate IFRS; for example, the use of fair values for financial instruments and the evaluation of intangible assets; and
- We suggest different ways to evaluate these effects. Our results are significant and imply that future research could usefully test the effects of non-compliance with one or more difficult-to-estimate IFRS.

Unlike much existing literature, which finds higher levels of management discretion among CEOs in the USA than in other countries ([Crossland and Hambrick, 2007](#)), we show that for IFRS adopters (for example, EU countries that mandatorily adopted IFRS for listed companies) the opposite is true: TMT in Italy reveal higher discretion, given the greater opportunities to perform earnings management with regard to the IFRS compared with the USA, with higher risks of FR and CEO dismissal. Remuneration of the dominant coalition can be another incentive to perform earnings management against the accounting standard: FR that increase the risks of TMT dismissal can be explained as a risk taken by the CEO, to be balanced against the benefits of remuneration premium gained because of misstatement of financial performance.

8. Conclusion

This study investigates the effects of FR on top management dismissal. It analyzes the effects of different types of FR (CN and RFS), FR severity and FR classified according to easy or difficult-to-estimate IFRS, on the likelihood of CEO/chairman dismissal. Performing logit regression models, which compare companies with and without FR, and using a unique database hand-collected directly from Italian POB documents providing information about FR, the research studies whether FR are a significant determinant of the probability of management dismissal.

Results show that RFS leads to a higher likelihood of chairman dismissal than CR: the distinction between the two types of restatement is a key aspect of European and Italian FR, which affects corporate governance. This result suggests that:

1. RFS is evaluated as more severe than CN.
2. Shareholders attribute more responsibility for FR to the chairman, often an independent member of the board, who has responsibility for monitoring, and it appears that shareholders lose confidence in the chairman.

FR severity is a significant determinant of the probability of CEO dismissal. FR with a higher level of severity related to income statement errors (earnings restatements) are most likely to lead to CEO dismissal. Moreover, the effects of restatement severity on CEO dismissal are greater when they decrease the net income of the company than where there is no change in net income. In other words, the effect of FR severity is mostly associated with poorer performances revealed in the restated income statement.

IFRS, which are more difficult-to-estimate, is a significant determinant of the probability of CEO dismissal. We find that FR involving at least one difficult-to-estimate IFRS and with a high number of difficult-to-estimate IFRS show an increased likelihood of CEO dismissal.

These results have several implications for theory, practice and future research.

Firstly, the model of CEO dismissal suggested by prior literature ([Fredrickson et al., 1988](#)) can be supplemented with a further variable: the effect of FR, which is the responsibility of CEO and chairman. The presence or absence of FR, FR severity and FR associated with easy or difficult to estimate IFRS can be considered as characteristics of management, and CEOs can be classified, as with or without these characteristics. FR is a disincentive to making material misstatements in the financial statement, given the high risk of management dismissal. FR, severe FR and FR from difficult-to-estimate IFRS are associated with two determinants affecting manager dismissal as follows:

1. Board expectations and attributions.
2. Board allegiances and values.

FRs disappoint board expectations in terms of performance and reduction of compensations, net income, cash flow and dividends. This is a threat to the stability of management, given that it is in charge of the financial statement and its reliability. Conflicts of interest of board members can also decrease their loyalty and independence regarding the dismissal of management in the case of FR.

Secondly, based on our results, top management needs to be aware of the risk of dismissal in the case of FR, especially when these are RFS, severe and linked to the flouting of difficult-to-estimate IFRS. Specifically, the chairman of the board of directors needs to be aware of the risk of dismissal in the case of RFS, as these RFS directly involve shareholders, while CEO needs to be aware of the risk of dismissal when FR involve technical factors (FR severity or FR associated with difficult-to-estimate IFRS).

Thirdly, future research studies into FR are expected to test the CEO dismissal model complemented with our variables of interests. For example, are FR types (CN or RFS) significant characteristics of TMT able to affect the likelihood of CEO dismissal? Have FRs involving shareholders (RFS) negative consequences only on the chairman or on other TMT components? Does FRs that directly involves the financial statement (FR severity or difficult-to-estimate IFRS) increase the risk of dismissal for the CEO or for other TMT members? The paper could also be useful to enrich UET. We find, for example, evidence that the institutional environment of EU countries does not moderate the TMT discretion, but future research could study the effect of the distribution of power among members of dominant coalitions and the effects of integration between coalition members, as noted by [Abatecola and Cristofaro \(2020\)](#).

Limitations of this study include the composition of the sample and the possibility of generalization of results. The sample includes a relatively small number of FR, given that we focus on listed companies and that Italian POB discloses small numbers of CN and RFS in Italy. However, the results can be generalized to countries covered by EU regulations. Last but not least, the study covers only the CEO and/chairman, while responsibility for FR can also lie with CFO, audit committee and other board members.

Notes

1. The Italian POB is the "Commissione Nazionale per le Società e la Borsa."
2. *Misstatement* is a difference of an amount, classification, presentation or disclosure between: an item in the financial statements; and the requirement of the accounting standards in this regard. Misstatements in financial statements are *material* when they can reasonably be expected to influence the decisions taken based on those financial statements.
3. Restating firms are firms for which the POB discovers material misstatements in financial reporting.
4. The Italian regulation is strictly connected with EU one (guideline 7 of ESMA, (2014) paragraph 61).

5. Without prejudice to the powers envisaged by article 157, paragraph 2, where it is ascertained that documents comprising the financial statements pursuant to this article do not comply with drafting regulations, CONSOB may request that the issuer publishes this fact and arrange publication of supplementary information as necessary to reinstate correct market information, Legislative Decree no. 58, February 24, 1998, Consolidated Law on Financial Intermediation, art. 154 ter, point 7 ([Italian Government, 2018](#)).
6. Except in the cases referred to in Article 156, the resolution of the shareholders' meeting or meeting of the supervisory board approving the annual accounts may be challenged by shareholders representing at least 5 per cent of the share capital on the grounds that the accounts fail to conform with the provisions governing the preparation thereof. Shareholder's representing the same percentage of the capital of companies with listed shares may request the courts to verify the conformity of the consolidated accounts with the provisions governing the preparation thereof; and CONSOB may take the actions referred to in Paragraph 1 within six months of the entry of the annual accounts or the consolidated accounts in the company register. Legislative Decree no. 58, February 24, 1998, Consolidated Law on Finance, art. 157, comma no 1 and 2.
7. Our main analysis tests CEO dismissal after 24 months from CONSOB inspection and its public disclosure of a problem in the financial statement. To compare timing, we also investigate CEO dismissal after 12 months. We expect that an efficient control system and the need to limit reputational damage would change the CEO within 1 year. We repeat all the multivariate regressions (untabulated) changing only the dependent variable, using a dummy variable for CEO dismissal after 12 months. However, results are less robust than the CEO dismissal after 24 months. This is an indication of the time, which listed firms take to react to POB enforcement actions.

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