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Audit committee accounting expertise, expectations management, and nonnegative earnings surprises



M.H. Carol Liu^a, Samuel L. Tiras^{a,*}, Zili Zhuang^b

^a Department of Accounting, E.J. Ourso College of Business, Louisiana State University, Baton Rouge, LA 70803, United States

^b School of Accountancy, Faculty of Business Administration, The Chinese University of Hong Kong, Shatin, NT, Hong Kong

A B S T R A C T

We investigate whether accounting expertise on audit committees curtails expectations management to avoid negative earnings surprises. Controlling for the endogenous choice of an accounting expert, we find that firms with an accounting expert serving on the audit committee exhibit: (1) less expectations management to avoid negative earnings surprises; (2) less nonnegative earnings surprises through expectations management; and (3) more nonnegative earnings surprises that are less susceptible to manipulations of both realized earnings and earnings expectations. We find, however, that the inclusion of an accounting expert on the audit committee curtails expectations management only in the interim quarters. While Brown and Pinello (2007) find a greater magnitude of downward revisions in analysts' forecasts in the fourth quarter, they also document a lower incidence of nonnegative earnings surprises. Together, this suggests that with an accounting expert, audit committees likely view the fourth quarter downward revisions as driven more by guidance than by manipulation, thus focusing on curbing only expectations management in interim quarters.

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1. Introduction

Managers have incentives to avoid negative earnings surprises because missing this earnings target adversely impacts the firm's stock price (Bartov et al., 2002; Skinner and Sloan, 2002). To avoid negative earnings surprises, the extant literature documents that managers are likely to manipulate

* Corresponding author. Tel.: +1 (225) 578 6275; fax: +1 (225) 578 6201.

E-mail address: tiras@lsu.edu (S.L. Tiras).

earnings upward and/or guide analysts' earnings expectations downward (Matsumoto, 2002; Bartov et al., 2002; Brown and Pinello, 2007, among others), tactics that are often referred to as the 'earnings surprise games' by the regulatory body and financial press (e.g., Levitt, 1998; Barsky, 2002). While recent studies show that the market becomes more skeptical of firms' earnings that just beat analysts' expectations in the post-Sarbanes Oxley Act (SOX) era (Koh et al., 2008; Keung et al., 2010),¹ financial executives surveyed by Graham et al. (2005) indicate that meeting or beating earnings expectations remains an important signal to the market about future performance of the firm.²

The evidence from the prior literature implies that the quality of meeting or beating earnings expectations as a signal about the firm is likely to be compromised with the noise from the tactics to avoid negative earnings surprises. Bedard et al. (2004) and Lin and Hwang (2010) find a negative association between audit committee accounting expertise and upward earnings management, suggesting that the monitoring of an accounting expert can reduce the noise in meeting or beating earnings expectations attributable to earnings management. The objective of our paper is to examine whether firms with an accounting expert serving on the audit committee reduce the noise by constraining downward expectations management.³

Since the primary responsibility of audit committees is to monitor the financial reporting process, an accounting expert on the committee to constrain earnings management is anticipated. Expectations management, however, is merely a reporting strategy and does not directly impact the quality of financial reporting. It remains an open question, therefore, whether an accounting expert on audit committee can constrain expectations management as well, or whether it provides an open hand for managers to employ expectations management when earnings management is constrained.

Expectations management typically starts with optimistic forecasts that analysts issue early in the forecasting period, followed by a downward revision to a meetable or beatable level as the earnings announcement approaches. To induce a downward revision in analysts' forecasts, managers need to 'walk down' analysts' earnings expectations by issuing earnings guidance or press releases. Expectations management, therefore, can be constructed as an example of managers abusing their discretion over disclosures to attain their short-term goal while clouding the information conveyed with meeting or beating earnings expectations.

Over the last decade, the responsibility of audit committees has evolved to include the monitoring of voluntary disclosures, suggesting that the audit committee would likely be able to constrain expectations management by curtailing managers' abuse of disclosures. For instance, the New York Stock Exchange (NYSE) explicitly requires audit committees to discuss disclosures in the company's Management Discussion and Analysis (MD&A), earnings press releases, and the earnings guidance provided to financial analysts and rating agencies [NYSE Listed Company Manual, Section 303A.07(B) and (C)]. Further, when providing guidance for implementing Section 302 of SOX, which requires public companies to maintain effective disclosure controls and procedures, the SEC recommended (but did not require) that companies establish a disclosure committee that would be responsible for the company's public disclosure. Many corporate boards delegate the oversight responsibility for the disclosure committee to the audit committee (National Association of Corporate Directors, 2007). These developments reflect a belief of the regulators that the responsibility of audit committees is not limited to monitoring the financial reporting process; rather, audit committees serve as the "ultimate" gatekeeper of financial disclosure (SEC, 1999).

The extant literature provides evidence on the association between audit committees and firms' voluntary disclosures. Karamanou and Vafeas (2005) find that firms with an accounting expert on the audit committee are more likely to issue management earnings guidance that is more accurate. Liu and Zhuang (2011) further show that management earnings guidance issued by firms with an

¹ Investors' skepticism of the earnings game is exemplified by lower earnings response coefficient for zero or small positive earnings surprises (Keung et al., 2010) and by diminishing market rewards for marginally beating analysts' expectations (Koh et al., 2008) in the post-SOX era.

² We use meeting or beating earnings expectations and nonnegative earnings surprises interchangeably throughout the paper.

³ Cohen et al. (2008) and Bartov and Cohen (2009) find that in the post-SOX era, managers substitute real earnings management for accrual-based earnings management and expectations management to avoid missing analysts' earnings expectations. We do not intend to examine real earnings management, as real earnings management involves economic actions that external auditors or audit committees cannot readily challenge.

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