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The association between characteristics of audit committee accounting experts, audit committee chairs, and financial reporting timeliness

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ABSTRACT

We investigate the association between audit committee (AC) members' financial expertise and financial reporting timeliness, and extend the discussion by investigating how the source of accounting expertise (e.g., public accounting or CFO) differentially influences financial reporting timeliness. We predict and find that AC accounting financial expertise is associated with timelier accounting information. Further, we find that accounting expertise gained from public accounting experience is associated with timelier financial reporting; however, accounting expertise gained from CFO experience is not. We also find that AC chairs (ACCs) with accounting expertise from public accounting experience are significantly associated with timelier financial reporting while ACCs with CFO-sourced accounting expertise are not. Our results are important for two reasons. First, our results suggest that AC accounting financial expertise contributes to AC effectiveness by improving the timeliness of financial information. Second, our findings highlight how personal characteristics of accounting financial experts influence contributions toward AC effectiveness.

1. Introduction

One important characteristic of audit committee (AC) effectiveness that has been addressed by academic research and regulatory bodies is AC financial expertise (e.g., Abbott, Parker, & Peters, 2004; BRC, 1999; Krishnan & Visvanathan, 2008). The purposes of this study are to (1) extend prior studies on AC financial expertise by investigating the association between AC accounting financial expertise and financial reporting timeliness, and (2) determine how the source of accounting expertise (i.e., public accounting experience, CFO experience) differentially influences timeliness.

Our investigation is particularly relevant because recent regulatory actions suggest that improving timeliness of financial reporting is a priority for regulators (e.g., Doyle & Magilke, 2013; Schmidt & Wilkins, 2013). For example, in 2003, the SEC mandated a tiered reduction in filing requirements, resulting in a 60-day filing deadline for large accelerated filers beginning in 2006 (SEC, 2005).[1] Behn, Searcy, and Woodroof (2006) contend that these requirements signal the SEC's position that improving financial reporting timeliness increases value to users. This is consistent with the FASB (2010) Conceptual Framework, which states that timeliness is an important aspect of financial information. Further, prior research suggests that financial reporting timeliness affects decision-makers' expected payoffs (Feltham, 1972) and security prices (Kross & Schroeder, 1984).

Prior research has investigated a number of factors associated with financial reporting timeliness (e.g., Ettredge, Li, & Sun, 2006; Sengupta, 2004), but has not yet investigated the association between AC financial expertise and financial reporting timeliness.[2] The relation between AC financial expertise and financial reporting timeliness is particularly important because the AC is charged with overseeing the audit engagement (Sarbanes-Oxley Act of 2002, 2002), which is a primary component of financial reporting timeliness (Jaggi & Tsui, 1999).[3] Recently, the Public Company Accounting Oversight Board (PCAOB) approved Auditing Standard 16 (AS 16) in order to improve communications

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[1] A large accelerated filer has a worldwide market value of outstanding voting and non-voting common equity by non-affiliates of $700M or more. All S&P 500 firms meet the criteria of an accelerated filer.

[2] While Ika and Ghazali (2012) investigate the association between AC effectiveness and financial reporting timeliness in an Indonesian setting, they do not consider AC financial expertise.

[3] Many audit committee charters explicitly state that timeliness is a responsibility of the audit committee. For example, PACCAR, Inc.'s charter states, “The Committee shall discuss with the head of the internal audit staff and the independent auditors … factors that may impact the effectiveness and timeliness of such audits.”

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between the external auditors and the AC, highlighting the importance of the AC in the audit process.[4] Furthermore, NASDAQ and NYSE listing standards mandate that the AC exercise an oversight role in SEC filings, including the earnings release process (Bochner & Blake, 2008). Accordingly, we investigate the association between AC members' financial expertise and financial reporting timeliness, measured by earnings announcement lag (*EAL*), audit report lag (*ARL*), and SEC late filings (*SECLATE*).[5]

Research suggests that the presence of financial experts on ACs is positively associated with AC effectiveness in monitoring financial reporting quality (e.g., Abbott et al., 2004; Cohen, Krishnamoorthy, & Wright, 2004; DeZoort, 1998; Kalbers & Fogarty, 1993). However, Dhaliwal, Naiker, and Navissi (2010) note an ongoing debate in the literature concerning the definition of what constitutes financial expertise. Prior research has adopted either a (1) narrow definition of financial expertise, which differentiates AFEs (i.e., experts that have education or experience in accounting or auditing) and non-AFEs (i.e., financial experts that only have work experience in finance positions, as a chief executive officer or company president), or (2) broad definition of financial expertise, which does not differentiate between AFEs and non-AFEs.

We use the narrow definition of financial expertise to investigate our first hypothesis – the association between AC financial expertise and financial reporting timeliness – because prior research finds that the type of financial expertise may differentially affect financial reporting quality (e.g., Badolato, Donelson, & Ege, 2013; Dhaliwal et al., 2010; Hoitash, Hoitash, & Bedard, 2009; Krishnan & Visvanathan, 2008). Specifically, we use hand-collected biographical data to determine AC member experience, and we classify each member as an AFE, non-AFE, or non-financial expert.[6]

DeFond, Hann, and Hu (2005) suggest that accounting financial expertise may be more important for tasks that require a high degree of accounting sophistication. Similarly, Beasley, Carcello, Hermanson, and Neal (2009) and Hoitash et al. (2009) both suggest that AC AFEs are more involved with judgments, estimates, and assumptions inherent in GAAP and the audit process. Following DeZoort (1998), who contends that specific accounting experience improves AC members' capacity to understand technical issues facing their companies, we predict that increased technical competency will reduce the amount of time needed for the AC sufficiently to discuss, comprehend, and evaluate significant accounting issues with the auditor and management (c.f., Audit Standard No. 16). That is, we predict that AFEs on ACs will facilitate timelier financial reporting through superior technical competency, which improves communication efficiency between management and the AC, as well as the auditor and the AC, regarding significant judgments, estimates, assumptions, unusual transactions, and dispute resolutions.[7] Therefore, we expect that an increased proportion of AFEs on the AC will be associated with increased financial reporting timeliness.

The second purpose of our study is in response to Bedard and Gendron's (2010) call for researchers to take a deeper view of the agency role of AC AFEs to assess how personal characteristics influence contributions toward AC effectiveness. Specifically, and unlike most prior research that has homogeneously classified AC members as AFEs if they meet the narrow definition of a financial expert, we also investigate the effects of AC members' accounting expertise source on financial reporting timeliness.[8] Using biographical data, we classify AFEs as having accounting financial expertise derived through experience in public accounting or obtaining accounting certification (PAAFEs), or through experience as a CFO, controller, or other accounting supervisory position (CFOAFEs).

The extant literature provides evidence that the role of the CFO is shifting away from technical accounting and toward strategic planning (Aier, Comprix, Gunlock, & Lee, 2005), and managing associations with venture capitalists and the investing public (Jones, 2000). Edur (1999) finds that CFOs perceive that accounting functions are a relatively minor part of their duties. While DeFond et al. (2005) suggest that AC members are responsible for tasks that require high degrees of accounting sophistication, the changing nature of CFO responsibilities inherently increases the variance in CFO backgrounds and accounting competency (Aier et al., 2005). This variance in accounting competency increases the likelihood that CFOAFEs will not have the requisite technical competency efficiently to navigate a discussion with the auditor or management concerning significant accounting policies and unusual transactions (as is expected of a financial expert). Conversely, PAAFEs, are more likely to possess the requisite accounting knowledge because their experiences are more homogeneously centered on accounting- and audit-related issues. We suggest that PAAFEs will have a greater comprehension of GAAP issues and the audit process (i.e., GAAS), which will lead to timelier financial reporting through increased communication efficiency between management and the AC, as well as the auditor and the AC, regarding significant judgments, estimates, assumptions, unusual transactions, and dispute resolutions. Accordingly, we predict that AC public accounting expertise will be associated with more timely accounting information than AC CFO expertise.

The third purpose of our study is to investigate how the financial expertise of the AC chair (ACC) is associated with financial reporting timeliness. The ACC is responsible for such functions as setting the meeting agenda, controlling the meeting and discussions, building the appropriate relationships with auditors and management, and developing chemistry among AC members (Bedard & Gendron, 2010). However, Carcello, Hermanson, and Ye (2011) note that very little research separately examines the role of the ACC in facilitating AC effectiveness. The ACC, as the nexus for the AC's interactions with management and the internal and external auditors, is critical to financial reporting timeliness (PricewaterhouseCoopers, 2003). Leveraging the theory of our previous predictions, we contend that ACC accounting financial expertise will facilitate timelier financial reporting. Finally, we expect that ACCs with PA-sourced accounting expertise will be associated with timelier financial reporting than ACCs with CFO-sourced accounting expertise.

We use a sample of 996 S&P 500 firm-year observations from 2006 to 2008.[9] The results generally support our hypotheses and suggest that the proportion of AFEs on an AC is positively associated with the financial reporting timeliness.[10] Further, our results from tests of AC accounting expertise source suggest that the most positive impact on financial reporting timeliness is achieved when firms have a higher

[4] AS 16 supersedes AU sec. 310; sec 380; sec 9380; and Auditing Interpretations of Section 380.

[5] We measure *EAL* (*ARL*) as the number of days between a firm's fiscal year end and the earnings announcement (audit report signature) date.

[6] Our categorization of AC financial expertise is based on biographical information and is not limited to the members designated as financial experts in a company's 10-K.

[7] Salterio (2012) suggests audit timeliness is related to the outcome of auditor–client negotiations, and Ng and Tan (2003) suggest that effective ACs facilitate more timely negotiation resolution. While this is certainly a mechanism through which AC financial expertise could enhance financial reporting timeliness, it is important to note that dispute resolution is just one of many communications that ACs must engage in throughout the reporting process.

[8] Consistent with the SEC's original definition of a financial expert, most prior research (e.g., Dhaliwal et al., 2010; Hoitash et al., 2009; Krishnan & Visvanathan, 2008) has grouped all AC members with experience as a controller, auditor, CPA, CFO, financial controller, or chief accounting officer as an AFE.

[9] Following prior research (e.g., Klein, 2002; Krishnan & Visvanathan, 2008), we use a sample of S&P 500 firms to conduct our analysis. In addition, our sample period starts in 2006, because this is the first year that firms with more than $700 million in public float were required to reduce their filing period to 60 days (SEC 2005). All companies listed on the S&P 500 in 2006 had public floats in excess of $700 million. Thus, accelerated filing deadlines affected all firms in our sample.

[10] Results are robust to inclusion of firm and governance characteristics (e.g., Hoitash et al., 2009).