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Audit committee financial expertise and properties of analyst earnings forecasts[☆]

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ABSTRACT

An important role of financial accounting information is to aid financial statement users in forming expectations about the firm's future earnings. Prior research finds that accounting financial expertise of the audit committee is associated with higher financial reporting quality. We extend this literature by examining the association between audit committee financial expertise and analysts' ability to anticipate future earnings. We find a significant association between *accounting* financial expertise on the audit committee and analyst earnings forecasts that are more accurate and less dispersed. In contrast, we do not find a significant association between non-accounting financial expertise (i.e., supervisory expertise) and forecast accuracy or forecast dispersion. These findings contribute to our understanding of the benefits of accounting expertise in audit committees by demonstrating an association between accounting financial expertise and improvements in analyst earnings forecasts.

1. Introduction

Prior research provides evidence that having accounting financial experts on the audit committee is associated with higher financial reporting quality (e.g., DeFond, Hann, & Hu, 2005; Dhaliwal, Naiker, & Navissi, 2010; Krishnan & Visvanathan, 2008). We extend this research to examine whether improved financial reporting quality from such expertise is associated with the ability to anticipate future earnings. The Financial Accounting Standard Board (FASB) (1978) notes in the Statement of Financial Accounting Concepts No. 1 that "financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions." While prior studies suggest that audit committee expertise is associated with improved financial reporting quality, there is little empirical evidence on the association between audit committee's financial expertise and decisions of financial statement users. We examine an important aspect of users' investment decisions, i.e., their ability to anticipate future earnings. Specifically, we investigate the association between audit committee financial expertise and financial analysts' ability to predict future earnings.

We focus on analyst earnings forecasts for several reasons. First, Schipper (1991) suggests that analyst behavior can provide insight into the activities and beliefs of investors that cannot be observed directly. Analysts, as sophisticated users of financial reporting information, provide direct evidence about whether users incorporate improvements in financial reporting into their decision-making process. Second, as Kothari (2001) states, "almost all models of valuation either directly or indirectly use earnings forecasts." Thus, given analysts' role as a key provider of information to the capital markets, empirical evidence on whether audit committee financial expertise relates to analysts' forecasting ability is useful to investors in firm valuation. Kecskes, Michaely, and Womack (2010) find evidence that analysts' earnings-based recommendation changes are more informative than discount rate-based recommendations, supporting the notion that the value of analysts' recommendations is primarily linked to how well they can discern a firm's future earnings. Finally, while prior research has documented a link between accounting expertise on the audit committee and financial reporting quality, prior research has not explored a direct link with users of financial statement information. We address this gap in the literature in examining the association between audit committee financial expertise and analysts' ability to anticipate future earnings.

The Sarbanes–Oxley Act of 2002 required the Securities Exchange Commission (SEC) to issue rules mandating that the audit committee of every public company have a designated financial expert; and that the name of that financial expert be disclosed (Sarbanes–Oxley Act of 2002). The SEC suggests that having at least one financial expert on

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the audit committee should improve the quality of information available to investors. Prior research supports this notion by showing that the financial expertise of the audit committee is significantly associated with a lower incidence of financial statement restatement (Abbott, Parker, & Peters, 2004), a reduced likelihood of material weaknesses in internal control reported during an auditor change (Krishnan, 2005), a reduction in fraud (Farber, 2005), and lower expected rates of return on pension plan assets (Comprix, Guo, Zhang, & Zhou, 2012).

The SEC initially proposed a stringent definition of financial expert, which defined individuals as financial experts only if they had education and experience in accounting or auditing (i.e. as a certified public accountant, auditor, chief financial officer, financial controller or accounting officer). In response to criticism that this definition was overly restrictive, the SEC adopted a broader definition of audit committee financial expert. Specifically, an audit committee member could be deemed a financial expert if the member has had work experience in accounting or auditing, as well as work experience in finance positions or as a chief executive officer (CEO) or company president. Therefore, financial expertise may include expertise in accounting, finance, or in supervising the preparation of financial statements (supervisory expertise). However, many argue that the current definition of financial expertise may be too broad and lack the ability to ensure high financial reporting quality.

Consistent with this, prior research finds that the presence of accounting financial expertise (but not non-accounting financial expertise) on the audit committee is associated with certain financial reporting characteristics such as greater accounting conservatism (Krishnan & Visvanathan, 2008), higher quality accruals (Dhaliwal et al., 2010), and lower earnings management (Bédard, Chtourou, & Courteau, 2004; Carcello, Hollingsworth, & Neal, 2006). The accounting financial expertise of the audit committee is also associated with a reduction in suspicious auditor switches (Archambeault & DeZoort, 2001) and higher firm credit ratings (Ashbaugh-Skaife, Collins, & LaFond, 2006). Prior research also suggests that investors care about the accounting financial expertise of audit committee members. For example, DeFond et al. (2005) find that companies appointing audit committee members with accounting financial expertise experience significant positive abnormal market returns, while no market reaction is observed upon the appointment of those with non-accounting financial expertise.

Financial analysts use accounting information to form expectations of future earnings (e.g., Abarbanell & Bushee, 1997). Furthermore, survey evidence suggests that audit committee financial expertise matters to financial analysts. Dickins, Hillison, and Platau (2009) survey financial analysts and find that analysts are more confident in the financial statements when the Audit Committee Financial Expert (ACFE) has accounting-based financial expertise. However, there is little evidence on how financial analyst earnings forecasts vary with audit committee financial expertise. Thus, if audit committee accounting expertise increases both the quality of financial information which financial analysts use to formulate their forecasts and analyst confidence in the financial information provided, we expect the properties of analysts' earnings forecasts to improve with audit committee accounting expertise.

To address our research question, we examine the associations between audit committee financial expertise and analyst earnings forecast properties (i.e., accuracy and dispersion). Financial analysts are viewed as sophisticated financial statement users and their earnings forecasts are commonly used as a proxy for the market's expectation of earnings, which is a critical element in firm valuation. We find that the accounting financial expertise of the audit committee is significantly associated with greater analyst forecast accuracy and lower forecast dispersion. In contrast, examining the broad definition of financial expertise adopted by the SEC, we find that non-accounting financial expertise is not significantly associated with either improved analyst forecast accuracy or lower analyst forecast dispersion.

This study contributes to the literature in the following ways. First, building on prior studies that examine the relation between audit committee expertise and financial reporting quality, we examine whether audit committee expertise is associated with improved analyst forecasts. Our findings extend the literature by showing a link between accounting expertise on the audit committee and forecasts of future earnings. Our results also contribute to the debate on the definition of financial expertise on an audit committee. Our evidence suggests that accounting financial expertise (but not non-accounting financial expertise) enhances financial analysts' ability to anticipate future earnings. In line with prior research (Archambeault & DeZoort, 2001; Ashbaugh-Skaife et al., 2006; Bédard et al., 2004; Carcello et al., 2006; Dhaliwal et al., 2010; Krishnan & Visvanathan, 2008) these results suggest that accounting specific financial expertise on the audit committee is especially beneficial.

The paper proceeds as follows. Section 2 reviews prior literature and develops the hypotheses relating audit committee financial expertise to the properties of analysts' forecasts. Section 3 describes the research methodology. Section 4 presents the empirical results and Section 5 concludes the paper.

2. Prior research and hypotheses development

2.1. Audit committees and financial expertise

Prior studies using the broad definition of financial expertise have provided mixed evidence about an association between financial expertise and financial reporting quality. Abbott et al. (2004), and Agrawal and Chadha (2005) find that financial expertise of the audit committee (under a broad definition) is negatively related to the occurrence of restatement. Farber (2005) also employs the broad definition of financial expertise and finds a significantly lower occurrence of financial fraud in firms with financial expertise on the audit committee. However, Anderson, Mansi, and Reeb (2004) employ the broad definition of financial expertise and find no association between audit committee financial expertise and cost of debt. Additionally, anecdotal evidence suggests that financial expertise obtained through experience as a CEO or president does not ensure an adequate understanding of accounting matters for an audit committee member (Livingston, 2003).

Later studies adopt a narrower definition of financial expertise, similar to the definition initially proposed by the SEC. This definition differentiates between accounting and non-accounting financial expertise. Such research has provided more consistent associations between accounting financial expertise on the audit committee and financial reporting quality. For instance, Krishnan and Visvanathan (2008) find that firms with accounting financial experts on the audit committee are associated with more conservative financial reporting. Dhaliwal et al. (2010) finds a significant positive relation between accounting expertise on audit committees and accruals quality. Additionally, research has examined whether accounting financial expertise on the audit committee affects stock prices. Both Davidson, Xie, and Xu (2004) and DeFond et al. (2005) find that the market rewards companies for the appointment of accounting financial experts, but shows no reaction for the appointment of audit committee members with corporate financial management expertise. These studies clearly suggest that the market discriminates between accounting and non-accounting financial expertise on the audit committee.

2.2. Hypotheses development

An effective audit committee can enhance the credibility and reliability of the financial statements provided to users. The SEC and the Blue Ribbon Committee (1999) suggest that the primary responsibilities of the audit committee include assessing accounting policies, evaluating accounting judgment, appointing and overseeing external auditors, and appraising the quality of the firm's financial reports. Carcello et al. (2006) indicate that, while almost all companies disclose whether an audit committee financial expert serves on the audit committee, the majority of these designated financial experts