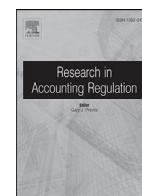




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## Research Report

## Setting expected rates of return on pension plan assets: New evidence on the influence of audit committee accounting experts

Joseph Comprix<sup>a</sup>, Jun Guo<sup>b,\*</sup>, Yan Zhang<sup>c</sup>, Nan Zhou<sup>c</sup><sup>a</sup>Syracuse University<sup>b</sup>Rutgers, The State University of New Jersey, Camden<sup>c</sup>State University of New York at Binghamton

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## ABSTRACT

This study examines whether having accounting experts on audit committees can mitigate the upward bias of expected rates of return (ERR) on pension plan assets documented in prior research. ERRs are found to be lower in firms with accounting expertise on their audit committees. These results are robust after controlling for variables from extant governance and pension research, and they suggest that audit committee accounting experts can help deter managers from setting higher ERRs on pension assets. While extant studies find that opportunistic setting of pension assumptions can be controlled through regulation, this paper provides new evidence on the influence of audit committee accounting experts on critical pension estimates. This newfound governance effect is different from and incremental to the regulation effect previously documented in the pension accounting literature.

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## Introduction

Earnings management in the context of pension accounting is typically conducted by altering critical assumptions needed to account for pension assets and liabilities. Accounting Standard Codification (ASC) 715, *Compensation – Retirement Benefits*, requires firms with defined benefit pension plans to use the expected rate of return on pension plan assets (ERR hereafter) assumption to calculate pension costs (*The Financial Accounting Standards Board (FASB), 2009*).<sup>1</sup> Since a change in the ERR is subject to managerial discretion and can significantly impact net income (*Amir & Benartzi, 1998; Picconi, 2006*), the ERR is potentially a useful vehicle for managers to manipulate earnings.<sup>2</sup> For example, companies

are more likely to change ERR assumptions to increase earnings (*Godwin, Goldberg, & Duchac, 1996*), before acquiring other firms (*Bergstresser, Desai, & Rauh, 2006*), to boost executives' cash compensation (*Comprix & Muller, 2006*), and to meet or beat analyst forecasts (*An, Lee, & Zhang, 2014*).

To limit managers' opportunistic use of the ERR, SFAS 132R requires firms to disclose the percentages of pension plan assets held as equity securities, debt securities, real estate, and other assets. This improved transparency in pension accounting not only aids users in assessing the reasonableness of the company's ERR, but also constrains managers' discretion over choosing the ERR. Indeed, *Chuk (2013)* finds that the footnote disclosures required in SFAS 132R are effective in reducing managerial discretion when setting the ERR on pension assets.

An alternative to SFAS 132R's regulatory approach to controlling for agency problems in setting pension assumptions is to improve corporate governance, which is a mechanism to monitor managers and to protect shareholders through the board of directors. The audit committee is an integral part of a firm's governance mechanisms, because the board is required to delegate its accounting oversight authority to its audit committee under the Sarbanes-Oxley Act (SOX) Section 205. As discussed in *DeFond and Zhang (2014)*, SOX related provisions strengthen the role of the audit committee in corporate governance. First, to increase monitoring incentives, SOX reaffirms the prior *SEC (1999)* rule and requires entirely independent directors on the audit committee. Second, SOX requires at least one financial expert on the audit

\* Corresponding author.

E-mail addresses: [jcompri@sy.edu](mailto:jcompri@sy.edu) (J. Comprix), [jun.guo.acct@rutgers.edu](mailto:jun.guo.acct@rutgers.edu) (J. Guo), [yzhang@binghamton.edu](mailto:yzhang@binghamton.edu) (Y. Zhang), [nzhou@binghamton.edu](mailto:nzhou@binghamton.edu) (N. Zhou).<sup>1</sup> ASC 715 encompasses Statement of Financial Accounting Standards (SFAS) 158 (*FASB, 2006*), SFAS 132R (*FASB, 2003*), and SFAS 87 (*FASB, 1985*), which were the governing provisions before they were swept up into ASC 715.<sup>2</sup> While changes in the discount rate and salary inflation rate may also affect pension expense/income, we follow the pension accounting literature and do not investigate the discount rate and salary inflation rate in this paper, because these two rates are less likely to be subject to manipulation. The salary inflation rate typically exhibits little variation across firms or time. The discount rate is usually close to the rate on Aa corporate bonds, following a letter from the Securities and Exchange Commission (SEC) to the Emerging Issues Task Force (EITF) in 1993 in which the SEC suggested Moody's Aa bond rate be used as an appropriate proxy for the discount rate (*Zion & Carcache, 2002*).

committee. Third, NYSE and NASDAQ listing requirements adopted pursuant to SOX require at least three directors on the audit committee. Given that the role of the audit committee in corporate governance is more important than ever (EY, 2013), the audit committee is more relied upon and effective in the post-SOX era (Rupley, Almer, & Philbrick, 2011; Zhao & Ziebart, 2015).

The audit committee's responsibility in overseeing pension accounting is often explicitly discussed in audit committee charters.<sup>3</sup> According to an audit committee member of a NYSE firm, "the audit committee looks at expense reports, loans to individuals, related party transactions, contracts, and agreements, particularly those related to compensation and pensions" (Beasley, Carcello, Hermanson, & Neal, 2009, 98). More specifically, the role of the audit committee in pension accounting is to "discuss with management whether discount rates and investment return rates are reasonable and justifiable based on economic trends and the company's investment portfolio" (PwC, 2012, 2). Consequently, this study investigates whether audit committees with sophisticated accounting knowledge are better able to oversee the complicated assumptions used in pension accounting.

The focus is placed on the ERR assumption, because upward changes in ERRs lead directly to increases in expected returns and lower pension costs. Even small changes of ERRs have a large impact on the bottom line.<sup>4</sup> Moreover, if a company's ERR proves to be overstated, losses from actual returns failing to meet expected returns are recognized over several years to reduce volatility in income (as opposed to reversing in the next period as with most accruals). Thus, managing pension expense through the ERR is a useful tool for earnings management. This is particularly true in the long term, as pension smoothing rules ensure that the reversals of overstated ERRs are reflected in income over an extended period.

The role of audit committees in overseeing pension estimates is important, because outsiders would have difficulty evaluating these estimates. First, all of the information that outsiders need to fully understand whether managers have chosen appropriate pension assumptions is not available to them. Second, even with the pension information that is disclosed in financial statements, research provides evidence that investors and analysts fail to fully impound that information into prices and forecasts (Picconi, 2006). Third, there are legitimate reasons to observe differences in ERRs, because differing investment mixes can cause ERR assumptions to vary across companies. Consequently, audit committees are asked to exercise considerable judgment when monitoring pension accounting estimates.

Since the opportunistic use of pension assumptions may not be clear to investors, and even to audit committee members who lack specialized knowledge, the involvement of accounting experts on the audit committee is expected to be particularly valuable in reducing the use of aggressive and complex pension assumptions. Audit committee members who are accounting experts are more likely to discuss specific judgments, estimates, and assumptions involved in accounting policies (Beasley et al., 2009). Studying whether accounting expertise on audit committees mitigates the opportunistic use of pension assumptions is important given

the prevalence and magnitude of defined benefit pension plans,<sup>5</sup> the opacity of pension accounting, and prior evidence that the ERR is an important earnings management technique.

The measure of audit committee accounting expertise is based on SOX Section 407, which requires firms to disclose whether there is a financial expert serving on the audit committee or the reason why the company lacks such an expert. There is a debate on whether a narrow or a broad definition of financial expertise should be adopted. A narrow definition refers to accounting expertise with accounting knowledge and experience, whereas a broad definition also includes non-accounting financial expertise such as supervisory or finance experience. The narrow view of financial expertise is adopted in this study, because pension accounting is highly technical and requires a thorough understanding of accounting, rather than merely having an extensive background in business. The emphasis on audit committee accounting expertise is supported by the findings in prior studies, as accounting expertise is priced by capital markets (DeFond, Hann, & Hu, 2005), is associated with the quality of financial reporting (Krishnan & Visvanathan, 2008), and is valued by companies searching for audit committee members (Beasley et al., 2009).

Using data from defined benefit pension plans from 2003 to 2007,<sup>6</sup> this study examines whether audit committee accounting expertise can mitigate the upward bias of ERRs on pension plan assets documented in prior studies. ERRs are found to be lower in those firms with at least one accounting expert on the audit committee. The results are robust after controlling for corporate governance, management incentives, SFAS 132R disclosures, the composition of pension plan assets, and general economic conditions. Since having multiple accounting experts on the audit committee may also contribute to audit committee effectiveness (Carcello, Hollingsworth, & Neal, 2006), the percentage of accounting experts on the audit committee is used as an alternative measure to capture the extent of audit committee accounting expertise. As expected, the results indicate that the higher the percentage of accounting experts, the lower the ERR.

This paper has policy implications for standard setters with regard to pension accounting and for accounting regulators with regard to audit committees. First, because of the magnitude of pension funds, pension accounting is a likely vehicle for earnings management (Bergstresser et al., 2006; Comprix & Muller, 2006). To constrain agency costs, FASB standard setters have issued a series of statements, mandating firms to disclose more pension related information. While these regulations reduce managerial discretion in setting ERRs (Chuk, 2013), this paper finds that audit committee accounting expertise is also effective in curbing earnings manipulation through pension accounting (and the effect is incremental to SFAS 132R). This newfound governance effect suggests that improving corporate governance can be a feasible, low-cost alternative to burdening firms with more pension accounting regulations.

Second, "the communication between an audit firm and the audit committee is fundamental to a reliable and high-quality audit," said James Doty, chairman of the Public Company Accounting Oversight Board (PCAOB).<sup>7</sup> According to Auditing Standards No. 16 (PCAOB, 2012), the auditor should communicate to the audit committee on accounting policies and practices, critical accounting

<sup>3</sup> For example, AK Steel's audit committee charter explicitly states that "the Committee shall have oversight responsibility for, and shall periodically review with management and the Corporation's independent auditors, pension accounting matters, including selection of assumptions as to discount rate and actuarial rate of return, and calculation of corridor charges and pension expense." ([http://www.aksteel.com/pdf/investor\\_information/Audit%20Committee%20Charter\\_July18\\_2013.pdf](http://www.aksteel.com/pdf/investor_information/Audit%20Committee%20Charter_July18_2013.pdf)).

<sup>4</sup> As an example, footnote 3 of An et al. (2014, 699) provides a discussion of IBM's pension accounting in 2000 and 2001. For IBM, a 10 basis point change in the ERR would have generated \$500 million of pension income in that timeframe.

<sup>5</sup> Nearly 70% of the S&P 500 firms currently have defined benefit pension plans. The aggregate total pension assets under defined benefit plans in S&P 500 firms is around \$1.3 trillion in 2007 (liabilities are about the same).

<sup>6</sup> The sample starts in fiscal year 2003, the first full year of SOX 407 under which public firms are required to disclose whether they have at least one financial expert on their audit committees. It ends in fiscal year 2007 to avoid confounding market effects caused by the subsequent financial crisis.

<sup>7</sup> <http://www.journalofaccountancy.com/news/2016/apr/pcaob-audit-committee-communication-rules-20164184.html#sthash.PkBJDSUk.dpuf>.

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