PRACTITIONER SUMMARY

How the Source of Audit Committee Accounting Expertise Influences Financial Reporting Timeliness

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SUMMARY: This article summarizes “The Association between Characteristics of Audit Committee Accounting Experts, Audit Committee Chairs, and Financial Reporting Timeliness” (Abernathy, Beyer, Masli, and Stefaniak 2014), which investigates the association between audit committee members’ accounting expertise and financial reporting timeliness. While we find a positive relation between audit committee accounting expertise and financial reporting timeliness, interestingly, we also find that accounting expertise gained from public accounting experience is associated with more timely financial reporting than accounting expertise gained from CFO experience. We discuss implications of these findings for auditors, companies, and regulators.

Keywords: audit committee; audit committee chair; accounting expertise; financial reporting timeliness.

INTRODUCTION

In 2014, the Securities and Exchange Commission (SEC) filed a record 755 enforcement actions, foreshadowing that audit committee effectiveness is certain to undergo scrutiny in the coming years. One determinant of audit committee effectiveness that has received attention is audit committee members’ financial expertise (National Commission on Fraudulent Reporting [the Treadway Commission] 1987; Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees 1999; U.S. House of Representatives 2002). For example, SOX Section 407 required the SEC to adopt rules mandating publicly traded firms’ audit committees maintain at least one member who is a financial expert or to disclose reasons for not adopting this requirement. The SEC initially proposed a *narrow* definition of financial expert; namely, an

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individual who has education and experience in accounting or auditing (e.g., auditor, CFO, controller, or accounting officer).

In response to criticism that this definition was overly restrictive, the SEC (2002b) eventually adopted a *broader* definition of an audit committee financial expert, which states an audit committee member can be designated as a financial expert if he/she has accounting expertise or certain types of nonaccounting expertise (e.g., investment banker, financial analyst, CEO, or company president). Subsequent research has provided evidence that the contribution of financial expertise to audit committee effectiveness is most pronounced when financial expertise is derived from education or experience in accounting or auditing (i.e., the *narrow* definition).

Recently, we conducted a study (Abernathy, Beyer, Masli, and Stefaniak 2014) that examined whether accounting financial expertise influenced financial reporting timeliness.¹ We also investigate how the source of this expertise (e.g., whether an accounting financial expert obtained expertise via public accounting or via a CFO role) influences financial reporting timeliness. We also investigate how financial reporting timeliness is influenced by the audit committee chair's expertise. In this paper, we discuss the theoretical underpinnings of our hypotheses, review our findings, and help explain why the source of an audit committee member's financial expertise likely plays a significant role in financial reporting timeliness.

HYPOTHESES

Accounting Financial Expertise and Timeliness

Recent regulatory actions suggest that improving financial reporting timeliness is a priority for standard setters and regulators (FASB 2010; SEC 2005). We contend that the relation between audit committee financial expertise and financial reporting timeliness is particularly important because the audit committee is charged with overseeing the audit engagement (U.S. House of Representatives 2002), which research generally views as one of the most important empirically examinable determinants of financial reporting timeliness (Krishnan and Yang 2009).² In fact, 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" (PACCAR 2013).

Additionally, the SEC and PCAOB require the auditor to communicate with the audit committee all critical accounting policies and practices used by the client, alternative treatments of material items within GAAP, and ramifications of each treatment, as well as the treatment preferred by the auditor (Deloitte 2010; PCAOB 2012). We contend that as the audit committee's

¹ Timeliness, in general, refers to the length of time required to provide financial information to investors. The FASB and IASB have recognized timeliness as a qualitative characteristic of relevant financial information (FASB 2010). Our specific measures of timeliness are described in the "Research Method" section of this paper.

² Recent evidence shows that many firms issue earnings releases before the completion of the audit (Krishnan and Yang 2009). However, the SEC has stated it is their understanding that a company's audit is complete or substantially complete by the time the company issues its earnings announcement (SEC 2002a). Therefore, these are usually situations where the audit has been substantially completed and where management and the audit committee have discussed the audit and financial results with the external auditor. Furthermore, NASDAQ and NYSE listing standards mandate that the audit committee exercise an oversight role in SEC filings, including the earnings release process (Bochner and Blake 2008).

financial expertise increases, it reduces the amount of time needed to sufficiently discuss, comprehend, and evaluate significant accounting policies and unusual transactions with the auditor, thereby reducing the time needed to complete the audit and increasing financial reporting timeliness. Accordingly, we first hypothesized that audit committees with a higher proportion of accounting financial experts would be associated with improved overall financial reporting efficiency.

Type of Accounting Financial Expertise and Timeliness

Our second hypothesis focused on the notion that there is significant variation in CFO backgrounds. Contrary to the predominant expectation that all CFOs are accounting savvy, [Aier, Comprix, Gunlock, and Lee's \(2005\)](#) survey provides evidence that companies are beginning to adopt a new, revised role for CFOs that decreases the emphasis on the CFO's knowledge of basic accounting and emphasizes the CFO's role in strategic planning, information technology initiatives, and managing associations with venture capitalists and the investing public. [Aier et al. \(2005\)](#) also suggest that CFOs often focus on complex business deals that improve financial performance rather than external reporting, and conclude that CFOs' accounting skills may suffer as they move away from their historical roles of enforcers of companies' financial reporting requirements.

This shift in CFO responsibility and requisite accounting knowledge could affect the financial reporting processes of organizations that appoint CFOs to the audit committee to act as accounting financial experts. Accordingly, we contended that audit committee members with public accounting sourced expertise were better positioned to facilitate timelier financial reporting than audit committee members with CFO sourced expertise were. Using similar arguments to our first hypothesis, we hypothesized that audit committees with a higher proportion of public accounting sourced accounting financial experts will be associated with timelier financial reporting.

Audit Committee Chairs and Timeliness

Our final set of hypotheses examined the audit committee chair. The audit committee chair is the primary point of contact between the audit committee and management and internal and external auditors, and ultimately determines its effectiveness ([Bromilow 2010](#); [PricewaterhouseCoopers 2003](#)). As a result, we expected the audit committee chair to be the audit committee member most responsible for, and influential in, the timeliness of a company's financial reporting. Building upon our first two hypotheses, we expect that audit committee accounting financial expertise will be most valuable when it is provided by the audit committee chair, and that audit committee chair public accounting sourced expertise will result in timelier financial reporting.

RESEARCH METHOD

Development of Sample

Our sample included firms that were included in the S&P 500 for the first three years following the SEC's requirement that firms with more than \$700 million in public float were required to reduce their filing period to 60 days ([SEC 2002a](#)). We excluded firms that were added to or dropped out of the S&P 500 during our sample period, leaving a final sample of 996 firm-years (332 firms, three years of observations each) from 2006 through 2008.

FIGURE 1
Financial Reporting Timeliness Variables

Primary Dependent Variables

To test our hypotheses, we employed three measures used in prior studies as proxies for timeliness—earnings announcement lag, audit report lag, and SEC late filing. Earnings announcement lag is the number of days between a firm’s fiscal year-end and the earnings announcement date ([Krishnan and Yang 2009](#)), audit report lag is the number of days between a firm’s fiscal year-end and the audit report date ([Schwartz and Soo 1996](#)), and SEC late filing occurs if the firm has issued any SEC filing beyond the required date within the fiscal year ([Impink, Lubberink, van Praag, and Veenman 2012](#)). Figure 1 displays these measures.

Primary Independent Variables

To measure the financial expertise of the audit committee, we calculated the proportion of accounting and nonaccounting financial experts on the audit committee (the number of accounting financial experts on the audit committee divided by the total number of directors on the audit committee). For the purposes of our study, accounting financial experts were audit committee members who had experience as a CPA, auditor, CFO, or controller, while nonaccounting financial experts had experience as CEO or president of a for-profit company.

To determine an accounting expertise source, we also calculated the proportion of public accounting experts and CFO experts. Specifically, public accounting financial experts included those who had an accounting-based license (CPA, CMA, etc.) and/or had experience in public accounting (i.e., auditing), while CFO accounting financial experts included those who had experience *only* as a CFO, chief accounting officer, or controller. Finally, we recognized that directors could possess both public accounting and CFO experience. We grouped these directors into their own category, which identified that they had both CFO and public accounting experience.

To test the association between audit committee chair financial expertise and timeliness, we identified each audit committee chair who was an accounting financial expert. For our tests relating to the source of audit committee chair expertise, we categorized the audit committee chair

TABLE 1
Financial Reporting Timeliness and Audit Committee Characteristic Summary

Panel A: Timeliness

<u>Variable</u>	<u>Mean</u>	<u>Median</u>
Earnings Announcement Lag	34 days	31 days
Audit Report Lag	55 days	56 days
Late Filings	6%	0%

Panel B: Audit Committee Composition

<u>Expertise Type</u>	<u>Mean</u>	<u>Median</u>
Nonaccounting Financial Experts	62%	67%
Accounting Financial Experts	24%	25%
Public Accounting Experience	6%	0%
CFO Experience	14%	0%
Both CFO and Public Accounting Experience	4%	0%

Panel C: Audit Committee Chair Expertise

<u>Chair Expertise</u>	<u>Mean</u>	<u>Median</u>
Accounting Financial Experts	34%	0%
Public Accounting Experience	11%	0%
CFO Experience	18%	0%
Both CFO and Public Accounting Experience	5%	0%

Source: S&P 500 firms from 2006 to 2008, excluding financial industries.

accounting financial experts into public accounting chairs, CFO chairs, and chairs with both CFO and public accounting experience.

Control Variables

We included several firm (e.g., size, leverage, profitability, complexity, industry, analyst following), audit (e.g., Big 4 audit, auditor tenure, audit fees), and governance (e.g., separation of the roles of CEO and chairman of the board and number of audit committee meetings) characteristics that prior research had shown to affect financial reporting timeliness to control for these influences. We refer interested readers to [Abernathy et al. \(2014\)](#) for exact model specifications and definitions of the variables.

RESULTS

Descriptive Statistics

Table 1 presents descriptive data for the sample. The average firm announces earnings approximately 34 days after the fiscal year-end, while the average firm's audit report is dated about

55 days after the fiscal year-end. Approximately 6 percent of our sample's SEC filings were filed late.

The average audit committee in our sample consists of four directors. Approximately 6 percent of audit committee members had public accounting experience, 14 percent had CFO experience, and 4 percent had both accounting and CFO experience; indicating that accounting financial experts comprised approximately 24 percent of the average audit committee. The remaining directors consisted of 62 percent nonaccounting financial experts, and 14 percent nonfinancial experts. Thirty-four percent of our sample firms had an accounting financial expert serving as the audit committee chair, with 11 percent of the audit committee chairs having public accounting experience, 18 percent having only CFO experience, and 5 percent having both public accounting and CFO experience.

Primary Analyses

Table 2 presents the summarized results for our regression analyses. The results of the regressions used to test our first hypothesis are provided in Panel A of Table 2. The results provide evidence that higher proportions of audit committee accounting financial expertise were associated with timelier financial reporting, as measured by both earnings announcement lag and audit report lag, but not with lower incidences of SEC late filings.

However, the results of the regressions used to test our second hypothesis (Table 2, Panel B) provided evidence that the proportion of *public accounting* sourced accounting financial experts is associated with timelier financial reporting as measured by all three of our measures (earnings announcement lag, audit report lag, and SEC late filings). However, this association was not found for *CFO* sourced accounting financial experts.

The results of the regressions used to test our final hypotheses (which investigated the effects of audit committee chair expertise) provided evidence that having a chair with accounting financial expertise only contributed to shorter audit report lag, but not shorter earnings announcement lag or lower incidences of SEC late filings (Table 2, Panel C). However, the results of the regressions used to test chair-expertise source (Table 2, Panel D) provided evidence that having an audit committee chair with *public accounting* experience is associated with timelier financial reporting (using all three measures), but having an audit committee chair with only *CFO* experience was not associated with timelier financial reporting (using any measure). Our results highlight the importance of audit committee chair experience, and how the source of a chair's accounting expertise can differentially influence financial reporting timeliness.

PRACTICAL APPLICATIONS

The SEC has placed a significant amount of responsibility on the audit committee and its members for monitoring financial reporting. According to SOX, the audit committee is expected to monitor the integrity of the company's financial statements and internal controls, the qualifications and independence of the company's independent auditor, and the performance of both its independent auditor and the internal audit function ([U.S. House of Representatives 2002](#)). Therefore, the qualifications and expertise of audit committee members is crucial to audit committee effectiveness. Our research provided evidence that suggested audit committee members' accounting expertise, and source of said expertise, can influence the timeliness of financial reporting, which is important information for auditors, company management, and regulators alike.

TABLE 2

Audit Committee Financial Expertise Measures and Their Association with Financial Reporting Timeliness Measures

Panel A: Percentage of Audit Committee Expertise

	Earnings Announcement Lag	Audit Report Lag	SEC Late Filing
Nonaccounting Financial Experts	NA	NA	NA
Accounting Financial Experts	++	++	NA

Panel B: Source of Audit Committee Accounting Expertise

	Earnings Announcement Lag	Audit Report Lag	SEC Late Filing
Public Accounting Experience	+++	+++	+++
CFO Experience	NA	NA	NA
Both CFO and Public Accounting Experience	+	NA	NA

Panel C: Audit Committee Chair Expertise

	Earnings Announcement Lag	Audit Report Lag	SEC Late Filing
Nonaccounting Financial Expert	NA	NA	NA
Accounting Financial Expert	NA	+	NA

Panel D: Audit Committee Chair Accounting Expertise

	Earnings Announcement Lag	Audit Report Lag	SEC Late Filing
Public Accounting Experience	+++	+++	++
CFO Experience	NA	NA	NA
Both CFO and Public Accounting Experience	NA	NA	NA

+ Indicates that the characteristic is associated with timelier financial reporting.

More + in the cells indicates a stronger statistical association.

NA indicates no statistical association with the timeliness of financial reporting.

One of the keys to an efficient audit is the resolution of conflicts or disagreements with management regarding material misstatements, implementation of new financial accounting and reporting standards, or appropriate disclosures. Audit committees play an important role in helping resolve these conflicts. Our results indicate that audit committee members with accounting expertise, specifically sourced from public accounting experience, facilitate financial reporting timeliness. We contend that audit committee members with accounting expertise are better able to understand and assess accounting issues and determine appropriate resolutions. In addition, audit

committee members with accounting expertise are well positioned to share their knowledge of a matter with other audit committee members without the same level of accounting technical competence. Further, our results suggest that audit committee chairs with accounting expertise provide important insight and direction as the committee addresses conflicts between independent auditors and company management.

Companies and boards of directors may find our results informative as they seek to assemble effective audit committees with members who have appropriate diversity of backgrounds in order to fulfill the roles and responsibilities established by SOX. While SOX does not require audit committee members to have accounting expertise, our results suggest such expertise can influence the timeliness of financial reporting. In addition, the source of audit committee members' accounting expertise ought to be considered when seeking to add a director to an audit committee or to appoint a director as a chair.

While it may be impractical to implement a narrow definition of financial expertise for the entire audit committee, our results provide evidence that audit committee effectiveness can be enhanced by having members and chairs who have public accounting experience. Perhaps regulators can address the expertise of the audit committee chair as a means of improving audit committee effectiveness.

CONCLUSION

We summarize the findings of [Abernathy et al. \(2014\)](#) and discuss the implications for audit committee members. In particular, we find that audit committee members with accounting expertise are associated with timelier financial reporting. We also find that the source of accounting expertise for audit committee members and audit committee chairs is an important factor in determining the timeliness of financial reporting. The results suggest that audit committee effectiveness may be improved by obtaining audit committee members who, because of their experience, have a more specific knowledge of GAAP issues and the audit process.

These findings may be important for auditors, companies, and regulators given that SOX increased the roles and responsibilities of audit committees in order to improve audit committee effectiveness. With the significant increase in roles and responsibilities, audit committee members' expertise is even more critical. Accordingly, auditors may want to consider the accounting expertise of their client's audit committee as they plan their audits. Audit committee members with accounting expertise may help to efficiently resolve any conflicts that arise between company management and independent auditors. Likewise, to improve the timeliness of financial reporting, companies and their boards of directors should consider the background and accounting expertise of potential audit committee members and audit committee chairs. Finally, regulators may want to consider readdressing the qualifications of audit committee members and the source of audit committee members' accounting expertise. Regulators should consider encouraging companies to include audit committee members and audit committee chairs with accounting expertise from public accounting experience.

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