THE NUMBER OF PROFESSIONALLY CERTIFIED ACCOUNTING EXPERTS ON AUDIT COMMITTEES AND CONFIDENCE IN EARNINGS: A STUDY OF RETAIL INVESTORS' PERCEPTIONS

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Key Words: CPAs, audit committee composition, audit committee financial expertise
JEL Classifications: M42, M48

Abstract

The purpose of this study is to determine whether the composition of a company's audit committee affects decisions by retail (non-institutional) investors. We examine if these investors' confidence in reported earnings is affected by the number of committee experts under the U. S. Securities and Exchange Commission's original, more restrictive definition of an expert (accountants and auditors), the expanded definition, or those who do not qualify under either definition. A sample of AAII (American Association of Independent Investors) members responded to an Internet-based questionnaire and assessed their confidence in the earnings quality of a hypothetical company, contingent on the financial expertise represented in the committee. Results suggest that as the number of Certified Public Accountants (experts under the more restrictive definition) on an audit committee increases, there is a general tendency for confidence in earnings to increase also. The statistical significance of this trend however is illuminated by both demographic and behavioral characteristics of the investors.

INTRODUCTION

When trust in corporate financial reporting was at its low point in 2002, the Sarbanes-Oxley Act (SOX) was passed by the U. S. Congress to put more stringent requirements on corporate management, the Board of Directors, the audit committee, and independent auditors. Subsequently, implementation regulations from the Securities and Exchange Commission (SEC) and its Public Company Accounting Oversight Board (PCAOB) filled in details, particularly the amount and quality of financial expertise expected from the members of the audit committee. We investigate a significant empirical question related to these regulations, a question affecting policy makers, investors, and governing boards: To what extent does the relative number of Certified Public Accountants (CPAs) on an audit committee affect retail investors' confidence in a corporation's financial reports?

The purpose of this study is to determine whether the composition of a company's audit committee affects decisions by active retail (non-institutional) investors. Specifically, we examine if these investors' confidence in reported earnings is influenced by the number of experts under the original, more restrictive definition (accountants and auditors), the expanded definition, or those who do not qualify under either definition.[1]

SOX AND AUDIT COMMITTEE FINANCIAL EXPERTISE: A HISTORICAL REVIEW

In response to concerns about corporate earnings management, and the ineffectiveness of audit committees in their oversight of accounting and reporting, Arthur Levitt, Jr., Chairman of the SEC in 1998 formed a "Blue Ribbon" committee to review and make recommendations concerning how audit committees function. One of the recommendations in the report, released in February 1999, was that every director serving on an audit committee should be "….financially literate …. or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise."[2]

The report goes on to elucidate that audit committees have a "… recognizable need for members with accounting and/or related financial expertise -- where 'expertise' signifies past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial

[1] In their survey of business students, Ragothaman and Gelman (2013) find that SOX was perceived to have had a positive impact.

[2] Blue Ribbon Committee Report on Improving the Effectiveness of Corporate Audit Committees, released February 8, 1999, available at https://www.sec.gov/news/press/pressarchive/1999/99-14.txt

sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities." In contrast to financial expertise, financial literacy merely "…signifies the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement."

Abbott, Parker and Peters (2004) and Smith (2006) find that implementation of the Blue Ribbon recommendations improved audit committee effectiveness. Even earlier, and more generally, the New York Stock Exchange in 1978 required listed companies to have audit committees, eventually clarified as consisting of at least three independent and financially literate individuals including a chair with accounting or financial management expertise. Other exchanges soon followed.

Nonetheless, in reaction to a series of yet more accounting scandals, perceived "audit failures" and the collapse of major corporations such as Enron and WorldCom, SOX was passed, leading to specific audit committee requirements. Pressure had been mounting on corporations for several years to improve the effectiveness of audit committees. In this environment, one of SOX's many provisions was a requirement that every U.S. publicly traded company establish an audit committee composed of independent members of the Board of Directors to oversee the work of the company's registered public accounting firms (SOX, Section 301).

Audit committees were also mandated to:

- oversee the accounting and reporting processes of the company (SOX, Section 2(a)(3)(A));

- receive reports from the auditor of all critical accounting policies and practices as well as alternative treatments and disclosures that have been discussed with management, the auditor's preference among the alternatives and their ramifications, as well as any other written communication with management (SOX, Section 204); and
- receive all disclosures of internal control deficiencies reported by the CEO and CFO (SOX, Section 302(a)(5)(A)).

In order to fulfill these responsibilities effectively, SOX required the SEC to issue rules requiring registrant companies to disclose whether or not, and if not why not, there was at least one "financial expert" on the committee (SOX, Section 407(a)). The responsibility to define a "financial expert" was delegated to the SEC. The SEC proposed a definition of a financial expert as someone with, among other qualities, experience in preparing or auditing financial statements of comparable companies and in internal accounting controls (SEC 2002).

However, commenters expressed concern that companies, especially smaller ones, would find the original definition too restrictive, hindering their ability to attract qualified members.[3] In its presentation of SOX's final rules, the SEC reported that "The proposed definition of the term 'financial expert' proved to be the most controversial aspect of the proposals - more commenters remarked on it than on any other topic addressed by the proposed

[3] Singhvi (2015) provides evidence that fails to support the belief that SOX would make it difficult to find financial experts to serve on audit committees.

rules".[4] In response to these concerns the SEC, in January 2003, issued looser rules to expand the definition of "audit committee financial expert." The final definition therefore includes someone with experience preparing, auditing, analyzing, or evaluating financial statements of comparable companies (SEC 2003). This expansion of the definition opened the door to financial analysts, fund/portfolio managers, venture capitalists, bank lending officers, and others who are not strictly accountants or auditors.

Audit Committee Financial Expertise: An International Perspective

Financial literacy requirements for audit committee members vary across countries. This section provides a brief review of international requirements for audit committee financial expertise.

The European Union (EU) requires that at least one member of the audit committee have competence in accounting and/or auditing.[5] While competence required to perform a statutory audit is specified, no clarification is provided concerning what qualifies as "competence in accounting and/or auditing" for the audit committee member. Nevertheless, that "competence" requirement is more akin to the original, more restrictive, SEC requirement.

But a recent (2014) amendment to EU requirements added that, "However, in view of the size of boards in companies with reduced market capitalisation and in small and medium-sized public-interest entities, it is appropriate to provide that the functions

[4] See https://www.sec.gov/rules/final/33-8177.htm

[5] See http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02006L0043-20140616

assigned to the audit committee for such entities, or to a body performing equivalent functions within the audited entity, may be performed by the administrative or supervisory body as a whole." [6] Thus, small companies in the EU need not have audit committees, and the above sentence seems to leave open the possibility that the administrative or supervisory body could have no auditing and/or accounting competence at all.

Individual countries within the EU can add their own unique input into the debate concerning financial expertise. For example, the German Corporate Governance Code[7] states that "...the chairman of the Audit Committee shall have specialist knowledge and experience in the application of accounting principles and internal control processes."

While not a member of the EU, the Swiss Code of Best Practice for Corporate Governance[8] states that the majority of audit committee members "including the Chairman, should be experienced in financial and accounting matters. In complex situations, at least one member should be a financial expert (e.g. current or former CEO, CFO or financial auditor)."

Provision C.3.1 of the UK Corporate Governance Code[9] ("the Code") states that "the board should 'satisfy itself' that at least

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[6] See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0056&from=EN

[7] See http://www.dcgk.de/en/code/archive.html?file=files/dcgk/usercontent

[8] See http://www.economiesuisse.ch/sites/default/files/downloads/swisscode_e_web_0.pdf

[9] Available at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf

one member of the committee has recent and relevant financial experience." The Code is not specific about what constitutes "relevant experience", but Smith[10] suggests it may be "as an auditor or a finance director of a listed company. It is highly desirable for this member to have a professional qualification from one of the accountancy bodies."

The UK Disclosure and Transparency Rules[11] apply to all listed companies, and DTR.7.1.1R, states that at least one member of the audit committee must have competence in accounting and/or auditing. The Code is not a rigid set of rules and requirements. It is a set of principles designed to assist boards of directors in creating their corporate governance arrangements. However companies are expected to "comply or explain". Small publicly traded companies have a bit more leeway in judging that the Code's provisions may be disproportionate or less relevant for them.

Only recently (2015) did Japan create its own requirement: "…at least one person who has appropriate expertise on finance and accounting should be appointed as *kansayaku*".[12] Most Japanese companies are Companies with *Kansayaku* Board, and the document anticipates that companies that take a form other than Company with *Kansayaku* Board will apply this principle as well. Prior to the 2015 Governance Code, Lee and Allen (2013) explain

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10 The Smith Guidance on Audit Committees, produced by Sir Robert Smith in 2003, is part of the UK Corporate Governance Code. It is available at http://www.ecgi.org/codes/documents/ac_report.pdf .

11 See http://www.fca.org.uk/firms/markets/ukla

12 See http://www.fsa.go.jp/en/refer/councils/corporategovernance/20150306-1/01.pdf

the differences between audit committees and *Kansayaku*, and make no mention of financial expertise requirements.[13]

The 2013 amendment to Clause 49 of the Listing Agreement by the Securities Exchange Board of India (SEBI) deals with corporate governance. It requires that for all publically traded companies, "all members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise".[14] Bhasin (2012) reviews Indian audit committee issues.

Thus, all over the world, there are different nuances concerning what constitutes financial literacy for audit committees. Jeanjean and Stolowy (2009) acknowledge the ambiguity in what qualifies as financial "expertise", "competence" and "literacy". The debate that occurred for the exact wording of SOX was focused on how firms could implement the law at reasonable cost and effectiveness. But since one function of an effective audit committee is to assure investors that earnings are fairly presented, we ask whether the actual requirement as debated for SOX has any impact on investors' decision making.

LITERATURE REVIEW

Considerable research has examined the influence of the composition, including the financial expertise, of the audit committee. This prior research focused on the impact of the

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[13] See also https://sydney.edu.au/law/anjel/documents/ZJapanR/ZJapanR19_07_Takahashi_Sh.pdf, who make no statement about audit committee composition, but do explain Japanese corporate structure.

[14] See http://indianboards.com/files/clause_49.pdf

committee's composition in three major categories: financial reporting quality, internal controls, and market reaction.

Several papers asked whether the presence of a financial expert improves a firm’s quality of earnings. Abbott, Parker and Peters (2004) and Agrawal and Chadha (2005) find that the presence of an accounting financial expert (AFE, the narrow definition as originally proposed by the SEC) reduces the likelihood of a restatement. Bédard, Chtourou, and Courteau (2004) and Dhaliwal, Naiker, and Navissi (2010) conclude that the presence of AFEs improves the quality of accruals. AFEs have been found to be significantly associated with almost all measures of accounting conservatism (Krishnan and Visvanathan (2008)). Seetharaman, Wang, and Zhang (2014) conclude that the quality of earnings improves with AFEs on audit committees. As the financial and accounting expertise on an audit committee increases, it is less likely to allow managers to waive material misstatements (Keune and Johnstone (2012)).

Other research has examined whether financial expertise and other audit committee attributes together improve earnings quality. These other attributes include the status of the audit committee relative to management (Badolato, Donelson and Ege (2014)), the status of the audit committee chair (Bruynseels, Krishnamoorthy and Wright (2015)), industry expertise (Cohen, Hoitash, Krishnamoorthy and Wright (2014)), legal expertise (Krishnan, Wen and Zhou (2011)), and “busyness”, which measures the number of other positions that the AFE is also serving as an expert (Tanyi and Smith (2015)). Different sources of financial expertise affect financial reporting timeliness (Abernathy, Beyer, Masli and Stefaniak (2014), Schmidt and Wilkins (2013)). Bryan, Liu, Tiras and Zhuang (2013) conclude that the presence of an AFE on the audit committee improves earnings quality only if it is actually optimal for a firm to have such an expert. From a public policy viewpoint, their result implies that firms should have flexibility in deciding the level and type of financial expertise on their audit committees.

The presence of accounting financial experts also has been found to improve internal controls. Companies with disclosed internal control weaknesses are more likely to have audit committees with less financial expertise (Zhang, Zhou, and Zhou (2007)). Hoitash, Hoitash, and Bedard (2009) conclude that AFEs are associated with more effective internal controls, as measured by disclosing no SOX Section 404 material weaknesses. Having accounting and auditing experts on the audit committee actually reduces firms' investment in internal auditing (Barua, Rama, and Sharma (2010)), consistent with a substitution effect between audit committee financial expertise and other forms of internal control monitoring.

Another stream of research examines stock market reactions and valuation effects to announcements concerning audit committee composition and the financial expertise of its members. The stock market positively reacts to announcements of AFEs joining audit committees (Davidson, Xie, and Xu (2004), DeFond, Hann, and Hu (2005)). Moreover, Singhvi, Rama, and Barua (2013) find that there is significant negative market reaction to the departure of AFEs, but no such reaction to the departure of other types of experts or non-experts, suggesting that the SEC's expanded definition of an audit committee financial expert may be perceived as too broad. Firms trading on the Toronto Venture Exchange displayed a significantly positive impact on valuations (Tobin's Q) and significantly negative impact on cost of equity capital when they voluntarily adopted a policy requiring all audit committee members to be independent and financially literate (Chen and Li (2013)).

Finally, the positive impact of having a financially literate audit committee appears globally, such as for Australian firms (Sultana and Van der Zahn (2015), Sultana (2015)), Singapore firms, (Kusnadi, Leong, Suwardy and Wang (2015)), Spanish firms (Garcia-Sanchez, Frias-Aceituno and Garcia-Rubio (2012)), and UK firms (Alzeban and Sawan (2015)).

A synthesis of this prior research suggests that (a) both financial reporting quality and internal controls generally improve with the appointment of a narrowly defined accounting financial expert to the audit committee, and (b) the broad market, where movements are most strongly affected by large institutions, recognizes and reacts positively to such appointments. Malik (2014) reviews the literature dealing with the impact of audit committee composition. However, retail investors' perceptions of professionally certified accounting experts (CPAs) on audit committees have not been investigated. The present study fills that void and in so doing adds to the literature investigating the impact of the audit committee composition.

METHOD

Data were collected from a sample of AAII (American Association of Independent Investors) members via an Internet-based questionnaire. The questionnaire presented a short scenario of a hypothetical software company. The scenarios varied in terms of the types of financial experts sitting on the audit committee[15]. Respondents were presented with one of the following five different four-member audit committee scenarios:

Scenario 1: 1 CPA as Chair, plus 3 fillers (i.e., plausibly qualified to sit on the committee, but not financial experts, even under the expanded definition)
Scenario 2: 2 CPAs, 1 as Chair, plus 2 fillers
Scenario 3: 3 CPAs, 1 as Chair, plus 1 filler
Scenario 4: 4 CPAs, 1 as Chair
Scenario 5: 1 non-CPA (Chair), but with financial expertise under the original restrictive SEC guidelines, plus 3 fillers.

Across all five committee scenarios, biographies of CPAs and fillers were paraphrased from actual company proxy statements, thus ensuring that the scenarios were representative of audit committee members investors are likely to read, and ensuring that fillers were plausibly qualified. The five scenarios also controlled for gender and ethnicity by referring to the members as Mr. A, Mr. B, etc. Ages ranged from 52-59. Respondents assessed only one scenario randomly presented across the sample. Subjects' confidence in the reported earnings was based on the following instructions:

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15 Bryan, Liu, Tiras and Zhuang (2013) report that in the post-SOX era, 38% of their sample firms have more than one accounting expert (original SEC definition) on their audit committees. They find, as noted above, that having multiple accounting experts improves the quality of a firm's earnings only if it is optimal for a firm to have more than one such expert.

AppMultiverse is a software company with sales of $1 billion. You have recently been evaluating this company as a possible investment. The company just announced unexpectedly high quarterly earnings. Reading the most recent proxy statement, you found that its Audit Committee consisted of the following individuals: (One of the five committee scenarios)

How much confidence do you have in the quality of the reported earnings?

Confidence was recorded by moving a virtual pointer across a confidence scale ranging from zero "I have no confidence" to 100 "I have confidence". As the pointer was moved left to right respondents viewed increasing whole numbers corresponding to confidence values and could stop the pointer at any point along the scale.

An email blast was sent to 12,000 AAII members directing them to the questionnaire's website. We recorded results if a respondent provided his/her confidence in earnings quality. Not all respondents answered all of the demographic questions, hence there are different sample sizes for different statistical tests.

336 investors responded by at least starting the survey and responding to the confidence question, representing a 2.8% return rate. Demographic characteristics of the sample are presented in Table 1 contingent on those answering the Confidence in Earnings question.

Table 1
Sample Demographics

Age	
20-40	5
41-60	54
over 60	270
# of years as an investor	
0-2 Years	2
3-5 Years	3
6-10 Years	5
11-15 Years	9
16-20 Years	21
Over 20 Years	287
How many hours per week spent on investment activities	
0-3 Hours	95
4-10 Hours	144
11-20 Hours	57
Over 20 Hours	31
Portfolio size	
Less than $100,000	8
$100,001 to $1,000,000	88
$1,000,001 to $10,000,000	174
Greater than $10,000,000	48

Prefer not to answer	8
Professional Money Manager?	
Yes	7
No	319
Level of education	
Did not graduate from high school	0
High school / GED	7
Some college / Associate's Degree	28
Baccalaureate Degree	101
Masters (or equivalent) Degree	127
Doctorate Degree	62
CPA?	
Yes	27
No	296
Gender	
Male	299
Female	18
Race	
Caucasian	303
African-American/Black	1
Hispanic	5
Asian	5

Other	7

RESULTS

Table 2 presents the confidence scores across the five scenarios.

Table 2
Mean Confidence in Earnings Quality Depends on the Number of CPAs on the Audit Committee

Number of CPAs on Audit Committee	Number of Respondents	Mean Confidence in Earnings Quality
0	83	61.89
1	49	64.29
2	70	63.36
3	66	66.73
4	68	67.57

Although both the range (61.89 – 67.57) and mean confidence scores support the general conclusion that confidence in earnings increases as the number of CPAs on the committees increase, this trend was not statistically significant. To probe for potential mediating factors we examined confidence scores across the scenarios in relationship to demographic and behavioral characteristics of the sample. Because of sample sizes and distribution of sample characteristics across the scenarios, non-parametric statistics were applied. Table 3 presents demographic and behavioral factors related to the confidence scores across the scenarios.

Table 3
Non-parametric Mann-Whitney U-tests for differences in confidence in earnings quality, when there are one or more CPAs on the Audit Committee, compared to no CPAs on the Committee

Demographic or Behavioral Descriptor	N	Mann-Whitney U-test p-value	Mean confidence with no CPAs	Mean confidence with CPAs
20 or more years of investing experience	287	0.060	61.73	66.14
Manage a portfolio valued in excess of $1 million	222	0.085	61.23	66.29
Have voted against candidates nominated to be boards	221	0.039	59.27	65.85

Always or sometimes investigate who is serving on a board and board committees when making investing decisions	208	0.087	61.15	65.36

Table 3 data highlight the factors illuminating the trend reported in Table 2. Two demographic factors significantly influence the perceptions of the quality of earnings relative to the number of CPAs on the committee: size of portfolio (significant at the 8.5% level), and years of experience as an investor (significant at the 6% level). Retail investors with portfolios larger than $1 million and those with 20 or more years' investing experience perceive greater confidence in the earnings report when there are 1 or more CPAs on the committee as opposed to no CPAs.

Two behavioral factors significantly motivate this relationship: having voted against a candidate for the audit committee, and basing investment decisions on always or sometimes investigating who serves on board committees. Retail investors who have voted against a candidate for the audit committee (quite significant, at the 3.9% level) and those who base investment decisions on reading the proxy statements (significant at the 8.7% level) feel more confident in the earnings when there are one or more CPAs on the committee as opposed to no CPAs.

DISCUSSION AND FUTURE RESEARCH

This study was designed and executed to answer a significant question: To what extent does the relative number of professionally certified accounting experts (CPAs) on an audit committee affect retail investors' confidence in a corporation's financial reports? Moreover, this question extends the research stream summarized in the literature review. We obtained an answer from a sample of AAII members, a group of engaged retail investors who by virtue of paid, voluntary membership, self-identify as interested investors.

These are members of an organization created as "an independent, nonprofit corporation formed for the purpose of assisting individuals in becoming effective managers of their own assets through programs of education, information and research" (AAII Mission Statement). Based on their responses, as the number of CPAs on an audit committee increases there is a general tendency for confidence in earnings to also increase. The statistical significance of this trend however is illuminated by both demographic and behavioral characteristics of the investor.

The statistical significance of these underlying factors adds to the import of our findings because they describe not retail investors generally, but committed and diligent investors specifically. Investors who vote against a board candidate or who consider board committee membership when making investment decisions are engaging in due diligence. They are not relying merely on stock tips or following a family member's advice.

Past research has examined reactions of securities prices, the daily fluctuations of which are often dominated by large institutions, but we were interested in individual retail investors. Our findings describe not only retail investors generally but focus on a small and significant segment: Investors with portfolios of least $1 million, investors with 20 or more years of experience as investors, and those who invest time, energy, and personal voice via a vote when they invest their money. Table 3 thus summarizes a subset of AAII investors, for whom investment is an exercise in due diligence. This due diligence underscores the salience of our findings.

Our research question was framed in the context of SOX generally and the provision requiring financial expertise on audit committees specifically. Because mandating financial expertise on audit committees was one of the provisions of SOX, our findings have implications not only for retail investors, but also for corporate boards and for public policy in countries establishing standards pursuing best practices. A major implication is that Boards of Directors now have an empirical basis for answering the question: How do we implement standards while concurrently communicating the strongest signals to investors?

Aside from answering a question, our findings also raise a question for future research. The confidence in earnings scores reported in Table 2 ranged from 61.89 to 67.57. Thus, confidence across the five scenarios could be characterized as less than complete. One possible interpretation for this finding may be attributable to the description of our hypothetical company, AppMultiverse, a software company with sales of $1 billion. It is possible that AAII members may bring an implicit skeptical bias to earnings reports in general. It is also possible that an earnings report from a tech company raises a skepticism among savvy investors that a report from companies in a different industry does not. Both of these implications are worthy of additional investigation. Further research is warranted as well into the similarities between U. S. investors and those in other countries.

CONCLUSION

Because of increasingly advanced search engines, broadband capability, and mobile computing, sophisticated retail investors are able to access financial information as needed, anytime, anywhere. This information, whether market, industry, or company-specific, will be used by investors in assessing their confidence in a company's reports. Our paper empirically demonstrates the impact of the financial expertise of audit committee members as a significant aspect of company-specific information generally, and professionally certified accounting expertise specifically. These findings have implications not only for governmental agencies mandating public policy on what companies must report, but also for governing boards deciding who should sit on audit committees. These decisions will ultimately provide investors not only with information they need to know, but with information they have a right to know.

ACKNOWLEDGEMENT

The authors thank Charles Rotblut, CFA, President of the American Association of Independent Investors (AAII), for his invaluable assistance in securing the sample for this study.

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