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Audit committee financial expertise, gender, and earnings management: Does gender of the financial expert matter?

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ABSTRACT

The effectiveness of the presence of financial expertise on the audit committee (AC) in reducing earnings management has been the subject of many previous studies with mixed findings. This paper suggests that the mixed findings may be due to prior studies not distinguishing between the genders of the financial experts on the AC. We investigate how financial expertise affects earnings management taking into account the gender of the financial expert. We use the data of a sample of 5660 US firm-year observations from 2007 to 2013 which was analysed using least squares regressions clustering by firm. The results indicate that proportion of financial expertise on the AC and gender reduces earnings management. We then group the AC financial experts by gender, and examine whether the gender of the financial expert matters. The results show that the proportion of female financial experts on the AC is significantly associated with less earnings management while the proportion of male financial experts does not significantly affect earnings management; this suggests that previous studies indicating that the presence of a financial expert on the AC may have been influenced by gender of the female financial experts. Further, our findings may also partly explain the contradictory findings of prior studies on the effect of financial expertise on the ACs effectivness.

1. Introduction

Audit committee (AC) plays a key role in overseeing, monitoring and advising the management of an organization in implementing internal accounting control systems and the preparation of financial statements (Arun, Almahrog, & Aribi, 2015; Bédard & Gendron, 2010; Sun, Liu, & Lan, 2011). According to Klein (2002), in their role as overseers of the firm's financial reporting process, members of the AC meet regularly with the firm's managers and auditors to review the corporation's financial statements, audit process, and internal accounting controls. To improve the effectiveness of the AC following accounting scandals, such as the Enron Scandal in the US, there are now requirements in many countries for some members of the AC to have financial expertise (Badolato, Donelson, & Ege, 2014; Bédard & Gendron, 2010; Blue Ribbon Committee, 1999; General Accounting Office, 1991; Sarbanes-Oxley Act, 2002; Smith Committee, 2003).

The requirements for an AC to have a financial expert among its members has attracted considerable research as to whether such financial expertise makes a difference (e.g., Badolato et al., 2014; Bédard & Gendron, 2010; Carcello, Hollingsworth, Klein, & Neal, 2006; Dhaliwal, Naiker, & Navissi, 2010; Ismail & Abdullah, 2013). For example, Badolato et al. (2014) found that ACs with both financial expertise and high relative status are associated with lower earnings management. Qi and Tian (2012) also found that the presence of a financial expert on the AC reduces earnings management while Davidson, Xie, and Xu (2004) reported significant positive stock price reaction when new members of the AC have financial expertise. Although Albring, Robinson, and Robinson (2014) found that accounting expertise contributes to the AC's monitoring of auditor independence, they report that broader financial expertise is not an effective mechanism. A review article on the evidence of the effectiveness of financial expertise on aspects of financial reporting by Bédard and Gendron (2010) report that 57% of the studies identified found a positive association between financial expertise and ACs effectiveness, while 10% found a negative association and the remaining 33% indicated a non-significant association. Thus, on the evidence provided by Bédard and Gendron (2010), the effectiveness of financial expertise in curtailing financial reporting abuses is mixed.

There are a number of possible reasons for the conflicting results on the effectiveness of the AC ranging from sample size, statistical method

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used, time period, and country of study. In this study we suggest that the conflicting results may have been due to prior studies not distinguishing between the genders of the financial experts on the AC. This is because most existing studies investigating the monitoring role of financial expertise operationalize financial expertise as 'the presence' of a financial expert on the audit committee (e.g., Bédard, Chtourou, & Courteau, 2004; Carcello et al., 2006;Dhaliwal et al., 2010; Krishnan & Visvanathan, 2008; Liu, Tiras, & Zhuang, 2014; Yang & Krishnan, 2005) or the 'proportion of financial experts' on the AC (e.g., Albring et al., 2014; Badolato et al., 2014) without distinguishing whether the financial expert is 'female' or 'male'. It is, therefore, possible that the results which found that financial expertise constrains earnings management may be influenced by the 'gender' rather than 'financial expertise' of the AC member. If this suggestion is plausible, we would expect AC female experts to have a more pronounced effect on earnings management than their male counterparts would. Such a finding may also explain the contradictory results on the effectiveness of financial expertise. This is because the genders of the AC 'financial expert' used by extant research are likely to differ from one study to the other.

The objective of our study is to investigate the effect of the AC financial expertise and gender on earnings management. In particular, we seek to determine if gender of the financial expert matters in constraining earnings management. We first investigate the impact of AC financial expertise and gender as per existing literature. We then split financial experts from our sample of 5660 US firm years from 2007 to 2013 by gender into female financial experts and male financial experts and investigate how they affect earnings management. The findings suggest that financial expertise and gender are associated with less earnings management. When the financial experts are split by gender, the results show that the proportion of female financial experts on the AC is significantly associated with less earnings management. However, the proportion of male financial experts does not significantly affect earnings management.

Our study contributes to the existing literature in two main ways. First, our evidence suggests that existing research findings on the effectiveness of AC financial expertise in reducing earnings management (e.g., Badolato et al., 2014; Qi & Tian, 2012) may have been driven by female financial expertise. Second, the results of our study also contribute to existing literature by offering a plausible reason for the contradictory findings on the effectiveness of financial expertise as a monitoring mechanism (e.g., Badolato et al., 2014; Bédard & Gendron, 2010). We suggest that a possible reason for the contradictory results on the effectiveness of AC financial expertise is due to the differences in the gender of the financial expert across the different studies. Further, our study also contributes to the limited and contradictory evidence for the efficacy of gender on constraining earnings management (e.g., Ismail & Abdullah, 2013; Qi & Tian, 2012; Thiruvadi & Huang, 2011).

The rest of this paper is organized as follows. Section 2 reviews the literature and develops hypotheses on financial expertise, gender, and financial expertise by gender. Section 3 discusses the research method and data. While Section 4 discusses and presents the empirical findings, Section 5 reports our robustness checks. Finally Section 6 summarizes the research and draws some conclusions.

2. Literature review and hypotheses development

2.1. Theoretical framework

Bédard and Gendron (2010) found that most research on ACs was guided by legal and economic theories. According to legal theories, ACs should be effective because they need to fulfil their responsibilities required by law. Although the legal theories apply to our study, it is mostly guided by agency theory – the most prominent economics-based theory used to explain ACs effectiveness. The theory – mostly attributed to Jensen and Meckling's (1976) paper – suggests that agency costs arise because of the separation of ownership from control since managers as agents will not always act in the best interests of the principal (shareholders). To reduce the agency costs, the principal (shareholders) will incur monitoring costs. According to agency theory, monitoring expenditure allows the principal to better observe the agent's actions, thereby preventing the agent from taking the actions that the reduce firm's value (Gomez-Mejia & Wiseman, 1997; Tosi & Gomez-Mejia, 1989). These monitoring expenditures include costs of hiring board members who will then form subcommittees such as the AC. To be effective, the members of the AC are expected to have certain qualities such as financial expertise and diversity in terms of gender, which are the focus of this study.

A number of views are expressed in literature to explain why AC finance expertise and gender may improve monitoring effectiveness. For example, Harris and Raviv (2008) suggest that financial experts have lower costs of acquiring information about the complexity and associated risks of certain financial transactions and hence are able to efficiently monitor senior management. Gore, Matsunanga and Yeung (2011, p. 772) also suggest that 'while incentive to monitor is important, effective monitoring requires a high degree of specialised knowledge in order to evaluate managerial decisions. Without adequate financial training and experience, even motivated directors cannot determine whether the firm's financial policies are appropriate'. Krishnan and Visvanathan (2008) add that AC members with finance expertise enhance accounting conservatism by their better monitoring capability-driven knowledge base, job expectation as demanded by audit committee charter, and economic incentives to mitigate the risk of litigation and protect reputational capital.

Regarding presence of women on the board, Adams and Ferreira (2009) suggest that their presence is likely to contribute to improved monitoring because they are not part of the 'old-boys' club', which puts them closer to independent directors. Moreover, by examining the monitoring intensity of women with respect to retention decisions and compensation contracts, Adams and Ferreira (2009) evince that women are stricter monitors than their male counterparts. Also, scholars have suggested that gender diversity facilitates effective monitoring by broadening expertise, experience, interests, perspectives and creativity (Erhardt, Werbel, & Shrader, 2003; Hoever, Van Knippenberg, Van Ginkel, & Barkema, 2012). Moreover, according to Chattopadhyay, George, and Shulman (2008), gender diversity may give rise to conflict due to lack of trust, and this is likely to increase scrutiny.

2.2. Prior studies and hypotheses development

2.2.1. Financial expertise

The financial background of board members represents one of the most widely investigated attribute that is of interest to regulators. For example, Beekes, Pope, and Young (2004) postulate that, to be efficient as a monitoring mechanism, directors should have enough monitoring incentives and understand the consequences of financial reporting decisions. Arguably, directors should be able to understand the consequences of financial reporting decisions if they have the required financial background. This helps them to understand the complexity of financial reporting, to identify and to ask questions which make managers think harder, to understand auditors' judgement, and to support the auditor in auditor-management disputes (DeZoort & Salterio, 2001; Kalbers & Fogarty, 1993; Levitt, 2000; Mangena & Pike, 2005; Zhang, Zhou, & Zhou, 2007).

Since the AC is responsible for the financial reporting process, board members who sit on the AC should have the skills, financial expertise and training required to fulfil their duties and investigate the reasonableness of CEO explanations. The importance of financial expertise is emphasised by SOX (2002) which states that directors should have the required experience in preparing and auditing financial statements and accounting for accruals, estimates, and reserves (Dhaliwal et al., 2010). Beasley, Carcello, Hermanson, and Neal (2009) note that one of the most crucial requirements for serving on the AC is that the directors