ABSTRACT. Management has the opportunity to promote self-serving accounting practices, such as earnings management, when management can effectively avoid oversight by the audit committee. This article investigates the effects of financial knowledge and dispositional trust on the ability of audit committee members to recognize management attempts to avoid full disclosure to the board and potentially deceive board members. The results of a controlled laboratory experiment with 40 experienced audit committee member participants indicate that: (1) Audit committee members with less financial knowledge are more likely to accept insufficient client explanations for accounting judgments than are more knowledgeable audit committee members; (2) Audit committee members with less financial knowledge are more likely to reject sufficient client explanations for accounting judgments than are more knowledgeable audit committee members; and (3) Audit committee members that place higher levels of trust in others are more likely to accept insufficient client explanations for accounting judgments than are less trusting committee members.

KEY WORDS: accounting choice, audit committee, earnings management, financial knowledge, judgment, trust

Introduction

This study employs an experiment with highly experienced corporate directors who serve on audit committees to systematically examine the factors that determine the effectiveness of directors in promoting accurate and reliable accounting disclosures. Members of the audit committee of the board of directors are specifically charged with the oversight of financial reporting. However, audit committee members have often failed to protect shareholders by inadequately monitoring and controlling the accounting judgments made by management (see e.g., Powers et al., 2002; Rosen, 2003). A long list of recent corporate failures and revenue restatements indicates that managers have often engaged in earnings management and earnings manipulation, and many audit committees have not been effective in identifying and preventing unscrupulous accounting practices. Merchant and Rockness (1994) identify earnings management and manipulation as the greatest threats to ethics in accounting, and the public relies on audit committees to prevent unethical accounting practices. One source of audit committee ineffectiveness results from corporate directors’ reliance upon management for the provision of clear explanations and rationales for accounting choices. In an environment where directors rely on management for critical information, management has substantial opportunities to deceive board members or to provide them with information that insufficiently explains accounting practices. We investigate whether director traits influence the ability of audit committee members to recognize management attempts to avoid audit committee oversight through evasive, insufficient, and sometimes blatantly inaccurate descriptions of accounting disclosures.

Audit committees have received substantial attention in recent regulation. The Sarbanes-Oxley Act, SEC Rule 10A-3, and recently implemented regulations of the NYSE all emphasize the need to
increase the financial expertise of audit committee members (Sarbanes-Oxley Act, 2002; NYSE, 2003; U.S. SEC, 2003). The primary goals of new regulation are to promote quality corporate governance and effective oversight of the audit process through improved audit committee characteristics and increased committee authority. Our research examines the role of two audit committee member characteristics, financial knowledge and trust, on audit committee judgments in the setting of directors’ analyses of management explanations for accounting choices. Financial knowledge and trust each have a substantial capacity to influence governance quality.

Audit committees are specifically required to evaluate accounting judgments made by management (NYSE, 1999; Sarbanes-Oxley Act, 2002), and the financial literacy of the audit committee is a key determinant of its ability to manage these duties. While regulation has mandated audit committee independence and increased the financial literacy requirements for audit committee members, studies of audit committee financial knowledge reveal disturbingly low levels of knowledge for the non-financial experts on the committee (see e.g., Buckley and Van Der Nat, 2003). In addition, descriptions of corporate failures have revealed that board and audit committee members lacked the knowledge to understand the accounting information they were charged with overseeing, and this lack of knowledge contributed to these firms’ downfalls (see e.g., Powers et al., 2002; Rosen, 2003).

The Sarbanes-Oxley Act requires that firms disclose whether or not at least one audit committee member is a financial expert, but the Act does not actually require a financial expert, and it does not set financial literacy requirements for all members (Sarbanes-Oxley Act, 2002). Section 303A.07 of the NYSE’s manual indicates that all audit committee members must be financially knowledgeable, but boards have the discretion to define “financially knowledgeable” (NYSE, 2003). The experiment described herein takes place after the passage of SOX and the new stock exchange listing requirements. As a result, the participants in the experiment are “financially knowledgeable” audit committee members. This research directly measures the financial literacy of audit committee members and examines the effects of this knowledge on committee members’ judgments regarding the sufficiency of management explanations for accounting judgments.

Sparse research has examined the effects of financial knowledge on audit committee judgments or decision-making processes outside of empirical studies of the effects of the presence of financial experts on audit committees.

Recent audit research also suggests that audit committee members’ trust may play a central role in the committee’s oversight function. Experimental evidence indicates that trust is a significant determinant of auditors’ judgments and evidence evaluation processes, and it follows that trust will also influence audit committee judgments (Rose and Rose, 2003; Rose, 2007). Decision makers that trust the source of information are more likely to support the source and accept the information as accurate and reliable (Anderson et al., 1994; Birnbaum and Stegner, 1979; Hirst, 1994; Schul, 1993). As a result, trust can play a critical role in evaluations of management explanations for accounting judgments. If audit committee members with high levels of dispositional trust place excessive faith in management, it may be necessary to make explicit and strong situational indicators of management credibility available to audit committee members. Management might have more capacity to act in its own interests and promote inaccurate financial reporting when directors possess excessive levels of trust in others.

The effects of knowledge and trust on audit committee judgments were investigated using a laboratory experiment with 40 highly experienced audit committee members. The results from the experiment indicate that: (1) Audit committee members with less financial knowledge are more likely to accept insufficient client explanations for accounting judgments than are more knowledgeable audit committee members; (2) Audit committee members with less financial knowledge are more likely to reject sufficient client explanations for accounting judgments than are more knowledgeable audit committee members; and (3) Audit committee members that place higher levels of trust in others are more likely to accept insufficient client explanations for accounting judgments than are less trusting committee members. Overall, the results indicate that calls for increased financial expertise of audit committee members have the potential to improve audit committee oversight processes by improving audit committee members’ abilities to review client explanations for accounting judgments.