

AUDIT COMMITTEE ACCOUNTING EXPERTISE AND CHANGES IN  
FINANCIAL REPORTING QUALITY

by

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In this dissertation, I examine whether financial reporting quality increases following the appointment of an accounting expert to the audit committee. Prior literature documents positive cross-sectional associations between maintaining an accounting expert on the audit committee and financial reporting quality. Although this suggests that accounting expertise enhances the quality of a firm's financial reports, it is unclear whether financial reporting quality improves after appointing an accounting expert. Additionally, I explore how the strength of alternative governance provisions and the current expertise of the audit committee influence relations between appointing an accounting expert and changes in financial reporting quality.

I hypothesize that accounting experts possess the financial backgrounds needed to detect accounting manipulations and the reputational capital to warrant actions that limit exposure to financial reporting failures. Therefore, I predict that newly appointed

accounting experts have the ability and incentive to strengthen financial reporting systems and increase the quality of financial reports. Furthermore, I predict that incremental improvements in reporting quality following the appointment of an accounting expert are larger for strong governance firms because they possess the infrastructure necessary to act on audit committee recommendations and for firms with no prior accounting expertise because of opportunities for new accounting critiques by financially minded individuals.

I test these predictions on a sample of 1,590 audit committee appointments between 2003 and 2005. Overall, I do not find empirical evidence of a change in financial reporting quality following the appointment of an audit committee accounting expert. However, I find that firms with strong governance that appoint an accounting expert experience larger post-appointment improvements in reporting quality than do firms with weak governance, as highlighted by more income-decreasing discretionary accruals, larger increases in earnings response coefficients, and higher quality accruals. Additionally, my evidence suggests that strong governance firms appointing their first accounting expert increase their reporting quality following the appointment. Therefore, my results imply that accounting expertise complements other governance mechanisms involved in financial monitoring. Overall, I provide evidence regarding the audit committee's influence over financial reporting and the conditions associated with effective use of accounting expertise.

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## CHAPTER I

### INTRODUCTION

One of the primary functions of audit committees is to monitor the firm's financial reporting system. Prior studies find evidence of a positive relation between accounting expertise on the audit committee and the quality of the firm's financial reports, suggesting that audit committee members with accounting backgrounds enhance financial monitoring.<sup>1</sup> Furthermore, DeFond, Hann, and Hu (2005) document positive abnormal returns for firms that appoint an accounting expert to their audit committee, consistent with investors believing that adding accounting expertise enhances corporate governance and increases shareholder value.<sup>2</sup> Although these results imply that appointing an accounting expert will improve financial oversight, there is currently little direct evidence of increases in reporting quality when firms appoint an accounting expert to their audit committee. In this dissertation, I examine whether the firm's financial reporting quality improves following the appointment of an accounting expert, and whether the extent of the improvement in financial reporting quality varies based on the strength of alternative governance mechanisms, or the presence of an accounting expert on the audit committee.

Understanding how appointing an accounting expert relates to changes in the firm's financial reporting quality is important for several reasons. First, although boards of directors designate responsibility for overseeing a company's accounting and financial

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<sup>1</sup> See Carcello, Hollingsworth, Klein, and Neal (2008), Farber, Huang, and Mauldin (2008), Dhaliwal, Naiker, and Navissi (2006), and Bryan, Liu, and Tiras (2007), among others.

<sup>2</sup> I refer to "audit committee accounting experts" as "accounting experts" for convenience going forward.

reporting processes to the audit committee (Bill 2006), it is not clear whether having an accounting expert allows the firm to communicate financial information to market participants in a way that enables more accurate assessments of firm value. Therefore, my analysis provides important information to investors regarding the factors driving the premium to accounting expertise (DeFond et al. 2005). Second, despite assertions within regulatory initiatives such as Section 407 of the Sarbanes-Oxley Act of 2002 (SOX) that having financially minded members enhances the ability of audit committees to oversee the financial reporting process, there is a lack of evidence on whether adding accounting expertise influences the financial reporting decisions made by managers. My study enhances our understanding of whether increases in the number of accounting experts serving on audit committees relates to higher quality financial reports.<sup>3</sup> Finally, existing research does not provide a definitive answer to the question of when accounting expertise is successful at fostering high quality financial reporting. By relating changes in financial reporting quality following the appointment of an accounting expert to the strength of alternative governance provisions, and the current expertise of the audit committee, I provide insight into the conditions necessary for accounting expertise to have a significant impact on the firm's financial reporting system.

There are at least two factors that support the conclusion that appointing an accounting expert leads to increases in financial reporting quality. The first is that individuals with accounting backgrounds should be better able to discover accrual

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<sup>3</sup> A recent survey of 178 public companies from the *Fortune* 100 and NASDAQ 100 suggests the fraction of audit committee members who are accountants doubled from 5 percent in 2002 to 11 percent in 2005, and the number of audit committees with at least one accountant increased from 20 percent to 38 percent during the same period (Huron Consulting Group 2006).

manipulations than non-accounting experts (Carcello et al. 2008). Second, accounting experts are likely to bear a higher loss in reputation and human capital from serving on the audit committee of a firm that discloses an accounting restatement (Srinivasan 2005) or faces a class action lawsuit (Fich and Shivdasani 2006). This combination of ability and incentive should prompt new accounting experts to take actions that strengthen the overall reporting system and improve financial monitoring in a way that results in higher quality financial reporting.

However, it is not necessarily the case that appointing an accounting expert will result in increases in the firm's financial reporting quality. First, there is the possibility that prospective audit committee members with a high degree of accounting expertise are drawn to firms that already produce high quality financial reporting (Engel 2005). Furthermore, newly appointed accounting experts may lack sufficient influence to materially impact managers' financial reporting decisions. Finally, the SOX requirement that firms identify the financial expert on their audit committee possibly creates an incentive for firms to appoint accounting experts exclusively for compliance purposes. Thus, the presence of these competing possibilities renders the issue of whether appointing an accounting expert relates to improvements in financial reporting quality an empirical question.

The audit committee is only one body responsible for providing financial oversight, and the literature provides mixed evidence regarding how accounting expertise works with other aspects of a firm's governance structure. Strong corporate governance signals a commitment to oversight, and implies that the firm possesses the infrastructure needed

to act on audit committee recommendations. Therefore, appointing an accounting expert could only improve financial reporting quality when accompanied by complimentary governance provisions (Blue Ribbon Committee 1999; DeFond et al. 2005; Dhaliwal et al. 2006). Alternatively, firms with strong corporate governance may exert stronger control over the firm's financial reporting decisions, irrespective of the activities of the audit committee, thereby reducing the impact of audit committee financial expertise on the firm's reporting quality (Carcello et al. 2008; Bryan et al. 2007). Given these alternatives, the question of whether associations between appointing an accounting expert and changes in financial reporting quality will be positively or negatively influenced by the strength of the firm's corporate governance structure remains unresolved.

The incremental impact of appointing an accounting expert could also vary according to the composition of the existing audit committee. When an audit committee does not possess accounting expertise, appointing an accounting expert introduces a monitor that is intimately familiar with the financial reporting process. If the lack of accounting expertise results in inadequate financial monitoring, and the new accounting skills allow the audit committee to more effectively monitor managers' reporting decisions, then improvements in financial reporting quality could be largest for firms that appoint their first accounting expert. However, appointing an accounting expert can add to the influence of accounting experts on the audit committee and the board as a whole. If a minimum number of accounting experts on the audit committee are necessary to pressure managers into action, then improvements in reporting quality could be largest for firms

that appoint an accounting expert to an audit committee with prior accounting expertise.

As a result, I also examine whether associations between adding an accounting expert and changes in financial reporting quality relate to whether the firm maintained an accounting expert on the audit committee in the year prior to appointment.

I use a sample of 1,590 firm-years with annual meeting dates between 2003 and 2005 where the firm appointed an outside board member and assigned them to the audit committee in my analysis. Consistent with prior literature (DeFond et al. 2005; Carcello et al. 2008), I use biographical information from proxy statements to designate audit committee appointees as accounting experts if they are a certified public accountant, or have either worked in public accounting, or for a public company as the chief financial officer or controller. Next, I identify non-accounting financial experts as individuals with investment banking experience, or who have supervised those responsible for preparing financial statements, usually as the chief executive of a public firm. Finally, I define all other audit committee appointees as non-experts.

I examine whether appointing an accounting expert relates to improved financial reporting quality by comparing reporting quality in the three years prior to appointment with the three years following appointment, conditional on the appointee's accounting background. I measure financial reporting quality using a variety of proxies from the accounting literature including abnormal accruals from the modified Jones model (Dechow et al. 1995), the earnings response coefficient (Collins and Kothari 1989), and accruals quality (Dechow and Dichev 2002). Furthermore, I differentiate between firms with strong and weak corporate governance structures using a composite governance



measure based on board and audit committee characteristics and the ratio of institutional shareholdings (Carcello et al. 2008). Finally, I measure the extent of prior accounting expertise by examining whether the firm maintained an accounting expert on the audit committee in the year prior to each sample appointment.

My results suggest that financial reporting quality does not improve, on average, following the appointment of an accounting expert to the audit committee. However, I find evidence consistent with the assertion that firms with strong corporate governance experience larger improvements in financial reporting quality following the appointment of an accounting expert than firms with weak corporate governance. Specifically, my results suggest that firms with strong corporate governance become more conservative with accruals (i.e. use more income-decreasing accruals) following the appointment of an accounting expert. Additionally, my evidence highlights that firms with strong governance experience larger increases in earnings response coefficients and Dechow and Dichev (2002) accruals quality following the appointment of accounting experts than firms with weak governance. Finally, I find evidence that firms appointing their first accounting expert shift to more income-decreasing accruals and have higher accruals quality following the appointment, but only when there is a strong corporate governance structure in place.

Overall, the results of this dissertation add to our understanding of how audit committee composition influences financial reporting decisions. Prior studies (Dhaliwal et al. 2006; Carcello et al. 2008) contend that having audit committee members with accounting backgrounds relates to high quality financial reporting, and DeFond et al.



(2005) identify a premium for firms that appoint an accounting expert. Furthermore, the literature provides mixed evidence regarding whether accounting expertise and other governance provisions are complements (DeFond et al. 2005; Dhaliwal et al. 2006) or substitutes (Carcello et al. 2008; Bryan et al. 2007). I add to these studies by providing evidence regarding the conditions under which the appointment of an accounting expert is associated with increases in financial reporting quality. My results indicate that reporting quality improves following the appointment of an accounting expert, but only when the firm maintains a strong corporate governance structure. Thus, appointing an accounting expert to the audit committee is only likely to lead to improvements in financial reporting quality if the firm is equipped to utilize the expertise (DeFond et al. 2005). Additionally, my evidence is also relevant to regulators looking to assess whether regulatory changes (SOX, NYSE, Nasdaq) designed to increase the amount of financial expertise on audit committees resulted in higher quality financial information being communicated to market participants.

The remainder of this dissertation proceeds as follows: In Chapter II, I review the related literature. Chapter III presents my hypotheses, while Chapter IV describes my sample selection and research design. In Chapter V, I provide the detail of my primary empirical results, and present the results of robustness checks and sensitivity analyses in Chapter VI. Finally, I provide concluding remarks in Chapter VII.

## CHAPTER II

### LITERATURE REVIEW

#### Background on Audit Committees

The audit committee plays a central role in the financial monitoring of a firm. First, audit committee members maintain responsibility for oversight over accounting policies and judgments, as well as the quality of the overall financial statements (Blue Ribbon Committee 1999; Bill 2006). Furthermore, the audit committee is typically responsible for selecting outside auditors, and meeting with financial managers to gauge whether they are acting in the firm's best interest (Klein 2002b). DeFond et al. (2005) suggest that these responsibilities often require significant accounting sophistication in that they involve assessing the reasonableness of complex financial matters such as the company's accounting reserves, and management's handling of proposed audit adjustments suggested by the external auditors.

Each of the major stock exchanges (i.e. NYSE, NASDAQ, AMEX) requires that all audit committee members be able to read and understand financial statements (Bill 2006). Furthermore, Section 407 of SOX requires firms to designate an audit committee member as a "financial expert" in their proxy statement, or explain why it is cost prohibitive to maintain one if there is no financial expert (Engel 2005).<sup>4</sup> These provisions suggest that

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<sup>4</sup> The final version of SOX Section 407 defines a financial expert as someone with experience preparing or reviewing financial statements, or supervising individuals engaged in such activities (Bill 2006). I refer to these individuals as "general" financial experts for the remainder of this dissertation. It should be noted that the final SOX definition of a financial expert contrasts with the definition in draft versions of Section 407 that focused on experience specifically in finance and accounting (DeFond et al. 2005).

regulators consider an individual's financial background to be an important characteristic of the audit committee member's ability to successfully monitor the financial reporting process.

Prior literature suggests that investors assign a market premium to firms that appoint individuals thought to be more effective monitors to their boards of directors. For example, Rosenstein and Wyatt (1990) identify positive short-window abnormal returns surrounding the appointment of independent outside directors, while Fich (2005) finds evidence of a market premium for firms that appoint the chief executive of another firm to their board. One interpretation of these results is that investors perceive outsiders to be less susceptible to excessive influence from top management. Furthermore, the results from Fich (2005) suggest the outside director premium varies directly with the operating performance of the appointee's home firm, consistent with rewards for firms that appoint outsiders possessing a track record of successful oversight. DeFond et al. (2005) also provide evidence of a positive stock market reaction for firms that appoint an accounting expert to their audit committee, with one interpretation being that accounting skills enhance the ability of the audit committee to oversee high-quality financial reporting. In addition, DeFond et al. (2005) find that firms that appoint a non-accounting financial expert do not experience abnormal returns surrounding appointment, which implies the premium to financial expertise is limited to individuals with accounting backgrounds.

### Consequences of High Quality Financial Reporting

Existing research suggests that there are economic benefits to high quality financial reporting. For example, Xie (2001) finds that firms with low levels of discretionary

accruals experience higher risk-adjusted returns than firms with high discretionary accruals. Furthermore, Francis et al. (2005) provides evidence that firms with low Dechow and Dichev (2002) accruals quality face higher costs of debt and equity capital than firms with high quality accruals. Finally, results from Palmrose et al. (2004) highlight a market penalty of approximately 9% (based on short-window abnormal returns) for firms disclosing an accounting restatement, and larger penalties for firms that fail to quantify the misstatement. One possible explanation for these results is that investors perceive low quality financial reporting to indicate the presence of high agency costs. Evidence supporting this idea comes from studies highlighting opportunistic use of financial reporting by managers before equity offerings (Teoh et al. 1998), and stock option exercises (Bartov and Mohanram 2004).

#### Accounting and Financial Expertise and Financial Reporting Quality

The accounting literature provides support for cross-sectional associations between accounting expertise and high quality financial reporting. For example, prior studies document reduced usage of discretionary accruals (Carcello et al. 2008) and abnormal income-increasing accruals (Bedard et al. 2004) when firms have at least one general financial expert on their audit committee. Additionally, Xie et al. (2003) document that the percentage of investment bankers on the audit committee is associated with lower current discretionary accruals. Taken together, these results suggest possessing at least one individual with experience from the financial sector is associated with high quality financial reporting. In addition, firms with at least one accounting expert on their audit committee have been shown to have lower levels of performance adjusted discretionary

accruals (Carcello et al. 2008) and higher accruals quality (Dhaliwal et al. 2006). Finally, Krishnan and Visvanathan (2008) identify a positive association between the proportion of audit committee members with accounting expertise and measures of accounting conservatism, suggesting that financial experts constrain overpayments to managers and other parties (Watts 2003a, 2003b).

There are also documented associations between financial/accounting expertise and the incidence of accounting irregularities. Prior studies suggest that firms with at least one general financial expert disclose fewer accounting restatements (Agrawal and Chadha 2005; Abbott et al. 2004), and are less likely to face enforcement action by the SEC (Abbott et al. 2004). In addition, Zhang et al. (2007) and Bedard et al. (2007) find that firms with a larger percentage of financial experts (both accounting and non-accounting) are less likely to report an internal control weakness over financial reporting, while Krishnan (2005) documents an inverse association between the number of general audit committee financial experts and the likelihood that predecessor auditors identify an internal control weakness in the 8-K accompanying an auditor change. These results support the idea that financial experts are associated with stronger internal control systems over financial reporting, which should relate to the quality of published financial reports.

Audit committee accounting expertise has also been linked to more informative earnings. More specifically, prior studies provide evidence of higher earnings response coefficients for firms having at least one accounting expert on their audit committee (Bryan et al. 2007; Qin 2007) than firms without an accounting expert. These results

suggest that accounting expertise is associated with investor perceptions that earnings are persistent (Collins and Kothari 1989), and therefore of high quality.

### Governance Changes and Changes in Financial Reporting Quality

Existing research also links changes in board and committee composition to changes in financial reporting quality. For example, Klein (2002a) documents that firms transitioning from an independent board/audit committee to a non-independent board/audit committee have significantly higher levels of abnormal accruals following the switch than a control sample of firms. Furthermore, Felo et al. (2003) provide evidence that an increase in the fraction of audit committee members with general financial expertise is associated with improvements in analyst perceptions of disclosure quality, while Carcello et al. (2008) finds evidence of a decline in abnormal accruals in the year after an accounting expert joins the audit committee. Alternatively, Menon and Williams (2004) find some evidence that discretionary accruals are larger following the appointment of an audit committee member that was formerly employed by the firm's external auditor, implying that employing an accounting expert that is a former audit partner impairs the audit function's independence.

Governance changes unrelated to the audit committee have also been shown to relate to changes in financial reporting quality. For example, Geiger and North (2006) suggest that hiring a new chief financial officer is associated with a decrease in discretionary accruals. One interpretation of this result is that new CFOs possess sufficient influence and expertise to bring best practices that impact the reported financial statements of their

firm.<sup>5</sup> Furthermore, Matsunaga and Yeung (2008) find that hiring a chief executive with a background as a chief financial officer is associated with higher quality voluntary disclosures, suggesting that financially minded CEOs recognize the importance of high quality financial disclosures.

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<sup>5</sup>An alternative explanation include outgoing CFOs using accruals to increase income prior to their departure, and new CFOs using a “big-bath” strategy upon arrival to general higher future income.



### CHAPTER III

#### HYPOTHESIS DEVELOPMENT

##### Appointing an Accounting Expert and Changes in Financial Reporting Quality

Audit committee changes occur for a variety of reasons. Open audit committee positions arise when current members leave through voluntary resignation, retirement, dismissal, and term expiration, or when the board decides to increase the size of the audit committee. Appointments to and dismissals from the audit committee can also result when members rotate committee responsibilities. While the evidence from prior literature suggests that having an accounting expert on the audit committee is associated with strong current financial reporting practices, it is not clear whether appointing an accounting expert relates to improvements in financial reporting quality. More specifically, although the existing evidence is consistent with accounting experts using their financial training to enhance monitoring over financial reporting, it is also consistent with alternative explanations such as a matching process between firms with strong financial reporting systems and audit committee members with extensive accounting backgrounds. Thus, the question of whether adding an accounting expert to the audit committee is associated with improvements in financial reporting quality remains unresolved.

Accounting expertise should relate to a new audit committee member's ability to oversee the financial reporting process for several reasons. First, given the increasingly complex nature of accounting transactions (Cox 2005; Herz 2005), experience preparing



and reviewing financial statements increases the ability of audit committee members to ask management probing questions and effectively evaluate the responses (KPMG 2006).<sup>6</sup> Second, accounting experts should be more familiar with the nature of internal and external audit procedures, and therefore more apt to use auditor recommendations as a catalyst to improve the reporting system (Abbott et al. 2004; DeZoort and Salterio 2001). Finally, accounting experts often have experience designing and implementing financial reporting systems, which should allow them to both understand the financial issues facing management and advise them on best financial reporting practices.

Prior literature also suggests that litigation and human capital concerns provide accounting experts with incentives to enforce high quality financial reporting during their tenure on the audit committee. First, accounting experts may be more susceptible to litigation arising from accounting failures relative to other audit committee members and directors because of state court decisions holding experts to a higher standard (Cost and Miller 2005; Cunningham 2007).<sup>7</sup> These concerns are reflected in a recent survey highlighting that many audit committee members feel they have inadequate directors and officers (D&O) insurance coverage, despite safe harbor provisions contained in SOX designed to protect directors from liability under federal securities law (KPMG 2006).

Audit committee members have also been shown to suffer declines in their labor market value from being associated with poor financial reporting quality. For example,

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<sup>6</sup> Admittedly, the Blue Ribbon Committee (1999) highlights that an audit committee member's ability to question managers' reporting decisions may not require financial expertise.

<sup>7</sup> Linck et al. (2008), suggest that increases in the litigation risk and time commitments of audit committee service prompted a decrease in the proportion of active executives serving as audit committee members from 54.8% in 1998 to 41.6% in 2004.

Srinivasan (2005) finds that the audit committee members of firms disclosing an accounting restatement are more likely to lose their board positions at the restating firm and at other firms where they hold directorships, while Fich and Shivdasani (2006) highlight that the outside directors of firms facing class action lawsuits alleging financial misrepresentation experience a decline in other outside directorships following the suit.<sup>8</sup> Given that accounting experts are unlikely to be able to credibly plead ignorance with regard to suspect accounting, there is the possibility that this translates into greater reputational penalties from misreported financial statements with respect to the other individuals on an audit committee.

Alternatively, there are at least three reasons for why appointing an accounting expert would not elicit a measurable improvement in the quality of the firm's financial reports. First, economic theory suggests that individuals will only accept audit committee invitations when the marginal personal benefit exceeds the marginal personal cost (Perry and Peyer 2005). Based on the potential for reputational harm from serving on the audit committee of a firm that reports an accounting failure (Srinivasan 2005; Fich and Shivdasani 2006), prospective members will likely perform due diligence procedures to assess the integrity of the inviting firm's financial reporting system prior to acceptance (Engel 2005). One implication of this process is that accounting experts should be drawn to the audit committees of firms that already produce high quality financial reporting. Second, a newly appointed accounting expert is only one member of the audit committee,

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<sup>8</sup> It should be noted that Srinivasan (2005) documents that only 4% of the directors from firms disclosing an accounting restatement are specifically named in class action lawsuits, and that audit committee members are no more likely to face litigation than other directors.

and they may lack the influence needed to materially alter the financial reporting decisions made by managers. Finally, Section 407 of SOX requires that firms disclose in their proxy statement whether their audit committee has a financial expert, which creates the prospect that firms appoint accounting experts for compliance purposes rather than to improve the quality of financial reporting. To test between these alternative explanations, I propose the following Hypothesis (stated in the null):

**H1** *Firms that appoint an accounting expert to their audit committee experience no improvement in financial reporting quality following the appointment.*

#### Conditional on Governance Strength

A related question involves whether associations between appointing an accounting expert and changes in financial reporting quality vary according to the strength of alternative governance provisions already in place. Prior literature documents that strong corporate governance is associated with lower levels of earnings management, suggesting that governance provisions limit managers' ability to use financial reporting opportunistically. For example, evidence from Dechow et al. (1996) is consistent with a positive association between the fraction of board seats held by insiders and the likelihood of enforcement action by the SEC, while evidence from Klein (2002a) suggests that firms with more independent boards have lower levels of abnormal accruals. These results imply that boards governed by outsiders serve as effective monitors over the financial reporting process: More generally, Garcia Lara et al. (2008) highlight that financial reporting is more conservative when there is a strong corporate

governance structure in place, and that the direction of causality moves from governance strength to conservative financial reporting.

Some existing evidence suggests that having an accounting expert complements the other components of a firm's corporate governance structure. DeFond et al. (2005) find that abnormal returns surrounding the appointment of accounting experts are concentrated in firms with strong corporate governance, suggesting that investors consider accounting expertise to increase firm value when firms have the infrastructure necessary to effectively use the expertise (Blue Ribbon Committee 1999). Additionally, Dhaliwal et al. (2006) find that accounting expertise relates to high quality accruals when there is a strong audit committee, while Krishnan and Visvanathan (2008) find that associations between accounting expertise and conservatism are conditional on having a board with overall strong governance. This suggests improvements in financial reporting quality following the appointment of an accounting expert should be larger for firms with strong versus weak corporate governance structures.

Alternatively, if firms with strong corporate governance structures already possess the tools necessary to produce high quality financial reports, there could be less room for improvement following the appointment of an accounting expert. Consistent with this idea, Bryan et al. (2007) find that positive associations between accounting expertise and earnings response coefficients are smaller for firms with strong governance.

Furthermore, results from Carcello et al. (2008) suggest that other corporate governance mechanisms substitute for accounting expertise in limiting earnings management through discretionary accruals. As a result, an alternative possibility is that improvements in

reporting quality following the appointment of an accounting expert will be larger for firms that lack compensating governance provisions, suggesting that accounting expertise and other governance provisions are substitutes. To test between these alternatives, I present Hypothesis 2 (stated in the null):

**H2** *Firms with strong corporate governance structures will experience the same change in financial reporting quality following the appointment of an accounting expert to the audit committee as firms with weak corporate governance structures.*

#### Conditional on Prior Accounting Expertise

The incremental effect of appointing an accounting expert to the audit committee is also likely to be dependent on whether an accounting expert is already present. If the firm does not maintain accounting expertise on their audit committee, then appointing an accounting expert introduces an external monitor with the experience necessary to ask probing questions of management regarding financial reporting decisions (KPMG 2006). Furthermore, given that accounting experts are also likely to be familiar with the audit process, appointing an audit committee's first accounting expert increases the chance the firm acts on suggestions raised during external and internal audit procedures (Abbott et al. 2004). As a result, one possibility is that firms appointing their first accounting expert will experience the largest improvements in financial reporting quality following the appointment.

However, an alternative is that the critical mass necessary for accounting expertise to influence accounting policy is greater than one. In other words, having several accounting experts on the audit committee could increase the influence of the audit

committee over managers' financial reporting decisions. Furthermore, having multiple accounting experts on the committee could allow accounting experts to better determine the proper accounting for technically complex issues, i.e., the technical knowledge of different accounting experts could complement each other. In either case, there will be increasing returns to scale from the financial monitoring provided by accounting experts, and improvements in financial reporting quality following the appointment of an accounting expert would be largest for firms with prior accounting expertise. To test between these alternatives, I present Hypothesis 3 (stated in the null):

- H3** *Firms with no prior accounting expertise on the audit committee will experience the same change in financial reporting quality following the appointment of an accounting expert as firms with an accounting expert already on the audit committee.*



## CHAPTER IV

### VARIABLE DEFINITIONS AND DESCRIPTIVE STATISTICS

#### Sample Formation and Variable Measurement

To form my sample, I start with the S&P 1,500 firms listed in the RiskMetrics database (formerly the Investor Responsibility Research Center). Based on these firms, I identify all outside board appointments where the appointee was assigned to the audit committee, and participated in their first annual shareholders meeting between 2003 and 2005 to focus on the post-SOX environment. I use outside director appointments because they are more likely to lead to changes in financial reporting practices than reassigning audit committee responsibilities among active directors. Of the 6,042 board appointments during the sample period, 2,389 individuals were also placed on the audit committee. Next, I group appointments made in the same year together to focus on firm-year observations, which reduces the sample by 799 observations.<sup>9</sup> Panel A of Table 1 provides the details of my sample selection procedures, which results in a final sample of 1,590 firm-years in which the firm appointed an individual to the audit committee.

I classify each appointee into one of three categories according to their financial backgrounds using biographical information from proxy statements, in line with prior literature (DeFond et al. 2005; Carcello et al. 2008). I define appointees as accounting

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<sup>9</sup> Note that approximately 13% of firms appointed more than one individual to the audit committee in a given year. Given that I am primarily interested in identifying firms that appoint an accounting expert to their audit committee, I do not differentiate between firms that appoint only an accounting expert, from firms that appoint any combination of accounting experts and non-accounting experts.

experts if they are a certified public accountant, or have worked either in public accounting, or for a publicly traded firm as the chief financial officer or controller.<sup>10</sup> Additionally, I define non-accounting financial experts as individuals with experience in investment banking, or as the supervisor of those responsible for preparing financial statements, usually as the chief executive officer of a public firm. I define all other audit committee appointees as non-financial experts.

Panel B of Table 1 presents a summary by year of my sample appointments according to these three groupings of financial expertise. The results highlight that significantly more accounting experts were appointed to audit committees during my sample period (41%) than in the pre-SOX period used by DeFond et al. (2005) (17%). Panel C presents a frequency distribution of sample appointments by Fama and French (1997) 12 industry, and provides a comparison to Compustat firms in fiscal year 2005. The sample breakdown is generally consistent with the Compustat population, except for more appointments of accounting experts by retail and business equipment firms, and fewer appointments of accounting experts by financial firms. Panel D presents a summary of appointments grouped by governance strength and prior accounting expertise, and highlights that no single pairing of my conditional factors dominates the sample. Table 2 lists the variables used in my tests.

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<sup>10</sup> It should be noted that firms are only required to provide the work experience of board members during the most recent five years in the proxy statement. The extent to which individuals with accounting expertise early in their career are classified as non-experts will add noise to my measure of accounting expertise.



**Table 1. Sample Selection**

<i>Panel A: Observations Detail</i>				
				Number of appointments
Total first-time board appointments for firms listed in RiskMetrics database with annual meeting dates between 2003 and 2005				6,042
Less new appointees not assigned to audit committee				(3,653)
Less duplicate appointments in same year				(799)
<b>Final Sample</b>				<b>1,590</b>

  

<i>Panel B: Audit Committee Appointments by Year</i>				
Year	Accounting expert	Non-accounting financial expert	Non-financial expert	Total
2003	195	214	118	527
2004	267	206	108	581
2005	184	182	117	482
<b>Total</b>	<b>646</b>	<b>602</b>	<b>343</b>	<b>1,590</b>

  

<i>Panel C: Frequency of Sample Firms by Industry Groups</i>							
Industry description	Accounting expert		Non-accounting financial expert		Non-financial expert		Compustat firms
Consumer non-durables	40	6%	43	7%	12	3%	4%
Consumer durables	25	4%	17	3%	6	2%	2%
Manufacturing	73	11%	84	14%	47	14%	8%
Energy	24	4%	20	3%	18	5%	6%
Chemicals	17	3%	15	2%	8	2%	2%
Business equipment	137	21%	85	14%	54	16%	17%
Telecommunications	7	1%	17	3%	1	0%	4%
Utilities	34	5%	34	6%	24	7%	3%
Retail	84	13%	75	12%	37	11%	7%
Healthcare	55	9%	47	8%	30	9%	11%
Financial	92	14%	101	17%	67	20%	19%
Other	58	9%	64	11%	39	11%	16%

  

<i>Panel D: Summary of Appointments Sorted by Conditional Factors</i>				
Prior accounting expertise	Weak governance		Strong governance	
	No	Yes	No	Yes
Appoint accounting expert				
Yes	180	92	189	109
No	216	153	190	200

**Panel A** describes the criteria used to arrive at the final sample of firm-year observations. **Panel B** presents a summary of the sample audit committee appointments conditional on appointee financial backgrounds. Accounting experts are certified public accountants, or individuals who have worked in public accounting, or as the controller or chief financial officer of a public firm. Non-accounting financial experts are individuals with experience in investment banking or as the chief executive of a public firm. All other appointments are Non-financial experts. **Panel C** summarizes the sample by Fama and French (1997) 12 industry groups, and provides a comparison to the 2005 Compustat universe. **Panel D** presents a summary of appointments sorted by governance strength and prior accounting expertise.

**Table 2.** Variable Definitions

<i>Variable</i>	<i>Description</i>	<i>Source</i>
<i>AE</i>	Indicator variable = 1 if the firm appointed an accounting expert; 0 otherwise	Proxy Statement
<i>SGov</i>	Indicator variable = 1 if the composite governance index based on board characteristics and the percentage of institutional owners is above the sample median; 0 otherwise. The components of this measure are described in Table 4.	RiskMetrics Thompson 13F
<i>PriorAE</i>	Indicator variable = 1 if firm had an accounting expert prior to appointment; 0 otherwise	Proxy Statement
<i>LnAssets</i>	Log of total assets = $\ln[at]$	Compustat
<i>LnMVE</i>	Log of market value of equity = $\ln[csho*prcc\_f]$	Compustat
<i>LnFollow</i>	Log of the number of analysts issuing quarterly earnings forecast within 90 days prior to earnings announcement	I/B/E/S
<i>Leverage</i>	Book value of long term debt divided by total assets = $[dltt / at]$	Compustat
<i>OpCycle</i>	Log of operating cycle calculated as $\ln[360/[sale/average(rect)] + 360/(cogs/average(inv))]$ over sample period	Compustat
<i>InvCycle</i>	Depreciation expense divided by assets in prior year = $[dp / at_{t-1}]$	Compustat
<i>PPE</i>	Net plant & equipment divided by assets = $[ppent / at]$	Compustat
$\sigma_{Sales}$	Standard deviation of sales over sample period = $\sigma[sale]$	Compustat
$\sigma_{OCF}$	Standard deviation of operating cash flow over sample period scaled by average assets over sample period = $\sigma[oancf / at]$	Compustat
$\sigma_{Returns}$	Standard deviation of daily returns over fiscal period	CRSP
<i>Persistence</i>	Coefficient from regression of earnings before extraordinary items in year t on earnings in year t+1 [ib]	Compustat
<i>Beta</i>	Coefficient from regression of returns on the CRSP value-weighted index using monthly returns calculated on a 24-month rolling basis.	CRSP
<i>PropLoss</i>	Proportion of fiscal years over sample period that the firm reports income before extraordinary items [ib] < 0	Compustat
<i>Loss</i>	Indicator variable = 1 if income before extraordinary items [ib] < 0 in current period; 0 otherwise	Compustat
<i>Distress</i> <sup>11</sup>	Indicator variable = 1 if Z-score from Altman (2000) is greater than 2.675; 0 otherwise	Compustat
<i>UE</i>	Earnings surprise calculated as actual quarterly earnings [actual] – median analyst forecast [medfeps] issued 90 days prior to quarter end [rdq]	I/B/E/S Compustat
<i>ROA<sub>t-1</sub></i>	Prior year income before extraordinary items divided by assets $[ib_{t-1} / at_{t-1}]$	Compustat
<i>OCF</i>	Operating cash flow divided by assets = $[oancf / at]$	Compustat
<i>BtM</i>	Book equity divided by market equity = $[ceq / csho*prcc\_f]$	Compustat
<i>SalesGrowth</i>	Sales growth over sample period = [sale]	Compustat
<i>Firm age</i>	Number of years since first listed on Compustat	Compustat
<i>Litigation</i>	1 if high litigation industry: SIC 2833-2836, 3570-3577, 7370-7374, 3600-3674, 5200-5961; 0 otherwise	Compustat
<i>HighTech</i>	1 if high technology industry: SIC 3500-3699, 3800-3899, 4800-4899, 7300-7399; 0 otherwise	Compustat
<i>Delaware</i>	Indicator variable = 1 if firm is incorporated in Delaware [state]; 0 otherwise	Compustat

<sup>11</sup> Z-score calculated as  $3.3(ib/at) + 1.0(sale/at) + 1.4(re/at) + 1.2(wcap/at) + 0.6((csho*prcc\_f)/lt)$ .

**Table 2. (continued).**

<i>Variable</i>	<i>Description</i>	<i>Source</i>
<i>Top5Own</i>	Percentage of shares held by top five executives = [shown_excl_opts / csho]	Execucomp
<i>Big 4</i>	Indicator variable = 1 if the firm employs a Big 4 auditor [au < 8]; 0 otherwise	Compustat
<i>Tenure</i>	Number of years following audit committee appointment	Proxy Statement
<i>CEOTenure</i>	Number of years as CEO	Execucomp
<i>Lambda</i>	Equal to the inverse Mills ratio based on selection model described in Appendix A.	Various
<i>Accruals</i>	Residual from estimating cross-sectional regressions by 2-digit SIC industry using the Modified Jones model (Dechow et al. 1995) using the following equation:  $TCA_{j,t} = b_0 + b_1(\Delta Sales_{j,t} - \Delta Rec_{j,t}) + b_2 PPE_{j,t} + \varepsilon_{j,t}$ where: $TCA = [-1 * \Delta \text{Accounts receivable} + \Delta \text{Inventory} - \Delta \text{Accounts payable} - \Delta \text{Taxes payable} + \Delta \text{Other assets}]$ $CFO = [(-1 * recch + invch + apalch + txach + aoloch) / at]$ $\Delta Sales = [oancf / at]$ $PPE = [sale / at]$ $\Delta Rec = [ppent / at]$ $= [rect / at]$	Compustat
<i>CAR</i>	3-day cumulative abnormal return surrounding Compustat quarterly earnings announcement date calculated as raw return less the CRSP value-weighted index adjusted for dividends.	CRSP Compustat
<i>AQ</i>	Dechow and Dichev (2002) modified by McNichols (2002) and Francis et al. (2005) accruals quality measure calculated as the standard deviation of residuals from yearly cross-sectional regressions by Fama-French 48 industry of changes in working capital accruals on lagged, current, and future cash flows from operations, change in sales, and property, plant & equipment (all scaled by average total assets) over a four-year rolling basis.  $TCA_{j,t} = b_0 + b_1 OCF_{j,t-1} + b_2 OCF_{j,t} + b_3 OCF_{j,t+1} + b_4 \Delta Sales_{j,t} + b_5 PPE_{j,t} + \varepsilon_{j,t}$	Compustat

This table contains definitions for the variables used in my study. Database definitions (i.e. Compustat, Execucomp, etc.) are included in brackets when appropriate.

### Summary Statistics

Table 3 provides summary statistics for the firms in my analysis. I obtain financial statement data from Compustat, stock return data from CRSP, information on executive

compensation and CEO turnover from Execucomp, and analyst forecast details from I/B/E/S. Panel A provides statistics for my dependent variables conditional on appointee accounting/financial backgrounds. On average, firms that appoint an accounting expert have more negative discretionary accruals and lower accruals quality. Panel B provides a summary of independent variables by appointee background, and highlights that firms that appoint an accounting expert have larger betas. Furthermore, firms that appoint an accounting expert are more likely to be from a high technology or high litigation industry, suggesting that complex firms have higher demand for technical experience from board members as opposed to financial experience. Finally, firms that appoint a non-accounting financial expert are larger and more mature than other sample firms. Panel C provides Pearson correlations for select independent variables used in my regression analysis. The largest correlations are between leverage and distress (-0.57) and beta and the standard deviation of returns (0.51).<sup>12</sup>

**Table 3.** Summary Statistics

Variable	Total Sample	Accounting Expert	Non-accounting financial expert	Non-financial expert
Market value of equity	7,144 (1,600) [21,392]	6,671 (1,664) [21,213]	7,895 (1,784)* [20,854]	6,699 (1,273)* [22,620]
Leverage ratio	0.19 (0.17) [0.16]	0.19 (0.17) [0.16]	0.18 (0.16) [0.16]	0.18 (0.16) [0.16]
Operating cycle	4.94 (4.75) [1.18]	4.94 (4.77) [1.14]	4.92 (4.69) [1.14]	4.96 (4.77) [1.30]
Beta	1.15 (0.95) [1.00]	1.22** (1.01)** [0.98]	1.10* (0.93) [0.93]	1.13 (0.89) [1.11]

<sup>12</sup> I examine the variance inflation factors (VIF) in my multivariate analyses to test for multicollinearity, and find that distortion is not of major concern in that VIFs are less than 10 (Kennedy 2003).

**Table 3. (continued).**

Variable	Total Sample	Accounting Expert	Non-accounting financial expert	Non-financial expert
Abnormal 1 year return	0.16 (0.09) [0.54]	0.15 (0.08) [0.52]	0.15 (0.09) [0.50]	0.18 (0.09) [0.65]
Return on assets	0.04 (0.04) [0.09]	0.04 (0.04) [0.09]	0.04 (0.04) [0.10]	0.05 (0.04) [0.07]
Financial distress	0.63 (1.00) [0.48]	0.63 (1.00) [0.48]	0.63 (1.00) [0.48]	0.62 (1.00) [0.49]
Book to market ratio	0.51 (0.46) [0.37]	0.50 (0.44)* [0.38]	0.52 (0.47) [0.40]	0.51 (0.47) [0.31]
Firm age	24.68 (19.00) [16.47]	24.06 (18.00) [15.93]	25.87** (20.00)* [17.09]	23.71 (17.00) [16.28]
High litigation industry	0.27 (0.00) [0.44]	0.31*** (0.00)*** [0.46]	0.23** (0.00)** [0.42]	0.24 (0.00) [0.43]
High tech industry	0.30 (0.00) [0.46]	0.33** (0.00)** [0.47]	0.29 (0.00) [0.45]	0.26** (0.00)** [0.44]
Strong governance	0.51 (1.00) [0.50]	0.51 (1.00) [0.50]	0.50 (0.50) [0.50]	0.50 (1.00) [0.50]
CEO tenure	6.40 (4.00) [6.67]	6.49 (4.00) [6.99]	6.22 (4.00) [6.52]	6.55 (5.00) [6.26]
Top 5 ownership	0.04 (0.01) [0.14]	0.04 (0.01) [0.08]	0.04 (0.01)** [0.11]	0.06** (0.01)** [0.24]
Prior accounting expertise	0.41 (0.00) [0.49]	0.35*** (0.00)*** [0.48]	0.46*** (0.00)*** [0.50]	0.47* (0.00)* [0.50]
Discretionary accruals	0.14 (0.03) [0.57]	0.12 (0.02)** [0.53]	0.14 (0.02) [0.60]	0.18 (0.04) [0.60]
CAR	0.00 (-0.00) [0.07]	0.00 (0.00) [0.07]	0.00 (0.00) [0.07]	0.00 (0.01) [0.07]
Accruals quality	-0.05 (-0.04) [0.04]	-0.05* (-0.04) [0.05]	-0.05 (-0.04) [0.04]	-0.05 (-0.04) [0.03]

Table 3. (continued).

<i>Panel C: Pearson Correlations</i>										
	Accr.	AQ	MVE	Lev- erage	$\sigma$ Ret	Beta	BtM	Top 5 own	SGov	Prior AE
<i>Accruals</i>	1.00									
<i>AQ</i>	-0.05	1.00								
<i>MVE</i>	0.02	0.23*	1.00							
<i>Leverage</i>	-0.04	0.14	0.10*	1.00						
<i><math>\sigma</math>Returns</i>	0.07*	-0.29*	-0.38*	-0.17*	1.00					
<i>Beta</i>	0.04	-0.18*	-0.11*	-0.11*	0.51*	1.00				
<i>BtM</i>	0.00	-0.02	-0.28*	0.05	0.22*	0.01	1.00			
<i>HighTech</i>	0.07*	-0.17*	-0.11*	-0.23*	0.34*	0.37*	-0.12*			
<i>Top5Own</i>	-0.03	-0.04	-0.11*	-0.01	0.01	-0.01	-0.01	1.00		
<i>SGov</i>	0.00	-0.10*	-0.09*	-0.02	0.21*	0.05*	0.08*	-0.05*	1.00	
<i>PriorAE</i>	-0.05	0.03	-0.10*	0.02	0.02	0.05*	0.02	-0.00	0.03	1.00

This table provides summary statistics for the dependent and independent variables in my analysis. The sample period spans 2003-2005, and includes 1,590 firm years involving an appointment to the audit committee. **Panel A** presents mean (median) [standard deviation] values for dependent variables sorted on appointee backgrounds. **Panel B** presents mean (median) [standard deviation] values for independent variables sorted on appointee backgrounds. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels based on t-tests for means and a Wilcoxon rank-sum test for medians. **Panel C** provides Pearson correlations and their associated p-values for select variables. \* denotes statistical significance at the 5% level. Variable descriptions are presented in Table 2.

## CHAPTER V

### RESEARCH DESIGN AND RESULTS

#### Primary Tests

Hypothesis 1 tests for changes in financial reporting quality on average following the appointment of an accounting expert, while Hypotheses 2 and 3 examine whether these improvements are conditional on governance strength and prior accounting expertise, respectively. To test my predictions, I run a series of regressions where the dependent variable is one of three proxies for financial reporting quality used in the accounting literature. My sample includes the three years before and after each audit committee appointment (excluding the appointment year), for a maximum of 6 observations per sample firm-year. I begin by defining an indicator variable, *After*, that is equal to one if the firm year follows the appointment of a new member to the audit committee and a variable, *AE*, that is equal to one if the firm appointed an accounting expert at any time during the sample period. The interaction between these two variables (*AE* x *After*) captures the incremental change in reporting quality for firms appointing an accounting expert relative to firms that appoint non-accounting experts to their audit committee, and serves as the primary variable of interest in tests of Hypothesis 1.

I consider whether the strength of existing governance provisions influence the impact of added accounting expertise on changes in financial reporting quality by separately analyzing firms with strong governance and those with weak governance. My proxy for governance strength is a composite measure (*SGov*) that considers board and



audit committee characteristics and the percentage of institutional ownership (Carcello et al. 2008). Specifically, I define a firm as having strong governance if the composite measure is greater than the sample median for each year as described in Table 4.

**Table 4.** Components of Composite Governance Measure

<b>Component</b>	<b>Description</b>
Board size	1 if board size is between 6 and 9 members; 0 otherwise
Board experience	1 if the % of independent directors who hold seats on other firms' boards is greater than the median; 0 otherwise
Relative audit committee power	1 if the ratio of audit committee members to total board members is greater than the median; 0 otherwise
Audit committee independence	1 if a fully independent audit committee; 0 otherwise
Institutional ownership	1 if the ratio of institutional ownership is greater than the median; 0 otherwise

This table summarizes the components of the governance proxy. A firm is designated as having a strong corporate governance structure if the composite proxy is greater than the sample median.

Similar to my tests of Hypothesis 1, the interaction term (*AE x After*) captures the incremental change in reporting quality following the appointment of an accounting expert for each subsample. However, in tests of Hypothesis 2, I run a pooled regression with each independent variable interacted with *SGov* to test for differences between the two equations (*SGov* = 1 versus *SGov* = 0). In these pooled regressions, the coefficient on *AE \* After \* SGov* represents the difference in the post-appointment interaction term between the strong and weak governance samples, and serves as the variable of interest.

I consider whether having prior accounting expertise influences the impact of appointing an accounting expert on future financial reporting quality by separately analyzing firms that appoint their first accounting expert and those with an accounting expert already on their audit committee. I define a firm as having prior accounting



expertise (*PriorAE*) if there was at least one accounting expert on the audit committee in the year prior to the appointment of interest.

Similar to my tests of Hypotheses 1 and 2, the interaction term (*AE x After*) captures the incremental change in reporting quality for firms that appoint an accounting expert to their audit committee for each subsample. However, in tests of Hypothesis 3, I run a pooled regression with each independent variable interacted with *PriorAE* to test for differences between the two equations (*PriorAE* = 0 versus *PriorAE* = 1). In these pooled regressions, the coefficient on *AE \* After \* PriorAE* represents the difference in the post-appointment interaction term between the no prior accounting expertise and prior accounting expertise subsamples, and serves as the variable of interest.

There is also the possibility that a strong governance structure is a necessary condition for prior accounting expertise to influence the incremental change in financial reporting quality following the appointment of an accounting expert. As a result, I perform a second set of tests of Hypothesis 3 using interaction terms to consider the strength of alternative governance provisions and prior accounting expertise simultaneously. Specifically, I interact prior accounting expertise (*PriorAE*) with *AE \* After* and *After* in regressions segregated by governance strength, and interact governance strength (*SGov*) with *AE \* After* and *After* in regressions segregated by prior accounting expertise. In the regressions segregated by governance strength, the coefficient on *AE \* After* represents the incremental change in reporting quality for firms appointing their first accounting expert. Similarly, the in the regression segregated by prior accounting

expertise, the coefficient on *AE \* After \* SGov* represents the incremental change in reporting quality from having a strong governance structure.

My first measure of financial reporting quality is the signed abnormal accrual from the modified Jones Model (Dechow et al. 1995). Givoly and Hayn (2000) note that the extent of income-decreasing accruals represents the extent of conservatism in the accounting system.<sup>13</sup> Abnormal accruals are the residuals from yearly cross-sectional regressions for each 2-digit SIC industry of changes in total revenue and accounts receivable and the gross value of property, plant and equipment on the change in total current accruals (*TCA*) as follows:<sup>14</sup>

$$TCA_{j,t} = a_0 + a_1(\Delta Sales_{j,t} - \Delta Accounts\ Receivable_{j,t}) + a_2 PPE_{j,t} + \varepsilon_{j,t} \quad (1)$$

where:

$$TCA_{j,t} = \Delta Accounts\ Receivable_{j,t} + \Delta Inventory_{j,t} - \Delta Accounts\ Payable_{j,t} - \Delta Taxes\ Payable_{j,t} + \Delta Other\ Assets_{j,t}$$

I scale all variables by average total assets, and impose the restriction that there are at least 20 observations per year for each industry. Furthermore, I Winsorize all continuous variables at the 1 and 99 percent values to reduce the influence of outliers. I use the signed abnormal accruals as the dependent variable in OLS regressions of equation (2) as follows:

<sup>13</sup> As noted in Matsunaga and Yeung (2008), an alternative interpretation is that accruals represent managers' incentives to manage earnings upward (Cheng and Warfield 2005; Ali et al. 2007).

<sup>14</sup> I calculate *TCA* using information from the statement of cash flows because of evidence from Hribar and Collins (2002) suggesting that the balance sheet approach can lead to noisy estimates.

$$\begin{aligned}
Accruals_{j,t} = & \alpha_0 + \alpha_1[AE_j * After_{j,t}] + \alpha_2 AE_j + \alpha_3 SGov_j + \alpha_4 PriorAE_j \\
& + \alpha_5 After_{j,t} + \alpha_6 LnMVE_{j,t} + \alpha_7 Leverage_{j,t} + \alpha_8 OpCycle_j \\
& + \alpha_9 InvCycle_j + \alpha_{10} \sigma Returns_j + \alpha_{11} ROA_{j,t-1} + \alpha_{12} OCF_{j,t} \\
& + \alpha_{13} Loss_{j,t} + \alpha_{14} BtM_{j,t} + \alpha_{15} FirmAge_{j,t} + \alpha_{16} Litigation_j \\
& + \alpha_{17} Delaware_j + \alpha_{18} Top5Own_{j,t} + \alpha_{19} CEOTenure_{j,t} \\
& + \alpha_{20} Tenure_{j,t} + \alpha_{21} Big4_{j,t} + \sum \alpha_x Year + \varepsilon_{j,t}
\end{aligned} \tag{2}$$

In tests of Hypothesis 1, a negative coefficient on  $\alpha_1$  implies a substitution to more conservative (income-decreasing) discretionary accruals, while a positive coefficient suggests a change to more aggressive (income-increasing) use of accruals. Furthermore, tests of Hypotheses 2 and 3 compare the change in accruals policy conditional on governance strength and prior accounting expertise, respectively. As a result, the variable of interest is the post-appointment interaction term  $[AE * After]$  interacted with the conditioning variable, which is  $SGov$  for Hypothesis 2, and  $PriorAE$  for Hypothesis 3.

I include control variables to account for factors shown by prior literature to be associated with total accruals. I control for size using the market value of equity ( $LnMVE$ ), and the leverage ratio calculated as long-term debt divided by total assets ( $Leverage$ ). Following Dechow and Dichev (2002), I include the log of the operating cycle ( $OpCycle$ ) to control for uncertainty in operations. Additionally, in line with Khan and Watts (2007), I control for the length of the investment cycle ( $InvCycle$ ) and the standard deviation of daily returns ( $\sigma Returns$ ) to consider investment and firm-specific uncertainty, respectively. Given evidence from Ayers et al. (2006) highlighting a positive relation between firm performance and accruals, I include lagged return on assets ( $ROA_{t-1}$ ). Based on Ali et al. (2007), I control for the negative correlation between cash flows and accruals ( $OCF$ ), as well as for economic shocks through a dummy

variable identifying a loss in the current period (*Loss*). I control for growth firms using the book-to-market ratio (*BtM*), and the maturity of governance systems through the number of years listed on Compustat (*FirmAge*) (Khan and Watts 2007).

Accounting experts likely have different incentives to rigorously monitor the financial reporting process in more risky situations. Therefore, I control for high litigation industries (*Litigation*) using the Francis et al. (1994) categories. Furthermore, I control for managerial ownership (*Top5Own*) to consider managerial incentives to misreport accruals, and for CEO influence through the number of years the chief executive has held the position (*CEOTenure*) (Hermalin and Weisbach 1988). I also include the number of years following the audit committee appointment (*Tenure*) to control for learning effects by accounting experts and the time needed to implement structural changes to the financial reporting system, as well as for monitoring by high quality auditors through an indicator variable equal to one if the firm employs a large, national auditor (*Big4*). Finally, I include year fixed-effects to control for time-specific factors in all specifications. All variables are described in detail in Table 2, and results are presented using standard errors clustered by firm (Rogers 1993).

My next set of tests use the extent to which investors react to an earnings surprise as a proxy for high quality earnings. I calculate the earnings response coefficient (ERC) as the relation between the three-day cumulative abnormal return (*CAR*) surrounding quarterly earnings announcements, and unexpected earnings calculated as the I/B/E/S actual earnings minus the median analyst forecast (*UE*) using equation (3) as follows:

$$\begin{aligned}
CAR_{i,t} = & \phi_0 + \phi_1[AE_j * After_{j,t} * UE_{j,t}] + \phi_2[AE_j * UE_{j,t}] + \phi_3[SGov_j * UE_{j,t}] \\
& + \phi_4[UE_{j,t} * PriorAE_j] + \phi_5[After_{j,t} * UE_{j,t}] + \phi_6 AE_j + \phi_{10} SGov_j \\
& + \phi_7 PriorAE_j + \phi_8 After_{j,t} + \phi_9 UE_{j,t} + \phi_{10} [LnMVE_{j,t} * UE_{j,t}] \\
& + \phi_{11} [LnFollow_{j,t} * UE_{j,t}] + \phi_{12} [Leverage_{j,t} * UE_{j,t}] + \\
& + \phi_{13} [Beta_{j,t} * UE_{j,t}] + \phi_{14} [Loss_{j,t} * UE_{j,t}] \\
& + \phi_{15} [Persistence_j * UE_{j,t}] + \phi_{16} [Btm_{j,t} * UE_{j,t}] \\
& + \phi_{17} [Top5Own_{j,t} * UE_{j,t}] + \phi_{18} [CEOTenure_{j,t} * UE_{j,t}] \\
& + \sum \phi_x [FFIndustry_j * UE_{j,t}] + \sum \phi_x Year + \varepsilon_{j,t}
\end{aligned} \tag{3}$$

Prior research suggests that persistent earnings are more informative regarding firm value, and will elicit a stronger market reaction to earnings announcements (Kormendi and Lipe 1987; Collins and Kothari 1989).

In tests of Hypothesis 1, a positive coefficient on  $\phi_1$  implies that investors perceive earnings to be more informative following the appointment of an accounting expert, while a negative coefficient on  $\phi_1$  implies the opposite. Furthermore, tests of Hypotheses 2 and 3 compare the change in the market response to unexpected earnings following the appointment of an accounting expert conditional on governance strength and prior accounting expertise, respectively. As a result, the variable of interest is the post-appointment interaction term  $[UE * AE * After]$  interacted with the conditioning variable, which is  $SGov$  for Hypothesis 2, and  $PriorAE$  for Hypothesis 3.

I control for factors associated with the earnings response coefficient through interactive terms with unexpected earnings (Collins and Kothari 1989; Bryan et al. 2007). First, I include the log of the number of analysts issuing yearly earnings forecasts ( $LnFollow$ ) as a proxy for access to information about the firm's future cash flows derived from sources other than the earnings announcement (Bryan et al. 2007). Next, I control for risk through beta ( $Beta$ ) calculated using rolling 24-month periods (Collins

and Kothari 1989; Matsunaga and Yeung 2008). In line with Bryan et al. (2007), I control for economic shocks through dummy variables for a loss period (*Loss*), and earnings persistence (*Persistence*) based on a time-series regression of current earnings on future earnings (Collins and Kothari 1989). Finally I control for industry effects through dummy variables for the 12 Fama French industries interacted with unexpected earnings (Ali et al. 2007). All other variables are defined previously, and are summarized in Table 2.

My final measure of reporting quality is the accruals quality measure developed by Dechow and Dichev (2002), and modified by McNichols (2002) and Francis et al. (2005) that is based on the relation between reported earnings and cash flows. Dechow and Dichev (2002) argue that the quality of accruals decreases when there are large estimation errors in accruals. I calculate accruals quality based on the variability of residuals from yearly cross-sectional regressions by Fama-French 48 industry of changes in total current accruals on lagged, current, and future cash flows from operations, change in sales, and current gross level of property, plant, and equipment as follows:

$$TCA_{j,t} = b_0 + b_1 OCF_{j,t-1} + b_2 OCF_{j,t} + b_3 OCF_{j,t+1} + b_4 \Delta Sales_{j,t} + b_5 PPE_{j,t} + \varepsilon_{j,t} \quad (4)$$

where:

$$TCA_{j,t} = \Delta Accounts\ Receivable_{j,t} + \Delta Inventory_{j,t} - \Delta Accounts\ Payable_{j,t} - \Delta Taxes\ Payable_{j,t} + \Delta Other\ Assets_{j,t}$$

I scale all variables by average total assets, and require at least 20 observations per industry-year. Accruals quality (*AQ*) is the standard deviation of these residuals



aggregated in four year rolling increments.<sup>15</sup> I then use  $AQ$  as the dependent variable in an OLS regression using equation (5) as follows:

$$\begin{aligned}
 AQ_{j,t} = & \gamma_0 + \gamma_1 |AE_j * After_{j,t}| + \gamma_2 AE_j + \gamma_3 SGov_{j,t} + \gamma_4 PriorAE_{j,t} \\
 & + \gamma_5 LnAssets_{j,t} + \gamma_6 OpCycle_j + \gamma_7 \sigma Sales_j + \gamma_8 \sigma OCF_{j,t} \\
 & + \gamma_9 PropLoss_j + \gamma_{10} PPE_{j,t} + \gamma_{11} SalesGrowth_j + \gamma_{12} Litigation_j \\
 & + \gamma_{13} Delaware_j + \gamma_{14} CEOTenure_{j,t} + \gamma_{15} Tenure_{j,t} + \sum \gamma_x Year + \varepsilon_{j,t}
 \end{aligned} \tag{5}$$

Given that low values for  $AQ$  suggest low variability between earnings and cash flows, I multiply  $AQ$  by -1 to obtain a measure that varies directly with accruals quality. In tests of Hypothesis 1, a positive coefficient on  $\gamma_1$  implies that a more consistent mapping between earnings and cash flows following the appointment of an accounting expert, while a negative coefficient on  $\gamma_1$  implies a change to lower quality accruals.

Furthermore, tests of Hypotheses 2 and 3 compare the change in accruals quality following the appointment of an accounting expert conditional on governance strength and prior accounting expertise, respectively. As a result, the variable of interest is the post-appointment interaction term [ $AE * After$ ] interacted with the conditioning variable, which is  $SGov$  for Hypothesis 2, and  $PriorAE$  for Hypothesis 3.

I control for factors shown to be associated with accruals quality following Dechow and Dichev (2002) and Ali et al. (2007). First, I control for firm size through the log of total assets ( $LnAssets$ ). I also control for operations uncertainty through variability in sales ( $\sigma Sales$ ), variability in and cash flows ( $\sigma OCF$ ), and loss uncertainty through for the proportion of years during the sample period in which the firm reported a loss ( $PropLoss$ ). Finally, I control for capital intensity through net property plant and

<sup>15</sup> Note that I only keep observations in year t-1 and t+3 surrounding the appointment of interest because of independence concerns in the time series.

equipment scaled by total assets (*PPE*), and sales growth (*SalesGrowth*) (Dechow and Dichev, 2002). All other variables are defined previously, and summarized in Table 2.

### Empirical Results

Table 5 presents my results for tests of Hypothesis 1. First, I find insignificant coefficients on the post-appointment interaction term (*AE x After*) in Panel A based on discretionary accruals ( $t$ -statistic = 0.06), in Panel B based on the earnings response coefficient ( $t$ -statistic = -1.47), and in Panel C using Dechow and Dichev (2002) accruals quality ( $t$ -statistic = 0.14). This implies that the financial reporting quality of firms appointing an accounting expert to their audit committee does not change relative to firms that appoint non-accounting experts. As a result, the evidence summarized in Table 5 suggests that financial reporting quality does not increase on average when firms appoint an accounting expert to their audit committee. Furthermore, the coefficient on the post-appointment period (*After*) in Panels A and C are positive, which is evidence that firms use more income-increasing accruals ( $t$ -statistic = 1.79), and have higher accruals quality ( $t$ -statistic = 1.90) following appointments to the audit committee.

**Table 5.** Changes in Financial Reporting Quality: Tests of Hypothesis 1

<i>Panel A: Discretionary Accruals</i>		
Variable	Coefficient	$t$ -statistic
Accounting expert x After	0.002	(0.06)
Accounting expert	-0.023	(-1.47)
Strong governance	0.008	(0.53)
Prior accounting expertise	0.012	(0.86)
After	0.102*	(1.79)
Log of market value	0.015***	(2.65)
Leverage ratio	0.022	(0.41)
Operating cycle	0.035***	(4.17)
Inventory cycle	-0.155	(-0.67)
$\sigma$ Returns	0.907	(1.14)



**Table 5. (continued).**

Variable	Coefficient	t-statistic
Return on assets <sub>t-1</sub>	0.210*	(1.82)
Operating cash flow	-0.489***	(-4.88)
Loss in current year	-0.065**	(-2.33)
Book to market ratio	-0.034	(-0.67)
Firm age	-0.000	(-0.92)
High litigation industry	0.048**	(2.50)
Top 5 ownership	-0.025	(-0.37)
CEO tenure	0.000	(0.12)
Tenure	-0.021	(-1.37)
Big four auditor	-0.000	(-0.02)
Intercept	-0.224**	(-2.29)
Observations	4,581	
Adjusted R <sup>2</sup>	0.05	

**Panel B: Earnings Response Coefficient**

UE x Accounting expert x After	-0.035	(-1.47)
UE x Accounting expert	0.032	(1.58)
UE x Strong governance	0.013	(0.60)
UE x Prior expert	0.045***	(3.31)
UE x After	0.001	(0.046)
Accounting expert	-0.001	(-0.73)
Strong governance	0.001	(0.81)
Prior expert	-0.000	(-0.094)
After	-0.004**	(-2.18)
UE	-0.524***	(-8.43)
UE x Market value	0.030***	(4.83)
UE x Analyst following	-0.012	(-0.86)
UE x Leverage	0.101**	(2.34)
UE x Beta	-0.006	(-0.66)
UE x Loss	0.108***	(5.49)
UE x Earnings persistence	0.000	(0.11)
UE x Book to market ratio	0.026**	(2.49)
UE x Top 5 ownership	0.106	(1.25)
UE x CEO Tenure	0.001	(0.92)
Intercept	0.005**	(2.16)
Observations	16,551	
Adjusted R <sup>2</sup>	0.03	

**Table 5. (continued).**

<i>Panel C: Accruals Quality</i>		
Variable	Coefficient	<i>t</i> -statistic
Accounting expert x After	0.000	(0.14)
Accounting expert	-0.001	(-0.69)
Strong governance	-0.000	(-0.30)
Prior expert	0.001	(0.63)
After	0.005*	(1.90)
Log of assets	0.002***	(4.03)
Operating cycle	-0.001	(-0.69)
PPE	0.027***	(7.06)
$\sigma$ Sales	-0.006*	(-1.70)
$\sigma$ Cash flow	-0.176***	(-5.71)
Loss proportion	-0.013***	(-3.59)
Sales growth	0.001**	(2.19)
High litigation industry	0.002	(1.53)
Top 5 ownership	-0.006	(-0.51)
CEO tenure	0.000***	(2.96)
Big four auditor	0.003	(0.48)
Intercept	-0.048***	(-3.67)
Observations	1,354	
Adjusted R <sup>2</sup>	0.19	

This table presents estimates and *t*-statistics from a set of OLS regressions in tests of Hypothesis 1, where the dependent variable is one of three measures of financial reporting quality. **Panel A** uses signed discretionary accruals obtained using the modified Jones model in line with Equation (2). **Panel B** uses the 3-day cumulative abnormal return surrounding quarterly earnings announcements in line with Equation (3). Industry fixed effects interacted with unexpected earnings are also included but not reported. **Panel C** uses the modified Dechow and Dichev (2002) accrual quality measure calculated on a rolling basis over the prior four years, multiplied by -1 in line with Equation (5). Year fixed-effects are included but not reported in all regressions, and all continuous variables are Winsorized at the 1% and 99% levels. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Standard errors are adjusted for clustering within firms using procedures advanced in Rogers (1993). Variable descriptions are provided in Table 2.

Table 6 presents my results for tests of Hypothesis 2. In each panel, Column (1) represents firms with strong governance, Column (2) represents firms with weak governance, and Column (3) summarizes the coefficients on each independent variable interacted with strong governance (*SGov*) in the pooled regression, which measures the difference for each variable between the strong and weak governance subsamples. The evidence in Column (1) of Panel A suggests that firms with strong corporate governance

that appoint an accounting expert substitute to more income-decreasing accruals following the appointment, as illustrated by the significant coefficient on the post appointment interaction term ( $AE * After$ ) ( $t$ -statistic = -1.78).<sup>16</sup> Alternatively, Column (2) suggests no different in the post-appointment interaction term for firms with weak corporate governance ( $t$ -statistic = 1.45). One interpretation of these results is that a strong governance structure is a necessary condition for a transition to more conservative accruals following the appointment of an accounting expert. Additionally, Column (3) documents a significant difference ( $t$ -statistic = -2.21) between the coefficients on ( $AE * After$ ) between the strong and weak governance subsamples, which supports the conclusion that improvements in reporting quality following the appointment of an accounting expert are larger for firms with strong versus weak corporate governance.

Panel B of Table 6 provides evidence of an incremental improvement in earnings response coefficients following the appointment of an accounting expert in the strong governance subsample, as highlighted by the significant coefficient on  $UE * AE * After$  in Column (1) ( $t$ -statistic = 2.30), and an incremental decrease in earnings response coefficients for the weak governance subsample following the appointment of an accounting expert, as highlighted by the negative coefficient on  $UE * AE * After$  in Column (2) ( $t$ -statistic = -2.60). Furthermore, the results presented in Column (3) confirm that firms with strong governance have larger increases in their earnings response coefficients following the appointment of an accounting expert than firms with

<sup>16</sup> In terms of economic significance, the coefficient on the post-appointment interaction term is approximately 44% of the average discretionary accruals in my sample (-0.061 / 0.14).

weak governance, as illustrated by the significant difference between coefficients on ( $AE * After * UE$ ) ( $t$ -statistic = 3.40) for the two subsamples.

Panel C of Table 6 provides no evidence of an incremental change in Dechow and Dichev (2002) accruals quality in either the strong or weak governance subsamples following the appointment of an accounting expert, as highlighted by the insignificant coefficients on  $AE * After$  in Column (1) ( $t$ -statistic = 1.20) and Column (2) ( $t$ -statistic = -1.16), respectively. However, the evidence presented in Column (3) is consistent with the assertion that firms with strong governance have larger increases in Dechow and Dichev (2002) accruals quality following the appointment of an accounting expert than firms with weak governance based on the marginally significant difference between coefficients on ( $AE * After$ ) ( $t$ -statistic = 1.68) between the strong and weak governance subsamples.

**Table 6.** Changes in Financial Reporting Quality Conditional on Governance Strength: Tests of Hypothesis 2

Variable	(1)		(2)		(3)	
	<i>Strong governance</i> Coeff.	<i>t</i> -stat	<i>Weak governance</i> Coeff.	<i>t</i> -stat	<i>Difference</i>	<i>t</i> -stat
Accounting expert x After	-0.060*	(-1.78)	0.068	(1.45)	-0.128**	(-2.21)
Accounting expert	-0.007	(-0.40)	-0.059*	(-1.92)	0.052	(1.45)
Prior expert	0.020	(1.13)	0.002	(0.072)	0.018	(0.60)
After	0.061	(0.76)	0.174*	(1.91)	-0.113	(-0.93)
Log of market value	0.006	(0.83)	0.031***	(2.81)	-0.025*	(-1.94)
Leverage ratio	0.000	(0.01)	0.069	(0.77)	-0.069	(-0.61)
Operating cycle	0.052***	(4.20)	0.015	(1.24)	0.037**	(2.10)
Inventory cycle	0.092	(0.33)	-0.713*	(-1.95)	0.805*	(1.73)
$\sigma$ Returns	-0.514	(-0.77)	4.579**	(2.21)	-5.094**	(-2.33)
Return on assets <sub>t-1</sub>	0.164	(1.03)	0.288	(1.61)	-0.124	(-0.52)
Operating cash flow	-0.463***	(-3.35)	-0.498***	(-3.54)	0.035	(0.18)
Loss in current year	-0.035	(-1.34)	-0.100**	(-2.02)	0.065	(1.15)
Book to market ratio	-0.085***	(-3.24)	0.047	(0.36)	-0.132	(-1.01)
Firm age	-0.000	(-0.45)	-0.000	(-0.61)	0.000	(0.21)
High litigation industry	0.044**	(2.03)	0.051	(1.45)	-0.007	(-0.18)
Top 5 ownership	-0.128*	(-1.66)	0.159	(1.39)	-0.286**	(-2.11)

**Table 6. (continued).**

	(1)		(2)		(3)	
	<i>Strong governance</i>		<i>Weak governance</i>		<i>t-stat</i>	<i>Coeff.</i>
	<i>Coeff.</i>	<i>t-stat</i>	<i>Coeff.</i>	<i>Coeff.</i>		
CEO tenure	0.001	(0.86)	-0.001	(-0.67)	0.002	(1.05)
Tenure	-0.007	(-0.29)	-0.032	(-1.58)	0.025	(0.80)
Big four auditor	0.007	(0.25)	-0.009	(-0.28)	0.015	(0.35)
Intercept	-0.178	(-1.63)	-0.379*	(-1.80)	0.201	(0.84)
Observations	2,687		1,894			
Adjusted R <sup>2</sup>	0.07		0.04			

**Table 6. (continued).**

<i>Panel B: Earnings Response Coefficient</i>						
UE x Accounting Expert x After	0.088**	(2.30)	-0.081***	(-2.60)	0.175***	(3.40)
UE x Accounting Expert	0.020	(0.78)	-0.011	(-0.39)	0.025	(0.64)
UE x Prior expert	0.055**	(2.17)	-0.000	(-0.01)	0.045	(1.51)
UE x After	-0.074**	(-2.48)	0.049**	(2.28)	-0.120***	(-3.21)
Accounting expert	0.000	(0.19)	-0.003*	(-1.67)	0.003	(1.37)
Prior expert	0.001	(0.86)	-0.003*	(-1.66)	0.004*	(1.77)
After	-0.005*	(-1.94)	-0.005	(-1.56)	0.000	(0.071)
UE	-0.602***	(-5.26)	-0.434***	(-5.03)	-0.006	(-0.31)
UE x Market value	0.040***	(3.66)	0.017*	(1.95)	0.011	(1.00)
UE x Analyst following	-0.012	(-0.52)	-0.007	(-0.46)	0.001	(0.047)
UE x Leverage	0.147	(1.54)	0.142**	(2.35)	-0.012	(-0.11)
UE x Beta	0.008	(0.44)	-0.031***	(-2.65)	0.034*	(1.72)
UE x Loss	0.087***	(3.11)	0.095***	(2.92)	-0.017	(-0.39)
UE x Earnings persistence	-0.000	(-0.01)	0.002	(1.63)	-0.003	(-1.43)
UE x Book to market ratio	0.112**	(2.09)	0.011	(1.06)	0.092*	(1.81)
UE x Top 5 ownership	0.144	(1.38)	0.019	(0.11)	0.137	(0.72)
UE x CEO Tenure	0.000	(0.26)	0.002	(1.18)	-0.002	(-0.84)
Intercept	0.004*	(1.73)	0.007*	(1.89)	-0.002	(-0.52)
Observations	9,198		7,353			
Adjusted R <sup>2</sup>	0.03		0.04			

**Panel C: Accruals Quality**

Accounting expert x After	0.005	(1.20)	-0.005	(-1.16)	0.010*	(1.68)
Accounting expert	-0.002	(-0.95)	0.002	(0.44)	-0.003	(-0.83)
Prior expert	0.003	(1.52)	-0.001	(-0.55)	0.004	(1.37)
After	0.002	(0.40)	0.010***	(2.70)	-0.008	(-1.47)
Log of assets	0.002***	(3.44)	0.002***	(2.64)	0.000	(0.50)
Operating cycle	0.000	(0.15)	-0.003	(-0.97)	0.003	(0.94)
PPE	0.031***	(6.91)	0.019***	(2.93)	0.012	(1.55)
σSales	-0.003	(-0.63)	-0.009*	(-1.65)	0.007	(0.93)
σCash flow	-0.178***	(-4.81)	-0.160***	(-2.98)	-0.018	(-0.27)
Loss proportion	-0.012***	(-2.67)	-0.018***	(-2.84)	0.005	(0.70)
Sales growth	0.001***	(3.44)	0.000	(0.056)	0.001	(1.32)
High litigation industry	0.001	(0.73)	0.003	(1.31)	-0.002	(-0.57)
Top 5 ownership	0.014	(1.16)	-0.034*	(-1.71)	0.048**	(2.07)

**Table 6. (continued).**

Variable	(1)		(2)		(3)	
	<i>Strong governance</i>		<i>Weak governance</i>		<i>Difference</i>	<i>t-stat</i>
	Coeff.	<i>t</i> -stat	Coeff.	<i>t</i> -stat		
CEO tenure	0.000***	(2.81)	0.000	(1.47)	0.000	(0.66)
Big four auditor	0.004	(0.49)	0.003	(0.30)	0.001	(0.066)
Intercept	-0.060***	(-4.54)	-0.035	(-1.59)	-0.025	(-0.98)
Observations	840		514			
Adjusted R <sup>2</sup>	0.21		0.17			

This table presents estimates and the associated *t*-statistics from a set of OLS regressions in tests of Hypothesis 2, where the dependent variable is one of three measures of financial reporting quality. Column (1) is for firms with strong governance based on a variation of the Carcello et al. (2008) summary measure, column (2) is for firms with weak governance, and column (3) summarizes the difference between columns (1) and (2) based on the coefficients for each independent variable interacted with strong governance in a pooled regression combining the two subsamples.

**Panel A** uses signed discretionary accruals obtained using the modified Jones model in line with Equation (2). **Panel B** uses the 3-day cumulative abnormal return surrounding quarterly earnings announcements in line with Equation (3). Industry fixed effects interacted with unexpected earnings are included but not reported. **Panel C** uses the modified Dechow and Dichev (2002) accrual quality measure calculated on a rolling basis over the prior four years, multiplied by -1 in line with Equation (5). Year fixed-effects are included but not reported in all regressions. and continuous variables are Winsorized at the 1% and 99% levels. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Standard errors are adjusted for clustering within firms (Rogers 1993). Variable descriptions are provided in Table 2.

Table 7 presents my results for my first tests of Hypothesis 3. In each panel, Column (1) represents firms with prior accounting expertise, Column (2) represents firms appointing their first accounting expert, and Column (3) summarizes the coefficients on each independent variable interacted with prior accounting expertise (*PriorAE*) in the pooled regression, which measures the difference for each variable between the no prior accounting expertise and prior accounting expertise subsamples. The results presented in Panels A suggest no association between prior accounting expertise and incremental changes in discretionary accruals following the appointment of an accounting expert, as highlighted by the insignificant coefficient on *AE \* After* in Column (1) for firms with prior accounting expertise (*t*-statistic = -0.14) and in Column (2) for firms appointing their first accounting expert (*t*-statistic = 0.13). Furthermore, Column (3) highlights no



significant differences in the post-appointment interaction term ( $AE * After$ ) between the two subsamples ( $t$ -statistic = -0.19).

I find similar results for the earnings response coefficient and accruals quality regressions. Specifically, in Panel B of Table 7, the coefficient on  $UE * AE * After$  in Column (1) ( $t$ -statistic = -1.94) is significantly negative and the coefficient on  $UE * AE * After$  in Column (2) ( $t$ -statistic = -0.75) is not significant. Furthermore, Column (3) highlights no difference in the post-appointment interaction term between the two subsamples ( $t$ -statistic = -0.75). In Panel C of Table 7, the coefficients on  $AE * After$  in Column (1) ( $t$ -statistic = -1.02), and Column (2) ( $t$ -statistic = 0.95) are insignificant. Furthermore the coefficient on the difference in the post-appointment interaction term between the two samples ( $t$ -statistic = -1.38) shown in Column (3) is not significant. Thus, the results suggest that firms appointing their first accounting expert do not differ from firms with prior accounting expertise in terms of the incremental changes in financial reporting quality following the appointment of an accounting expert.

**Table 7.** Changes in Financial Reporting Quality Conditional on Prior Accounting Expertise: Tests of Hypothesis 3

Variable	(1)		(2)		(3)	
	<i>Prior Expert</i>		<i>No Prior Expert</i>		<i>Difference</i>	<i>t-stat</i>
	Coeff.	<i>t</i> -stat	Coeff.	<i>t</i> -stat		
Accounting expert x After	-0.005	(-0.14)	0.005	(0.13)	-0.011	(-0.19)
Accounting expert	-0.024	(-1.03)	-0.020	(-0.97)	-0.003	(-0.11)
Strong governance	0.017	(0.70)	0.005	(0.24)	0.012	(0.39)
After	0.044	(0.50)	0.149**	(1.99)	-0.105	(-0.91)
Log of market value	0.015*	(1.69)	0.016**	(2.11)	-0.001	(-0.05)
Leverage ratio	0.028	(0.40)	0.023	(0.31)	0.005	(0.05)
Operating cycle	0.049***	(3.17)	0.028***	(2.84)	0.021	(1.12)
Inventory cycle	-0.388	(-1.21)	0.016	(0.05)	-0.405	(-0.88)
$\sigma$ Returns	-0.544	(-0.62)	2.033*	(1.72)	-2.577*	(-1.75)
Return on assets <sub>t-1</sub>	0.260**	(2.02)	0.170	(0.94)	0.090	(0.40)
Operating cash flow	-0.504***	(-3.87)	-0.490***	(-3.35)	-0.014	(-0.07)

**Table 7. (continued).**

Variable	(1)		(2)		(3)	
	<i>Prior Expert</i>		<i>No Prior Expert</i>		<i>Difference</i>	<i>t-stat</i>
	Coeff.	<i>t-stat</i>	Coeff.	<i>t-stat</i>		
Loss in current year	-0.021	(-0.68)	-0.101**	(-2.40)	0.080	(1.53)
Book to market ratio	-0.095***	(-2.98)	0.001	(0.02)	-0.097	(-1.13)
Firm age	-0.001	(-1.25)	-0.000	(-0.14)	-0.001	(-0.80)
High litigation industry	0.058**	(2.24)	0.041	(1.55)	0.017	(0.45)
Top 5 ownership	-0.148	(-1.59)	0.025	(0.27)	-0.174	(-1.32)
CEO tenure	0.001	(0.41)	-0.000	(-0.09)	0.001	(0.37)
Tenure	-0.013	(-0.57)	-0.029	(-1.33)	0.016	(0.52)
Big four auditor	0.001	(0.04)	0.003	(0.15)	-0.002	(-0.05)
Intercept	-0.190	(-1.32)	-0.261**	(-1.97)	0.070	(0.36)
Observations	1,810		2,771			
Adjusted R <sup>2</sup>	0.08		0.04			

**Panel B: Earnings Response Coefficient**

UE x Accounting expert x After	-0.080*	(-1.94)	-0.026	(-0.75)	-0.041	(-0.75)
UE x Accounting expert	0.030	(0.69)	0.059**	(2.47)	0.034	(0.67)
UE x Strong governance	0.022	(0.50)	-0.006	(-0.31)	0.038*	(1.65)
UE x After	0.022	(0.71)	0.004	(0.21)	0.001	(0.018)
Accounting expert	-0.001	(-0.96)	-0.000	(-0.11)	0.001	(0.44)
Strong governance	-0.000	(-0.25)	0.003*	(1.77)	0.004*	(1.80)
After	-0.006**	(-2.20)	-0.003	(-0.82)	0.003	(0.75)
UE	-0.662***	(-4.35)	-0.325***	(-3.62)	0.298*	(1.75)
UE x Market value	0.031***	(3.22)	0.021**	(1.97)	-0.011	(-0.74)
UE x Analyst following	-0.002	(-0.092)	-0.011	(-0.80)	-0.009	(-0.34)
UE x Leverage	0.220**	(2.26)	-0.017	(-0.28)	-0.219**	(-1.98)
UE x Beta	0.002	(0.12)	-0.029**	(-2.31)	-0.033*	(-1.73)
UE x Loss	0.091***	(3.08)	0.137***	(4.30)	0.041	(0.94)
UE x Earnings persistence	-0.002	(-0.40)	-0.001	(-1.18)	0.001	(0.22)
UE x Book to market ratio	0.039*	(1.83)	0.029*	(1.78)	-0.010	(-0.38)
UE x Top 5 ownership	0.183	(0.85)	0.164*	(1.68)	-0.026	(-0.12)
UE x CEO Tenure	0.000	(0.060)	-0.001	(-0.77)	-0.001	(-0.60)
Intercept	0.000	(0.07)	0.007***	(2.64)	-0.007	(-1.59)
Observations	10,171		6,380			
Adjusted R <sup>2</sup>	0.04		0.03			

**Panel C: Accruals Quality**

Accounting expert x After	-0.005	(-1.02)	0.003	(0.95)	-0.008	(-1.38)
Accounting expert	-0.004*	(-1.65)	0.000	(0.11)	-0.005	(-1.32)
Strong governance	0.002	(0.86)	-0.002	(-1.12)	0.004	(1.38)
After	0.004	(1.02)	0.006	(1.49)	-0.002	(-0.33)
Log of assets	0.002**	(2.06)	0.002***	(3.63)	-0.001	(-0.60)
Operating cycle	-0.003	(-0.95)	-0.000	(-0.25)	-0.002	(-0.69)
PPE	0.032***	(4.92)	0.025***	(5.62)	0.007	(0.95)
$\sigma$ Sales	-0.003	(-0.58)	-0.008*	(-1.86)	0.005	(0.69)
$\sigma$ Cash flow	-0.153***	(-3.42)	-0.191***	(-4.57)	0.038	(0.62)
Loss proportion	-0.008	(-1.54)	-0.015***	(-2.83)	0.007	(0.93)
Sales growth	0.000	(0.90)	0.001**	(2.05)	-0.000	(-0.85)



**Table 7. (continued).**

Variable	(1)		(2)		(3)	
	<i>Prior Expert</i>		<i>No Prior Expert</i>		<i>Difference</i>	<i>t-stat</i>
	Coeff.	<i>t-stat</i>	Coeff.	<i>t-stat</i>		
High litigation industry	0.007***	(2.94)	-0.000	(-0.06)	0.007**	(2.22)
Top 5 ownership	-0.021	(-1.03)	0.003	(0.24)	-0.024	(-1.00)
CEO tenure	0.001**	(2.59)	0.000**	(1.97)	0.000	(1.12)
Big four auditor	-0.012***	(-2.64)	0.012	(1.40)	-0.024**	(-2.46)
Intercept	-0.027	(-1.49)	-0.060***	(-3.67)	0.033	(1.37)
Observations	528		826			
Adjusted R <sup>2</sup>	0.19		0.22			

This table presents estimates and the associated *t*-statistics from a set of OLS regressions in tests of Hypothesis 3, where the dependent variable is one of three measures of financial reporting quality. Column (1) is for firms with prior accounting expertise, column (2) is for firms appointing their first accounting expert to the audit committee, and column (3) summarizes the difference between columns (1) and (2) based on the coefficients for each independent variable interacted with prior accounting expertise in a pooled regression combining the two subsamples.

**Panel A** uses signed discretionary accruals obtained using the modified Jones model in line with Equation (2). **Panel B** uses the 3-day cumulative abnormal return surrounding quarterly earnings announcements in line with Equation (3). Industry fixed effects interacted with unexpected earnings are included but not reported. **Panel C** uses the modified Dechow and Dichev (2002) accrual quality measure calculated on a rolling basis over the prior four years, multiplied by -1 in line with Equation (5). Year fixed-effects are included but not reported in all regressions, and continuous variables are Winsorized at the 1% and 99% levels. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Standard errors are adjusted for clustering within firms (Rogers 1993). Variable descriptions are provided in Table 2.

Table 8 presents the results from tests of Hypothesis 3 that consider the strength of the firm's corporate governance structure when assessing the incremental influence of prior accounting expertise on future financial reporting quality. The evidence in Panel A suggests that firms with strong corporate governance transition to more conservative accruals following the appointment of their first accounting expert, as illustrated by the significantly negative coefficients on *AE \* After* (*t*-statistic = -2.11) in Column (1), and *AE \* SGov \* After* (*t*-statistic = -2.28) in Column (3). However, the coefficients on the post-appointment interaction terms are not significant in Panel B when the dependent variable is the earnings response coefficient, suggesting no combined effect for governance strength and prior accounting expertise. Finally, Panel C provides limited evidence of an increase in accruals quality following the appointment first accounting

expert to the audit committee of a firm with strong governance, with a marginally positive coefficient on  $AE * SGov * After$  ( $t$ -statistic = 1.65) in Column (3) when there is no prior accounting expertise. As a result, Table 8 provides limited support for the conclusion that financial reporting quality increases when firms appoint their first accounting expert, but only when there is a strong corporate governance structure in place.

**Table 8.** Combined Effects of Governance Strength and Prior Accounting Expertise

	<i>Strong governance</i>		<i>Prior accounting expert</i>	
	<i>Yes</i>	<i>No</i>	<i>No</i>	<i>Yes</i>
Accounting expert x After	-0.097** (-2.11)	0.082 (1.30)	0.078 (1.28)	0.052 (0.76)
Accounting expert x After x SGov			-0.166** (-2.28)	-0.053 (-0.64)
Accounting expert x SGov			0.015 (0.36)	0.094 (1.56)
SGov x After			0.070 (1.47)	0.066 (0.99)
SGov			0.003 (0.14)	-0.046 (-0.92)
Accounting expert x After PriorAE	0.096 (1.37)	-0.039 (-0.40)		
Accounting Expert x PriorAE	0.011 (0.32)	-0.065 (-0.98)		
PriorAE x After	-0.049 (-0.93)	-0.021 (-0.33)		
PriorAE	0.018 (0.73)	0.054 (1.04)		
Accounting expert	-0.012 (-0.46)	-0.034 (-1.01)	-0.032 (-0.99)	-0.097* (-1.76)
After	0.083 (1.01)	0.182** (2.15)	0.121 (1.54)	-0.008 (-0.082)
Log of market value	0.006 (0.83)	0.031*** (2.84)	0.015** (2.03)	0.016* (1.74)
Leverage ratio	0.002 (0.036)	0.076 (0.83)	0.026 (0.35)	0.027 (0.39)
Operating cycle	0.053*** (4.27)	0.013 (1.07)	0.028*** (2.83)	0.050*** (3.31)
Inventory cycle	0.081 (0.29)	-0.779** (-2.16)	-0.019 (-0.058)	-0.367 (-1.16)
σReturns	-0.513 (-0.77)	4.619** (2.24)	2.047* (1.76)	-0.519 (-0.60)

**Table 8. (continued).**

	<i>Strong governance</i>		<i>Prior accounting expert</i>	
	<i>Yes</i>	<i>No</i>	<i>No</i>	<i>Yes</i>
Return on assets <sub>t-1</sub>	0.168 (1.05)	0.273 (1.56)	0.166 (0.91)	0.259** (2.00)
Operating cash flow	-0.454*** (-3.30)	-0.477*** (-3.36)	-0.477*** (-3.25)	-0.506*** (-3.90)
Loss in current year	-0.035 (-1.30)	-0.099** (-1.99)	-0.100** (-2.39)	-0.019 (-0.62)
Book to market ratio	-0.085*** (-3.24)	0.047 (0.37)	-0.002 (-0.031)	-0.097*** (-3.04)
Firm age	-0.000 (-0.48)	-0.001 (-0.65)	-0.000 (-0.22)	-0.001 (-1.25)
High litigation industry	0.044** (2.00)	0.048 (1.39)	0.042 (1.56)	0.056** (2.13)
Top 5 ownership	-0.130* (-1.71)	0.167 (1.46)	0.024 (0.26)	-0.152* (-1.65)
CEO tenure	0.001 (0.96)	-0.001 (-0.59)	0.000 (0.024)	0.001 (0.44)
Tenure	-0.007 (-0.29)	-0.033 (-1.62)	-0.029 (-1.34)	-0.012 (-0.56)
Big four auditor	0.006 (0.23)	-0.015 (-0.49)	-0.002 (-0.075)	-0.003 (-0.10)
Intercept	-0.182* (-1.71)	-0.382* (-1.83)	-0.244* (-1.84)	-0.145 (-1.00)
Observations	2,687	1,894	2,771	1,810
Adjusted R <sup>2</sup>	0.07	0.04	0.04	0.08

***Panel B: Earnings Response Coefficient***

UE x Accounting expert x After	-0.004 (-0.09)	-0.082* (-1.87)	-0.094** (-2.11)	-0.169*** (-2.83)
UE x Accounting expert x After x SGov			0.068 (1.10)	0.229*** (3.09)
UE x Accounting expert x SGov			0.017 (0.39)	0.014 (0.21)
UE x SGov x After			-0.070 (-1.52)	-0.063* (-1.79)
Accounting Expert x SGov			0.002 (0.84)	0.004 (1.01)
SGov x After			-0.003 (-0.90)	-0.002 (-0.50)
UE x Accounting expert x After x PriorAE	0.149* (1.86)	-0.017 (-0.21)		
UE x Accounting expert x PriorAE	0.053 (0.86)	-0.018 (-0.24)		
UE x PriorAE x After	-0.064 (-1.24)	-0.025 (-0.65)		
Accounting Expert x PriorAE	0.001 (0.42)	-0.000 (-0.00)		
PriorAE x After	0.002 (0.64)	0.002 (0.55)		

**Table 8. (continued).**

	<i>Strong governance</i>		<i>Prior accounting expert</i>	
	<i>Yes</i>	<i>No</i>	<i>No</i>	<i>Yes</i>
UE x Accounting Expert	-0.007 (-0.16)	-0.001 (-0.02)	0.016 (0.40)	0.054 (0.95)
UE x After	-0.030 (-0.81)	0.061* (1.71)	0.044 (1.16)	0.044* (1.77)
Accounting Expert	-0.001 (-0.28)	-0.003 (-1.42)	-0.003 (-1.36)	-0.003 (-0.98)
After	-0.006** (-2.02)	-0.006* (-1.68)	-0.004 (-1.34)	-0.002 (-0.43)
UE	-0.594*** (-4.71)	-0.432*** (-4.88)	-0.690*** (-4.35)	-0.309*** (-3.09)
UE x Market value	0.040*** (3.40)	0.016* (1.75)	0.034*** (3.61)	0.019 (1.64)
UE x Analyst following	-0.013 (-0.57)	-0.007 (-0.45)	-0.004 (-0.18)	-0.018 (-1.25)
UE x Leverage	0.144 (1.42)	0.131** (2.24)	0.220** (2.25)	-0.012 (-0.19)
UE x Beta	0.004 (0.22)	-0.031*** (-2.61)	0.005 (0.30)	-0.031** (-2.32)
UE x Loss	0.082*** (2.99)	0.091*** (2.75)	0.089*** (3.05)	0.110*** (3.60)
UE x Earnings persistence	0.000 (0.00)	0.002* (1.67)	-0.001 (-0.29)	0.000 (0.078)
UE x Book to market ratio	0.132** (2.44)	0.013 (1.24)	0.042* (1.92)	0.041** (2.43)
UE x Top 5 ownership	0.179 (1.52)	0.011 (0.065)	0.199 (0.89)	0.143 (1.41)
UE x CEO Tenure	0.000 (0.23)	0.002 (1.18)	0.000 (0.11)	-0.001 (-0.90)
Intercept	0.005* (1.89)	0.007** (2.00)	0.007** (2.26)	-0.000 (-0.030)
Observations	9,198	7,353	10,171	6,380
Adjusted R-squared	0.03	0.04	0.04	0.03
<b><i>Panel C: Accruals Quality</i></b>				
Accounting expert x After	0.007 (1.28)	-0.003 (-0.52)	-0.003 (-0.52)	-0.009 (-1.11)
Accounting expert x After x SGov			0.011* (1.65)	0.009 (0.80)
Accounting expert x SGov			-0.005 (-0.96)	-0.002 (-0.23)
SGov x After			-0.007 (-1.29)	-0.009* (-1.71)
SGov			0.001 (0.21)	0.005 (1.40)
Accounting expert x After x PriorAE	-0.007 (-0.75)	-0.007 (-0.70)		
Accounting expert x PriorAE	-0.003 (-0.89)	-0.004 (-0.56)		

**Table 8. (continued).**

	<i>Strong governance</i>		<i>Prior accounting expert</i>	
	<i>Yes</i>	<i>No</i>	<i>No</i>	<i>Yes</i>
PriorAE x After	0.002 (0.28)	0.006 (1.12)		
PriorAE	0.004* (1.79)	-0.001 (-0.26)		
Accounting expert	-0.000 (-0.16)	0.003 (0.71)	0.004 (0.85)	-0.003 (-0.50)
After	0.001 (0.14)	0.008* (1.78)	0.009** (2.36)	0.009* (1.85)
Log of assets	0.002*** (3.42)	0.002*** (2.63)	0.002*** (3.60)	0.002** (2.11)
Operating cycle	0.000 (0.048)	-0.003 (-1.05)	-0.001 (-0.32)	-0.003 (-0.97)
PPE	0.030*** (6.92)	0.019*** (2.95)	0.024*** (5.60)	0.031*** (4.81)
$\sigma$ Sales	-0.003 (-0.74)	-0.010* (-1.74)	-0.008* (-1.92)	-0.003 (-0.56)
$\sigma$ Cash flow	-0.177*** (-4.78)	-0.157*** (-2.96)	-0.189*** (-4.56)	-0.152*** (-3.38)
Loss proportion	-0.012*** (-2.63)	-0.017*** (-2.83)	-0.015*** (-2.93)	-0.008 (-1.60)
Sales growth	0.001*** (3.37)	0.000 (0.13)	0.001** (2.02)	0.000 (0.89)
High litigation industry	0.001 (0.71)	0.003 (1.29)	-0.000 (-0.10)	0.007*** (2.90)
Top 5 ownership	0.015 (1.25)	-0.032 (-1.59)	0.003 (0.22)	-0.018 (-0.88)
CEO tenure	0.000*** (2.75)	0.000 (1.51)	0.000** (1.98)	0.001*** (2.69)
Big four auditor	0.004 (0.52)	0.002 (0.20)	0.012 (1.42)	-0.012** (-2.56)
Intercept	-0.061*** (-4.48)	-0.034 (-1.53)	-0.061*** (-3.72)	-0.029 (-1.57)
Observations	840	514	826	528
Adjusted R-squared	0.21	0.17	0.21	0.19

This table presents estimates and the associated *t*-statistics from OLS regressions that evaluate the impact of governance strength and prior accounting expertise simultaneously. The dependent variable is one of three measures of financial reporting quality. Columns (1) and (2) are for the strong versus weak governance subsamples, and columns (3) and (4) are for no prior versus prior accounting expertise subsamples. **Panel A** uses signed discretionary accruals obtained using the modified Jones model in line with Equation (2). **Panel B** uses the 3-day cumulative abnormal return surrounding quarterly earnings announcements in line with Equation (3). Industry fixed effects interacted with unexpected earnings are included but not reported. **Panel C** uses the modified Dechow and Dichev (2002) accrual quality measure calculated on a rolling basis over the prior four years, multiplied by -1 in line with Equation (5). Year fixed-effects are included but not reported in all regressions, and all continuous variables are Winsorized at the 1% and 99% levels. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Standard errors are adjusted for clustering within firms using procedures advanced in Rogers (1993). Variable descriptions are provided in Table 2.

To summarize, the results in Table 5 provide no evidence of an average increase in financial reporting quality following the appointment of an accounting expert to the audit committee. This suggests that appointing an accounting expert, in and of itself, is not associated with discernible improvements in the financial reporting decisions made by managers. However, the evidence in Table 6 suggests that firms with strong governance experience larger increases in financial reporting quality than firms with weak governance following the appointment of an accounting expert. More specifically, I find that strong governance firms that appoint an accounting expert substitute to more income-decreasing discretionary accruals, and have larger increases in earnings response coefficients and accruals quality following the appointment than firms with weak governance structures. These results suggest that accounting expertise is most effective at improving financial reporting quality when the firm maintains a governance structure that is able to make good use of the expertise (DeFond et al. 2005).

Finally, Table 7 documents that firms appointing their first accounting expert do not experience larger improvements in financial reporting quality than firms adding to the number of accounting experts on the audit committee. However, the evidence presented in Table 8 suggests that when there is a strong governance structure in place, appointing the first accounting expert to the audit committee is associated with substitution to more conservative and higher quality accruals following the appointment. Therefore, these results suggest that a strong corporate governance structure provides a necessary condition for firms introducing accounting expertise to experience increases in financial reporting quality following the appointment.

## CHAPTER VI

## ROBUSTNESS CHECKS AND SENSITIVITY TESTS

Within Group Changes in Financial Reporting Quality

In separate analyses, I re-perform my primary tests on a restricted sample of firms only appointing accounting experts to their audit committee to investigate the within-group variation over time.<sup>17</sup> In these tests, the post-appointment variable (*After*) captures the change in financial reporting quality with respect to the pre-appointment period. Untabulated results suggest no improvement, on average, in financial reporting quality for firms that appoint an accounting expert, in line with the evidence presented in Table 4. Table 9 presents results for modified tests of Hypothesis 2 (Columns 1 through 3) and Hypothesis 3 (Columns 4 through 6) using this accounting expert sample, where the dependent variable is discretionary accruals (Panel A) and accruals quality (Panel B).

The evidence in Panel A suggests that firms with strong governance utilize more income-decreasing accruals following the appointment than firms with weak governance, as indicated by the significantly negative coefficient on *After* ( $t$ -statistic = -1.70) in Column (3). Furthermore, the results presented in Panel B indicate that firms with strong governance increase their accruals quality following the appointment, as shown by the significantly positive coefficient on *After* ( $t$ -statistic = 1.71) in Column (1). Therefore, the evidence in both panels support the findings from Table 6. Finally, in contrast to the evidence in Table 7, I find evidence that firms appointing their first accounting expert

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<sup>17</sup> Given the possibility for selection bias, I utilize the 2-step approach advanced by Heckman (1979). Details of these procedures are included in Appendix A.



improve their accruals quality following the appointment, as highlighted by the significant coefficient on *After* ( $t$ -statistic = 1.89) in Column (4) of Panel B.

**Table 9.** Restricted Sample of Firms Appointing an Accounting Expert

	<i>Strong governance</i>			<i>Prior accounting expertise</i>		
	<i>Yes</i>	<i>No</i>	<i>Diff.</i>	<i>No</i>	<i>Yes</i>	<i>Diff.</i>
<i>After</i>	0.057 (0.60)	0.358** (2.43)	-0.297* (-1.70)	0.284* (1.88)	0.071 (0.74)	-0.221 (-1.21)
<i>Strong governance</i>				-0.032 (-1.03)	0.063** (2.17)	0.063** (2.18)
<i>Prior accounting expertise</i>	0.042 (0.91)	-0.277** (-2.00)	0.319* (1.91)			
<i>Log of market value</i>	0.021 (1.52)	-0.009 (-0.46)	-0.003 (-0.14)	0.013 (0.96)	0.002 (0.14)	-0.011 (-0.54)
<i>Leverage ratio</i>	-0.162* (-1.87)	0.334* (1.84)	-0.476** (-2.45)	-0.017 (-0.15)	0.028 (0.38)	0.051 (0.37)
<i>Operating cycle</i>	0.025** (2.01)	0.054* (1.80)	-0.013 (-0.48)	0.044** (2.27)	0.030 (1.48)	-0.013 (-0.46)
<i>Inventory' cycle</i>	0.293 (0.78)	-0.735 (-1.53)	0.958 (1.54)	0.191 (0.40)	-0.254 (-0.55)	-0.480 (-0.71)
$\sigma$ Returns	1.129 (1.22)	8.777** (2.31)	-6.849* (-1.88)	3.580* (1.96)	2.224 (1.40)	-1.380 (-0.57)
<i>Return on assets<sub>t-1</sub></i>	0.013 (0.072)	0.264 (0.93)	-0.382 (-1.04)	0.034 (0.14)	0.155 (0.83)	0.114 (0.38)
<i>Operating cash flow</i>	-0.449** (-2.35)	-0.289 (-1.52)	-0.197 (-0.72)	-0.406** (-2.11)	-0.523*** (-3.22)	-0.123 (-0.49)
<i>Loss in current year</i>	-0.114*** (-3.87)	-0.187** (-2.19)	0.072 (0.79)	-0.181*** (-2.81)	-0.090** (-2.39)	0.089 (1.21)
<i>Book to market ratio</i>	-0.039 (-0.93)	0.188 (0.67)	-0.263 (-0.88)	0.092 (0.65)	-0.123*** (-2.67)	-0.217 (-1.44)
<i>Firm age</i>	-0.001 (-0.53)	-0.003 (-1.21)	-0.000 (-0.14)	-0.002 (-0.89)	-0.002 (-1.61)	-0.001 (-0.32)
<i>High litigation industry</i>	0.034 (1.33)	0.081 (1.09)	-0.034 (-0.47)	0.061 (1.37)	0.041 (1.49)	-0.020 (-0.38)
<i>Top 5 ownership</i>	-0.099 (-0.67)	-0.139 (-0.58)	-0.209 (-0.91)	-0.156 (-0.85)	-0.056 (-0.27)	0.084 (0.31)
<i>CEO tenure</i>	0.001 (1.08)	-0.002 (-0.72)	0.004 (1.21)	-0.000 (-0.17)	-0.000 (-0.068)	0.000 (0.12)
<i>Tenure</i>	-0.011 (-0.41)	-0.052* (-1.91)	0.039 (1.08)	-0.063* (-1.87)	0.004 (0.20)	0.066* (1.65)
<i>Big four auditor</i>	-0.007 (-0.20)	0.128 (1.31)	-0.016 (-0.24)	0.061 (1.11)	0.052 (0.89)	-0.012 (-0.15)
<i>Lambda</i>	0.044 (0.25)	1.015* (1.90)	0.029 (0.13)	0.421 (1.59)	0.278 (1.29)	-0.166 (-0.47)
<i>Constant</i>	-0.257* (-1.77)	-1.453* (-1.94)	0.498 (1.08)	-0.771** (-2.10)	-0.439* (-1.72)	0.378 (0.80)
<i>Observations</i>	1,181	801		1,308	674	
<i>Adjusted R-squared</i>	0.06	0.04		0.03	0.07	



**Table 9. (continued).**

	<i>Strong governance</i>			<i>Prior accounting expertise</i>		
	<i>Yes</i>	<i>No</i>	<i>Yes</i>	<i>No</i>		
After	0.008*	0.007	-0.001	0.009*	-0.002	0.011
	(1.71)	(0.88)	(0.75)	(1.89)	(-0.34)	(1.42)
Strong governance				0.001	-0.004	0.003
				(0.47)	(-0.74)	(1.09)
Prior accounting expertise	-0.007*	-0.008	0.001			
	(-1.65)	(-1.06)	(1.24)			
Log of assets	0.000	0.002	0.001	0.001	0.001	0.000
	(0.27)	(0.98)	(1.12)	(0.93)	(0.28)	(0.20)
Operating cycle	-0.001	-0.000	-0.001	-0.003	0.001	-0.004
	(-0.34)	(-0.13)	(-0.29)	(-1.24)	(0.23)	(-0.38)
PPE	0.023***	0.023**	0.000	0.019***	0.033**	-0.008
	(3.17)	(2.13)	(0.91)	(3.15)	(2.48)	(-0.95)
σSales	-0.001	-0.008	-0.005	-0.003	-0.008	0.006
	(-0.17)	(-0.98)	(-0.70)	(-0.48)	(-0.93)	(0.82)
σCash flow	-0.159***	-0.081	0.028	-0.171***	-0.122*	-0.037
	(-3.07)	(-1.07)	(0.44)	(-2.91)	(-1.89)	(-0.61)
Loss proportion	-0.008	-0.022*	-0.009	-0.017**	-0.005	-0.007
	(-1.13)	(-1.76)	(-1.13)	(-2.08)	(-0.46)	(-0.96)
Sales growth	0.001***	-0.001	-0.001	0.000	0.000	0.000
	(3.52)	(-1.14)	(-1.61)	(0.68)	(0.56)	(0.83)
High litigation industry	-0.001	0.003	0.001	-0.001	0.004	-0.007**
	(-0.50)	(0.68)	(0.44)	(-0.34)	(0.81)	(-2.26)
Top 5 ownership	0.012	-0.039	-0.041*	-0.012	-0.045	0.025
	(0.47)	(-1.16)	(-1.78)	(-0.45)	(-1.08)	(1.11)
CEO tenure	0.000	0.000	0.000	0.000	0.001	-0.000
	(0.64)	(0.063)	(0.72)	(0.021)	(1.13)	(-1.05)
Big 4 auditor	0.023***	-0.002	0.004	0.019**	-0.007	0.023**
	(2.88)	(-0.25)	(0.33)	(2.15)	(-0.90)	(2.26)
Lambda	0.031*	0.019	0.029**	0.011	0.033	-0.022
	(1.75)	(0.71)	(2.16)	(0.60)	(0.97)	(0.05)
Constant	-0.080***	-0.058**	0.022	-0.050**	-0.075**	0.025
	(-3.53)	(-2.04)	(1.17)	(-2.26)	(-2.09)	(0.78)
Observations	382	226		404	204	
Adjusted R-squared	0.21	0.13		0.20	0.13	

This table presents results for alternative tests of Hypotheses 2 and 3 on a restricted sample of firms that appointed an accounting expert to their audit committee. See Tables 5 and 6 for equation details. Columns (1) through (3) present results segregated by governance strength, while Columns (4) through (6) presents results segregated by prior accounting expertise. **Panel A** uses signed discretionary accruals obtained using the modified Jones model in line with Equation (2). **Panel B** uses the modified Dechow and Dichev (2002) accrual quality measure calculated on a rolling basis over the prior four years, multiplied by -1 in line with Equation (5). Year fixed-effects are included but not reported in all regressions, and all continuous variables are Winsorized at the 1% and 99% levels. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Standard errors are adjusted for clustering within firms using procedures advanced in Rogers (1993). Variable descriptions are provided in Table 2.

### Separate Analysis of Governance Measure Components

My tests of Hypothesis 2 rely on a composite governance measure that combines several aspects of a firm's governance structure including board and audit committee characteristics, as well as the fraction of institutional ownership. To identify the specific governance components associated with changes in financial reporting quality following the appointment of an accounting expert, I evaluate each of the five components of my governance proxy (*SGov*) on an individual basis while re-performing tests of Hypothesis 2. Table 10 presents the results of this analysis. The evidence suggests that improvements in financial reporting quality following the appointment of an accounting expert are concentrated in firms with a large number of board members holding multiple outside directorships in terms of both discretionary accruals (Panel A) and accruals quality (Panel B), as highlighted by the significant coefficients on *AE x After* in Column (6) of each panel (*t*-statistics = -2.22 and 3.05, respectively). One interpretation of these results is that these directors with multiple board appointments have more reputation capital at stake, and are therefore more likely to act on recommendations made by accounting experts to limit the likelihood of financial reporting failures such as an accounting restatement. Alternatively, a second possibility is that multiple directorships are a sign of high ability (Kaplan and Reishus 1990).

**Table 10.** Analysis of Individual Components of Corporate Governance Proxy

	<i>Panel A: Discretionary Accruals</i>							
	(1)	(2)		(3)	(4)		(5)	(6)
		<i>Optimal board size</i>			<i>Board experience</i>			
	<i>Yes</i>	<i>No</i>	<i>Diff</i>	<i>High</i>	<i>Low</i>	<i>Diff</i>		
Accounting expert x After	0.029 (0.59)	-0.016 (-0.44)	0.045 (0.74)	-0.053* (-1.65)	0.094 (1.62)	-0.147** (-2.22)		
Accounting expert	-0.016 (-0.63)	-0.038* (-1.87)	0.022 (0.66)	-0.006 (-0.31)	-0.049* (-1.91)	0.043 (1.35)		
Prior accounting expertise	0.031 (0.65)	-0.018 (-0.50)	0.049 (0.81)	0.022 (1.29)	-0.010 (-0.37)	0.032 (1.00)		
After	0.085 (0.98)	0.124* (1.66)	-0.038 (-0.34)	0.129* (1.93)	0.051 (0.50)	0.078 (0.64)		
Log of market value	0.022** (1.97)	0.006 (0.61)	0.016 (1.04)	0.010 (1.52)	0.022* (1.78)	-0.012 (-0.86)		
Leverage ratio	0.018 (0.24)	0.057 (0.72)	-0.038 (-0.35)	-0.035 (-0.50)	0.080 (0.93)	-0.114 (-1.04)		
Operating cycle	0.038*** (3.01)	0.045*** (3.50)	-0.008 (-0.42)	0.040*** (3.23)	0.033*** (2.80)	0.007 (0.42)		
Inventory cycle	0.102 (0.31)	-0.751** (-1.98)	0.853* (1.67)	0.046 (0.15)	-0.222 (-0.63)	0.268 (0.57)		
σReturns	0.588 (0.43)	1.601 (1.53)	-1.012 (-0.58)	0.530 (0.61)	1.378 (0.98)	-0.848 (-0.51)		
Return on assets <sub>t-1</sub>	0.185 (1.21)	0.205 (1.37)	-0.020 (-0.093)	0.055 (0.38)	0.357* (1.94)	-0.302 (-1.31)		
Operating cash flow	-0.57*** (-4.68)	-0.302* (-1.68)	-0.266 (-1.24)	-0.47*** (-3.71)	-0.54*** (-3.47)	0.067 (0.34)		
Loss in current year	-0.078 (-1.64)	-0.066** (-2.32)	-0.012 (-0.22)	-0.039 (-1.55)	-0.097* (-1.75)	0.058 (0.96)		
Book to market ratio	0.002 (0.022)	-0.054** (-2.06)	0.056 (0.58)	-0.08*** (-3.15)	0.032 (0.29)	-0.119 (-1.04)		
Firm age	-0.002 (-1.44)	0.000 (0.41)	-0.002 (-1.37)	0.000 (0.35)	-0.002** (-2.36)	0.002** (2.18)		
High litigation industry	0.017 (0.62)	0.079*** (2.72)	-0.063 (-1.56)	0.061*** (2.65)	0.026 (0.79)	0.035 (0.87)		
Top 5 ownership	-0.028 (-0.26)	-0.014 (-0.12)	-0.014 (-0.087)	-0.061 (-0.63)	-0.006 (-0.057)	-0.056 (-0.41)		
CEO tenure	-0.000 (-0.016)	0.000 (0.13)	-0.000 (-0.094)	0.002 (1.46)	-0.002 (-1.12)	0.003* (1.79)		
Tenure	-0.024 (-1.02)	-0.021 (-1.09)	-0.003 (-0.11)	-0.023 (-1.26)	-0.021 (-0.74)	-0.002 (-0.059)		
Big four auditor	-0.019 (-0.54)	0.032 (0.91)	-0.051 (-1.01)	-0.023 (-0.83)	0.001 (0.037)	-0.023 (-0.69)		
Constant	-0.096 (-0.41)	-0.428** (-2.25)	0.332 (1.10)	-0.323** (-2.16)	-0.148 (-0.52)	0.041 (0.19)		
Observations	2,344	2,162		2,848	1,733			
Adjusted R-squared	0.05	0.06		0.06	0.04			

**Table 10. (continued).**

	(7)	(8)	(9)	(10)	(11)	(12)
	<i>Audit committee influence</i>			<i>Independent audit committee</i>		
	<i>High</i>	<i>Low</i>	<i>Diff</i>	<i>Yes</i>	<i>No</i>	<i>Diff</i>
Accounting expert x After	-0.022 (-0.67)	0.037 (0.69)	-0.059 (-0.94)	0.010 (0.28)	0.011 (0.23)	-0.001 (-0.019)
Accounting expert	-0.011 (-0.51)	-0.037 (-1.56)	0.025 (0.78)	-0.038* (-1.85)	0.005 (0.25)	-0.043 (-1.54)
Prior accounting expertise	0.030 (0.90)	-0.038 (-0.67)	0.067 (1.04)	0.004 (0.12)	-0.020 (-0.48)	0.024 (0.44)
After	-0.003 (-0.052)	0.235** (2.31)	-0.238** (-1.98)	0.079 (1.14)	0.167* (1.80)	-0.088 (-0.77)
Log of market value	0.020* (1.74)	0.008 (0.87)	0.012 (0.85)	0.011 (1.24)	0.021 (1.55)	-0.011 (-0.64)
Leverage ratio	0.033 (0.46)	-0.005 (-0.057)	0.037 (0.34)	0.046 (0.68)	-0.051 (-0.86)	0.097 (1.07)
Operating cycle	0.039*** (2.96)	0.049*** (3.74)	-0.009 (-0.49)	0.046*** (3.81)	0.042*** (3.36)	0.005 (0.28)
Inventory cycle	-0.324 (-1.10)	0.066 (0.15)	-0.390 (-0.73)	-0.286 (-0.98)	-0.291 (-0.84)	0.005 (0.012)
$\sigma$ Returns	-0.088 (-0.12)	2.242 (1.32)	-2.330 (-1.26)	1.035 (1.01)	-0.679 (-0.92)	1.714 (1.39)
Return on assets <sub>t-1</sub>	0.205 (1.34)	0.183 (1.09)	0.022 (0.097)	0.278** (2.04)	-0.107 (-0.62)	0.385* (1.75)
Operating cash flow	-0.49*** (-3.37)	-0.438*** (-3.18)	-0.056 (-0.28)	-0.54*** (-4.35)	-0.188 (-1.32)	-0.353* (-1.85)
Loss in current year	-0.036 (-1.29)	-0.109** (-2.16)	0.073 (1.26)	-0.088** (-2.49)	-0.003 (-0.074)	-0.086* (-1.74)
Book to market ratio	-0.08*** (-2.62)	0.052 (0.45)	-0.130 (-1.10)	-0.026 (-0.38)	-0.049 (-1.37)	0.023 (0.29)
Firm age	0.001 (0.76)	-0.002* (-1.84)	0.003* (1.95)	-0.001 (-0.60)	-0.001 (-1.43)	0.001 (0.63)
High litigation industry	0.035 (1.37)	0.064* (1.96)	-0.029 (-0.70)	0.061** (2.39)	0.016 (0.66)	0.045 (1.32)
Top 5 ownership	-0.010 (-0.11)	-0.048 (-0.39)	0.038 (0.24)	-0.030 (-0.31)	-0.079 (-0.68)	0.050 (0.34)
CEO tenure	-0.000 (-0.17)	0.000 (0.16)	-0.000 (-0.22)	-0.000 (-0.39)	0.001 (1.22)	-0.002 (-1.16)
Tenure	0.003 (0.15)	-0.053** (-2.29)	0.056* (1.82)	-0.017 (-0.97)	-0.044 (-1.44)	0.028 (0.78)
Big four auditor	-0.044 (-1.50)	0.032 (0.69)	-0.076 (-1.37)	0.004 (0.16)	-0.014 (-0.33)	0.019 (0.36)
Constant	-0.127 (-0.88)	-0.480 (-1.63)	0.353 (1.08)	-0.259 (-1.34)	-0.309** (-2.49)	0.050 (0.22)
Observations	2,609	1,897		3,405	1,101	
Adjusted R-squared	0.05	0.07		0.06	0.05	

**Table 10. (continued).**

	(13)	(14)	(15)
	<i>Institutional holdings</i>		
	<i>High</i>	<i>Low</i>	<i>Difference</i>
Accounting expert x After	-0.002 (-0.045)	0.007 (0.20)	-0.009 (-0.16)
Accounting expert	-0.025 (-1.03)	-0.021 (-1.00)	-0.004 (-0.14)
Prior accounting expertise	-0.025 (-0.56)	0.025 (0.64)	-0.050 (-0.85)
After	0.125 (1.14)	0.099 (1.33)	0.026 (0.20)
Log of market value	0.014 (1.49)	0.016 (1.38)	-0.003 (-0.19)
Leverage ratio	0.021 (0.26)	0.020 (0.25)	0.001 (0.0063)
Operating cycle	0.040*** (3.51)	0.044*** (2.98)	-0.004 (-0.19)
Inventory cycle	0.273 (0.84)	-0.996*** (-2.96)	1.269*** (2.69)
$\sigma$ Returns	0.322 (0.20)	1.722* (1.86)	-1.400 (-0.74)
Return on assets <sub>t-1</sub>	0.144 (0.79)	0.238* (1.67)	-0.094 (-0.41)
Operating cash flow	-0.549*** (-4.04)	-0.425*** (-2.73)	-0.124 (-0.60)
Loss in current year	-0.100** (-2.18)	-0.040 (-1.40)	-0.061 (-1.11)
Book to market ratio	0.043 (0.38)	-0.082*** (-2.87)	0.125 (1.07)
Firm age	-0.002 (-1.61)	0.000 (0.44)	-0.002 (-1.55)
High litigation industry	0.060** (2.29)	0.031 (1.00)	0.029 (0.72)
Top 5 ownership	-0.289** (-2.05)	0.097 (1.10)	-0.386** (-2.35)
CEO tenure	-0.001 (-0.71)	0.001 (1.16)	-0.002 (-1.19)
Tenure	-0.026 (-0.99)	-0.023 (-1.02)	-0.004 (-0.11)
Big four auditor	0.013 (0.36)	-0.013 (-0.40)	0.027 (0.54)
Constant	-0.274 (-1.05)	-0.282 (-1.57)	0.008 (0.027)
Observations	2,239	2,267	
Adjusted R-squared	0.05	0.06	

**Table 10. (continued).**

<i>Panel B: Accruals Quality</i>						
	(1)	(2)	(3)	(4)	(5)	(6)
	<i>Optimal board size</i>			<i>Board experience</i>		
	<i>Yes</i>	<i>No</i>	<i>Diff</i>	<i>High</i>	<i>Low</i>	<i>Diff</i>
Accounting expert x After	-0.005 (-1.17)	0.007** (1.97)	-0.012** (-2.15)	0.007** (2.02)	-0.011** (-2.31)	0.018*** (3.05)
Accounting expert	0.001 (0.26)	-0.003 (-1.30)	0.004 (1.05)	-0.002 (-0.92)	-0.001 (-0.18)	-0.001 (-0.39)
Prior accounting expertise	-0.004 (-1.11)	-0.003 (-0.79)	-0.001 (-0.28)	0.001 (0.40)	0.001 (0.61)	-0.001 (-0.24)
After	0.010*** (2.59)	-0.002 (-0.42)	0.011** (2.16)	0.002 (0.63)	0.01*** (2.81)	-0.009* (-1.77)
Log of assets	0.001 (1.17)	0.001 (1.23)	0.000 (0.17)	0.002*** (2.79)	0.003** (2.52)	-0.001 (-0.67)
Operating cycle	-0.001 (-0.64)	-0.000 (-0.025)	-0.001 (-0.37)	0.000 (0.25)	-0.003 (-1.09)	0.004 (1.07)
PPE	0.024*** (4.87)	0.027*** (4.69)	-0.003 (-0.40)	0.029*** (5.75)	0.02*** (3.79)	0.006 (0.72)
$\sigma$ Sales	-0.005 (-1.03)	-0.009* (-1.94)	0.005 (0.73)	-0.005 (-1.22)	-0.007 (-1.42)	0.002 (0.27)
$\sigma$ Cash flow	-0.172*** (-4.41)	-0.157*** (-2.77)	-0.016 (-0.23)	-0.166*** (-4.04)	-0.18*** (-3.82)	0.017 (0.27)
Loss proportion	-0.008* (-1.66)	-0.015** (-2.41)	0.006 (0.79)	-0.015*** (-3.09)	-0.010* (-1.70)	-0.005 (-0.62)
Sales growth	0.001 (1.64)	0.001 (1.62)	-0.000 (-0.41)	0.001* (1.88)	0.001 (1.33)	-0.000 (-0.028)
High litigation industry	0.003 (1.33)	0.003 (1.19)	0.000 (0.034)	0.002 (1.10)	0.003 (1.24)	-0.001 (-0.29)
Top 5 ownership	-0.008 (-0.58)	0.000 (0.021)	-0.008 (-0.39)	-0.008 (-0.57)	-0.000 (-0.024)	-0.007 (-0.35)
CEO tenure	0.000*** (2.60)	0.000 (1.22)	0.000 (1.05)	0.000*** (3.56)	0.000 (1.26)	0.000 (0.79)
Big 4 auditor	0.006 (0.88)	0.007 (0.56)	-0.001 (-0.059)	0.005 (0.54)	0.002 (0.27)	0.003 (0.22)
Constant	-0.075*** (-4.69)	-0.053** (-2.26)	-0.021 (-0.76)	-0.067*** (-4.30)	-0.06*** (-2.79)	-0.015 (-0.55)
Observations	692	638		825	505	
Adjusted R-squared	0.17	0.15		0.18	0.19	



**Table 10. (continued).**

	(7)	(8)	(9)	(10)	(11)	(12)
	<i>Audit committee influence</i>			<i>Independent audit committee</i>		
	<i>High</i>	<i>Low</i>	<i>Diff</i>	<i>Yes</i>	<i>No</i>	<i>Diff</i>
Accounting expert x After	0.002 (0.61)	-0.000 (-0.056)	0.003 (0.47)	0.003 (0.89)	-0.004 (-0.60)	0.006 (0.95)
Accounting expert	-0.002 (-0.89)	-0.001 (-0.24)	-0.002 (-0.47)	-0.002 (-1.15)	0.000 (0.13)	-0.003 (-0.67)
Prior accounting expertise	0.001 (0.22)	-0.008** (-2.47)	0.009* (1.89)	-0.003 (-1.26)	-0.007 (-1.16)	0.004 (0.57)
After	0.005 (1.38)	0.003 (0.76)	0.003 (0.55)	0.002 (0.68)	0.009** (2.16)	-0.007 (-1.33)
Log of assets	0.002* (1.79)	0.000 (0.54)	0.001 (1.02)	0.001 (1.39)	0.002 (1.16)	-0.001 (-0.41)
Operating cycle	-0.002 (-0.93)	-0.000 (-0.0051)	-0.002 (-0.59)	-0.001 (-0.68)	0.000 (0.049)	-0.001 (-0.42)
PPE	0.029*** (6.26)	0.019*** (3.23)	0.010 (1.35)	0.023*** (4.87)	0.031*** (5.11)	-0.008 (-1.06)
σSales	-0.006 (-1.33)	-0.007* (-1.71)	0.001 (0.20)	-0.008** (-2.04)	-0.006 (-0.95)	-0.002 (-0.32)
σCash flow	-0.172*** (-4.03)	-0.168*** (-3.74)	-0.004 (-0.068)	-0.184*** (-5.28)	-0.118** (-2.07)	-0.066 (-1.02)
Loss proportion	-0.005 (-0.94)	-0.018*** (-3.56)	0.013* (1.72)	-0.015*** (-3.40)	0.005 (0.57)	-0.020** (-2.04)
Sales growth	0.001** (2.42)	0.000 (0.55)	0.001 (1.23)	0.001** (2.08)	0.001* (1.82)	-0.000 (-0.61)
High litigation industry	0.000 (0.085)	0.005** (2.56)	-0.005 (-1.48)	0.002 (1.37)	0.004 (1.19)	-0.002 (-0.49)
Top 5 ownership	0.012 (0.68)	-0.026** (-2.05)	0.038* (1.76)	0.010 (0.90)	-0.041 (-1.47)	0.051* (1.71)
CEO tenure	0.000** (2.19)	0.000* (1.94)	0.000 (0.66)	0.000*** (3.11)	0.000 (1.22)	0.000 (0.021)
Big 4 auditor	0.005 (0.63)	0.008 (0.69)	-0.003 (-0.24)	0.003 (0.65)	0.025 (0.99)	-0.022 (-0.87)
Constant	-0.058*** (-3.48)	-0.066*** (-2.74)	0.008 (0.29)	-0.059*** (-4.42)	-0.01*** (-2.73)	0.041 (1.08)
Observations	728	602		1,031	299	
Adjusted R-squared	0.18	0.21		0.21	0.14	

**Table 10. (continued).**

	(13)	(14)	(15)
		<i>Institutional holdings</i>	
	<i>High</i>	<i>Low</i>	<i>Difference</i>
<b>Accounting expert x After</b>	-0.001 (-0.24)	0.004 (0.97)	-0.005 (-0.85)
Accounting expert	-0.001 (-0.23)	-0.002 (-0.83)	0.002 (0.45)
Prior accounting expertise	-0.001 (-0.22)	-0.007** (-2.26)	0.007 (1.37)
After	0.007** (1.99)	0.001 (0.33)	0.006 (1.27)
Log of assets	0.002* (1.79)	0.000 (0.53)	0.002 (1.17)
Operating cycle	0.003 (1.26)	-0.005** (-2.19)	0.007** (2.53)
PPE	0.039*** (7.26)	0.010* (1.82)	0.029*** (3.92)
$\sigma$ Sales	-0.005 (-0.93)	-0.007 (-1.64)	0.002 (0.30)
$\sigma$ Cash flow	-0.159*** (-4.28)	-0.212*** (-3.85)	0.053 (0.79)
Loss proportion	-0.011** (-1.98)	-0.008 (-1.64)	-0.002 (-0.31)
Sales growth	0.000 (1.38)	0.001** (2.40)	-0.000 (-0.83)
High litigation industry	0.004 (1.58)	0.002 (0.99)	0.001 (0.36)
Top 5 ownership	0.002 (0.10)	-0.001 (-0.085)	0.003 (0.13)
CEO tenure	0.001*** (2.85)	0.000 (1.11)	0.000* (1.74)
Big 4 auditor	-0.000 (-0.026)	0.012 (1.38)	-0.013 (-1.10)
Constant	-0.076*** (-3.94)	-0.050*** (-2.89)	-0.026 (-1.00)
Observations	711	619	
Adjusted R-squared	0.16	0.24	

This table presents results for an analysis of the separate components of my corporate governance proxy as part of robustness checks for tests of Hypothesis 2. See Tables 5 for equation details. **Panel A** uses signed discretionary accruals obtained using the modified Jones model in line with Equation (2). **Panel B** uses the modified Dechow and Dichev (2002) accrual quality measure calculated on a rolling basis over the prior four years, multiplied by -1 in line with Equation (5). Year fixed-effects are included but not reported in all regressions, and all continuous variables are Winsorized at the 1% and 99% levels. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Standard errors are adjusted for clustering within firms using procedures advanced in Rogers (1993). Variable descriptions are provided in Table 2.



### Alternative Definitions of Accounting Expertise

My definition of accounting expertise includes individuals with a variety of financial backgrounds, and there is the possibility that accounting experts with particular skill sets will be more effective than others at enhancing the financial reporting system following the appointment. For example, Carcello et al. (2008) note that having a CPA on the audit committee relates to fewer earnings management activities. One important distinction involves individuals with corporate financial backgrounds compared to those with public accounting experience, because the accounting expertise derives from preparation versus review of financial statements. As a result, I re-perform my tests of Hypothesis 2 defining accounting expertise based on whether or not the individual has experience in public accounting, and present the results in Table 11. This procedure highlighted that approximately 47% of the accounting experts in my sample had experience in public accounting. Panel A indicates that conclusions from Table 6 are consistent in terms of changes to more conservative accruals for firms with strong governance for both definitions of an accounting expert, as highlighted by the negative coefficients on  $AE \times After$  in Column (1) ( $t$ -statistic = -2.14) and Column (4) ( $t$ -statistic = -2.15). The results in Panel B of Table 11 suggest that firms with strong governance have larger improvements in accruals quality than firms with weak governance only when the accounting expert has a background in public accounting, as highlighted by the significant difference between  $AE \times After$  ( $t$ -statistic = 1.86) in Column (3). One interpretation of this result is that that experience reviewing financial statements is associated with audit committee members having a material impact on accruals quality.

**Table 11.** Comparison of Public Accounting to Corporate Financial Backgrounds

	<i>Public accounting background</i>			<i>Corporate financial background</i>		
	<i>SGov=1</i>	<i>SGov=0</i>	<i>Diff</i>	<i>SGov=1</i>	<i>SGov=0</i>	<i>Diff</i>
Accounting expert x After	-0.063** (-2.14)	0.011 (0.39)	-0.067* (-1.69)	-0.068** (-2.15)	0.028 (0.51)	-0.008 (-0.19)
Accounting expert	-0.012 (-0.63)	-0.005 (-0.11)	-0.005 (-0.090)	0.001 (0.084)	-0.030 (-0.64)	-0.003 (-0.073)
Prior accounting expertise	0.020 (1.10)	0.003 (0.12)	0.019 (0.61)	0.020 (1.17)	0.003 (0.10)	0.022 (0.69)
After	0.063 (0.79)	0.199** (2.13)	-0.161 (-1.31)	0.065 (0.81)	0.194** (2.25)	-0.169 (-1.41)
Log of market value	0.006 (0.84)	0.031*** (2.80)	-0.025* (-1.90)	0.006 (0.86)	0.030*** (2.76)	-0.024* (-1.87)
Leverage ratio	0.001 (0.019)	0.073 (0.79)	-0.070 (-0.61)	-0.001 (-0.022)	0.075 (0.82)	-0.074 (-0.65)
Operating cycle	0.052*** (4.17)	0.013 (1.02)	0.039** (2.20)	0.052*** (4.19)	0.014 (1.10)	0.038** (2.15)
Inventory cycle	0.094 (0.34)	-0.730** (-1.98)	0.862* (1.87)	0.100 (0.36)	-0.715* (-1.93)	0.857* (1.86)
$\sigma$ Returns	-0.511 (-0.76)	4.376** (2.17)	-4.79** (-2.26)	-0.533 (-0.80)	4.427** (2.10)	-4.824** (-2.20)
Return on assets <sub>t-1</sub>	0.165 (1.03)	0.280 (1.64)	-0.106 (-0.45)	0.163 (1.02)	0.272 (1.56)	-0.109 (-0.46)
Operating cash flow	-0.464*** (-3.37)	-0.495*** (-3.49)	0.022 (0.11)	-0.464*** (-3.36)	-0.493*** (-3.51)	0.027 (0.14)
Loss in current year	-0.035 (-1.33)	-0.100** (-2.05)	0.064 (1.15)	-0.036 (-1.34)	-0.099** (-2.02)	0.063 (1.13)
Book to market ratio	-0.085*** (-3.25)	0.050 (0.39)	-0.135 (-1.04)	-0.085*** (-3.23)	0.048 (0.38)	-0.133 (-1.04)
Firm age	-0.000 (-0.44)	-0.000 (-0.57)	0.000 (0.25)	-0.000 (-0.44)	-0.000 (-0.56)	0.000 (0.23)
High litigation industry	0.044** (2.07)	0.051 (1.42)	-0.010 (-0.24)	0.043** (2.03)	0.052 (1.46)	-0.013 (-0.30)
Top 5 ownership	-0.127* (-1.65)	0.152 (1.35)	-0.28** (-2.08)	-0.126 (-1.64)	0.158 (1.42)	-0.270** (-2.03)
CEO tenure	0.001 (0.85)	-0.001 (-0.56)	0.002 (0.97)	0.001 (0.86)	-0.001 (-0.60)	0.002 (0.96)
Tenure	-0.007 (-0.29)	-0.033 (-1.60)	0.027 (0.86)	-0.007 (-0.30)	-0.033 (-1.62)	0.027 (0.84)
Big four auditor	0.008 (0.30)	-0.010 (-0.32)	0.022 (0.51)	0.007 (0.26)	-0.008 (-0.25)	0.019 (0.44)
Constant	-0.180 (-1.65)	-0.388* (-1.80)	0.191 (0.79)	-0.129 (-0.75)	-0.907* (-1.95)	0.194 (0.83)
Observations	2,687	1,894		2,687	1,894	
Adjusted R-squared	0.07	0.04		0.07	0.04	

**Table 11. (continued).**

	<i>Public accounting background</i>			<i>Corporate financial background</i>		
	<i>SGov=1</i>	<i>SGov=0</i>	<i>Diff</i>	<i>SGov=1</i>	<i>SGov=0</i>	<i>Diff</i>
Accounting expert x After	0.003 (0.85)	-0.003 (-0.92)	0.009* (1.86)	0.004 (1.08)	-0.005* (-1.74)	0.001 (0.23)
Accounting expert	-0.000 (-0.14)	-0.002 (-0.47)	0.000 (0.074)	-0.002 (-0.85)	0.003 (0.97)	-0.002 (-0.52)
Prior accounting expertise	0.003 (1.64)	-0.001 (-0.57)	0.004 (1.44)	0.003 (1.61)	-0.001 (-0.55)	0.004 (1.31)
After	0.002 (0.55)	0.009** (2.42)	-0.005 (-0.98)	0.002 (0.50)	0.010*** (2.59)	-0.004 (-0.71)
Log of assets	0.002*** (3.48)	0.002*** (2.65)	0.000 (0.48)	0.002*** (3.44)	0.002*** (2.66)	0.000 (0.44)
Operating cycle	0.000 (0.18)	-0.003 (-0.93)	0.003 (0.93)	0.000 (0.15)	-0.003 (-0.97)	0.003 (0.93)
PPE	0.031*** (6.92)	0.019*** (2.93)	0.011 (1.50)	0.030*** (6.93)	0.019*** (2.94)	0.011 (1.51)
$\sigma$ Sales	-0.003 (-0.62)	-0.009 (-1.59)	0.006 (0.88)	-0.003 (-0.70)	-0.009 (-1.62)	0.007 (0.90)
$\sigma$ Cash flow	-0.177*** (-4.83)	-0.162*** (-3.03)	-0.017 (-0.27)	-0.178*** (-4.83)	-0.161*** (-3.02)	-0.016 (-0.25)
Loss proportion	-0.012*** (-2.69)	-0.018*** (-2.90)	0.006 (0.72)	-0.012*** (-2.73)	-0.018*** (-2.98)	0.005 (0.72)
Sales growth	0.001*** (3.40)	0.000 (0.051)	0.001 (1.37)	0.001*** (3.50)	0.000 (0.080)	0.001 (1.33)
High litigation industry	0.001 (0.68)	0.003 (1.31)	-0.002 (-0.59)	0.001 (0.66)	0.003 (1.25)	-0.002 (-0.52)
Top 5 ownership	0.015 (1.20)	-0.035* (-1.74)	0.050** (2.14)	0.015 (1.21)	-0.035* (-1.77)	0.05** (2.07)
CEO tenure	0.000*** (2.79)	0.000 (1.55)	0.000 (0.67)	0.000*** (2.83)	0.000 (1.53)	0.000 (0.65)
Big 4 auditor	0.004 (0.48)	0.003 (0.28)	0.001 (0.071)	0.003 (0.47)	0.003 (0.28)	-0.000 (-0.01)
Constant	-0.088*** (-2.64)	-0.048 (-1.39)	-0.026 (-1.04)	-0.060*** (-4.61)	-0.035 (-1.59)	-0.025 (-0.98)
Observations	824	506		824	506	
Adjusted R-squared	0.20	0.16		0.20	0.16	

This table presents results for robustness tests of Hypothesis 2 using alternative definitions of an accounting expert. Columns (1) through (3) present results for accounting experts with public accounting backgrounds, while Columns (4) through (6) presents results defining accounting expertise according to corporate financial backgrounds. See Table 5 for equation details. **Panel A** uses signed discretionary accruals obtained using the modified Jones model in line with Equation (2). **Panel B** uses the modified Dechow and Dichev (2002) accrual quality measure calculated on a rolling basis over the prior four years, multiplied by -1 in line with Equation (5). Year fixed-effects are included but not reported in all regressions, and all continuous variables are Winsorized at the 1% and 99% levels. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Standard errors are adjusted for clustering within firms using procedures advanced in Rogers (1993). Variable descriptions are provided in Table 2.

### Weighted Least Squares Approach

An alternative strategy to only using adjusted standard errors (Rogers 1993) in controlling for heteroskedasticity is through a Weighted Least Squares approach. Choosing the weighting factor involves selecting a factor believed to be proportional to the variance of the residuals, and Hribar and Nichols (2007) suggest that one possibility is weighting by cash flow volatility as a nondiscretionary driver of accrual variance.<sup>18</sup> I re-perform my tests of Hypothesis 2 with discretionary accruals as the proxy using a WLS approach scaled by the standard deviation of cash flows ( $\sigma OCF$ ), and present the results in Table 12. The evidence suggests that this transformation has no material impact on the interpretation of analyses summarized in Table 6.

**Table 12.** Weighted Least Squares Regressions

Variable	<i>Strong Governance</i>		<i>Weak Governance</i>		<i>Difference</i>	
	Coefficient	<i>t</i> -stat	Coefficient	<i>t</i> -stat	Coefficient	<i>t</i> -stat
Accounting expert x After	-0.061*	(-1.95)	0.068	(1.29)	-0.129**	(-2.22)
Accounting expert	-0.008	(-0.41)	-0.059	(-1.34)	0.051	(1.19)
Prior accounting expert	0.019	(1.27)	0.002	(0.096)	0.017	(0.62)
After	0.063	(1.39)	0.173***	(2.61)	-0.111	(-1.43)
Log of market value	0.006	(0.84)	0.031***	(3.08)	-0.025**	(-2.21)
Leverage ratio	-0.001	(-0.014)	0.067	(0.74)	-0.069	(-0.67)
Operating cycle	0.052***	(3.91)	0.015	(0.80)	0.036	(1.62)
Inventory cycle	0.093	(0.29)	-0.714	(-1.31)	0.807	(1.35)
$\sigma$ Returns	-0.517	(-0.65)	4.583***	(2.86)	-5.098***	(-3.09)
Return on assets <sub>t-1</sub>	0.161	(1.26)	0.288	(1.38)	-0.127	(-0.55)
Operating cash flow	-0.460***	(-3.95)	-0.500**	(-2.33)	0.039	(0.17)
Loss in current year	-0.035	(-1.38)	-0.101**	(-2.40)	0.066	(1.42)
Book to market ratio	-0.086***	(-2.92)	0.047	(0.88)	-0.132**	(-2.33)
Firm age	-0.000	(-0.50)	-0.000	(-0.53)	0.000	(0.23)
High litigation industry	0.044**	(2.34)	0.050*	(1.69)	-0.006	(-0.19)
Top 5 ownership	-0.125	(-1.01)	0.156	(0.78)	-0.282	(-1.26)
CEO tenure	0.001	(0.73)	-0.001	(-0.56)	0.002	(0.90)
Tenure	-0.007	(-0.40)	-0.032	(-1.44)	0.025	(0.88)

<sup>18</sup> As noted by Hribar and Nichols (2007), this approach changes the interpretation of coefficients to reflect unusual relations between discretionary accruals and the volatility of the firm's operating cash flows.

**Table 12. (continued).**

Variable	Strong Governance		Weak Governance		Difference	
	Coefficient	t-stat	Coefficient	t-stat	Coefficient	t-stat
Big four auditor	0.007	(0.12)	-0.008	(-0.12)	0.015	(0.17)
Intercept	-0.178	(-1.58)	-0.378**	(-2.28)	0.201	(1.04)
Observations	2,687		1,894			
Adjusted R <sup>2</sup>	0.07		0.04			

This table presents results for robustness tests of Hypothesis 2 using a weighted least squares approach with the standard deviation of cash flows as the weight in line with Hribar and Nichols (2007), where the dependent variable is signed discretionary accruals from the modified Jones model in line with Equation (2). Year fixed-effects are included but not reported in all regressions, and all continuous variables are Winsorized at the 1% and 99% levels. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Standard errors are adjusted for clustering within firms using procedures advanced in Rogers (1993). Variable descriptions are provided in Table 2.

### Disclosure of Audit Committee Appointments in a Press Release

Firms that disclose the details of new board appointments in a press release may be different from those who wait until the annual report if a public announcement signals a commitment to increased financial oversight. To test for sensitivity to this factor, I first perform a *Lexis-Nexus* search by appointee name and year to identify press releases disclosing the details of the board appointments in my sample. This procedure highlighted that approximately 71% of firms disclose the audit committee appointment. I then re-perform my tests of Hypothesis 2 separately on the press release and non-press release samples, and present the results in Table 13. Panel A provides mixed results for the two subsamples based on discretionary accruals. First, firms that disclose audit committee appointments in a press release increase their financial reporting quality following the appointment of an accounting expert, as highlighted by the negative coefficient on *AE x After* ( $t$ -statistic = -1.66) in Column (1), but the difference is not significant from the weak governance subsample in Column (3) ( $t$ -statistic = -1.33). Alternatively, for firms not disclosing in a press release, the difference in the coefficient



on *AE x After* between the strong and weak governance subsamples are significantly different from each other (*t*-statistic = -2.24) in Column (6). Panel B summarizes results using accruals quality, where the positive coefficient on *AE x After* (*t*-statistic = 1.71) in Column (1) suggests an increase in accruals quality for firms with strong governance that disclose the announcement in a press release, and Column (3) highlights this is significantly different from the firms with weak governance (*t*-statistic = 2.26).

**Table 13.** Analysis of Firms Disclosing Appointments in a Press Release

	<i>Disclosed in press release</i>			<i>Not disclosed in press release</i>		
	<i>SGov = 1</i>	<i>SGov = 0</i>	<i>Diff</i>	<i>SGov = 1</i>	<i>SGov = 0</i>	<i>Diff</i>
Accounting expert x After	-0.065*	0.024	-0.089	-0.017	0.245**	-0.262**
	(-1.66)	(0.44)	(-1.33)	(-0.33)	(2.29)	(-2.24)
Accounting expert	-0.015	-0.040	0.026	0.024	-0.145**	0.169**
	(-0.73)	(-1.17)	(0.64)	(0.50)	(-2.07)	(2.01)
Prior accounting expertise	0.013	-0.016	0.029	0.058	0.070	-0.013
	(0.70)	(-0.60)	(0.89)	(1.21)	(1.39)	(-0.18)
After	0.104	0.237**	-0.133	-0.171	-0.046	-0.125
	(1.09)	(2.47)	(-0.98)	(-1.53)	(-0.20)	(-0.51)
Log of market value	0.002	0.031**	-0.028*	0.020	0.050*	-0.030
	(0.31)	(2.40)	(-1.90)	(0.98)	(1.91)	(-0.87)
Leverage ratio	0.048	0.063	-0.015	-0.206*	0.050	-0.256
	(0.58)	(0.59)	(-0.11)	(-1.78)	(0.26)	(-1.11)
Operating cycle	0.055***	0.018	0.037*	0.057**	-0.009	0.066
	(3.67)	(1.34)	(1.81)	(2.26)	(-0.28)	(1.57)
Inventory cycle	-0.022	-0.816*	0.795	0.232	-0.857	1.089
	(-0.068)	(-1.94)	(1.50)	(0.30)	(-1.12)	(0.97)
σReturns	-0.091	4.690*	-4.781*	-3.167*	4.610	-7.778*
	(-0.13)	(1.70)	(-1.67)	(-1.74)	(1.28)	(-1.93)
Return on assets <sub>t-1</sub>	0.235	0.198	0.037	-0.521	0.672	-1.193*
	(1.35)	(0.98)	(0.14)	(-1.10)	(1.64)	(-1.92)
Operating cash flow	-0.481***	-0.437***	-0.044	-0.196	-0.628*	0.432
	(-2.94)	(-2.66)	(-0.19)	(-0.93)	(-1.78)	(1.06)
Loss in current year	-0.059**	-0.093	0.033	0.093	-0.123	0.216**
	(-2.04)	(-1.53)	(0.49)	(1.47)	(-1.42)	(2.03)
Book to market ratio	-0.090***	0.105	-0.195	-0.056	-0.094	0.038
	(-3.07)	(0.58)	(-1.07)	(-0.86)	(-1.42)	(0.40)
Firm age	-0.000	-0.001	0.000	0.001	0.000	0.001
	(-0.54)	(-0.72)	(0.25)	(0.36)	(0.0079)	(0.21)
High litigation industry	0.051**	0.056	-0.005	0.012	0.028	-0.016
	(2.01)	(1.31)	(-0.097)	(0.30)	(0.41)	(-0.20)
Top 5 ownership	-0.199**	0.141	-0.34**	0.091	0.298	-0.207
	(-2.03)	(1.24)	(-2.33)	(0.54)	(0.85)	(-0.51)

**Table 13. (continued).**

	<i>Disclosed in press release</i>			<i>Not disclosed in press release</i>		
	<i>SGov = 1</i>	<i>SGov = 0</i>	<i>Diff</i>	<i>SGov = 1</i>	<i>SGov = 0</i>	<i>Diff</i>
CEO tenure	0.001 (1.24)	-0.002 (-0.86)	0.003 (1.40)	-0.001 (-0.54)	-0.000 (-0.0051)	-0.001 (-0.32)
Tenure	-0.015 (-0.51)	-0.040* (-1.66)	0.025 (0.68)	0.031 (1.19)	-0.002 (-0.051)	0.033 (0.69)
Big four auditor	0.025 (0.68)	-0.010 (-0.23)	0.035 (0.59)	-0.046 (-1.45)	-0.030 (-0.52)	-0.016 (-0.24)
Constant	-0.203 (-1.62)	-0.425 (-1.57)	-0.144 (-0.61)	-0.278 (-0.74)	0.222 (0.74)	0.135 (0.30)
Observations	2,198	1,479		483	411	
Adjusted R-squared	0.07	0.03		0.08	0.07	

**Panel B: Accruals Quality**

Accounting Expert x After	0.007 (1.71)	-0.008* (-1.68)	0.015** (2.26)	-0.005 (-0.81)	0.001 (0.053)	-0.006 (-0.46)
Accounting Expert	-0.003 (-1.20)	0.005 (1.29)	-0.008* (-1.70)	-0.000 (-0.080)	-0.010 (-1.25)	0.010 (1.08)
Prior accounting expertise	0.004* (1.83)	-0.001 (-0.33)	0.005 (1.37)	0.000 (0.047)	0.001 (0.14)	-0.000 (-0.08)
After	0.001 (0.19)	0.011** (2.52)	-0.010 (-1.57)	0.012 (1.63)	0.007 (0.95)	0.005 (0.43)
Log of assets	0.002** (2.54)	0.002** (2.08)	0.000 (0.23)	0.005*** (3.11)	0.005** (2.56)	0.000 (0.14)
Operating cycle	0.001 (0.80)	-0.002 (-0.57)	0.003 (0.94)	-0.006* (-1.91)	-0.010 (-1.58)	0.004 (0.59)
PPE	0.036*** (6.92)	0.019** (2.29)	0.017* (1.88)	0.009 (1.12)	0.013 (1.18)	-0.004 (-0.28)
$\sigma$ Sales	-0.003 (-0.63)	-0.008 (-1.33)	0.004 (0.58)	-0.004 (-0.63)	-0.024 (-1.07)	0.020 (0.83)
$\sigma$ Cash flow	-0.211*** (-5.09)	-0.182*** (-2.96)	-0.029 (-0.40)	-0.022 (-0.39)	0.012 (0.12)	-0.033 (-0.31)
Loss proportion	-0.013*** (-2.69)	-0.017** (-2.41)	0.004 (0.51)	-0.011 (-0.90)	-0.025** (-2.14)	0.013 (0.82)
Sales growth	0.001*** (3.55)	0.000 (0.44)	0.001 (1.03)	0.001 (0.89)	-0.002 (-1.31)	0.003* (1.69)
High litigation industry	0.001 (0.52)	0.002 (0.79)	-0.001 (-0.33)	0.004 (1.08)	0.003 (0.56)	0.001 (0.21)
Top 5 ownership	0.031** (1.99)	-0.038* (-1.85)	0.07*** (2.68)	-0.008 (-0.50)	0.001 (0.017)	-0.009 (-0.13)
CEO tenure	0.000** (2.43)	0.000** (2.48)	0.000 (0.058)	0.001** (2.53)	-0.000 (-0.74)	0.001 (1.57)
Big 4 auditor	0.003 (0.28)	0.015 (0.79)	-0.012 (-0.58)	0.007 (0.88)	-0.012* (-1.76)	0.019* (1.77)



**Table 13. (continued).**

	<i>Disclosed in press release</i>			<i>Not disclosed in press release</i>		
	<i>SGov = 1</i>	<i>SGov = 0</i>	<i>Diff</i>	<i>SGov = 1</i>	<i>SGov = 0</i>	<i>Diff</i>
Constant	-0.062*** (-4.02)	-0.054* (-1.89)	-0.008 (-0.27)	-0.054** (-2.08)	0.007 (0.19)	-0.061 (-1.39)
Observations	691	399		147	115	
Adjusted R-squared	0.21	0.18		0.22	0.19	

This table presents results for robustness tests of Hypothesis 2 on subsets of my sample defined based on whether the firm disclosed the audit committee appointment in a press release. Columns (1) through (3) present results using the set of firms disclosing the appointment in a press release, while Columns (4) through (6) summarizes results using the set of firms that do not disclose the appointment. **Panel A** uses signed discretionary accruals obtained using the modified Jones model in line with Equation (2). **Panel B** uses the modified Dechow and Dichev (2002) accrual quality measure calculated on a rolling basis over the prior four years, multiplied by -1 in line with Equation (5). Year fixed-effects are included but not reported in all regressions, and all continuous variables are Winsorized at the 1% and 99% levels. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Standard errors are adjusted for clustering within firms using procedures advanced in Rogers (1993). Variable descriptions are provided in Table 2.

### Expanding the Size of the Audit Committee

In my primary analyses, I do not consider the reason for audit committee vacancies that generate the need for a new appointment. Although firms are not required to disclose the reasons for the vacancy, it is possible to segregate firms that replaced an outgoing audit committee member from those that increased the size of the audit committee to accommodate the new appointee. Of the appointments in my sample, 38% involved growing the size of the audit committee. To test for differences across these two conditions, I re-perform my tests of Hypothesis 2 separately for firms that replaced an outgoing board member versus those that increased the size of their audit committee. Panels A and B of Table 14 summarize the results of these procedures. The evidence suggests that only firms with strong governance that replace an outgoing audit committee member with an accounting expert increase financial reporting quality following the appointment, as highlighted by the negative coefficient on *AE x After* ( $t$ -statistic = -1.98) in Column (6) of Panel A, and the marginally positive coefficient on *AE x After* ( $t$ -statistic = 1.65) in Column (6) of Panel B. One interpretation of these results is that

replacing an outgoing member with an accounting expert reflects a conscious decision to change the makeup of the audit committee to one that is better equipped to provide financial oversight.

**Table 14.** Analysis of Firms Increasing the Size of the Audit Committee

	<i>Audit committee grew</i>			<i>Audit committee did not grow</i>		
	<i>SGov = 1</i>	<i>SGov = 0</i>	<i>Diff</i>	<i>SGov = 1</i>	<i>SGov = 0</i>	<i>Diff</i>
Accounting Expert x After	-0.043 (-0.57)	0.088 (0.87)	-0.131 (-1.05)	-0.067* (-1.89)	0.050 (1.05)	-0.118** (-1.98)
Accounting Expert	-0.025 (-0.90)	-0.018 (-0.38)	-0.007 (-0.13)	0.003 (0.11)	-0.064 (-1.56)	0.067 (1.43)
Prior accounting expertise	0.025 (0.78)	-0.082 (-1.42)	0.108 (1.62)	0.015 (0.76)	0.044* (1.96)	-0.028 (-0.94)
After	0.085 (0.54)	0.131 (1.11)	-0.046 (-0.23)	0.037 (0.46)	0.139 (1.40)	-0.102 (-0.80)
Log of market value	0.014 (1.05)	0.066*** (2.71)	-0.052* (-1.85)	0.002 (0.29)	0.016 (1.54)	-0.014 (-1.06)
Leverage ratio	-0.101 (-0.82)	0.144 (0.66)	-0.245 (-0.99)	0.033 (0.42)	-0.005 (-0.077)	0.038 (0.37)
Operating cycle	0.068*** (3.03)	0.035 (1.42)	0.033 (0.99)	0.047*** (3.33)	0.007 (0.49)	0.041** (2.03)
Inventory cycle	-0.513 (-0.81)	0.238 (0.29)	-0.752 (-0.73)	0.345 (1.17)	-1.054** (-2.43)	1.399*** (2.63)
$\sigma$ Returns	-2.27** (-2.13)	11.61** (2.34)	-13.88*** (-2.75)	0.016 (0.018)	1.565 (0.97)	-1.549 (-0.84)
Return on assets <sub>t-1</sub>	-0.024 (-0.074)	0.793* (1.73)	-0.817 (-1.46)	0.286 (1.56)	0.099 (0.78)	0.187 (0.84)
Operating cash flow	-0.129 (-0.49)	-0.99*** (-3.22)	0.87** (2.14)	-0.67*** (-4.31)	-0.344** (-2.44)	-0.325 (-1.55)
Loss in current year	0.033 (0.68)	-0.154 (-1.13)	0.188 (1.30)	-0.057* (-1.77)	-0.082** (-2.18)	0.025 (0.51)
Book to market ratio	-0.039 (-1.02)	0.290 (0.72)	-0.329 (-0.81)	-0.11*** (-3.30)	-0.062** (-2.11)	-0.049 (-1.10)
Firm age	-0.000 (-0.25)	0.001 (0.62)	-0.001 (-0.66)	-0.000 (-0.40)	-0.001 (-1.38)	0.001 (0.69)
High litigation industry	0.128** (2.39)	0.179 (1.43)	-0.051 (-0.38)	0.009 (0.43)	0.007 (0.27)	0.002 (0.049)
Top 5 ownership	-0.182 (-1.17)	-0.025 (-0.098)	-0.157 (-0.52)	-0.115 (-1.33)	0.190 (1.57)	-0.306** (-2.01)
CEO tenure	-0.000 (-0.21)	-0.008 (-1.43)	0.007 (1.30)	0.002 (1.30)	0.001 (0.91)	0.001 (0.37)
Tenure	-0.034 (-0.93)	-0.019 (-0.37)	-0.016 (-0.25)	0.005 (0.18)	-0.026 (-1.24)	0.031 (0.90)
Big four auditor	0.095* (1.78)	-0.081 (-0.80)	0.176 (1.53)	-0.005 (-0.16)	0.008 (0.26)	-0.013 (-0.28)

**Table 14. (continued).**

	<i>Audit committee grew</i>			<i>Audit committee did not grow</i>		
	<i>SGov = 1</i>	<i>SGov = 0</i>	<i>Diff</i>	<i>SGov = 1</i>	<i>SGov = 0</i>	<i>Diff</i>
Constant	-0.352*	-0.993*	0.641	-0.127	-0.087	-0.040
	(-1.66)	(-1.94)	(1.16)	(-1.08)	(-0.70)	(-0.23)
Observations	870	536		1,817	1,358	
Adjusted R-squared	0.10	0.05		0.06	0.05	
<b>Panel B: Accruals Quality</b>						
Accounting Expert x After	0.010	-0.004	0.013	0.004	-0.007	0.011*
	(0.92)	(-0.47)	(1.02)	(0.89)	(-1.41)	(1.65)
Accounting Expert	-0.008**	0.009	-0.017**	0.001	0.001	-0.001
	(-2.15)	(1.33)	(-2.27)	(0.27)	(0.29)	(-0.13)
Prior accounting expertise	-0.002	0.007	-0.008	0.003*	-0.001	0.005
	(-0.41)	(1.48)	(-1.41)	(1.71)	(-0.34)	(1.28)
After	-0.011	0.015***	-0.027**	0.004	0.009**	-0.005
	(-1.01)	(3.03)	(-2.11)	(0.95)	(2.09)	(-0.75)
Log of assets	0.001	0.001	0.001	0.003***	0.002**	0.001
	(0.91)	(0.85)	(0.34)	(3.45)	(2.23)	(0.75)
Operating cycle	-0.000	0.000	-0.000	0.001	-0.005	0.006*
	(-0.063)	(0.027)	(-0.064)	(0.51)	(-1.61)	(1.71)
PPE	0.030***	0.025***	0.005	0.031***	0.015**	0.016*
	(3.64)	(2.76)	(0.39)	(5.83)	(2.05)	(1.86)
$\sigma$ Sales	-0.009	-0.003	-0.006	0.002	-0.011*	0.013
	(-1.30)	(-0.49)	(-0.63)	(0.41)	(-1.70)	(1.61)
$\sigma$ Cash flow	-0.127*	-0.37***	0.24**	-0.19***	-0.104*	-0.094
	(-1.85)	(-3.75)	(2.08)	(-4.43)	(-1.93)	(-1.39)
Loss proportion	-0.015	-0.025**	0.010	-0.011**	-0.017**	0.006
	(-1.34)	(-2.09)	(0.65)	(-2.07)	(-2.35)	(0.69)
Sales growth	0.001*	0.002**	-0.001	0.001***	-0.000	0.001
	(1.77)	(2.19)	(-1.18)	(2.81)	(-0.33)	(1.52)
High litigation industry	-0.001	0.018***	-0.018***	0.001	0.001	0.000
	(-0.11)	(3.60)	(-2.60)	(0.58)	(0.38)	(0.036)
Top 5 ownership	-0.016	-0.063**	0.047	0.019	-0.022	0.041
	(-0.45)	(-1.99)	(0.99)	(1.38)	(-0.99)	(1.57)
CEO tenure	0.001**	0.000	0.000	0.000**	0.000	0.000
	(2.10)	(1.07)	(0.78)	(2.02)	(0.87)	(0.68)
Big 4 auditor	-0.004	0.037	-0.042	0.005	-0.005	0.010
	(-0.81)	(1.35)	(-1.53)	(0.57)	(-0.91)	(0.97)
Constant	-0.039	-0.078*	0.039	-0.08***	-0.033*	-0.051**
	(-1.43)	(-1.97)	(0.83)	(-0.07***)	(-0.018)	(-2.16)
Observations	216	110		(-4.45)	(-0.96)	
Adjusted R-squared	0.16	0.49		624	404	

This table presents results for robustness tests of Hypothesis 2 on subsets of my sample based on whether the firm increased the size of the audit committee. Columns (1) through (3) present results using the set of firms that grew the size of their audit committee, while Columns (4) through (6) summarizes results using the set of firms that replaced an outgoing audit committee member. **Panel A** uses signed discretionary accruals obtained using the modified Jones model in line with Equation (2). **Panel B** uses the modified Dechow and Dichev (2002) accrual quality measure calculated on a rolling basis over the prior four years, multiplied by -1 in line with Equation (5). Year fixed-effects are included but not reported in all regressions, and all continuous variables are Winsorized at the 1% and 99% levels. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Standard errors are adjusted for clustering within firms using procedures advanced in Rogers (1993). Variable descriptions are provided in Table 2.

## CHAPTER VII

### CONCLUSION

Boards of directors designate responsibility for overseeing a company's accounting and financial reporting processes to the audit committee. Although this implies that audit committees play a major role in the monitoring of a firm's financial reporting decisions, it is not clear whether appointing an accounting expert is associated with higher financial reporting quality in the future. The evidence in this dissertation suggests that appointing an accounting expert to the audit committee does not by itself lead to improvements in financial reporting quality, and that the conditions surrounding a newly appointed accounting expert influence the change in reporting quality following the appointment. Specifically, my evidence suggest that improvements in financial reporting quality are larger following the appointment of an accounting expert to a firm with strong governance, reinforcing conclusions from DeFond et al. (2005) that the benefits to appointing an accounting expert are concentrated in firms that are well suited to utilize the expertise. This is particularly important because prior literature is mixed regarding whether accounting expertise and other governance mechanisms are complements or substitutes. Furthermore, my results suggest that firms with strong governance that appoint their first accounting expert show increased financial reporting quality following the appointment, highlighting that strong governance is a necessary condition for prior accounting expertise to impact the incremental change in financial reporting quality following an appointment.

One limitation in my analysis is that I assume that all accounting experts have the same incentives to oversee financial reporting. Admittedly, other factors such as career concerns and wealth effects play a role in who accepts audit committee appointments, and the intensity of monitoring after such appointments. Therefore, a possibility for future research involves incorporating measures of audit committee member pay and prestige to consider these incentives. A second limitation is that my results are not conclusive regarding the premium to accounting expertise. Although improved financial reporting quality following the appointment of an accounting expert could imply a lower cost of capital, there could also be future cash flow implications resulting from greater financial oversight. Finally, my data set only includes audit committee appointments from a three-year window, which limits the number of observations in my sample. As more data on audit committee appointments become available, future research can investigate whether links between added accounting expertise and changes in financial reporting quality persist over time.

## APPENDIX

## CONTROLLING FOR SELF-SELECTION IN REGRESSIONS TESTING FOR WITHIN-GROUP VARIATION

Given the analysis on within-group variation (Table 9) has the possibility for self-selection bias because the restricted sample only includes firms appointing an accounting expert (Bryan et al. 2007; Farber et al. 2008), I follow the two-stage procedure outlined by Heckman (1979), and begin by running a first-stage probit model of firm characteristics regressed against an indicator variable equal to one for firms that appointed an accounting expert ( $AE$ ) using equation (6) as follows:

$$\begin{aligned}
 AE_j = & \alpha_0 + \alpha_1 LnMVE_{j,t-1} + \alpha_2 Leverage_{j,t-1} + \alpha_3 ROA_{j,t-1} + \alpha_4 Beta_{j,t-1} \\
 & + \alpha_5 Distress_{j,t-1} + \alpha_6 BtM_{j,t-1} + \alpha_7 FirmAge_{j,t-1} + \alpha_8 HighTech_{j,t-1} \\
 & + \alpha_9 Delaware_j + \alpha_{10} Top5Own_{j,t-1} + \alpha_{11} SGov_j + \alpha_{12} AE_{j,t-1} \\
 & + \sum \alpha_x Year + \varepsilon_j
 \end{aligned} \tag{6}$$

Note that this regression only includes one observation per sample firm-year, and that all explanatory variables are included at values in the year prior to appointment to isolate firm characteristics in place during the appointment process. Lennox and Francis (2008) highlight the importance of properly identifying the selection equation by including at least one unique explanatory variable that is not correlated with the dependent variable(s) used in the second stage regression. I use the indicator variable, *Delaware*, equal to one for firms incorporated in Delaware (0 otherwise) because liability rules thought to hold experts to a higher standard (Cunningham 2007) create potential aversion to audit committee appointments, but have little bearing on measures of financial reporting quality. Based on this first-stage regression, I calculate a variable, *Lambda*, equal to the



inverse Mills ratio, and include it as an independent variable in the second stage multivariate specifications presented in Table 9.

Klein (2002b) suggests that demand for a high quality audit committee arises from a variety of constituencies including management, shareholders, and creditors. I include variables shown by prior literature to relate to whether a firm maintains a financial or accounting expert on their audit committee (Agrawal and Chadha 2005; Bryan et al. 2007; Farber et al. 2008). First, given that large firms likely have more resources to monitor the reporting process, I follow DeFond et al. (2005) and Farber et al. (2008) and include the log of market capitalization (*LnMVE*) as a proxy for firm size. Next, following Agrawal and Chadha (2005), I include the debt ratio (*Leverage*) to consider the needs for external financing, and operating performance (*ROA*) as a proxy for prior managerial effectiveness. I also include systematic risk (*Beta*) calculated on a rolling basis over the prior 24 months, and financial distress (*Distress*) using the Z-Score (Altman, 2000), based on the idea that troubled firms could have different needs for board expertise.

In line with Farber et al. (2008), I include the book-to-market ratio (*BtM*) to account for the impact of growth opportunities on the demand for outside financial monitoring. I also include the number of years listed on Compustat (*FirmAge*) as a proxy for the maturity of existing governance systems (Khan and Watts 2007). Next, given that Farber et al. (2008) find that firms in high-technology industries are more likely to have an accounting expert, I include an indicator variable to one for firms with 2-digit SIC codes of 35, 36, 38, 48, or 73 (*HighTech*). I also include the percentage of shares held by the



top 5 executives (*Top5Own*) to consider incentives to misreport based on evidence from Bryan et al. (2007) that firms with high CEO ownership are more likely to have an accounting expert on their audit committee. Furthermore, I consider the possibility that a high quality auditor substitutes for accounting expertise by including an indicator variable equal to one for firms that employ a member of the Big four to perform their financial statement audit (*Big4*).<sup>19</sup>

I include a proxy for governance strength (*SGov*) based on evidence from Farber et al. (2008) suggesting that firms with strong governance are more likely to appoint an accounting expert using the summary governance metric described in Table 4, and whether the audit committee already maintains an accounting expert because firms balance financial oversight with the other responsibilities of board members (Adams and Ferreira 2007). I define a firm as having prior accounting expertise (*PriorAE*) if there was at least one accounting expert on the audit committee in the year prior to the appointment of interest.

Table 15 presents my regression results of the decision to appoint an accounting expert. In line with Farber et al. (2008), I find that large firms are less likely to appoint an accounting expert, while firms in high technology industries are more likely to appoint an accounting expert (marginal effect = 8.8%). One interpretation of these results is that large firms have more sophisticated financial reporting systems that reduce the need for accounting expertise, while complex firms have demand for increased monitoring. Furthermore, the evidence suggests that firms with at least one accounting expert already

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<sup>19</sup> As a robustness check, I substitute an auditor industry specialization metric based on Francis, Reichelt, and Wang (2005), with similar results to those presented in Table 3.

on the audit committee are less likely to appoint an additional accounting expert (marginal effect = -12.5%), consistent with the idea that nominating committees are significantly less likely to appoint additional accounting experts when there is currently an individual with an accounting background on the audit committee.

**Table 15.** Modeling the Decision to Appoint an Accounting Expert

<i>Variable</i>	Expected sign	Coefficient
Log of market value	-	-0.059* (-1.82)
Leverage ratio	?	0.084 (0.26)
Return on assets	?	-0.022 (-0.041)
Beta	?	-0.030 (-0.66)
Financial distress	-	-0.048 (-0.46)
Book to market ratio	?	-0.095 (-0.54)
Firm age	-	-0.004 (-1.56)
High tech industry	+	0.223** (2.47)
Delaware corporation	+	0.046 (0.56)
Top 5 ownership	+	-0.193 (-0.32)
Strong governance	+	0.004 (0.054)
Prior accounting expertise	-	-0.320*** (-4.02)
Big four auditor	?	0.157 (0.66)
Intercept	?	0.359 (0.92)
Observations		1,105
Pseudo R <sup>2</sup>		0.03

This table presents estimates and the associated z-statistics for a probit regression model, where the dependent variable is a binary variable equal to 1 for firms appointing an accounting expert, and 0 otherwise based on Equation (1). Year fixed effects are included but not tabulated. \*, \*\*, \*\*\* indicate statistical significance at two-tailed 10%, 5%, and 1% levels. Robust standard errors based on the method advanced by White (1980) are used. Variable descriptions are provided in Table 2.

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