2020-12

Audit committee independence and financial expertise and earnings management: evidence from China

Alkebsee, Hussien Radwan

Inderscience Enterprises Ltd.

Audit committee independence and financial expertise and earnings management: Evidence from China

Abstract

This paper investigates the effect of the audit committee's independence and financial expertise on financial reporting quality. In particular, we investigate the relationship between the audit committee's independence and financial expertise and accrual earnings management. Using a sample of Chinese public firms over the period of 2010 to 2017, the findings show a negative association between the independence of the audit committee and accrual earnings management. This finding suggests that a high proportion of independent directors on the audit committee enhances the monitoring role of the audit committee over earnings quality. We also, find no evidence regarding the effect of the audit committee's financial expertise on accrual earnings management. Our findings are robust to the potential endogeneity problem. This study has important implications for policymakers and other stakeholders.

Keywords: Earnings management; Audit Committee independence; audit committee financial expertise; China.

1. Introduction

The past scandals (including WorldCom and Enron companies) have drawn the attention to the role of a firm's audit committee and consider it as a sign of the audit committee's failure (DeFond and Francis, 2005, Beasley et al., 2009). Consequently, regulatory bodies (China security regulatory commission 2002 (CSRC), the U.S. Congress (SOX) 2002, the Security Exchange Commission (SEC); Blue Robin Commission, and New York Stock Exchange (NYSE)) have upgraded regulations to improving the audit committee's effectiveness in monitoring the quality of financial reporting. For example, SOX 2002 stipulates a firm to have fully independent audit committee members and at least one member with financial expertise. The CSRC recommends a firm to recruit the majority of the audit committee's directors as independent and should be non-executives (CSRC, 2002). Similar to the SEC, China's public firms are recommended to have at least one director who is a financial expert on the audit committee. Accordingly, a major reliance on the firm's audit committee has been replaced to enhance the integrity of financial reports. One of the most aspects that are concerned by regulators is the earnings management phenomenon. Prior studies have documented a significant association between the audit committee's independence and earnings management (Be´ dard et al., 2004, Klein, 2002, Sun et al., 2014). In addition, the extant literature