

# AUDIT COMMITTEE FINANCIAL EXPERTISE MANDATE AND EARNINGS MANAGEMENT MITIGATION

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## ABSTRACT

To restore the investor confidence and integrity of the financial accounting information provided to them, following the passage of the Sarbanes-Oxley Act (SOX), the SEC adopted two new rules in March 2003 to the public firms to mandate audit committee financial expertise (ACFE) per SOX 407 and to reconcile non-GAAP financial measures to the most comparable GAAP ones (Regulation G) per SOX 401(b). This study using quarterly filing data in the post-SOX era from March 2003 to December 2016 examines the impact of such requirements with a focus on the effect of ACFE on main earnings manipulation tactics used to meet or just beat analyst expectations (MBE). To the best of our knowledge, this is the first study to thoroughly investigate not only overall ACFE but also the variation in accounting and non-accounting expertise and their effect on three key earnings management tactics, namely, discretionary accruals, real activities management, and non-GAAP financial disclosures. We observe that firms with a higher level of ACFE, particularly accounting and finance expertise, exhibit a lower propensity to MBE after SOX. More importantly, we conclude that both upward earnings manipulations, including accrual-based and real activities management, are significantly mitigated by ACFE, through a complementary effect of accounting and supervisory expertise. However, we identify a clear strategic shift in which non-GAAP financial disclosures with unexpected exclusions become a popular alternative tactic for managers to MBE under the increasing presence of ACFE. This study provides empirical evidence with strong implications for regulators to consider more rigorous intervention and regulation on non-GAAP disclosures and to refine the requirement of audit committee financial experts with an emphasis on the complement of accounting and non-accounting financial expertise to effectively curtail earnings manipulation.

**Keywords:** Corporate governance; Audit committee financial expertise; Meet or beat analyst forecasts; Earnings management; Non-GAAP disclosures