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How important is it for CFOs or other top corporate executives to have accounting expertise? Around the turn of the century, when the financial director of a major bank stated that "the day of the finance director as bean counter is well and truly over," he was reflecting much contemporary thinking. But since then, perhaps driven by this century's notorious corporate accounting scandals and severe worldwide

Now, in a switch, the new scholarly paper, in the November issue of the **American Accounting Association** journal ***The Accounting Review***, probes a previously unexplored question – whether the presence, as well as the absence, of accounting expertise among top company managers can compromise financial reporting. The study concludes that it can, a finding with important implications for regulators, corporate directors, and, most crucially, external auditors charged with certifying the accuracy of client companies' financial statements.

Focusing on the CFOs, CEOs, and other top executives of more than 3,000 public companies, accounting professors Anne Albrecht of Texas Christian University, Elaine Mauldin of the University of Missouri, and Nathan J. Newton of Florida State University find that executives' backgrounds as partners or managers in audit firms can substantially increase the present likelihood of financial misstatements. That prior experience, they write, "provides extensive knowledge of audit procedures and negotiation tactics. As a result, executives could use their higher-order ability to hide misstatements or to avoid current-period adjustments when the external auditor finds misstatements." Restatements exposing the misreporting come, after all, only later.

In short, accounting competence in the C-suite is, the professors write, a "two-edged sword" that can either enhance or subvert financial reporting.

They further explain: "We do not expect that accounting competence alone leads to misstatements, because accounting competence may provide the ability to produce reliable financial reports, and we have no reason to expect more or less integrity from executives with accounting competence than from those without it. Instead... accounting competence interacts with other fraud risk elements to increase the risk of material misstatement."

What other fraud risk elements? The professors focus on executive compensation,

present in executive suites, the high-pay firms were about 30% more likely than their low-pay counterparts to misstate. The professors term this the “downside to a management characteristic [accounting expertise] considered beneficial in auditing standards.”

Contributing considerably to the problem is an apparent lack of awareness of this downside among external auditors. Although auditors typically charge companies higher fees in response to excesses in executive pay, the boost is much less when there is auditing background in the executive suite. In the words of the study, “this result is consistent with auditors’ over-trusting executives with accounting competence and discounting the fee premium associated with excess compensation.”

Put slightly differently, “executives’ accounting competence increase[es] the risk of material misstatement when combined with compensation-based incentives to misreport. However, we do not observe that audit fees reflect this increased risk, suggesting that auditors focus on the upside of accounting competence.”

The study drew on data from 3,252 public companies over a 10-year period. In any given year an average of about 12% of the firms had one or more top executives (as listed in proxy statements or annual reports) who had prior audit experience as a partner or manager at a public accounting firm. About 61% of the executives with this background were CFOs and about 9% were CEOs. About 10% of company financial reports contained misstatements that were corrected by subsequent restatements.

In measuring executive pay, the professors calculated expected compensation from many factors, including the size, complexity, and financial performance of firms and the tenures and management-ability scores of executives. How much this estimate differed from actual total pay was termed “excess compensation.” The results, ranging from negative to positive (below and above expected levels respectively),

Yet, although this combination constitutes a risk factor for misstatements, it fails to elicit nearly the boost in audit fees that excess executive pay would call forth in the absence of managerial accounting expertise. Moreover, this remains the case even when firms have had a past tendency to manipulate earnings upward, leading the professors to observe that "the results suggest auditors over-trust executives with accounting competence...regardless of evidence of an aggressive reporting attitude."

In conclusion, the authors write that "based on current auditing standards, auditors must consider executives' competence when assessing the risk of material misstatement. Yet, the standards focus on risks associated with a lack of competence and omit potential risk associated with higher competence...We provide evidence about the potential downside to a management characteristic considered beneficial in auditing standards."

The study, entitled "Do Auditors Recognize the Potential Dark Side of Executives' Accounting Competence?" is in the November issue of ***The Accounting Review***, a peer-reviewed journal published six times yearly by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *Auditing: A Journal of Practice and Theory, Accounting Horizons, Issues in Accounting Education, Behavioral Research in Accounting, Journal of Management Accounting Research, Journal of Information Systems, Journal of Financial Reporting, The Journal of the American Taxation Association,* and *Journal of Forensic Accounting Research.*

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