The impact of audit committee expertise on audit quality: Evidence from UK audit fees

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ABSTRACT

Governance regulators currently place great emphasis on ensuring the presence of financial expertise on audit committees (Sarbanes-Oxley, 2002; UK Corporate Governance Code 2010–2016). Underlying this is a belief that greater expertise enhances the effectiveness of audit committees and, by extension, the quality of the external audit. This study investigates the impact of audit committee expertise on one measure of audit quality - audit fees paid by FTSE350 companies. Our analysis finds that audit committees possessing greater levels of financial expertise are associated with higher audit fees. When we segregate financial expertise between accounting and non-accounting, we find that the positive impact identified is driven by non-accounting expertise. Furthermore, when we separate FTSE100 and FTSE250 firms we find the impact of financial expertise is confined to FTSE250 firms. Our findings are important as they highlight the usefulness of segregating financial expertise between specialists and non-specialists, something which regulators in the UK and in the USA currently do not do. Our findings also highlight the potential value of audit committee expertise in smaller as opposed to larger listed firms, suggesting that the value of expertise to audit quality depends on the specific financial reporting challenges firms face.

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1. Introduction

The past twenty five years have witnessed a renewed focus on the governance of companies, motivated largely by a number of high-profile corporate failures, many subsequently found to possess either weak or non-existent governance structures. The almost universal response has been the introduction of stronger governance in the hope that this will serve both to prevent unacceptable behaviour and increase the external transparency of what companies do and how they do it. In an effort to enhance the quality of firms’ governance, audit committees have been identified as an important mechanism through which the quality of financial reporting can be enhanced (Sarbanes-Oxley, 2002; UK Corporate Governance Code, 2010–2016). A key component of current governance recommendations in the UK is that audit committees should possess at least one member with “recent and relevant financial experience” (UK Corporate Governance Code, 2016: C.3.1). Broadly

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similar provisions apply elsewhere with, for example, Section 407 of the Sarbanes-Oxley Act (2002) (SOX) in the USA also stipulating that at least one member should be a financial expert.

Running parallel to the evolution of audit committee governance, academic research has sought to understand the use and usefulness of various audit committee characteristics with a particular emphasis on whether these characteristics influence audit quality (Chan, Liu, & Sun, 2013; Cohen, Hoitash, Krishnamoorthy, & Wright, 2014; Zaman, Hudaib, & Haniffa, 2011). As discussed by Armstrong, Guay, and Weber (2010) and Ghafran and O’Sullivan (2013), much of this research has been motivated by the emergence of increased governance regulation and the identification of a number of characteristics that governance regulators have deemed necessary to achieve greater audit committee effectiveness. As DeFond and Zhang (2014) note in the context of audit committee changes introduced in the USA by SOX, the required changes attempt to increase audit quality by improving client governance and thereby increasing client demand for audit quality. As a result, this strand of research has investigated the impact of audit committee size, independence, meeting frequency and the presence of financial expertise on a number of audit quality proxies, one of which is audit fees. The overall expectation in this strand of research is that higher levels of the recommended characteristics result in more intensive and more expensive audits. The available empirical evidence suggests that audit committee size and independence have a positive impact on audit fees (Abbott, Parker, Peters, & Raghunandan, 2003; Boo & Sharma, 2008; Carcello, Hermanson, Neal, & Riley, 2002; Lee & Mande, 2005; Mitra, Hossain, & Deis, 2007; Vafeas & Waegelein, 2007; Zaman et al., 2011). The findings in respect of meeting frequency are more mixed with Carcello, Hermanson, Neal, and Riley (2002) and Mitra et al. (2007) failing to find a significant impact while Krishnan and Visvanathan (2009) and Zaman et al. (2011) report a positive impact. However, while more frequent meetings may suggest greater committee diligence and hence lower fees, it is also possible that it may signal more serious audit-related issues that may serve to increase client risk and therefore result in higher fees.

In addition to size, independence and meeting frequency, there is a particular interest in the value of audit committee expertise since, as discussed by Tanyi and Smith (2015), financial expertise is important in safeguarding the financial reporting process. Specifically, financial experts on audit committees are seen as being best placed to evaluate those areas of the committee’s work requiring technical evaluation and decision-making. Existing research shows no consistent evidence on the impact of an audit committee’s financial expertise and audit fees with studies showing a mixture of findings, often undermined by the lack of consistency in the definition of what actually constitutes expertise. For example, in one of the earliest studies, Carcello et al. (2002) define expertise in terms of other directorships and report a positive impact on audit fees. Abbott et al. (2003), although using a broader definition capturing both qualifications and experience, also report a positive impact. However, using broadly similar measures of expertise, both Lee and Mande (2005) in the USA and Zaman et al. (2011) in the UK find no impact. Using narrower definitions of expertise, typically meaning members with professional accounting qualifications and experience, Krishnan and Visvanathan (2009) report a negative impact while Goodwin-Stewart and Kent (2006) and Rainsbury, Bradbury, and Cahn (2009) find no impact. In summary, therefore, existing research has shown mixed findings in relation to the value of financial expertise on audit committees but studies also display significant variation in how that expertise is defined.

The purpose of this paper is to undertake a comprehensive study of the impact of audit committee financial expertise on audit quality as represented by audit fees in large UK companies. Our study takes forward existing knowledge in a number of important respects. First, to our knowledge this is the first UK study to focus specifically on the relationship between financial expertise and audit fees. This is important since UK governance regulations operate on a comply or explain basis without legislative backing so firms remain free to make decisions on the presence and extent of financial expertise they deem appropriate for them. Second, as noted earlier, existing studies use a variety of financial expertise measures and report very mixed results. In this study we use both broad (i.e. qualifications and experience) and narrow (i.e. accounting) definitions of financial expertise in order to understand whether any impact on audit quality is sensitive to the definitions used. Third, in addition to more traditional definitions of financial expertise, we extend our analysis to incorporate expertise gained by audit committee members doing similar work in other firms to see whether the expertise expected to be gained from broader audit committee involvement impacts on audit quality in the member’s home firm. Fourth, we segregate our sample into FTSE100 and FTSE250 firms since size is expected to influence the governance issues faced by firms and, consequently, we are anxious to ascertain whether this also influences the use and usefulness of expertise in enhancing audit quality. A key issue here is whether smaller listed firms place more emphasis on the monitoring provided by financial experts (as well as the nature of that expertise) compared to FTSE100 firms who may be expected to already have significant levels of financial transparency in place (Armstrong et al., 2010). Finally, our study is not just of academic interest but is especially relevant to policymakers in the UK and elsewhere who continually work to seek an improvement in the quality of firm governance and have placed audit committee financial expertise at the centre of current reforms. By undertaking a comprehensive study of the relationship between a range of different measures of expertise and audit fees our findings can help regulators to make more evidence-based decisions going forward.

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1 Zaman et al. (2011) examine a range of audit committee characteristics and audit fees but their definition of expertise is simply a binary variable indicating the presence of a financial expert (broadly defined) or not. Crucially, the Zaman et al. (2011) study covers a period largely prior to the adoption of the Combined Code (2003) which contained the initial UK recommendation relating to audit committee expertise. Indeed, in footnote 10 of their paper, Zaman et al. (2011) mention that the absence of more varied definitions of expertise may be one limitation of their study.
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