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Diversity in skills-mix needed for effective audit committees

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THE recently revised Singapore Code of Corporate Governance requires audit committee members to have "recent and relevant accounting or related financial management expertise or experience". Results from our study show that accounting expertise alone is not sufficient. We find that financial reporting quality is higher when accounting expertise is combined with finance and/or supervisory expertise, either in the same person or by other members of the audit committee.

In our study, we extracted financial data from Compustat for 2006 to 2010. This is the biggest set of data available now, as newer financial statements are only available in Compustat typically one or two years after publication. We hand collected and codified audit committee members' areas of expertise based on annual report disclosures, either from SGX or respective company websites. The resulting useable sample size with both financial and audit committee information for our study is 423 companies.

Figure 1

Expertise in audit committees

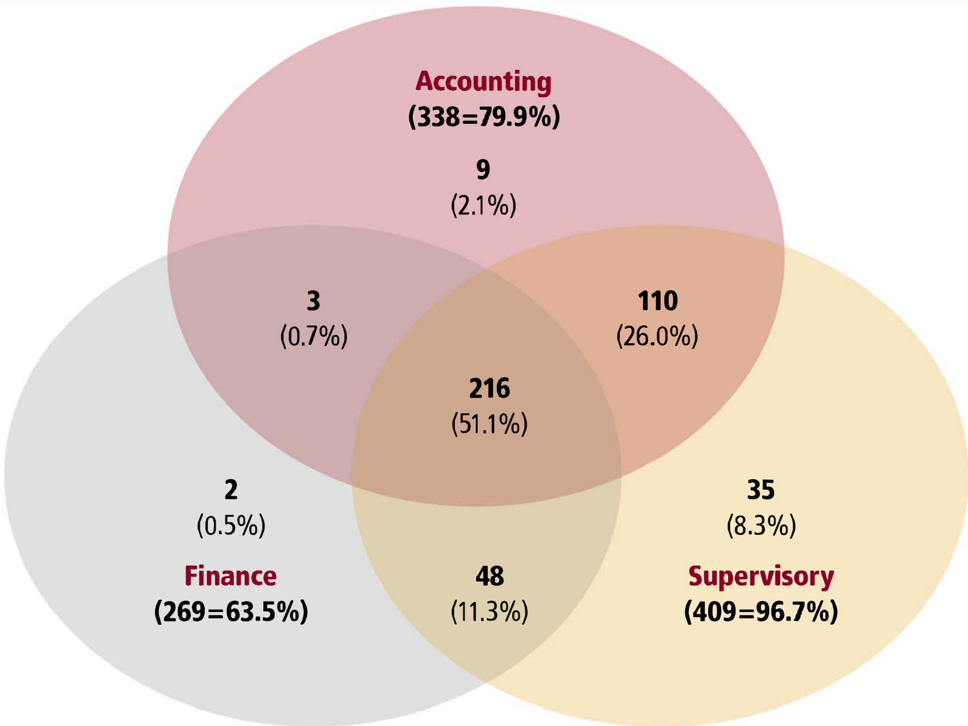
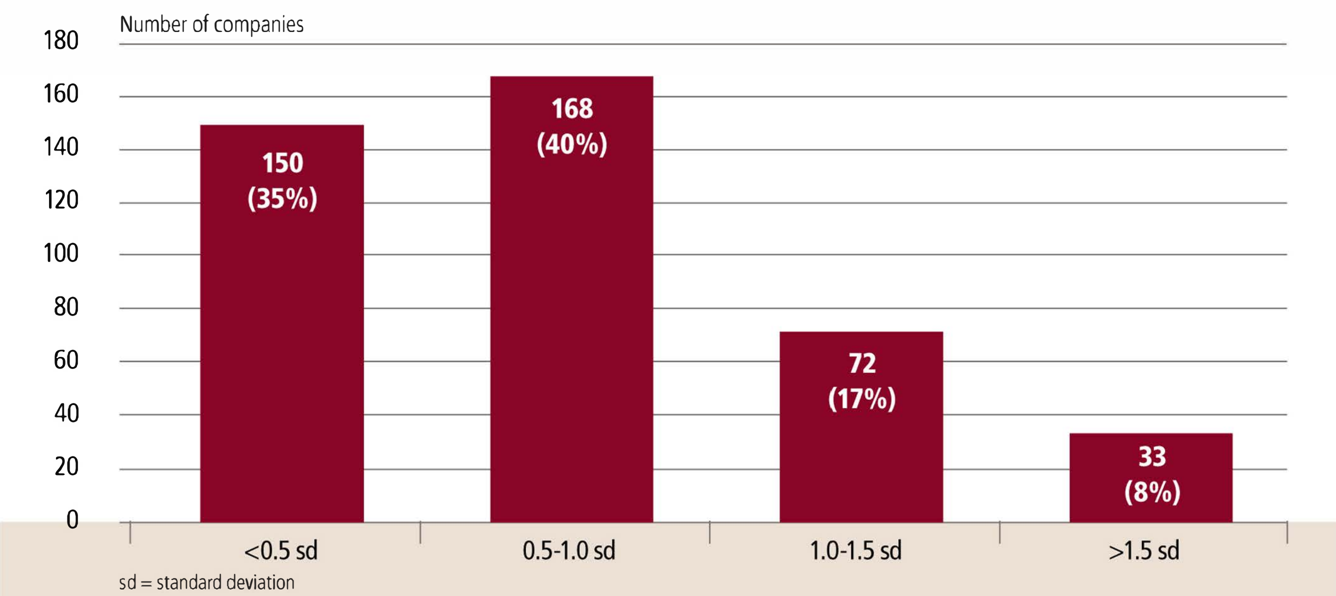


Figure 2

Financial reporting quality distribution



Accounting expertise

We define accounting expertise as audit committee members who are chartered accountants, certified public accountants (CPAs) or with work experience as chief financial officers, vice president of finance, financial controllers, or any other major accounting positions. We also took the opportunity to label two other expertise areas. Finance experts are defined as audit committee members with work experience as investment bankers, financial analysts, or any other financial management role, and supervisory experts are defined as audit committee members with work experience as CEOs or company presidents and directors. Naturally, a person may be classified into more than one expertise area. For example, a CPA who previously worked as an investment banker and now a CEO of a company would be considered as having three expertise areas.

In terms of expertise, all 423 companies have one form of expertise or another. Eighty per cent of the audit committees have accounting expertise, 64 per cent have finance and almost all have supervisory expertise. In fact, over half of the companies have all three expertise areas. Figure 1 shows the presence (and combination) of expertise in Singapore audit committees.

Financial reporting quality

We theorise that a firm's financial reporting quality is higher when its abnormal accrual is lower. Abnormal accruals are variations of current accruals from historical patterns of accruals. Accruals themselves are not necessarily bad, and are intended to reflect the economic phenomenon that took place in a business. However, research has consistently shown that management is able to influence earnings by manipulating accruals, thus lowering financial reporting quality. For example, management may use very different estimates in determining provisions or allowances that varied greatly from what it has been using to achieve a particular earning outcome.

We posit that the greater the variation, the higher the abnormal accruals. In our model, we used five years' accruals data and measured the variation in units of standard deviation to make it comparable across firms. We also controlled for industry characteristics, firm size, cash flows and other variables.

We find that abnormal accruals for three quarters of the companies in our sample are within one standard deviation of their historical patterns. Thirty-three companies (8 per cent) of the companies have abnormal accruals beyond 1.5 standard deviation. In fact, six companies had high variations in excess of three standard deviations.

Impact of expertise

In our first regression test, we examine the presence of accounting, finance and supervisory expertise independently against financial reporting quality. The results show that firms with audit committee members having some form of accounting expertise have a statistically significant correlation with higher financial reporting quality. In contrast, presence of finance or supervisory experience alone does not result in higher financial reporting quality.

As a further test, we examine the three expertise areas and their combinations simultaneously. The results indicate that audit committees with a combination of expertise (ie accounting with finance, accounting with supervisory or all three) have statistically significant correlation with higher financial reporting quality.

Our study has a number of policy implications. It supports the Code in requiring audit committee members to have some form of accounting expertise. However, financial reporting quality is higher when accounting expertise is combined with finance and/or supervisory expertise, either in the same person or by other members of the audit committee. This reinforces the importance of diversity in skills-mix of an audit committee.

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