

THE RELATIONSHIP BETWEEN INTERNAL AUDIT CHARACTERISTIC AND AUDIT COMMITTEE CHARACTERISTIC ON INTERNAL AUDIT CONTRIBUTION

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ABSTRACT

Internal auditing has become an important tool in helping an organisation to achieve its objectives. Organisations with internal audit activities capable of identifying business risks, and system inefficiencies and ineffectiveness, take appropriate corrective actions, and ultimately support continuous improvement. The contribution of internal audit and its determinants of internal audit characteristics, audit committee characteristics, and interaction between internal audit and audit committee are identified. Questionnaires were distributed to 413 public listed companies in Bursa Malaysia and 172 responses were received. The findings showed that internal audit contributed the most to internal control. The results revealed that internal audit competence has a significant effect on internal contribution. Hence, internal audit teams should consist of members with different expertise; both in technical and soft skills. Factors related to audit committee and interaction between audit committee and internal audit were not found to be significant. The relationship between audit committee and internal audit needs to be reinforced for better oversight mechanisms. The Malaysian Code of Corporate Governance and the International Professional Practice Framework should require higher compliance to IPPF with the disclosure on audit committee activities.

Keywords: Internal audit, audit committee, internal audit contribution.

INTRODUCTION

The Malaysian Code of Corporate Governance (MCCG) was first introduced in 2000 and the code was then revised in 2007 and 2012. This was then followed by the Bursa Malaysia Revamped Listing Requirement in 2001 and Guidelines on Internal Audit Function for Public Listed Companies in 2002. These enacted reforms aim to promote and improve corporate governance in public listed companies in Malaysia. Bursa Malaysia has recognized the importance of internal audit as the key governance function in public listed companies, and highlighted the roles as closely linked with audit committees. The revised MCCG Code 2007 recognises the importance of internal audit by requiring all companies to have an internal audit function. Both of these reforms have put internal audit in the lime-light of the means of improving risk management and governance. Besides, this is also helpful in order to preserve and enhance stakeholder value. Given the perceived importance of internal audit as part of good corporate governance, these changes are likely to enhance the role and value of internal audit (Coram, Ferguson & Moroney, 2006). When there is an adding value to the company, there should be no better resource of a company than internal auditing.

This study examines the effects of internal audit characteristics, audit committee characteristics, and interaction between internal audit and audit committee in regards to internal audit contribution. Several studies have found that these monitoring mechanisms are the important factors which contribute onto internal audit contribution (Al-Twaijry, Brierley & Gwilliam, 2004; Felix, Gramling & Maletta, 2001; Hay, Knechel & Wong, 2006; Messier & Schneider, 1988; Prawitt, Sharp & Wood, 2011; Prawitt, Smith & Wood, 2009). A number of recent studies (Carcello, Hermanson & Raghunandan, 2005; Gramling, Maletta, Schneider, & Church, 2004; Sarens & De Beelde, 2006) had called for further research into the contribution of the internal audit function from the perspectives of key corporate governance parties. Therefore, in this study, internal audit characteristics, audit committee characteristics, interaction between internal audit, and audit committee will give an influence towards internal audit contribution. This study is defined as the extent of roles which played by internal audit in risk management, control and governance.

LITERATURE REVIEW

Contribution of Internal Audit

When the internal audit profession was emerging in the 1940's, the scope of internal auditing and the reporting relationship was rather simple. The role of internal auditor has been described as the eyes and ears of management, which help to ensure that shareholders by individuals, as well as stakeholders' interests are being taken care of. However, the growing concerns over financial controls, management fears of fraud, an increased need for organizational efficiency, increase usage of information technology, environmental awareness and changes in legislation have had an impact on the development of internal audit. For instance, Malaysian Code of Corporate Governance (2000) has considered internal audit as one of the four cornerstones of good corporate governance. All these factors have shifted the focus of internal audit's work dramatically over the last decade, from validating financial controls into adding real value to the organisation.

The IPPF (IIAM, 2011) stated that the internal audit activity does adds value to the organization (and its stakeholders) when there is objective and relevant assurance; and contributes to the effectiveness and efficiency of governance, risk management, and control processes. The latest definition of internal auditing in 1999 expands the role of internal auditors in internal control, risk management, and governance. The growing emphasis on corporate accountability has led to a drive for more openness, in a way for business to manage and communicate their performance to key stakeholders. Internal audit appears on the horizon in respect of identifying risks and control, governess weaknesses and in contribution to their improvement, and ultimately at the same help to increase shareholders' value. Practice Standard 2100 of IPPF (IIAM, 2008) states that internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes by using a systematic and disciplined approach. Making an organisation successful is the key driver for corporate governance, risk management and internal controls. The action would reflect into the broad nature, or scope of internal auditing.

RESEARCH DESIGN

This study examines 181 companies listed in the Stock Exchange of Bursa Malaysia. The target population consists of 641 public listed and companies listed on the main board of Bursa Malaysia as at February 27, 2009. Year 2009 was chosen because MCCG has been revised in year 2007 and the revised MCCG has recognises as the importance of the internal

audit by requiring all companies to have an internal audit and set of stringent requirement for audit committee. The reasons why only companies from main board were chosen because these companies have similar homogeneity characteristics in terms of firm size (market capitalisation). Bigger companies used to have more resources and this might affect the internal audit effectiveness. Further, the population will include all industry except those companies from government sectors as these companies are subjected to special accounting practices and requirements. Another reason to include all industry is because corporate governance is crucial and fraud cases happen in all public listed companies regardless of type of industry.

The primary data of this research was obtained by using a questionnaire. Chief audit executive is selected as the respondents for this study. Chief audit executive reports to audit committee and maintain a strong and close working relationship with audit committee, which thus deemed to be as the appropriate parties in evaluating the quality of internal audit and quality of audit committee and contribution of internal audit. The theoretical framework of this research is as shown in Figure 1.

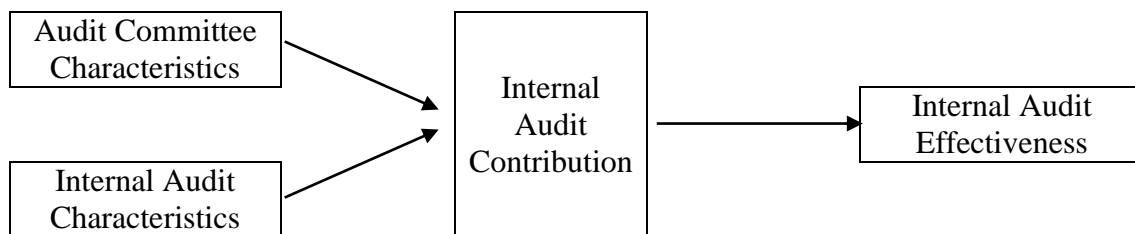


Figure 1. Research Framework.

Measuring Internal Audit Contribution

The internal audit contribution in this study is the audit committee’s assessment of internal audit contribution to risk management, control and governance. Each item has a five-point rating scale with a score of five for “Very high”, four for “Moderate High”, three for “Neutral”, two for “Fairly Low” and one for “Very low”. These questions are adopted from a research of Institute of Internal Auditors Malaysia (2008).

Internal audit contribution to risk management is measured in section C of the questionnaire which consists of questions relating to risk assessment, risk management, and risk communication. In terms of measuring internal audit contribution in control, there are relatively include with the control of effectiveness, control adequacy and alignment of control and organizational objectives which were included in section C of the questionnaire. As governance is wide, therefore there are more dimensions which internal audit can contribute such as board related, communication and reporting, ethic related, governance related and management related. For each category of contribution, an average score across the items will be calculated.

RESULT

Descriptive Statistics

Table 1 shows that the average internal audit competence is 0.95 with the minimum of 0.63 and maximum 1.42. The average internal audit independence (IAI) is 9.13 with a minimum of 2.00 and a maximum of 11.00. The average of work performance is 4.31 with a minimum of 3.13 and a maximum of 5. Among the three dimensions of work performance, the planning

of work performance has to be considered as maximum (4.39) and minimum (3.00) while the performing of work performance scores the lowest with the mean of 4.12.

Audit committee independence, which is an item of audit committee characteristic, is found to have a mean of 4.33 with the minimum of 1.00 and a maximum of 5.00, which is quite high. The average audit committee financial literacy is lower as compared to audit committee independence, with a mean of 3.87. In terms of interaction between audit committee and internal audit, audit committee review and meeting between audit committee and internal audit score is relatively high with a score of 4.25 and 4.27 respectively. Both variables have a maximum score of 5.00 and a minimum of 2.00. Dismissal of CAE (DISM) only scores 3.79 with a minimum of 1.00 and a maximum of 5.00.

Table 1. Descriptive statistics (n = 172).

Variables	Mean	SD	Skewness	Kurtosis
IAC	0.95	0.17	0.54	-0.20
IAI	9.13	1.66	-1.63	3.95
WP	4.31	0.44	-0.06	-0.77
WP_RESULT	4.34	0.49	-0.27	-0.35

Findings

In the regression analyses shown in Table 2, all of the three models (Model 1, Model 2 and Model 3) were found to be significant with F-statistics ranging from 2.813 to 12.135, and all models were found to be strongly significant either at $p < .01$ or $p < .05$. However, the percentages of variance which explained by the models are in between of 15% to 43%. Only seven out of thirty hypotheses are found as significant. Most of all are related to internal audit characteristics.

The findings of this study are consistent with the findings of a corporate governance study which conducted by Zain, Subramaniam and Stewart (2006) on two characteristics of audit committee, namely the independence and financial literacy. Zain, Subramaniam and Stewart (2006) had found that the more independent and stronger the level of financial literacy of audit committee, the greater the contribution of internal auditors to financial statement audit. Their results do support the current debate on the appointment of independent audit committee members and the need for members to be financial literacy. According to Abbott and Parker (2000), the independent and active audit committee member will demand a high level of audit quality because of their concerns about monetary or reputational losses, which might be resulted from the lawsuit or SEC sanction. These inconsistent findings could be explained by the usage of different basis of measuring the audit committee independence and financial literacy. This study used Likert scale in order to measure audit committee independence and financial literacy which might not fully captured within the both characteristics of audit committee; whereas, the study of Zain, Subramaniam and Stewart (2006) used number of outside directors on the audit committee as a percentage of total directors on the audit committee and score 1 to 5 (1 = poor, 2 = below par, 3 = good, 4 = very good, 5 = excellent) in order to measure the extent of audit committee member in terms of knowledge and experience in accounting and auditing.

CONCLUSIONS

The study found that there is a significant relationship between the internal audit competency and internal audit contribution in control. Similarly, Felix, Gramling and Maletta (2001) and

Mazlina Zain, Subramaniam and Stewart (2006), which found that the more competence the internal audit, the greater the internal auditors' perception of their contribution to the external audits. Companies should consider level of education and types of experiences when appointing new internal auditor. This finding has given an implication to the importance of certified internal audit and IIAM should consider of making this as a mandatory for the manager to own a certified internal audit.

Most of the audit committee characteristic's factors and interaction between audit committee and internal audit shows an insignificant result with the internal audit contribution. This finding does not support the mandating of audit committee independence and financial literacy's requirement in the revised MCCG 2007 for the purpose of better oversight mechanism, as well as what has been recommended by IPPF to have close working relationship between audit committee and internal audit. These findings also have implication to the revised MCCG which requires independence and financial literacy of audit committee, and the Institute of Internal Auditors (IIA) which recognises audit committees and internal auditors that have interlocking goals and a strong working relationship with the audit committee. These are essential for each perspective in order to fulfill its responsibilities to senior management, board of directors, shareholders, and other outside parties. Given that internal audit is new in Malaysia, companies should establish proper guidelines in audit charter or ensure compliance to IPPF in order to increase the quality of internal audit characteristic which would lead to higher internal audit contribution.

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