
**AUDIT COMMITTEE CHARACTERISTICS AND INVESTMENT IN
INTERNAL AUDIT FUNCTION: EVIDENCE FROM MALAYSIA LISTED
COMPANIES**

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ABSTRACT

As one of the corporate governance mechanisms, audit committee is viewed as an essential self-regulatory internal governance instrument and is expected to provide an overseeing role over the entire process of financial reporting, particularly the working of the internal control system and the work of the auditors. However, there is limitation on the relationship between the audit committee characteristics and the level of investment in internal audit function. This study examines the relationship between audit committee characteristics and investment in internal audit function. The current study used a sample of top 100 listed companies in Bursa Malaysia based on 2017 market capitalisation. Data were collected from the annual report of the listed companies for a period of three years (2014 – 2016). Using Stata software, multiple regression analyses was used to test the hypotheses. The results indicate that, there is a significant relationship between audit committee characteristics (independence, tenure and size) and investment in internal audit function.

Keywords: Audit committee, Investment, internal audit function

1. INTRODUCTION

Internal audit has become a very crucial component of global businesses. It is a vital constituent of the risk management, internal control structure of the organization (Anderson, Christ, Johnstone & Rittenberg, 2012). Internal audit is carried out in different legal and cultural environments within organizations that differ in size, aim and structure, and also by the individuals within or outside the organization (Fadzil, Haron & Jantan, 2005). The main objective of the internal audit is to protect the rights and interests of stockholders. By evaluating governance, control and risk management, internal audit can help an organization to fulfil its goal or improve its firm performance (Carcello, Hermanson & Raghunandan, 2005).

Audit Committee are the sub-committee of the board that oversee the function of the internal audit function (IAF). The audit committee and IAF play important roles in an organization to ensure the credibility and reliability of financial reporting. This role has been highlighted by the Securities and Exchange Commission (SEC) in the U.S. and other accounting regulators (Zain & Subaramaniam, 2007).

Working together with the IAF, or in order to support the IAF, the audit committee is responsible for reviewing the internal audit plan and making sure the scope of the internal audit activity is adequate within the organization (Zain, Subramaniam & Stewart, 2006). Hence an effective IAF may aid the audit committee with the assertions concerning control; independent assessment of accounting procedures and practices; revelation on risk and fraud (Hermanson & Rittenberg, 2003).

With this regard, the Bursa Malaysia has highlighted the importance of IAF and audit committee in its listing requirement. They compulsory audit committee in all listed companies in Malaysia to ensure better interaction between management, internal and external auditors and to ensure the independence of the audit function. There is evidence that the Securities and Exchange Commission (SEC) in Malaysia attached the importance of IAF in improving financial reports and accounting practices (Yasin & Nelson, 2013).

More investment in IAF leads to increase the effectiveness in overseeing the financial reporting process and thus, increases the quality of financial statement. Also, large investment in IAF may help to improve the competency of IAF's members individually that in turns can assist the management in establishing stronger controls over financial reporting, and thus, reduce the existence of control problem (Al-Rassas & Kamardin, 2015). However, some companies perceive the IAF as a non-earning unit and thus give least importance to the department.

In determining the level of investment in the IAF, little is known about the factors that is associated with the investment in IAF. Therefore, the main issue that need to be addressed is why some companies are willing to invest largely in IAF while others do not (Carcello, Hermanson & Raghunandan, 2005). There is limited literature that provide the evidence on the factors that leads to the level of investment in IAF which will be the focus of this study.

The current study examines the level of investment in IAF in relation with the characteristics of audit committee in Malaysia environment. This study investigates several characteristics of audit committee (independence, tenure and size) and evaluating whether these characteristics have significant relationship with investment in IAF.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1 Audit committee characteristic

Salleh & Haat (2014) perceive an audit committee as a sub-committee of the company's board of directors, which provides a proper connection among the board members, the system of internal controlling and monitoring and the external auditor. Further, audit committee is defined by DeZoort et al., (2002) as the committee that includes members with high qualifications, power and resources to guarantee that the interests of stakeholders are protected. This protection can be achieved by ensuring the financial reporting quality, promoting internal controls and managing risks during its monitoring efforts.

The concept of audit committees has been in existence for ages. Audit committee was introduced in the United State (US) in 1978 (Spira, 2003). Audit committee was established to provide oversight in the process of financial reporting and establish procedures for internal control matters and financial reporting concerns. From the Tradeway Report in 1987, the New York Stock Exchange (NYSE) required the adoption of audit committee by all listed firms. Further, the Sarbanes Oxley Act (SOX, 2002) mandated the full adoption of audit committee by all listed companies in the NYSE. In the United Kingdom (UK), the Cadbury Committee (1992) recommended the adoption of audit committee to enhance public confidence after the 1980 crisis (Hrichi, 2009). Furthermore, the Smith Review (2003) also suggested the mandatory adoption of audit committee by all listed companies. Hence, the characteristics of audit committee considered in this study are audit committee independence, audit committee tenure and audit committee size.

2.1.1 Audit committee independence

Xie, Davidson & DaDalt (2003) and Bédard, Chtourou & Courteau (2004) define an independent non-executive director as a member who does not have a relationship with the company except being on its board.

Based on the MCCG (Revised Code, 2007), the audit committee has to be structured fully by non-executive directors, with most of them being independent directors. This recommendation is in line with the advantage of having non-executive directors, who could find solutions for the problems of inconsistency among internal managers and mitigate the conflict between managers and shareholders (Carcello, Hermanson & Raghunandan; 2005).

Generally, the independence level of the audit committee has been extensively investigated in the previous studies. Most of these studies examine the relationship between audit committee

independence with three areas of earning management, earning quality and audit fees. Amar (2014) and Salleh & Haat (2014) point out that the independence of audit committee member has significant impact on earnings management. Similarly, Klein (2002) also documents that the independence of audit committee is negatively impact to earnings management. Furthermore, Bradbury, Mak, & Tan (2006) report that an independent audit committee is associated with greater earnings quality. Their results explain that the effectiveness of audit committees will increase when it comprises of independent directors, which is consistent with regulators' calls for more independent audit committees. Vafeas & Waagelein (2007) and Carcello et al., (2002) demonstrate that audit committee independence is positively related to audit fees. This implies that, firms will pay little or no extra audit fees when audit committee comprises of more independent directors. Thus, this is consistent with the view that audit committees serve as a complement to external auditors in monitoring management actions and financial reporting process. However, there is a dearth in the literature that relates audit committee independence and investment in IAF. Hence this study predicts the following hypothesis:

H1: Audit committee independence has a positive relationship with investment in IAF

2.1.2 Audit committee tenure

Ghafran (2013) defines audit committee tenure as the length of time in which the audit committee members have been in the boards. Boone, Khurana & Raman (2008) argue that a long-term relationship with a firm is crucial for the audit committee to understand specific knowledge about the client's accounting system, internal control, operations as well as the client's industry. Shafie et al., (2009) provide empirical evidence that audit committee tenure is positively associated with the auditor reporting quality as a clean audit report will be issued with long tenure of engagement with the same audit committee.

Boone, Khurana and Raman (2008) argued that a long-term relationship with client is crucial for the audit committee to understand specific knowledge about the client's accounting system, internal control, operations as well as the client's industry features. Furthermore, Deis and Giroux (1992) and Copley and Doucet (1993) posited that a long audit committee tenure improves the audit quality performed by external auditors. Shafie et al., (2009) provided empirical evidence that audit committee tenure is positively associated with the auditor reporting quality as a clean audit report will be issued with long tenure of engagement with the same audit committee. However, there is a dearth in the literature that relates audit committee tenure and investment in IAF. Hence this study predicts the following hypothesis:

H2: Audit committee tenure has a positive relationship with investment in IAF

2.1.3 Audit committee size

Yasin & Nelson (2013) indicate that when there are larger numbers of audit committees, the members can bring resources such as expertise and experience to the firm that will contribute to the effectiveness of audit committee in monitoring management. The Smith Report (2003), Sarbanes Oxley Act (2002) and the Cadbury Report (1992) required that there must be minimum of three members in the audit committee. The revised MCCG (2012) mandates that the board should establish an audit committee and it must be composed of not less than three members.

A study from Beasley & Salterio (2001) posits that organizations are likely to include independence directors of the audit committee beyond the minimum requirement when the size of audit committee increases to enhance their effectiveness in performing their responsibilities. Vafeas & Waegelein (2007) shows a positive relationship between audit committee size and audit fees. Similarly, Hoitash & Hoitach (2009) indicate a positive association between audit committee size and audit fees. Their study highlights the significance of audit committee size in upholding their independence. However, there is limitation in the literature on the relationship between audit committee size and investment in IAF. Hence, this study predicts the following hypothesis.

H3: Audit committee size has a positive relationship with investment in IAF

2.2 Investment in IAF

The costs incurred (investment) for the IAF typically comprise manpower, training, out-sourced service provider and travelling. Malaysian Corporate Governance Code (2012) requires that listed companies to disclose the incurred costs for the internal audit over the financial year. As such, it could be perceived that the financial resources are crucial for enabling an effective internal audit function.

An effective IAF is one of the foundation stones of internal corporate governance monitoring mechanisms, along with the board of directors and the audit committee, which contribute towards the quality of corporate governance, through its oversight role (Prawitt et al., 2009; Soh & Martinov-Bennie, 2011). In order to improve the IAF, internal auditors must possess a suitable degree of experience and communication competence (Gramling & Hermanson, 2006). The Institute of Internal Auditors Attribute Standards stipulates that internal auditors should have skills, knowledge, as well as other competencies considered necessary to effectively fulfil their duties (IIA, 2005; 2008). It is critical for the IAF to be sophisticated enough to carry out its monitoring role and contributions in the area of corporate governance. Hence, for the IAF to be sophisticated it should have greater resources to enhance the competence and cognitive abilities

for the internal auditors; and increase the ability to access specialized knowledge of the independent firm that specializes in providing audit services.

3. RESEARCH DESIGN

3.1 Population and sampling

The initial sample of this research consists of top 100 companies listed on Bursa Malaysia based on the 2017 market capitalization. This study observes the firms over a three-year period (i.e. from 2014 to 2016). These firms were selected because they are more likely to have complete internal audit and audit committee data. However, this study excluded the finance sector due to their difference in corporate governance act which differentiate them from other sectors. Data pertaining to audit committee and IAF variables were hand collected from respective annual reports of public companies listed on Bursa Malaysia.

3.2 Measurement of variables

The dependent variable for this study is investment in IAF and is measured as the cost born by internal audit function (Barua et al., 2010).

The independent variables include audit committee independence, audit committee tenure and audit committee size. The audit committee independence is measured as the percentage of number of independent audit committee members to the total number of audit committee members (Abdul Rahman & Ali, 2006; Mohamad et al., 2012). Audit committee tenure is measured as the average tenure of audit committee directors (Abbott et al., 2004; Barua et al., 2010). While audit committee size was measured as the number of audit committee member (Klein, 2002; Zhang et al., 2007).

Table 1: Summary of the operationalization of the variables used in the study

Variables	Acronym	Operationalization
Investment in internal Audit	IAFNV	the cost born by internal audit function
Audit committee independence	ACIND	The percentage of total number of independent audit committee members of the firm divided by the total number of audit committee members
Audit committee tenure	ACTEN	The average tenure of audit committee member
Audit committee size	ACSIZE	The number of directors in audit committee of the firm

4. FINDINGS AND DISCUSSION

To examine the relationship between audit committee characteristics and investment in IAF, the following cross sectional-time series OLS regression is used to investigate the potential impact.

$$IAFNV = \beta_0 + \beta_1 ACIND_{it} + \beta_2 ACTEN_{it} + \beta_3 ACSIZE_{it} + \epsilon_{it}$$

Where:

IAFNV = the natural log of the cost born by internal audit function; **ACIND** = Audit committee independence; **ACTEN**= Audit committee tenure, **ACSIZE**= Audit committee size; ϵ = error terms.

Table 2: Relationship between audit committee characteristics and investment in IAF

Model	Coefficient	T	Sig
ACIND	-0.256	-2.43	0.031
ACTEN	-0.063	-5.26	0.000
ACSIZE	0.273	4.65	0.000
Number of obs		300	
F (3, 310)		167.52	
Prob > F		0.0000	
R-squared		0.698	
Adj R-squared		0.664	

Generally, table 2 shows that there is a significant relationship between audit committee characteristics and investment in IAF. The result is consistent with the study of Barua, Rama & Sharma (2010) who found a significant relationship between audit committee characteristics and investment in IAF.

Specifically, this study shows that there is a negative significant relationship between audit committee independence and investment in IAF. This shows that when there are more independent audit committee members, the level of investment in IAF will reduce. Furthermore, audit committee tenure and investment in IAF shows a negative significant relationship. This indicates that, longer tenure of audit committee members will reduce the level of investment in IAF as members will have increased firm specific knowledge, and the need for having a greater assurance from the IAF will reduce. Lastly, audit committee size and investment in IAF show a positive significant relationship. The result indicates that larger audit committee may demand greater assurance from the IAF. This is because, larger member will have a better link with the environment as they will be more capable, more expertise and more experience which will increase the effectiveness of the committee.

5. CONCLUSION

This study focuses on the relationship of two corporate governance mechanism which are audit committee and IAF. There is a limitation in the literature on the relationship between audit committee characteristics and investment in IAF except the study of Barua, Rama & Sharma (2010) in the United State of America. In terms of audit committee tenure, this study is in line with the study of Barua, Rama & Sharma (2010) who found that audit committee tenure is associated with lower investment in IAF. Hence, the results of this study contribute to the current literature such as the study of Carcello, Hermanson & Raghunandan (2005) and Barua, Rama &

Sharma (2010).

Furthermore, this study has a significant theoretical contribution in validating the theoretical perspectives of the agency theory. The significant relationship revealed between audit committee characteristics (i.e. independence, tenure and size) and investment in IAF can be explained with the agency theory. For instance, at one extreme, Carcello, Hermanson & Raghunandan, (2005) revealed that the effectiveness of IAF increases when input from the audit committee is taken into consideration for audit plans. At the other extreme, Barua, Rama & Sharma, (2010) argued that the involvement of an effective audit committee is bound to strengthen the internal controls of the firm and, therefore, reduces the need for assurance provided by internal auditors.

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