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IMPACT OF AUDIT COMMITTEE EXPERTISE AND AUDIT COMMITTEE INDEPENDENCE ON INTERNAL AUDIT FUNCTION

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ABSTRACT

The widespread appointment of the audit committee as a crucial mechanism of a corporate governance indicates that audit committee is significant in the framework of corporate accountability. The purpose of this paper is to determine the relationship between audit committee characteristics (expertise and independence) and investment in internal audit function in Malaysia public listed companies. A cross-sectional regression model using Stata statistical software has been proposed. This model will be used to study the relationship between the variables. Based on the proposed conceptual framework, research hypotheses are developed.

Keywords: Audit committee, investment in internal audit function, expertise, independence

INTRODUCTION

The 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 functioning of the internal control system and the function of the auditors (Blue Ribbon Committee (BRC), 1999; Hermanson & Rittenberg, 2003). The audit committee is expected to be familiar with the criteria to assess internal control like assessment procedures and source of information (Godwin-Stewart & Kent, 2006).

Independent audit committee directors are viewed by the market as professional members who are willing to facilitate advice and counsel (Sori et al., 2008). Chang and Sun (2010) posit audit committee members with financial accounting expertise to improve the financial reporting quality. Audit committee members with accounting background enhance the ability of audit committee in curbing management involvement in earnings management activities to cover self-interest behavior.

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However, Claessens, Djankov and Lang (2000) in a survey of 238 Malaysian firms found out that 67.2 % of shareholding wad in the hands of family members and their descendants. Hence, there is likelihood that family members will involve in selection process of audit committee directors who are less likely to challenge their decision. Moreover, A-Hamid, Mohammed Sori, and M-Nassir (1999) argued that the ineffectiveness of the audit committee stems from its inability to carry out its traditional responsibilities and maintain its technical competency with regard to accounting and psychological aspects of the internal audit profession. Zulkarnain and Shamsher (2007) argued that many Malaysian audit committees only act as a 'rubber stamp' and are only formed to comply with the requirement of Bursa Malaysia, as the Bursa Malaysia makes it compulsory for all public listed companies to have an audit committee. Hence, this study is set out to investigate the impact of audit committee expertise and independence on the resources available to the internal audit function.

An effective internal audit function aids the audit committee with: assertions concerning control; independent assessment of accounting procedures and practices; risk and fraud analysis (Hermanson & Rittenberg, 2003). Internal audit function also serves as a prized asset for the audit committee to reach its financial reporting obligation (Bishop, Hermanson, Lapides, & Rittenberg, 2000). On the other hand, the audit committee is responsible for reviewing the internal audit plan and making sure the scope of the internal audit activity is adequate. (Mat Zain et al. 2006). Moreover, Carcello et al. (2005) argue that an audit committee must exact some sort of control over the internal audit function to make sure whether the internal audit system plays effective controlling role and provides support to the audit committee. This may be done by exercising control over the organization's resources set aside for internal audit function. This study offers empirical evidence from a developing country that may help in enriching the existing literature on internal audit as well as audit committee and understanding of the global configuration of the internal audit profession, especially in Malaysia where there is limited literature that investigate the association between audit committee expertise, audit committee independence and internal audit investment.

LITERATURE REVIEW

Audit committee

The widespread employment of the audit committee as a crucial mechanism of a corporate governance indicates its significance in the framework of corporate accountability, where audit committees are expected to safeguard investors' interests (Zanni & Terrell, 2002). The securities commission (SC) introduced the establishment of audit committees back in 1993. Since 1994, the Bursa Malaysia has required that a listed company should appoint an audit committee that satisfies several requirements, including: the composition of not less than three members, with

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most of them being independent directors, with a minimum of one member with a membership of the Malaysian Institute of Accountants (MIA), or who has considerable experience in accounting and qualifications such that he/she can be considered by the Stock Exchange as 'financially literate'. Similarly, the revised MCCG (2007) recommends that the directors of the audit committee have to be non-executives, financially literate and as a minimum, one of these members must be associated with an accounting association.

According to the agency theory, audit committees are crucial mechanisms that ensure that the agent is working to increase the wealth of all shareholders. The role of the audit committee in the internal corporate governance is to minimize the information asymmetry that could in turn, result in decreased agency problems. More importantly, investors make use of corporate financial statements as their source of financial information. However, it is suggested that audit committees should possess some crucial characteristics, such as independent members and expert members to perform its duties more effectively (DeZoort et al., 2002).

Audit committee expertise and investment in internal audit function

Audit committee expertise is generally regarded as a critical characteristic for an audit committee's effective operation (Baxter & Cotter, 2009). The MCCG requires that all directors of the audit committee must be financially literate and a minimum of one director should be associated with an accounting association or body (Revised MCCG, 2007). Furthermore, the Bursa Malaysia Corporate Governance Guide (2009) defines the financial literacy of audit committee directors as the capability to read and understand financial statements, the capability to analyze financial statements and ask significant questions about the company's operations against internal controls and risk factors, and capability to recognize and understand the using of accepted standards of accounting.

Barua et al. (2010) found that internal audit investment decreases as the number of financially expertise directors in audit committee increases. Reviewing the studies on audit committee financial expertise and its relationship with earnings management, Xie et al. (2003) reported a negative association between other non-accounting financial experts (e.g. corporate or investment banking backgrounds) and practices of earnings management. In a similar vein, Bédard et al. (2004) concluded that an audit committee comprising a minimum of one director with financial and governance expertise is effective in reducing the earnings management practices. The results support the SOX Act's assertion that financial expertise is a significant characteristic of an audit committee to undertake its responsibility in monitoring the activity of financial reporting and auditing process. Further, the findings also largely support the Blue Ribbon Committee (BRC, 1999) in that that audit committee members with financial expertise are more likely to perform an active role. In light of this, the following hypothesis is proposed.

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H1: there is a relationship between audit committee expertise and investment in internal audit

Audit committee independence and investment in internal audit function

The question regarding the independence level of audit committee is considered an important part of its composition (Joshi & Wakil, 2004). The independence of audit committee members is a crucial characteristic that influences the efficiency of the committee in overseeing the process of financial reporting. Beasley (1996), Xie et al. (2003) and Bédard et al. (2004) define an independent non-executive director as a member who does not have a relationship with the company except being on its board.

Xie et al. (2003) found that earnings management is less likely to occur in companies whose audit committee include outside corporate directors. The authors argue that since audit committee is responsible for monitoring financial performance and reporting, having outside corporate members is associated with the committee's ability to monitor the management self-interest action. Similarly, Klein (2002) found a negative relation between audit committee independence and abnormal accruals. Furthermore, Bédard et al. (2004) showed that when 100% of the members are independent, there is a significant decrease in the possibility of aggressive earnings management. Further, the study of Siagian and Tresnaningsih (2011) found that the quality of earnings reporting can be improved by independent board of directors and independent audit committees. They claimed that those independent directors from management on both boards and audit committees, significantly enhance the boards' monitoring function and prevent poor financial reports. Considering this, the following hypothesis is proposed.

H2: there is a relationship between audit committee independence and investment in internal audit.

Firm specific attribute

There are several attributes of the firm that could affect investment in internal audit. These factors will not be the focus of this study but serve as controlling variables. The factors include leverage, inventory, firm size and operating cash flow. These control variables are incorporated in the current research's models because they were found by previous studies to have a real effect on the investment in internal audit function (e.g. Al-Rassas & Kamardin, 2015; Alzeban, 2015; Barua et al., 2010; Carcello et al., 2005; Zhang et al., 2007). Therefore, if these variables are not controlled, it would probably lead to bias in the ultimate outcome of the models that test the pure association between the characteristics of audit committee and investment in internal audit.

The proportion of debt in a company's capital structure creates the need for monitoring on behalf of the debtholders (Chow 1982; Francis & Wilson, 1998). It is assumed that the more the company relies on debt, the more likely is the board of directors to invest in internal audit function. Carcello Hermanson & Raghunadan (2005) reported that an increased proportion of debt positively affects a company's investment in its internal audit function. Invention ratio has been used by literature to proxy for complexity for operations (Abbott et al. 2010). It has been argued that the need for better monitoring by an effective internal audit increases with firm complexity (Ramamoorti, 2003). The results of Carcello et al. (2005) show that firm complexity is positively related to the investment in internal audit function. As for firm size, Carcello et al. (2005) pointed out that large firms invest more in internal audit function. In addition, the results of prior studies indicate a positive relationship between firm size and internal audit investment (Abbott et al., 2010; Goodwin-Stewart & Kent, 2006; Anderson et al 2010). Finally, extant works provided empirical evidence that operating cash flow is positively related to internal audit investment (Carcello et al., 2005; Abbott et al., 2010).

Relationship between audit committee and internal audit function

The Institute of Internal Audit (IIA, 2002b) posit that there should be open communication between the audit committee and IAF and ensure that internal auditors have regular access to the committee for the organization to achieve its goals. By doing this, the IAF can raise issues that is affecting management, while the audit committee has direct access to information that they might not have (Bishop et al., 2000). Thus, an effective working relationship between the audit committee and IAF is key to effective corporate governance (Davies, 2009).

One of the appropriate ways for the audit committee to monitor IAF is to have an influence over resources available to the IAF (Barua, Rama & Sharma 2010; Carcello, Hermanson & Raghunandan, 2005). The effective audit committees are more likely to demand greater assurance in order to achieve higher financial reporting quality (Kamolsakulchai, 2015). As such, firms with effective audit committees may be expected to invest more in IAF as a signal to the external users that the firms possess the effective internal governance mechanisms and reports the higher quality financial information. Sarens, De Beelde & Everaet (2009) found the audit committee and IAF have complementary role within firms' governance system.

Proposed framework

The conceptual framework proposed in this study is presented in Figure 1. The research aims at investigating the relationship between audit committee characteristics (expertise and independence) and investment in internal audit.

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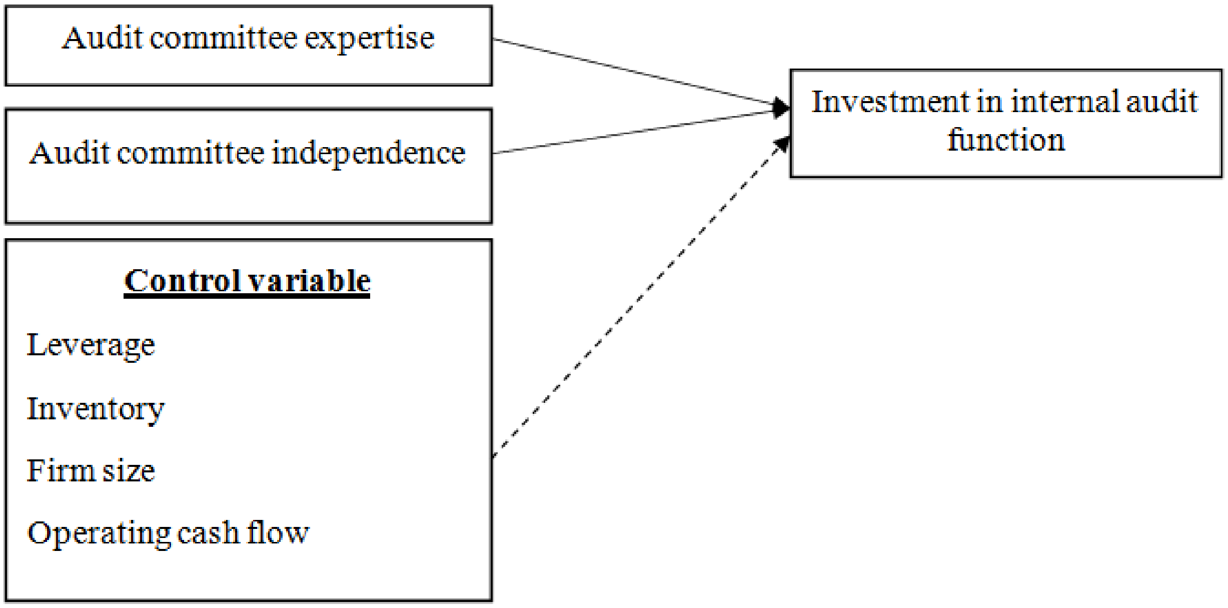

METHODOLOGY

In achieving the objectives of the study, a quantitative approach is employed. The total population for this study is the entire listed companies in the Bursa Malaysia excluding financial sector. The financial sectors are excluded because they have a specific and different regulation on corporate governance compare to other sectors. Data pertaining to audit committee and internal audit variables will be extracted from respective annual reports of public companies listed on Bursa Malaysia. Finical data (i.e. firm size, leverage, inventory and operation cash flow) will be extracted from financial database "DataStream". Hence, to achieve this end, cross sectional-time series regressions is conducted using panel data analysis. Data are analysed and processed using Stata software version 13.

CONCLUSION

The audit committee and internal audit play important roles in an organization to ensure the credibility and reliability of financial reporting. This study focuses on the impact of audit committee characteristics (expertise and independence) and its influence on investment in internal audit function. This study is aimed to extend the literature on investment in internal audit in Malaysia. Interestingly, the Malaysia Code of Corporate Governance (MCCG 2007) has mandated listed companies to publish information about the internal audit cost in their annual reports. Hence data on investment in internal audit function is publicly available in the annual reports of Malaysian listed companies.

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