



AUDIT COMMITTEE EFFECTIVENESS AND
INTERNAL AUDIT: AN EMPIRICAL
INVESTIGATION WITH AUDIT QUALITY

BY

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ABSTRACT

Increased concerns regarding corporate accountability in various developed nations have been associated with the need for effective audit committee and internal control systems. This is due to large corporate collapses which have demonstrated problems with the quality of financial reporting and auditing. This study examines the nature and extent of the relationship between audit committee characteristics and internal audit function characteristics with audit quality whereby audit fee is used as a proxy for audit quality. The corporate governance characteristics included in this study are audit committee expertise, frequency of audit committee meetings, structure of internal audit function and size of internal audit function. This study applied the agency theory and resource dependence theory. This study also formulated eight hypotheses that guided the analysis and using publicly available information of 200 Malaysian public listed companies for the financial year end 2009 and 2010 each. This study provides recent evidence of a positive relationship between audit quality and two audit committee characteristics: audit committee with postgraduate qualification and frequency of audit committee meeting. Further, a positive relationship is found between audit quality and internal audit function characteristic, which is size of internal audit function. The results indicate firms that consist of more audit committee members with higher tertiary education and meets regularly with well-resourced internal audit units have a significant relationship with the audit quality. Apart from contributing to the literature on corporate governance and audit quality, this study may serve as an input for the regulator to encourage strict enforcement for Malaysian-listed companies to incorporate corporate governance practices especially on audit committee composition and internal audit function.

خلاصة البحث

وقد ارتبط تزايد المخاوف بشأن مساءلة الشركات في مختلف الدول المتقدمة مع ضرورة لجنة لمراجعة الحسابات ونظم فعالة للرقابة الداخلية. هذا يرجع إلى انهيار الشركات الكبرى التي أثبتت مشاكل مع جودة التقارير المالية والتدقيق. هذه الدراسة بفحص طبيعة ومدى العلاقة بين الخصائص جنة المراجعة الداخلية ومراجعة الحسابات مع الخصائص الدالة جودة المراجعة حيث يتم استخدام أتعاب المراجعة كبديل للحصول على جودة التدقيق. خصائص حوكمة الشركات المدرجة في هذه الدراسة هي مراجعة لجنة الخبرة ، وتواتر اجتماعات لجنة مراجعة الحسابات ، وهيكل وظيفة المراجعة الداخلية وحجم وظيفة المراجعة الداخلية. طبقت هذه الدراسة على نظرية الوكالة والموارد نظرية التبعية. وضعت هذه الدراسة أيضا ثمانية الفرضيات التي وجهت للتحليل واستخدام المعلومات المتاحة للجمهور من 200 2009 شركة عامة مدرجة في ماليزيا في نهاية السنة المالية 2009 و 2010 لكل منهما. هذه الدراسة تقدم دليلا آخر على وجود علاقة إيجابية بين جودة مراجعة الحسابات واثنين من الخصائص جنة التدقيق : لجنة مراجعة الحسابات مع المؤهلات العليا وتواتر اجتماع لجنة مراجعة الحسابات. كذلك ، تم العثور على علاقة إيجابية بين جودة المراجعة الداخلية ومراجعة الحسابات ووظيفة مميزة ، والذي هو حجم وظيفة المراجعة الداخلية. وتشير النتائج إلى أن الشركات تتألف من أكثر من أعضاء لجنة مراجعة الحسابات مع التعليم العالي الجامعي التي تجتمع بانتظام مع وحدات تتمتع بالموارد الكافية لمراجعة الحسابات الداخلية ، وعلاقة كبيرة مع نوعية مراجعة الحسابات. وبصرف النظر عن المساهمة في الأدب حول حوكمة الشركات وجودة مراجعة الحسابات ، وربما هذه الدراسة كمدخل لتنظيم لتشجيع التنفيذ الصارم للشركات المدرجة في ماليزيا لإدماج ممارسات حوكمة الشركات خاصة على تشكيل لجنة المراجعة والتدقيق الداخلي ووظيفة.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

(Fatimah Binti Mat Yasin)

Signature.....

Date.....

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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EMPIRICAL INVESTIGATION WITH AUDIT QUALITY**

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LIST OF ABBREVIATIONS

AC	Audit Committee
ACCA	Association of Chartered Certified Accountants
AT	Agency Theory
BRC	Blue Ribbon Committee
CG	Corporate Governance
EAF	External Audit Fees
IPC	Infrastructure Project Companies
KLSE	Kuala Lumpur Stock Exchange
MCCG	Malaysian Code of Corporate Governance
MIA	Malaysian Institute of Accountants
MICPA	Malaysian Institute of Certified Public Accountants
RPG	Recommended Practice Guide
SC	Securities Commissioner
SEC	Securities and Exchange Commission

CHAPTER ONE

INTRODUCTION

1.0 INTRODUCTION

This chapter serves as the introductory chapter for the study. This chapter comprises the background of the study, followed by the problem statement, objectives of the study and motivation of the study. It also provides a discussion of the significance of the study and ends with a discussion of the structure of the study.

1.1 BACKGROUND OF THE STUDY

Regulators recently highlighted the increased vital role of internal audit functions in supporting the audit committee to ensure the quality of financial reporting and auditing (i.e. Malaysia Corporate Code of Governance, 2007; Securities Exchange Commission, 2004). Likewise, one of the roles of the audit committee is to oversee the quality of monitoring mechanisms implemented by the firm (i.e. internal audit function). Cohen et al. (2002) argued that corporate governance developments have also identified the internal audit function as playing a key role in assessing and improving the quality of such systems. In Malaysia, other than the audit committee which has been mandatory since 1993, the Malaysian Code on Corporate Governance (MCCG) also states as principle that the board of directors should maintain a sound system of internal control. Further, the key amendments in the latest MCCG that has been revised in October 2007 has emphasized on the audit committee roles and responsibilities, eligibility criteria and mandating internal audit function (Securities Commission, 2007).

In response to the revised MCCG (2007), the revised Listing Requirements of Bursa Malaysia in 2008 has provided greater obligation for public-listed companies to enhance Malaysia's corporate governance regime. Specifically, the amended Listing Requirements of 2008 outline the requirements for financial reporting disclosure on corporate governance matters and continuing listing obligations. Amongst the significant changes made are the amendments to strengthen the effectiveness of the audit committee. All audit committee members are now should be financially literate and at least one should be a member of an accounting association or body. The internal audit function is also made compulsory to provide a more effective support to the audit committee in carrying out its functions.

Ideally, the audit committee should be efficient and provide maximum transparency. This component of a company needs other groups, such as the internal audit function, to complete their effectiveness (Davidson et al., 2005). Audit committees assume important responsibilities with respect to internal audit. One of the most important functions of the committee is to oversee internal and external audit performances and to advise the board on audit matters. Therefore, an effective audit committee should enhance audit quality. A good audit committee will purchase high-quality audit service in order to reduce the likelihood of fraudulent financial reporting. As such, audit committees have the potential to enhance the effectiveness of the internal audit function as well as external audit work, which in turn, has implications for the audit quality which is indicated by the higher external audit fees.

In Malaysia, By-Laws (On Professional Conduct and Ethics) (2010)¹ and Recommended Practice Guide 7(RGP7)² issued by the Malaysia Institute of Accountants (MIA) stipulate a recommended basis for determining audit fees. The guidelines emphasize that the level of fee to be mutually agreed between the auditor and the client largely depends upon four factors, namely, (a) the skill and knowledge required, (b) level of training and experience of the staff involved, (c) the time necessarily occupied and the degree of responsibility and (d) urgency of work involved.³ In this study, it is expected that the audit committee characteristics and internal audit function might influence these factors which subsequently affect the level of external audit fees charged by auditor and audit quality whereby the higher the audit fees paid to the auditors, the higher the audit quality of the firms.

This study attempts to examine the association of certain audit committee's effectiveness and internal audit functions with audit quality, measured by external audit fees. Conceptually, this study extends the current knowledge about the audit quality variation by suggesting that the effectiveness of the audit committee and internal audit function will partly drive the cost of the external audit indicating high audit quality. Therefore, given the importance of corporate governance and auditing services, it is appropriate to examine whether the corporate governance mechanisms (i.e. audit committee and internal audit) influence the quality of auditing, which is reflected in the statutory audit fees paid by Malaysian-listed companies.

¹ The Revised By-Laws (On Professional Ethics, Conduct and Practice) of the Malaysian Institute of Accountants are issued by the Council of the Malaysian Institute of Accountants come into effect on 1 January 2011.

² The RPG7 represents the best current practice endorsed by the MIA and comes into effect on 1 March 2010 which replaced the prior guide issued in 2007.

³ See By-Laws (On Professional Ethics, Conduct and Practice) Section 240.2A and RPG7 Para 2.10

1.2 RESEARCH PROBLEM

Increased concerns regarding corporate accountability in various developed nations have been associated with the need for effective audit committee and internal control systems. This has been reflected through recent voluntary corporate governance guidelines. This is due to large corporate collapses which have demonstrated problems with the quality of financial reporting and auditing. For example, the beginning of the new millennium has seen the discovery of a variety of accounting frauds and scandals in the USA (Enron, Worldcom). This trend was not confined to the US only but also to other countries including Europe (Parmalat), UK (Shell), and Malaysia (Transmile, most recently the Port Klang Free Zone (PKFZ) scandal). These trends of scandals have tarnished the reputation of the accounting profession. It has also damaged investors' confidence on corporate financial reports and raised doubts about the audit function. Following these events, several steps were taken to reinforce the quality of corporate governance, including audit committee effectiveness, internal audit function and external audit practices. As part of the overall internal control environment, the audit committees and internal auditors have a responsibility to provide oversight on the reliability of financial reporting.

In addition, the recent subprime crisis in the US that occurred in the late 2007 also emphasized for the need of good corporate governance. The crisis has led to a debate concerning the efficiency and the role of corporate governance. The crisis indicated the failure to regulate good governance which affected the mobilization of funds in an effective way. Thus, the roles of audit committee and internal audit as the firm's internal control mechanisms are very important to ensure the reliability of financial reporting. Greece is one of the countries most affected by the crisis. The depth of the recession that happened in Greece was revealed to be much more severe

than previously thought and, given the country's declining competitiveness, the ability of Greece to bounce back with strong growth that would help debt servicing in the medium term was put in doubt (Ioannides, 2011). It is argued that the problems currently facing this country revolve around the central issue of governance. The areas to be improved have been highlighted to ensure the creation of an effective system of corporate governance in this country.

Further, the increasing controversy over financial reporting problems and inadequate audit committee oversight in recent years have resulted in greater demand for understanding the impact that audit committees have on the financial reporting process (Abbott et al., 2004). Much attention has been concentrated on the audit committee on the monitoring of the company management. Audit committees assume important responsibilities with respect to the internal audit, such as reviewing the internal audit programme and ensuring the adequacy of the scope of internal audit activities. As such, audit committees have the potential to enhance the effectiveness of the internal audit function as well as external audit practices, and this, in turn, has implications for audit quality.

In particular, with the growing recognition of the influence that audit committees have on the financial reporting process (Carcello and Neal, 2000), a key research question is whether such committees impact internal audit contribution to financial reporting and consequently the external audit practices. Thus, the research questions of this study are as highlighted below.

General Research Question (GRQ): What is the relationship of audit committee's effectiveness and internal audits functions with audit quality?

Specific Research Question One (SRQ1): Which of the audit committee's characteristics affect audit quality?

Specific Research Question Two (SRQ2): Which of the internal audit function characteristics affect audit quality?

These questions are important since the current focus on corporate governance specifically in MCCG 2007 has directed attention on the roles played by audit committees, internal and external auditors in reducing the risk of the auditors providing incorrect audit opinions.

1.3 OBJECTIVES OF THE STUDY

The main objective of the study is to investigate the relationship between audit committee effectiveness and internal audit function with audit quality in Malaysian-listed companies whereby audit quality is measured by external audit fees. Given the Bursa Malaysia listing requirements that require listed companies to disclose MCCG practices in their corporate annual report, this provides an avenue for a viable research related to corporate governance effectiveness. Understanding the effectiveness of the corporate governance should provide some valuable insights to the regulators or policy makers to encourage strict enforcement for the companies to incorporate corporate governance practices especially on audit committee composition and internal audit function. The presence of corporate governance mechanisms could improve the quality of financial reporting and ensure proper monitoring control of the company through effective audit committee and internal audit function. Therefore, this study will explore the importance of the audit committee characteristics and internal audit functions, which are theoretically important in the determination of audit quality, but which have been largely unexplored.

Previous researchers have addressed factors associated with external audit fees (Simunic, 1980; Gonthier and Schatt, 2007), however, very few researchers have

directly investigated the relationship between governance mechanisms and audit quality (measured by external audit fees), especially in Malaysia. Hence, this study extends these research by specifically exploring the association between audit committee effectiveness and internal audit function characteristics with audit quality. In addition, this study extends previous internal audit research (Carey et al., 2000; Goodwin and Kent, 2006; Singh and Newby, 2010) that has examined factors associated with internal audit existence or staffing levels, but not the financial investment in internal auditing (internal audit cost). Further, this study extends the literature by including managerial experience and academic qualification (i.e. postgraduate qualification), in building the hypotheses related to audit committee experts.

Therefore, this study aims to examine to what extent audit committees and internal audit characteristics (audit committee expertise, frequency of audit committee meetings, structure of internal audit function and internal audit cost) affect audit quality. In relation to that, the study assumes that audit committees have the potential to enhance the effectiveness of the internal audit function and external audit works, and this, in turn, have implications for the audit quality.

1.4 MOTIVATION OF THE STUDY

The motivation for examining this issue is as follows. First, there is an increasing emphasis in the profession and academic on the role of the internal audit as part of the firm's corporate governance. The Institute of Internal Auditors (IIA), for example, states that internal auditing can bring a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Besides, the motivation for this paper stems from the importance of effective audit

committees and internal auditing in the financial reporting and corporate governance processes. The revised Malaysian Code of Corporate Governance in 2007 emphasized the audit committees' roles and responsibilities, eligibility criteria and mandating internal audit function for each public-listed company. The MCCG 2007 provides strong support for this study as it provides a guideline for Malaysian companies to better monitor the firm's performance. Thus, given this enforcement, it provides a viable research idea for audit market research in Malaysia, in relation to the audit committee, internal audit and audit quality. Further, the listing requirements made by Bursa Malaysia on the audit committee and internal audit function have provided the motivation to further investigate its effectiveness by focusing on the audit quality in Malaysia. Hence, further research on this is clearly warranted.

Apart from that, most of these studies that have examined the relationship between internal audit and audit fees that measured the audit quality are conducted in either the USA or Australia. There is little evidence from environments that are different. Therefore, it is important that evidence from different jurisdictions is available to improve our understanding on the importance and role of internal auditor in developing countries such as Malaysia. This thesis attempts to examine the situation in Malaysia and contribute to the growing body of literature in this area.

1.5 SIGNIFICANCE OF THE STUDY

This study is significant as it has several implications for research. First, it examines and utilises a sample of companies listed in Malaysia which is a developing country compared to the US and Australia which have been the focus of a number of similar prior studies. Thus, this study adds to the growing body of international literature concerned with linkages between various corporate governance mechanisms (i.e. audit

committee and internal audit) and various facets of the audit processes. Further, this study sheds some light on whether there is a linkage between audit committee and internal audit and audit quality. Understanding the nature of this relationship is important, as it has an economic implication for firms as audit committee and internal auditors both serve as monitoring mechanisms of a firm.

Second, this study expects to provide some significant implications for the auditing practices by means of providing evidence on the effectiveness of MCCG practices which had been revised in October 2007. According to the revised MCCG 2007, the key amendments to the Code are aimed at strengthening the board of directors and audit committees, and ensuring that the board of directors and audit committees discharge their roles and responsibilities effectively. On audit committees, the amendments spell out the eligibility criteria for appointment as an audit committee member, the composition of audit committees, the frequency of meetings and the need for continuous training. In addition, internal audit functions are now required in all public-listed companies and the reporting line for internal auditors clarified.

From a practical perspective, the study provides feedback to the regulators (i.e., Securities Commissioner and Bursa Malaysia) on the need for policies that support and enhance the link between the audit committee and the internal audit function. Plus, the regulators can consider key features in the appointment of directors with necessary prerequisites such as academic qualification and senior managerial experience. Following this, the regulators can ensure mechanisms are in place to train potential or existing directors to obtain the features of the financial expert, and thus add value to the quality of financial statements.

1.6 ORGANISATION OF THE STUDY

The study is organized as follows:

Chapter 1: **Introduction.** The introduction highlights the background and problem statement of the study, objectives of the study, motivation of the study, and significance of the study.

Chapter 2: **Literature Review.** This chapter reviews the literature on audit quality specifically in the relationship between audit quality with audit committee and internal audit. Since audit committee and internal audit are part of the corporate governance mechanisms, a discussion of corporate governance will first be provided. The aim for this chapter is to articulate the gap in extant audit committee, internal audit and audit quality research and justify the research questions for the study.

Chapter 3: **Theory and Hypothesis Development.** This chapter explains the theoretical framework and develops the hypotheses for further examination. The first section utilised the agency theory and resource dependence theory to explain the fundamental basis of a view of audit committee and internal audit as an effective mechanisms to monitor agent behaviour on behalf of shareholders' interest. The next section highlights the hypotheses development of the study.

Chapter 4: **Research Methodology.** This chapter involves a discussion of the research design used in the study. It explains the methodology applied in the study which includes sample selection, data collection, variable measurement and regression models used.

Chapter 5: **Analysis, Results and Research Findings.** In this chapter, the findings are analyzed and discussed. The first section discusses the descriptive statistics which provide the details of the variables and samples examined in the study. The next

section explains the correlations and regression results. At the end of the chapter, it explains the results of the hypothesis testing.

Chapter 6: **Conclusion.** This chapter concludes the overall study. It provides a brief summary of the results and findings. It also explains the limitations of the study, implications of the study and suggestions for future research.

1.7 CONCLUSION

The study extends the literature on audit committee effectiveness and internal audit function characteristics in relation to audit quality, and complements prior studies on audit committee expertise. The objective of the study is to investigate the association between these audit committee effectiveness and internal audit function characteristics with audit quality, whereby external audit fees is used as an indicator of audit quality.

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

This chapter discusses an overview of corporate governance mechanisms (i.e. audit committee and internal audit) and audit quality (measured by external audit fees) on extant studies conducted in developed and emerging economies. The first section will provide a brief overview of corporate governance and its relation to the audit committee and internal audit. The next section draws on the extant audit quality and external audit fees literature and followed by research gaps in this area to provide motivation for this study.

2.1 CORPORATE GOVERNANCE OVERVIEW

Most countries in the world now have their own corporate governance codes and are placing more emphasis on improving corporate governance. In Malaysia, The Malaysian Code on Corporate Governance (MCCG) first issued in March 2000 has marked a significant milestone in corporate governance reform in Malaysia. It codified the principles and best practices of good governance and described optimal corporate governance structures and internal processes. The Finance Committee defined Corporate Governance in Malaysia in the Report on Corporate Governance (2002) as follows:

The process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account the interests of other stakeholders (High Level Finance Committee Report 1999, p. 1).