



The impact of audit committee characteristics on the implementation of internal audit recommendations



Abdulaziz Alzeban^{a,*}, Nedal Sawan^b

^a King Abdulaziz University, Saudi Arabia

^b Liverpool Business School, UK

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ABSTRACT

Regulators and others highlight the importance of the interaction between the audit committee and internal audit. One of the roles of the audit committee is to review and monitor management's response to internal audit findings and recommendations. This study provides empirical evidence of the association between audit committee characteristics and perceptions of implementation of internal audit recommendations. Using data from a survey of chief internal auditors from UK-listed companies, the study finds that greater perceptions of the implementation of internal audit recommendations are strongly related to the presence of independent members of the audit committee and to those members' expertise in accounting and auditing. The results also suggest that perceptions of implementing internal audit recommendations are influenced by frequent meetings between the audit committee and chief internal auditors.

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1. Introduction

The importance of effective internal audit and the existence of an effective audit committee (AC), as the foundation of good corporate governance, has been increasingly recognized in the aftermath of various financial collapses (Bédard & Gendron, 2010). Many such collapses occurred in the early 2000s, causing confidence in capital markets to plummet. Consequently, more attention has been directed toward the internal audit function (IAF) and the AC's role in helping the board of directors discharge its financial and fiduciary obligations (Puri, Trehan, & Kakkar, 2010). As a corporate governance mechanism, the AC is charged with scrutinizing company financial information and with facilitating the work of internal audit and financial accountants. The AC is also obligated to monitor the IAF. To execute these duties, the AC must assist the IAF which acts to discharge the committee's responsibilities on its behalf. In addition, the AC and the IAF must be attached to senior management, so they are not undermined by other organizational functions (Soh & Bennie, 2011).

Substantial archival research shows that AC characteristics influence internal audit (e.g. Adel & Maissa, 2013; Abbott, Parker, & Peters, 2010; Barua, Rama, & Sharma, 2010; Callahan & Soileau, 2010; Cahill, 2006; Mat Zain, Subramaniam, & Stewart, 2006; Stewart & Kent, 2006; Goodwin, 2003). Specifically, the internal audit budget is associated with the number of AC meetings, suggesting that a diligent AC is more supportive of the IAF, leading to a higher internal audit budget (Barua et al., 2010). However, no empirical research examines the impact of such characteristics on perceptions of the degree of success in implementing internal audit recommendations. This lack of research motivates the current study, which attempts to fill the void by exploring empirically whether specific AC characteristics influence the effectiveness of internal audit

* Corresponding author.

(EIA). We measure EIA by the perceptions of Chief Internal Auditors (CIAs) regarding the implementation of internal audit recommendations. As a second motivation, we seek to determine the degree of influence of each of the AC's characteristics upon the EIA. Thus, the results of this study will complement existing research and point the way to further research opportunities.

The present study also extends prior research by introducing a different measure of the EIA. It examines the link between AC characteristics, and perceptions regarding the degree of implementation of internal audit recommendations, whereas previous studies focused on other indicators, for example, reporting independence and quality assurance review procedures (Callahan & Soileau, 2010), internal audit budget (Barua et al., 2010; Carcello, Hermanson, & Raghunandan, 2005), and size of internal audit unit and proportion of staff with audit experience (Mat Zain et al., 2006). It is argued that the greater the independence of the AC, the higher the perception of successful implementation of internal audit recommendations. Likewise, there are perceptions that implementation of internal audit recommendations is higher when there is greater expertise among the AC members, and when the AC has frequent meetings. Four AC characteristics (independence of AC, expertise of AC members, number of meetings, and number of members) are identified as features affecting EIA. We formulate hypotheses on the impact of these characteristics on EIA and test these hypotheses via regression models on data collected from 188 CIAs in UK companies listed on the London Stock Exchange. This sample is chosen since the UK institutional context is mature in terms of internal audit and risk management (Zaman, 2001; Zaman, Hudaib, & Haniffa, 2011), having reached the stage where the UK *Corporate Governance Code* (Financial Reporting Council (FRC), 2012b) indicates the responsibility of the board of directors as being to determine the significant risks a company will accept in order to obtain its strategic objectives. Additionally, the board is mandated to report to shareholders annually its behavior in this respect.

Our hypotheses result from the assumption that more effective internal audit outcomes arise from a more independent, competent and interactive AC. Such a committee is predisposed to act within its span of control, and consequently, internal audit recommendations are more likely to be implemented, resulting in greater internal audit effectiveness.

2. Prior research and hypotheses development

The *Financial Reporting Council (FRC) (2012a,b) Guidance on Audit Committee and Corporate Governance Code* describe ACs as key to good corporate governance, and obligate them to monitor and review the effectiveness of the IAF. Additionally, ACs are required to provide direct access to the board chairman and to the AC for the internal auditor, who must be accountable to the AC. Furthermore, the AC has responsibility for reviewing and evaluating the annual internal audit work plan, for receiving periodic reports on the outcomes of the internal auditors' work, and for reviewing and monitoring managerial response to the findings and recommendations contained within those outcomes. The AC is also obliged to meet with the head of internal audit at least annually without management being present, and to evaluate the role and degree of EIA within the company's risk management system. Essentially, the AC is responsible for monitoring the IAF and for ensuring it is provided sufficient financial resources (Carcello, Hermanson, Neal, & Riley, 2002). In fact, more financial resources have been shown to flow to the IAF when its annual budget is reviewed by the AC (Carcello et al., 2005).

The AC, and the EIA, have been explored by Callahan and Soileau (2010) in connection with their influence on the implementation of enterprise risk management (ERM) within organizations. These researchers discussed the particular AC characteristics of: number of members, number of meetings, and the percentage of members who are financial experts. In respect of internal audit, they considered organizational reporting independence and staff competence. Their findings demonstrated that the number of AC meetings and the percentage of financial experts among AC members (AC characteristics), and reporting independence and quality assurance review procedures (internal audit functions), are related to the likelihood that a firm will implement ERM processes.

The link between AC oversight and the resources directed toward internal control activities was explored by Abbott et al. (2010). They demonstrated that ACs with greater IAF oversight generally invest more in the IAF, by underwriting more hours to that activity, and by the level of implementation of IAF recommendations. Similarly, Mat Zain et al. (2006) showed, in the Malaysian context, a positive link between internal auditors' assessment of their contribution to financial statement audits and three particular characteristics of the AC: the proportion of independent AC members, their knowledge and experience of accounting and auditing, and the extent of AC review of internal audit programs, budget, and co-ordination proposals. Hence, a link between AC characteristics and the implementation of IAF recommendations exists in the internal auditors' perception of their potential contribution.

AC traits may support or hinder internal auditors, meaning the AC can be helpful or otherwise in the implementation process. Mihret and Yismaw (2007) highlight the need for management support in providing the necessary resources to the IAF to enable successful implementation of recommendations. Adams (1994) used agency theory to explain why it is in management's interest to maintain a robust internal audit department. Clearly, the aim of audit effectiveness is logical, but it cannot be realized without management commitment to implement internal auditors' recommendations (Van Gansberghe, 2005; Sawyer, 1995).

It is important to acknowledge that none of the factors identified is truly independent since the AC's behavior in one area may be conditional upon its actions in another. Many researchers (e.g. Mat Zain et al., 2006; Abbott, Parker, & Peters, 2004; Goodwin, 2003; Abbott & Parker, 2000) have recognized that the nature of the AC is determined by its level of independence, member expertise, number of members, number of meetings, and the extent of interaction with the internal auditor. This study accepts these premises but differs, in particular from that conducted by Mat Zain et al. (2006) in that it suggests an

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