

CHAPTER 3

METHODOLOGY AND METHODS

3.1 INTRODUCTION

In this chapter, the relationship between the variables are discussed under the theoretical framework. The hypotheses of the research are also developed from relevant literature on the topic of research. Finally, the questionnaire and the statistical analysis are discussed under method and design.

3.2 THEORETICAL FRAMEWORK

The main variable of interest to this study is the dependent variable of internal auditor's professional objectivity. From the literature review, the relationship between effective audit committees and internal auditors professional objectivity is attempted to be explained by four independent variables.

i) **Approval of Internal Audit Charter**

The first independent variable is audit committees approval of the internal audit charter. The internal auditor needs the authority, responsibility, and resources to be able to do his effectively. These are specified in the internal audit charter. If top management (board or audit committee of the board) approves the charter, the necessary authority, responsibility and resources will be ensured.

ii) **Audit Committees' Responsibility For the Hiring, Firing and Compensations of Internal Auditor**

The second independent variable is the audit committees' responsibility for the hiring, firing and compensations of the internal auditor. Where management controls the internal auditors appointment, promotions and other incentives, his objectivity and independence will be impaired. Therefore the internal auditor will be insulated from management influence, if the audit committee has authority for his hiring, firing, and compensation.

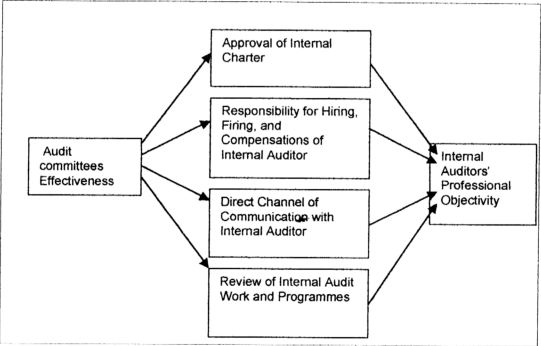
iii) **Direct Channel of Communication Between Audit Committee and Internal Auditor**

The third and perhaps the most important variable is a direct channel of communication between the audit committee and the internal auditor. The internal auditor should communicate to the audit committee through memos, meetings and special reports. By so doing, the audit committee will be aware the problems impeding the efficiency and effectiveness of the internal auditor and can take the necessary actions to eliminate them.

iv) **Review of Internal Audit Work and Audit Programmes by Audit Committee**

Finally the audit committee should review the programmes and work of the internal auditor. Through this, they can ensure that the internal auditor does not suffer from any restrictions on the scope of his activities, or management influence in his work. Figure 3.1 below shows the relations between the dependent and the independent variables.

Figure 3.1: Independent Variables Affecting Professional Objectivity Of Internal Auditors



However, it is suggested in the literature review that only effective audit committees can interact with internal auditors in the above-mentioned four areas, thereby enhancing their professional objectivity and independence. The effectiveness of audit committees is attempted to be explained by four independent variables as mentioned below.

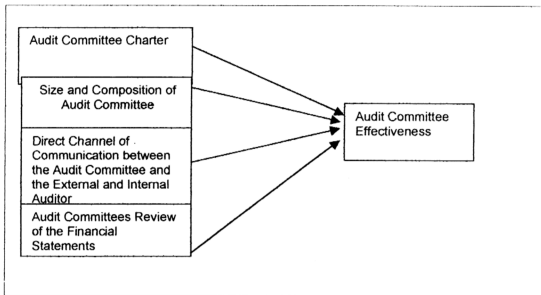
The first one is the audit committee charter. The audit committees authority, responsibility and resources that they require to carry out their duties, are provided for in the charter, which should be approved by the board.

The second independent variable is the size and composition requirement of the audit committee. This ensures that the audit committee members possess the necessary skills, competencies and independence, to carry out their work effectively.

The third independent variable is a direct channel of communication between the audit committee and both auditors (that is, internal and external auditors). This will ensure that both auditors carry out their duties freely and fairly, thus preserving their objectivity and independence. In the absence of a direct channel communication between the audit committee and the two auditors, the audit committee will not be aware of their constraints. Thus, both auditors may be subject to management pressures, thereby impairing their objectivity and independence.

Finally, the fourth variable is the audit committee's responsibility of reviewing the financial statements and internal controls, before the board approves the financial statements. Carrying out this function effectively require the audit committee to have scheduled meetings. Figure 3.2 below shows the dependent (audit committee effectiveness) and the four independent variables.

Figure 3.2: Independent Variables Affecting Audit Committee Effectiveness



Finally, the link between audit committees effectiveness and the internal auditors professional objectivity is looked at, how the variables under audit committee effectiveness influence those of the internal auditors professional objectivity, via audit committees.

From the above models, the important research questions will be:-

1. Will the audit committees' approval of the internal audit charter, enhance the internal auditors' professional objectivity?
2. Will the internal auditor's professional objectivity be enhanced when the audit committee is responsible for their hiring, firing and determining their incentives?
3. Will the internal auditor's professional objectivity be enhanced when there is a direct channel of communication between them and the audit committee?
4. Will the internal auditor's professional objectivity be enhanced when the audit committee reviews their work and programmes?
5. Will audit committees be effective when the board approves the audit committee charter?

6. Will audit committees be effective when their size and composition are in compliance with the KLSE listing requirements?
7. Are audit committees effective when there is a direct channel of communication between them and the internal and external auditor?
8. Will audit committees be effective when they review the financial statements before being approved by the board?
9. Will effective audit committees enhance the internal auditors professional objectivity?

3.3 HYPOTHESES DEVELOPMENT

The KLSE listing requirements (section 344a) require all KLSE listed companies to have audit committees. BNM/GP1 too required all BIs to have audit committees. One of the duties of such committees is to oversee the internal audit functions. According to Vanasco (1994), one of the purposes of audit committees is to strengthen the internal auditors independent. However the mere existence of audit committees does not guarantee the strengthening of the internal auditors independence. Audit committees must be effective in order to enhance the internal auditors professional objectivity and independence.

The KLSE listing requirements and BNM/GP1 have outlined certain conditions, which must be satisfied by audit committees, if they are to be effective. They have stated that the size of the audit committee should not be fewer than three, majority of whom should be non-executive directors. They further require that the chairman of the committee should also be non-executive (independent) director. Sori, Mohamed and Hamid (2001b), in their study concluded that institutional investors perceived that majority of the audit committee members should be independent directors. The BRC (NYSE, 1999) and the Treadway Commission⁴(1987) emphasized this. Non-executives directors who are independent from the company can preserve a high degree of independence from management influence (Vanasco, 1996).

According to the BRC (NYSE, 1999), for audit committees to be effective, its members must be dedicated, interested and committed to the responsibilities of the audit committee. To be effective, the KLSE listing requirements states that members of the audit committee should be financially

literate and at least one of the members must be a member of the Malaysian Institute of Accountants (MIA). Vinten (1999), Vanasco (1996) and Sori et al. (2001b) reiterated this.

Direct channel of communication between the audit committee and both auditors (internal and external), is another requirement for effective audit committees (Verschoor and Liotta, 1990, and Vanasco, 1996). According to the BRC (1999), the audit committee should review the adequacy of the scope, functions and resources of the internal auditor. The review should be extended to the internal auditors programs, processes and their results, as well as the actions taken by management on audit recommendations (BRC, 1999 and Vanasco, 1994).

The KLSE listing requirement and BNM/GP1 also specified that audit committees should review the company's financial statements before being approved by the board. By reviewing the financial statements, audit committees can effectively attain their objective of enhancing public confidence in the credibility of the financial statements, and at the same time fulfill their role of protecting the interest of the shareholders (Verschoor and Liotta, 1990, Hamid, Mohamed and Nassir, 1999, and Simnet, Green and Roebusk as cited by Sori, Mohamed, Hamid and Nassir, 2001).

Where audit committees are effective, how can they enhance the internal auditors' professional objectivity and independence? The audit committees can improve the internal auditors objectivity and independence, by approving the internal audit charter and terms of reference, which defines the purpose, authority, responsibilities and resources of the internal auditor (IIA, 2001b; Cooper, 1993; Vinten, 1999; Verschoor and Liotta, 1990). According to Vanasco (1996), this is very essential for the enhancement of the internal auditor's objectivity and independence.

Where the audit committee is responsible for the hiring, firing, compensations and the incentives of the internal auditor, his professional objectivity and independence will be improved and the chances of his recommendations being implemented will be greatly increased (Vanasco, 1994b & 1996, Weizhong and Shourong, 1997, Kalbers, 1992, Vinten, 1999, and Gul and Subramaniam, 1994).

According to Verschoor and Liotta (1990), Razaee and Lander (1993) and Vinten (1999), a direct communication between the internal auditor and the audit committee is crucially important for the effectiveness of the internal auditing department. Direct communication in the form of meetings between the audit committee and the internal auditor (without members of management present), strengthens the internal auditors independence (Verschoor and Liotta, 1990, Kalbers, 1992, and Vanasco, 1996).

Audit committees should oversee the internal auditor. Thus they should be responsible for evaluating the internal auditors objectives, reviewing their work and performances as well as significant and unexpected internal audit findings and managements response to them (Thornton, 1996, and Read and Raghunandan, 2001). The most important benefit to be gained from the existence as well as a close working relationship between audit committees and internal auditors, is the independence of both the audit committee and the internal auditor (Olivario and Newman, 1993, as cited by Mohamed; Hamid, Sori and Nassir, 2001c; Gul and Subramaniam, 1994; Razaee and Lander, 1993; Cooper, 1993). Thus, from the above literature, the following hypotheses are derived:

- H_1 : Internal auditors professional independence will be enhanced when Audit Committees approve the internal audit charter.
- H_2 : Internal auditors' professional objectivity will be enhanced when the audit committee is responsible for the chief internal auditors hiring, firing and determining his incentives.
- H_3 : Internal auditors professional objectivity will be enhanced if there is a direct channel of communication between them and the audit committee.
- H_4 : Internal auditors professional objectivity will be enhanced when the audit committee reviews their work and audit programmes.
- H_5 : Audit committee will be effective when the board approves the audit committee's charter.
- H_6 : Audit committees will be effective when they comply with the size and composition requirements of the KLSE listing and BNM/GP1 requirements.

- H₇*: Audit committees will be effective when they have a direct channel of communication with the internal and the external auditor.
- H₈*: Audit committees are effective when they review the financial statements and the interim reports before the board approves them.
- H₉*: Effective audit committees enhance the internal auditor's professional objectivity.

H₁ to *H₄* will test the influence of effective audit committees (independent variable) on the internal auditors' professional objectivity (dependent variable) and *H₅* to *H₈* will test the effectiveness of audit committees. The relationship between effective audit committees and internal auditor's professional objectivity, *H₉*, will be measured by testing the effect of all the four variables affecting audit committee effectiveness on each of the four variables affecting internal auditor's professional objectivity.

3.4 METHOD AND RESEARCH DESIGN

3.4.1 Questionnaire Design

A mail questionnaire was used to collect data. The questionnaire was developed to measure the dependent (internal auditor's professional objectivity) and the independent (audit committees effectiveness) variables. The questions were adapted from Kalbers (1992), Sori et al. (2001), Guidelines for internal auditors of Public Listed Companies (SCM, 2001), and other relevant literatures. The questionnaire is divided into four parts: A survey instrument as shown in Appendix A was prepared which had four sections, one focusing on background information of the respondent and the organization, one focusing on existence, functions, size, composition and activities of audit committee, one on the audit committee effectiveness, and the last part on the relationship between audit committees and internal auditors' professional objectivity. Each section had numerous descriptive statements and the last two parts were with Likert-type scale, whereby, part three was with not effective at all/highly effective or not at all/large extent (where applicable), and part four was with very low likelihood/very high likelihood. Subjects were requested to make a subjective judgment on a

seven-point scale. Likert scales are suitable for measuring attitudes and opinions. Kalbers (1992), Gul and Subramaniam (1994), Hamid et al. (1999) and Sori et al. (2001) used a seven-point Likert scale. Also included in part four were four conflict situations to determine how the internal auditors would react when executive management unduly interferes in their work or there are audit restrictions.

3.4.2 Population and Sample Size

There were 26 BIs in Malaysia as at 31 March 2002 comprising 11 domestic banks, two domestic Islamic banks and 13 foreign-owned banks, all of which are incorporated in Malaysia. All the BIs are under the purview of BNM. As required by BNM/GP1 and BNM/GP 10 guidelines all BIs have established audit committees and internal audit departments. Meanwhile, at least four local banks are listed under KLSE. As the population size is relatively small all BIs were selected for this study. A total of 70 persons were chosen comprising audit committee chairman of all the 26 BIs, chief internal auditors of all the BIs and 18 deputy chief internal auditors of BIs who have attended the audit committee meetings i.e. excluding 8 foreign-owned banks with a very small internal audit departments. The verbal checks with BIs indicate that not all deputy chief internal auditors attend the audit committee meetings, and therefore they would not be able to give their views on audit committee effectiveness. With regard to audit committee members, only the chairmen were chosen for the study. Preliminary discussions with a few chief internal auditors revealed that only the audit committee chairmen deal more frequently with the chief internal auditors and the executive management, and therefore only they could provide more reliable feedback to the survey instrument. The study intends to obtain feedback from 100% of the population identified. Though research on the effectiveness of audit committees in carrying their responsibilities in Malaysia is still in its infancy stage, it does not preclude the possibility of establishing the perceptions of the internal audit department on the effectiveness of audit committees (Hamid, Mohamed and Nassir, 1999).

3.4.3 Data Collection Method

The research instrument was discussed with three very experienced chief internal auditors of BIs for clarity and relevance. A pilot test, using six randomly chosen BIs, was conducted to further refine the questionnaire.

The resulting survey was administered to all the 70 subjects chosen. Included in each envelop sent was a cover letter addressed to the individuals concerned describing the objectives of the study and requesting participation. In order to encourage more response, wherever possible, the respondents' names and their actual addresses were obtained and they were contacted prior to sending the survey instrument. A copy of the research instrument was also enclosed with a self addressed stamped envelop. To ensure anonymity, no names of respondents or their institutions are required and assurance is given in the cover letter that the information collected will be analysed on aggregate basis and will only be used for the purpose of this research. A total of 38 usable responses were received. The breakdown is as shown below.

Table 1
Survey Response Rate

	LOCAL BI		FOREIGN BI		TOTAL	
	<i>No. of response received</i>	<i>Response rate</i>	<i>No. of response received</i>	<i>Response rate</i>	<i>No. of response received</i>	<i>Response rate</i>
Audit Committee Chairmen	8	61.5%	6	46.2%	14	53.8%
Chief Internal Auditors (CIA)	10	76.9%	7	53.8%	17	65.4%
Deputy CIA	7	53.8%	0	0%	7	39.0%
<i>Total</i>	25	64.1%	13	41.9%	38	54.3%

3.4.4 Statistical Tests

The data obtained from the study was analyzed by using the SPSS (version 9.0) statistical package. Besides performing descriptive analysis, reliability tests were carried out to measure the interrelationship between variables to determine to what extent the survey questions have measured what they are suppose to measure. Also performed were multiple regressions analysis using stepwise selection method, General Linear Model Univariate analysis, ANOVA, Dunnett tests and Post- Hoc tests. The eight hypotheses will test the effectiveness of audit committees and the effect of effective audit

committees (independent variable) on the internal auditor's professional objectivity (dependent variable).

3.5 CONCLUSION

This chapter justifies the methodological framework adopted in this study. The next chapter will present and discuss the results of the statistical tests described in this chapter.