

## **CHAPTER 4: FINDINGS**

### **4.1 INTRODUCTION**

In the previous chapter the variables that explained the effectiveness of audit committees were discussed, as well as for those that explain how effective audit committees could enhance the internal auditors professional objectivity and independence. The hypotheses for the research were also developed. In this chapter the questionnaire responses received are analysed with respect to the variables identified in chapter 3. This analysis includes a descriptive statistics as well as hypothesis testing.

### **4.2 BACKGROUND OF RESPONDENTS**

The analysis is based on 29 responses from audit committee members and internal auditors. From appendix 2a, it can be seen that 93% of the audit committee respondents are males and 7% are females, while 76% respondents of the internal auditors are male and 24% are female. Of the internal auditors, 11% are certified internal auditors (CIA), and 89% are associate members of IIAM. 38% of the audit committee members have working experience of 0 – 5 years and 66% internal auditors have working experience falling within the same range. 45% audit committee members have working experience of between 6 and 10 years while 17% have experience of more than 11 years. On the other hand, 17% internal auditors have working experience of between 6 to 10 years and more than 11 years, respectively. On average, audit committee members have more years of working experience compared to the internal auditors.

For the sectors of the respondents, 24%, 31%, and 28% of the audit committee members are in the manufacturing, services and other sectors, respectively. For the internal auditors, 21%, 28%, 17% and 21%, are in the manufacturing, construction, services, and other sectors respectively. It can be seen that most of the audit committee members are in the construction, information technology

and other sectors, while most of the internal auditors are in the manufacturing, construction and other sectors.

### 4.3 ANALYSIS

Table 5.1 below shows the responses of the audit committee members and the internal auditors, to part 3 of the questionnaire in appendix 1 (that is audit committee effectiveness). The questions are categorized according to the variables, and the mean responses of each group to the variables are shown. The response of audit committee members to a variable is represented by "VAC" while that of the internal auditors is "VIA". "VIC" represents the mean response of the two groups.

**Table 4.1: Mean Responses to Part 3 of the Questionnaire.**

Variable	Questions	VAC	VIA	VIC
		MEAN	MEAN	MEAN
Audit committee charter	4 & 5	5.69	4.33	5.04
Size and composition	1 to3	5.86	4.47	5.17
Direct communication	6 to 10	5.84	4.6	5.22
Financial statement review.	11 to 16	5.92	4.53	5.21
Overall audit committee effectiveness (VAC 5, VIA 5 and VIC 5).	1 to 16	5.88	4.52	5.2

Table 5.2 below shows the results of the hypotheses testing of the variables for audit committee effectiveness. VIC 1 to 4 represents H<sub>1</sub> to H<sub>4</sub>. All the variables are tested for effectiveness of audit committees that is the group mean (VIC)

being equal to 6 (t value of 6). On the likert scale, 6 represent “effective”. Thus for audit committees to be effective, the mean rating for the group must be 6 or more

**Table 4.2: Hypotheses Testing of Audit Committee Effectiveness Variables.**

	Test Value = 6					
	t	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
VIC1	-5.931	28	.000	-.9569	-1.2874	-.6264
VIC2	-5.586	28	.000	-.8345	-1.1405	-.5285
VIC3	-6.403	28	.000	-.7793	-1.0286	-.5300
VIC4	-6.627	28	.000	-.7914	-1.0360	-.5468

#### 4.3.1. AUDIT COMMITTEE EFFECTIVENESS.

##### 4.3.1.1 Audit Committee Charter

*H<sub>1</sub>: Audit committee are effective when the board of directors approves the audit committee charter.*

We are testing that audit committees are effective when the board approves the audit committee charter and therefore the group mean (VIC) is equal to 6 (that is zero difference). The t-value of −5.931 is not significant at a 95% confidence interval and also the confidence interval range does not include zero. Thus the hypothesis must be rejected.

Rejecting the hypothesis could be due to the difference in the ratings of the audit committee members and the internal auditors. The mean of the audit committee members rating (table 5.1) for their effectiveness is 5.69, which is higher than the internal auditors mean rating of 4.33. The audit committee members believe that they are more effective than the internal auditors perceive them to be.

The audit committee members and the internal auditors were asked if their organisation have an audit committee charter and whether the board approves the charter. From appendix 2B, all the audit committee members indicated that their organizations have audit committees and the board approves the audit committee's charter. On the other hand, 86% internal auditors indicated that their organizations have audit committees and another 86% mentioned that the board approves the audit committee charter, while the rest (14%) indicated that their organizations do not have audit committees. When ask whether the board reviews the audit committee charter, 14% of the audit committee members indicated that the board does not review the audit committee charter, while 86% mentioned that reviews are done and they range from quarterly to 2 years above. Of the internal auditors 86% indicated that the audit committee charter is reviewed by the board, but 45% stated that the board does no such reviews. The negative responses to the questions indicate a violation of the KLSE listing requirements (ss 15.10.1 and 15.12). These sections require all listed companies to have audit committees with their charter approved by the board.

#### **4.3.1.2 Size and Composition**

*H<sub>2</sub>: Audit committees will be effective when they comply with the size and composition requirements of the KLSE listing requirements.*

The probability of observing a group mean (VIC) that is greater than +5.59 or less than -5.59 is less than 0.005 (not significant). Thus the hypothesis that audit committees are effective when they comply with the size and composition



requirements of the KLSE listing requirements cannot be accepted. Thus the audit committee members and the internal auditors do not believe that merely complying with the size and composition requirements of KLSE does not make audit committees effective. Again the difference in the ratings of the audit committee members (5.87) and that of the internal auditors (4.47) could be the reason for rejecting the hypothesis. Another reason could be the violations of the listing requirements by some of the companies.

For the size and composition of their audit committees, the audit committee members and the internal auditors were asked about the size of their audit committees and whether an accountant is a member of the audit committee (compliance with this requirement had been deferred until June, 2002). It can be seen from appendix 2C that majority of audit committee members indicated that their audit committees consist of 3 to 5 members, and at least one member is an accountant (that is an MIA member). 31% of the audit committee members did not indicate whether an accountant is a member of their audit committee. All the internal auditors (70%) except for 30% (who gave no indication), indicated that the size of their audit committees as ranging between 3 and 5. For an accountant being a member of the audit committee, one internal auditor indicated that the audit committee in his organization does not have an accountant as one of its members, 31% gave no indication and the rest (66%) mentioned that an accountant is a member of their audit committee. Its quite encouraging that most of the companies have fulfilled this requirement (ss. 15.10.1c) even though its not yet effective. Most of the audit committee members (79%) and the internal auditors (59%) stated that majority of their board members are independent directors. However, 10% and 14% of the internal auditors and audit committee members respectively, indicated no, while 10% and 31% of the audit committee members and internal auditors respectively, gave no indication (appendix 2c). The effective date for the requirement (ss. 15.10.1b) that majority of the audit committee members should be non-executive independent directors, had been deferred until June 2002. However, most of the companies are probably aware of

the importance of the independence of the audit committees, and have decided abide by the requirement (ss. 15.10.1b) even before it becomes effective. For the audit committee chairman being an independent director, all the audit committee members and 93% of the internal auditors mentioned that the audit committee chairman of their organisations are independent directors, and only 7% of the internal auditors said no. When ask whether the board reviews the audit committee's term of office, 55% of the internal auditors and 86% of the audit committee members indicated that the board carries out reviews. However, 14% and 45% of the audit committee members and internal auditors said their board carries out no such reviews.

From appendix 2c, it can be seen that some of the companies are violating the KLSE listing requirement, of section 15.11, which require the chairman of the audit committee to be a non-executive independent director. Section 15.21 of the KLSE listing requirements also require the board to review the term of office of the audit committee members at least once every three years. When boards fail in their duties to carry out reviews of the member's term of office, they are violating the KLSE listing requirements. Some audit committee members and internal auditors mentioned that their chief executives officers are members of the audit committee. According to Abdullah (2001), this could greatly impair the objectivity of the internal auditor. This is a loophole in the KLSE listing requirement since it does not disqualify executive directors from becoming members of the audit committee.

#### **4.3.1.3 Direct Communication**

*H<sub>3</sub>: Audit committees are effective when they have a direct channel of communication with the internal and the external auditors.*

Here also the t-value is not significant at a 95% confidence interval and the confidence range does not contain a zero value. Thus the hypothesis should be rejected and a conclusion drawn that the audit committee members and the

internal auditors believe that their audit committees are not effective in their direct communications with both auditors (internal and external). In this case also, the audit committees members believe that they are effective in their communications with both auditors (5.84), while the internal auditors believe that they are not (4.46). This variation in the mean responses of the two groups as well as the violations of the KLSE listing requirements could be the cause for rejecting the hypothesis.

For the audit committees communication with internal and external auditors, the respondents were asked whether the audit committees approves and review the internal and external audit plan, as well as both auditors, independence, performance, scope and activities. The response show that 93% and 76% of the audit committee members and internal auditors respectively stated such reviews are done and ranged from quarterly to two years and above. However, the rest audit of the committee members and internal auditors indicated that their audit committees does not carry out such reviews. When asked whether the audit committees monitors corrective actions taken by management on both audit findings, 93% and 72% of the audit committee members and internal auditors respectively, answered "yes", the rest of the audit committee members and internal auditors` stated that the audit committees does not carry out such monitoring. The negative responses to the above questions is another indication of violation of the KLSE listing requirements (ss.15.13.1e & 1f) this shows that the audit committees concerned are failing in their duties and therefore may not be effective.

#### **4.3.1.4 Financial Statement Review**

*H<sub>4</sub>: Audit committees are effective when they review the financial statements and the interim reports before they are approve by the board.*

For the above hypothesis, the t-value of -6.627 is not significant at a 95% confidence interval. Thus the hypothesis should be rejected. This means that the

two groups believe that their audit committees are not effective in reviewing the financial statements and the interim reports before they are approved by the board. However, the audit committee members rated their effectiveness in financial statement review (5.94) higher than the internal auditors rated their effectiveness (4.5) in this area. This combined with the violations of the listing requirements by some companies, could be responsible for rejecting the hypothesis.

On the issue of financial statement review, the audit committee members and the internal auditors were asked whether their audit committees review the financial statements. The responses are tabulated in appendix 2B. From appendix 2.1B it can be seen that majority of the audit committee members (97%) and internal auditors (83%), indicated that their audit committees reviews: the internal accounting and financial controls; alternative generally accepted accounting principles; significant changes in accounting policies; year end adjustments; accounting estimates and judgments; and annual financial statements and interim reports. However, the rest of the audit committee members and the internal auditors mentioned that their audit committees do not carry out such reviews. The audit committee members and the internal auditors were also asked to state the other areas reviewed by their audit committees. In appendix 2.2B, the responses of the audit committees and internal auditors can be found. Some audit committee members mentioned that their audit committees also review environmental, risk management and compliance issues, while the internal auditors mentioned that their audit committees review major corporate results and decisions made, compliance to corporate governance and operational control and risk management.

Violations of the KLSE listing requirements (ss. 15.13.1g) can be observed from the responses. One of the main functions of audit committee according to the KLSE listing requirements is in the area of reviewing financial statements and internal control. This enabled the audit committees to enhance the credibility of

the financial statement and protect the shareholders interest. Audit committees cannot therefore be effective if they fail in this area.

### 4.3.2 INTERNAL AUDITORS RELATIONSHIP WITH AUDIT COMMITTEES

Table 5.2 below shows the responses of the audit committee members and the internal auditors, and that of the two groups combined, to part 4 of the questionnaire in appendix 1 (that is effective audit committees enhancement of internal auditors professional objectivity). The questions are categorized according to the variables, and the mean responses to the variables are shown. The response of audit committee members to a variable is represented by “VAC” while that of the internal auditors is “VIA”, and “VIC” represents the combined group.

**Table 4.3: Mean Responses to part 4 of the questionnaire**

Variable	Questions	VAC	VIA	VIC
		Mean	Mean	Mean
IA charter	2, 3, & 10	6.23	5.44	5.81
Hiring and firing of IA	4 & 5	6.24	5.89	6.08
Direct channel of communication with IA	1, 6, 7, 12, 13, & 14	6.14	5.27	5.71
Review of IA`s sand programmes and work.	8, 9, & 11	6.08	5.25	5.66
Overall whether effective~ AC`s enhance the IA`s professional objectivity (VAC 9, VIA 9 and VIC 9).	1 to 14	6.18	5.42	5.79

Table 5.4 below shows the hypothesis testing of the variables for audit committees enhancement of the internal auditors professional objectivity. VIC 6 to 10 represents H<sub>6</sub> to H<sub>10</sub>. All the variables are tested for effective audit

committee's likelihood of enhancing the internal auditors professional objectivity that is the group mean (VIC) being equal to 6 (t value of 6). On the likert scale, 6 represent "high likelihood". Thus for audit committees to have a high likelihood of enhancing the internal auditors professional objectivity, the mean rating for the group must be 6 or more.

**Table 4.4: Hypothesis Testing for the Internal Auditors Professional Objectivity Enhancement Variables**

	Test Value = 6					
	t	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
VIC5	-1.969	28	.059	-.1931	-.3940	.0078
VIC6	.635	28	.531	.0776	-.1729	.3280
VIC7	-3.062	28	.005	-.2931	-.4892	-.0970
VIC8	-3.843	28	.001	-.3362	-.5154	-.1570

### 4.3.2.1 Internal Audit Charter

*H<sub>5</sub>: Internal auditors professional objectivity is enhanced when the audit committee approves the internal audit charter.*

The t-value for this hypothesis is –1.97 and its significant at a 95% confidence interval. The confidence interval range also includes a zero value. Thus the hypothesis is accepted that internal auditors professional objectivity is enhanced when the audit committee approves the internal audit charter. The rating (6.23) of the audit committee members is again higher than that of the internal auditors (5.44), but the variation is not high like in the previous hypothesis.

The audit committee members and the internal auditors, where asked whether their audit committees approve the internal audit charter (see appendix 2D). A good number of the audit committee members (96%) and internal auditors (76%) indicated that the audit committee approves the internal audit charter, the rest of the audit committee members and the internal auditors stated that the audit committee does not approved the internal audit charter. When asked about the frequency of the audit committee's review of the internal audit charter, majority of the audit committee members (83%) and internal auditors (55%) mentioned that the audit committee reviews the internal audit charter and the reviews range from quarterly to two years and above. However, 17% of the audit committee members and 48% of the internal auditors stated that the audit committees in their organization do no such reviews. When asked whether senior management gives full support to the internal auditor, all the audit committee members and 79% of the internal auditors answered, "yes", while the rest of the internal auditors said "no". The answers given by the respondents, is an indication of the fact that Malaysian PLC's are aware of the significance of the internal auditors objectivity and independence.

However, from the responses it can also be seen that there are contraventions of the KLSE listing requirements (ss 15.13e), which required the audit committees to review the adequacy of the resources of the internal audit function and ensure that it has the necessary authority to carry out its work. The resource requirements and authority of the internal audit are specified in the internal audit charter. Therefore, if the audit committee does not approve and review the internal audit charter, they cannot ensure that the requirements of ss 15.13e are met, and they will be failing in their duties.

**4.3.2.2 Hiring, and Firing of the Internal Auditor.**

*H<sub>6</sub>: Internal auditors professional objectivity will be enhanced when the audit committee is responsible for the chief internal auditors hiring, firing and determining his incentives.*

For this hypothesis, a zero value lies within the confidence interval range and the t-value of 0.635 is significant at a 95% confidence interval. Therefore, the hypothesis is accepted. This supports the findings of Vanasco (1996) that when the hiring and firing of the internal auditor is vested with the audit committee, the internal auditor is likely to be more objective and independent. Again the variation between the ratings of the audit committee members (6.24) and that of the internal auditors (5.89) is not material.

To make the internal auditors more objective, the literatures suggest that the hiring and firing of the internal auditors should be vested with the audit committee. The respondents were asked whether the audit committees in their organisations are responsible for the hiring and dismissal of the internal auditor, as well as determining his remunerations, incentives and the budget of the internal audit department. In appendix 2D, 83% of the audit members and internal auditors answered, "yes" while 17% of them said no. From the literature review in chapter two, it can be inferred that in the organizations of the respondents who said "no", the internal auditors objectivity and independence is likely to be impaired because his incentives are controlled by management.

**4.3.2.3 Direct Channel of Communication**

*H<sub>7</sub>: Internal auditors professional objectivity is enhanced when there is a direct channel of communication between them and the audit committee.*



For this hypothesis, the t-value of -3.06 is not significant at a 95% confidence interval and the confidence interval range also contains no zero value. Thus the hypothesis is rejected. The group believes that a direct channel of communication between the audit committee and the internal auditor does not enhance the internal auditors professional objectivity. The rating of the audit committee members for this variable (6.14), is higher than that of the internal auditors (5.27). Some of the internal auditors indicated that the internal auditor in their organisation does not report to the audit committee and majority of the two groups indicated that the audit committee and the internal auditors do not have private meetings. These could be some of the reasons for the rejection of the hypothesis.

A direct channel of communication between the audit committee and the internal auditor is quite important if the audit committee is to effectively oversee the internal audit function. This requires the internal auditor to directly report to audit committee, and also to have scheduled as well as private meetings (without management presence) with the audit committee. The audit committee members and internal auditors were asked to state whether in their organizations, the internal auditor reports directly to the audit committee, as well as having private meeting with them, at least once a year. The audit committee members and the internal auditors responses are indicated in appendix 2D It can be seen that all and 41% of the audit committee members, and 76% and 28% of the internal auditors, indicate that the internal auditor in their organisations reports directly to the audit committee and have private meeting with them, respectively. However, 24% of the internal auditors mentioned that the internal auditor does not report to the audit committees in their organisation. For the internal auditors private meeting with the audit committee 59% and 72% of the audit committee members and internal auditors indicate that the internal auditor does not meet privately with the audit committee.

In the above organisation whether the internal auditor does not report to the audit committee and does not also have private meeting with the audit committee, the internal auditors objectivity is likely to be greatly affected. This is because the internal auditor cannot write reports that are critical of management but reflecting the true situation.

**4.3.2.4 Review of Internal Auditors Programmes and Work**

*H<sub>8</sub>: Internal auditors professional objectivity and independence is enhanced, when the audit committee reviews the internal audit work and programmes.*

In this situation also, the hypothesis is rejected. The t-value of -3.84 is not significant at a 95% confidence interval, and the interval range does not contain a zero value. This means that the group does not believe that the internal auditors professional objectivity is enhanced when the audit committee reviews the internal audit work and programmes. However, it can be seen that the audit committee's ratings ( ) is high than that of the internal auditors. Some of the respondents also indicated that in their organisations, the audit committee does not review the internal audit work and programmes, and are also not involve in monitoring the corrective actions taken by management, on internal audit reports. These might have lead to the lower rating by the internal auditors and therefore the rejection of the hypothesis.

The KLSE listing requirements (ss 15.13e) required the audit committee to review the adequacy of the scope and functions of the internal audit, and ss 15.13f require the audit committee to review the internal audit programme, processes, the results of the internal audit programmes, processes, or investigations undertaken and whether or not appropriate action is taken on the recommendations of the internal audit functions. The respondents were asked whether their audit committees approves, review, and evaluate the internal audit plan, performance, independence, scope, and activities of the internal auditor, as

well as actively monitoring corrective actions taken by management on their findings. The responses of the audit committee members and the internal auditors can be found in appendix 2D. The response indicates that majority of the audit committee members and the internal auditors confirm that the audit committees in their organisations carry out such reviews and monitoring. However, 7% of the audit committee members and 24% of the internal auditors, as well as 7% of the audit committee members and 31% of the internal auditors, mentioned that the audit committees in their companies do not perform such reviews and monitoring respectively. This indicates another the violation of KLSE listing requirements of ss 15.13e. Here also the audit committees in these organizations are failing to perform their duties as required by KLSE.

*H<sub>9</sub>: Effective audit committees enhance the internal auditors professional objectivity and independence.*

The above hypothesis is tested by comparing VIC 5 (table 5.1) and VIC 9 (table 5.3). The groups rating for the overall effectiveness of their audit committees is (5.2), and their rating for such audit committees to enhance the internal auditors professional objectivity is (5.79). The groups rating for audit committee effectiveness is between "somehow effective" and "effective". However, their rating for the audit committees overall likelihood of enhancing the internal auditors professional objectivity is between "some likelihood" and "high likelihood". Thus the combined group believes that their audit committees are "somehow effective" and therefore have "some likelihood" of enhancing the internal auditors professional objectivity (that is consistent in their opinion)..

The audit committee members rating for the effectiveness of their audit committee is 5.9 (almost "effective") and their rating for the audit committee enhancement of the internal auditors professional objectivity and independence is 6.16 (between "high likelihood" and "very high likelihood" but closer to "high likelihood"). That means the audit committee members believe that their audit

committees are "effective" and therefore have a "High likelihood" of enhancing the internal auditors professional objectivity and independence.

The ratings of the internal auditors for the effectiveness of their audit committees, and such committee's enhancement of the internal auditors professional objectivity and independence are 4.5 (between "neutral" and "somehow effective", and 5.4 (between "some likelihood" and "high likelihood". Therefore, the internal auditors believe that their audit committees are "Somewhat effective" and therefore have only "some likelihood" of enhancing the internal auditors professional objectivity and independence.

As a result, a conclusion can be drawn that there is a positive relationship between audit committee effectiveness and internal auditors professional objectivity. This conclusion could be further extended that both the audit committee members and the internal auditors believe that if audit committees are effective, the internal auditors objectivity and independence are likely to be enhanced.

#### **4.4 CONCLUSION**

From the above information, there is evidence of companies violating the KLSE listing requirements. Also the audit committee members believe that they are more effective than the internal auditors perceived them to be. The group believes that their audit committees are "somehow effective" and have "some likelihood" of enhancing the internal auditors professional objectivity and independence. The conclusions and implications of this study as well as recommendations for future research are discussed in the next chapter.