

**INTERACTIONS OF CORPORATE GOVERNANCE PLAYERS:  
POWER, TRUST AND AUDIT QUALITY**

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**FACULTY OF BUSINESS AND ACCOUNTANCY  
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KUALA LUMPUR**

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**INTERACTIONS OF CORPORATE GOVERNANCE PLAYERS:  
POWER, TRUST AND AUDIT QUALITY**

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# **INTERACTIONS OF CORPORATE GOVERNANCE PLAYERS: POWER, TRUST AND AUDIT QUALITY**

## **ABSTRACT**

A review of the literature has identified the importance of the interactions between key corporate governance players in enhancing audit quality. Nonetheless, little is known about how the interactions between the external auditor and other key governance players (i.e. audit committee and internal audit function) possibly influence the quality of audit performance. The aim of this study is to provide insights on the nature of the interactions between external auditor (EA) with the audit committee (AC) and internal audit function (IAF); and how these interactions influence audit quality. This study adopts an interpretive approach by using semi-structured interviews as the research method. Interviews were conducted with audit partners/senior managers, audit committee members and the head of the internal audit functions to provide insights to the research questions outlined in the study. While agency theory is an underlying theory that explains the subject under study, the study also draws on the power theory and source credibility theory to enhance understanding and illustrate the important roles of power and trust in the interaction between the EA with AC and IAF that affect audit quality. The study has identified the elements of positive expert and will in the power theory as having the greatest impact on the interaction between the EA with AC and IAF that affect the EAs' conduct of the audit. Expert power such as knowledge, expertise and experience of AC and IAF which are combined with their willingness to exercise the power enable ACs and IAFs to actively influence the audit performance. The findings also show the importance of social interaction in characterising the nature of interactions between the key governance players. The social interaction assists in building rapport between the parties which allows for greater interactions and information exchange between them that facilitate conduct of audit. The study also highlights the considerable importance of

interpersonal quality (i.e. honesty, humbleness, respect) in promoting regular communication and the ability to discuss accounting and auditing matters more openly. Both social interaction and good interpersonal quality were found to be essential in creating a good vibe between the parties thereby helping to establish trust in their interactions. Findings imply both power and trust are important in determining working relationship in terms of information exchange between EA with the other two governance players. Inherently, the information and knowledge shared by ACs and IAFs during the interactions may influence the EAs' actions when conducting the audit. With the presence of power and trust in the interactions, the quality of the audit process can be enhanced, particularly through audit planning, risk assessments, evidence gathering, and the timeliness of the audit. Eventually, it can enhanced the financial reporting quality and more accurate audit opinion can be provided. The study is significant as it provides insights into the specific aspects of interactions which focus on the role of power and trust and their influence on the conduct of auditors during the audit process. The findings are of interest to practitioners and regulators on the potential measures that enhance governance practice as well as the audit quality. The findings provide signals to the practitioners and policy-makers on the specific requirements in appointing the ACs and IAFs to enhance the interaction between the EAs with ACs and IAFs and accordingly improve the audit quality.

**Keywords:** Corporate governance players, interactions, power, trust, audit quality

# **INTERAKSI DI ANTARA PEMAIN TADBIR KORPORAT: KUASA, KEPERCAYAAN DAN KUALITI AUDIT**

## **ABSTRAK**

Kajian sastera yang lepas telah mengenalpasti kepentingan interaksi diantara pemain tadbir urus korporat dalam meningkatkan kualiti audit. Namun begitu, pengetahuan tentang bagaimana interaksi antara juruaudit luar dan pemain tadbir urus utama (iaitu jawatankuasa audit dan audit dalaman) boleh mempengaruhi kualiti prestasi audit adalah terhad. Tujuan kajian ini adalah untuk menambahkan pengetahuan mengenai jenis interaksi antara juruaudit luaran (EA) dengan jawatankuasa audit (AC) dan audit dalaman (IAF) yang dipraktikkan dalam industri; dan bagaimana interaksi antara pihak-pihak ini boleh mempengaruhi kualiti audit. Kajian ini adalah berdasarkan kepada pendekatan tafsiran yang menggunakan temu bual separa berstruktur sebagai kaedah penyelidikan. Temubual telah dijalankan dengan Rakan Kongsi Audit / Pengurus Kanan Audit, ahli-ahli Jawatankuasa Audit dan Ketua Unit Audit Dalaman untuk memberi maklumat kepada persoalan kajian yang telah digariskan dalam kajian ini. Bersandarkan kepada teori kuasa dan teori sumber kredibiliti, kajian ini menunjukkan kepentingan elemen kuasa dan kepercayaan dalam interaksi di antara EA dengan AC dan IAF yang seterusnya mempengaruhi kualiti audit. Kajian ini telah mengenalpasti bahawa kuasa kepakaran dan kemahuan merupakan elemen-elemen kuasa yang penting bagi mempengaruhi interaksi antara EA dengan AC dan IAF yang mana ianya akan mempengaruhi pelaksanaan audit. Gabungan antara pengetahuan, kepakaran dan pengalaman, dengan kemahuan untuk menggunakan kuasa yang ada itu membolehkan AC dan IAF terlibat secara aktif dalam interaksi yang akhirnya mempengaruhi prestasi audit. Di samping itu, hasil daripada temu bual juga menunjukkan kepentingan interaksi sosial dalam meningkatkan pencapaian audit. Interaksi sosial membantu membina hubungan antara pihak-pihak ini yang membolehkan lebih banyak interaksi dan pertukaran maklumat di antara mereka. Kajian

ini juga menunjukkan kepentingan kualiti peribadi (iaitu kejujuran, kerendahan hati, hormat) dalam menggalakkan komunikasi secara berkala dan perbincangan secara terbuka. Kedua-dua elemen, interaksi sosial dan kualiti peribadi, didapati penting dalam mewujudkan suasana yang baik antara pihak-pihak ini yang seterusnya mewujudkan kepercayaan dalam interaksi mereka. Dengan wujudnya kuasa dan kepercayaan dalam interaksi, kualiti audit akan dapat dipertingkatkan khususnya dari segi perancangan audit, penilaian risiko, pengumpulan bukti atau maklumat, dan tempoh masa audit. Secara khususnya, maklumat dan pengetahuan yang dikongsi oleh AC dan IAF semasa interaksi boleh mempengaruhi tindakan EA dalam menjalankan audit. Secara keseluruhan, kajian ini menunjukkan bahawa kuasa dan kepercayaan sebagai prasyarat penting dalam interaksi antara pemain utama tadbir urus korporat. Kajian ini adalah penting kerana ia memberikan pandangan di dalam aspek-aspek tertentu interaksi yang memberi tumpuan kepada peranan kuasa dan kepercayaan dan pengaruh interaksi kepada pelaksanaan audit oleh juruaudit luar. Hasil kajian ini penting kepada pengamal dan pengawal selia, berkenaan langkah-langkah yang boleh meningkatkan amalan tadbir urus dan kualiti audit. Penemuan kajian ini memberikan isyarat kepada pengamal dan penggubal dasar mengenai keperluan khusus dalam melantik AC dan IAF bagi meningkatkan interaksi antara EA dengan AC dan IAF dan seterusnya, kualiti audit.

**Kata kunci:** Pemain tadbir urus korporat, interaksi, kuasa, kepercayaan, kualiti audit

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## LIST OF SYMBOLS AND ABBREVIATIONS

AC	:	Audit Committee Chairman/ Member
BMLR	:	Bursa Malaysia Listing Requirements
BRC	:	Blue Ribbon Committee
CA	:	Chartered Accountant
CCSA	:	Certification in Control Self-Assessment
CIA	:	Certified Internal Auditor
CISA	:	Certified Information Systems Auditor
CMIIA	:	Certified Member, Institute of Internal Auditors
CPA	:	Certified Public Accountant
CRMA	:	Certified Risk Management Assurance
EA	:	Audit Partner/ Senior Manager
FRC	:	Financial Reporting Council
GLC	:	Government-linked Companies
HIAF	:	Head of Internal Audit Function
IA	:	Internal Audit
IAASB	:	International Accounting and Auditing Standard Board
ICSA	:	Institute of Chartered Secretaries and Administrators
IFAC	:	International Federation of Accountants
IR	:	Registered Engineer
ISA	:	International Standards on Auditing
ISQC	:	International Standards on Quality Control
MCCG	:	Malaysian Code on Corporate Governance
MIA	:	Malaysian Institute of Accountants

PCAOB : Public Company Accounting Oversight Board

PLC : Public Listed Companies

SOX : Sarbanes- Oxley Act

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## CHAPTER 1: INTRODUCTION

### 1.1 Introduction

An increasing amount of studies and international standards have identified the crucial roles of interactions between key corporate governance players in promoting high audit quality (Cohen, Gaynor, Krishnamoorthy, & Wright, 2007; Turley & Zaman, 2007; IAASB, 2013). Cohen et al. (2007) suggest that frequent interactions between the key governance players, especially among external auditors with audit committees and internal audit function, can enhance audit quality. The interactions allow these parties (i.e. external auditors, audit committee and internal audit function) to obtain information needed to perform their roles effectively mainly for external auditors in carrying out the audit function. In particular, the audit committee and internal audit function can share their knowledge and expertise about the organisations through the interactions with the external auditors (IAASB, 2013) to ensure sufficient information obtained by the external auditor to perform its audit duties effectively (Richard, 2006; Stvilia, Gasser, Twidale, & Smith, 2007). In addition, the interactions can help the audit committee and internal audit function to perform their monitoring and oversight roles which affect the quality of audit performance such as audit plan, understanding the entity's operations, assessing risk and evidence gathering (Felix, Gramling, & Maletta, 1998; Knechel, Krishnan, Pevzner, Shefchik, & Velury, 2013). Thus, the interactions between these key players, including formal and informal interactions, are important and can potentially influence the audit quality.

The aim of this thesis is to provide insights on the nature of the interaction between external auditors with audit committees and internal audit function and the influence of the interactions on the quality of audit performance. In particular, the study explores the interactions between these three parties in practice and how the interactions influence the

external auditor's performance of the audit process from the perspectives of the selected governance players (i.e. audit partners or senior manager; audit committee members and the head of the internal audit function) responsible for monitoring and assisting in the delivery of high audit quality in practice.

This chapter presents an overview of the thesis. The next section discusses the background to the research problem. Section 1.3 discusses research questions and research objectives, followed by motivations of the study in Section 1.4. Section 1.5 provides a brief account of theoretical perspectives and research methodology. The significance of the study is highlighted in Section 1.6, and the final section describes the organisation of the chapters in this thesis.

## **1.2 Background to the Research Problem**

The Asian financial crisis in 1997 and the downfall of international corporate giants (i.e. Enron, WorldCom, Tyco International, Parmalat, Transmile, etc.) in the early 2000s have drawn the attention of the public on the effectiveness of corporate governance mechanisms in ensuring financial reporting quality and audit quality. The corporate collapses and scandals have damaged investors' confidence in corporate financial reports (Holm & Laursen, 2007) and raised doubts about the audit quality (Worden, 2002; J. R. Francis, 2004; Kilgore, Radich, & Harrison, 2011; Alzoubi, 2016). The review of the extant literature establishes that poor corporate governance was one of the major reasons for the financial crisis (Harvey & Roper, 1999; Mitton, 2002; Mohammed, Mahenthiran, Rahman, & Hamid, 2006; Kirkpatrick, 2009) and the corporate downfall (Barrier, 2002; MacAvoy & Millstein, 2004; Agrawal & Chadha, 2005; Che Haat, Abdul Rahman, & Mahenthiran, 2008; Arguden, 2009; Othman & Abdul Rahman, 2014).

It is argued that poor corporate governance practices affect the reliability and quality of financial reporting adversely and essentially boils down to issues of audit quality which leads to corporate collapses. For example, the case of Enron offers evidence of the problem of financial reporting and audit quality due to the management's off balance sheet activities to hide mountains of debt from investors and creditors which failed to be reported by the board of directors, audit committee and the external auditor of the company. The case was initially attributed to financial reporting inadequacies and poor audit quality in which continues to raise broader issues of lack of sound corporate governance practices. Similarly, in Malaysia, few high-profile cases (i.e. Renong, Transmile, Megan Media Holdings Berhad, Perwaja Steel, Malaysia Airlines System (MAS), Sime Darby Berhad, etc.) have tarnished the corporate landscape due to the lack of sound corporate governance.

These events have stirred a number of professional and regulatory bodies globally to recommend reforms on corporate governance practices<sup>1</sup>(Mitton, 2002; Sawicki, 2009) in an attempt to improve the financial reporting and audit quality. A strong corporate governance framework requires the availability of high-quality audit and financial reporting (Alzoubi, 2016; Husnin, Nawawi, & Salin, 2016). In an attempt to improve audit quality, several changes in corporate governance have focused and re-examined the roles of the key governance players involved directly in the audit function, including external auditor, audit committee and internal audit function (FRC, 2010b). These three independent parties are part of the corporate governance key players (Cohen,

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<sup>1</sup> For example, in the UK (e.g. the Cadbury Committee, 1992; Smith Committee, 2003), France (Vienot I Report, 1995), Spain (Olivencia Report, 1998), USA (e.g. the Blue Ribbon Committee, 1999; Sarbanes Oxley, 2002), Malaysia (Malaysian Code on Corporate Governance 2000), Singapore (Singapore Code of Corporate Governance, 2001), Thailand (Thailand Code for Best Practice for Directors of Listed Companies, 2002), Australia (ASX Corporate Governance Council, 2003), Hong Kong (Hong Kong Corporate Governance Code, 2004), Bangladesh (Bangladesh Code of Corporate Governance, 2004).

Krishnamoorthy, & Wright, 2004; Gramling, Maletta, Schneider, & Church, 2004) which have monitoring and oversight roles in governance and audit function (Abbott, Parker, Peters, & Raghunandan, 2003; Johl, Subramaniam, & Mat Zain, 2012).

In particular, the external auditor plays an important role in serving the public interest to reinforce trust and confidence in financial reporting (Sarbanes-Oxley Act, 2002; Malaysian Code on Corporate Governance (MCCG, 2017). It is foremost responsible for ensuring high audit quality (Knechel et al., 2013). While ultimate responsibility for high-quality audit rests with the external auditor, an audit committee represents an effective mechanism for providing assurance to the board on monitoring management's action as well as overseeing the financial reporting and auditing process (Cadbury Committee Report, 1992; DeZoort, Hermanson, Archambeault, & Reed, 2002; Sarbanes-Oxley Act, 2002; Barua, Rama, & Sharma, 2010; Alzeban & Sawan, 2015). Meanwhile, the internal audit function is in the best position to help the external auditor and audit committee to understand the firm's internal control system and firm's risk management (Sarens & De Beelde, 2006; Suwaidan & Qasim, 2010) which can contribute to high-quality audit.

With a combination of understanding the audit related knowledge and roles play by these three key players, the current corporate governance framework (i.e. Sarbanes-Oxley Act, 2002; MCCG, 2017) emphasises the need for greater interactions between external auditor with audit committee and internal audit to improve the overall audit quality. The interactions between these three key players are expected to highlight critical aspects of financial reporting practices (Naiker & Sharma, 2009; Dhaliwal, Naiker, & Navissi, 2010) such as critical risks area in the financial reporting which is essential to enhance audit performance (Cohen et al., 2007).

Apart from the corporate governance framework, the importance of the interaction between these players has also been emphasised by International Accounting and

Auditing Standard Board (IAASB) through its Audit Quality Framework (2013), in which it addressed one of the key drivers of audit quality. It has also been previously highlighted in the International Standards on Auditing (ISA)<sup>2</sup> released by the IAASB including the ISA 260, ISA 315 and ISA 610 on the need for interaction between these three key players to improve audit quality. Through formal and informal interactions (Mat Zain & Subramaniam, 2007; Turley & Zaman, 2007; Salleh & Steward, 2012b), the key players can influence the views of others on certain audit process such as audit plan, risk assessments and internal control evaluation (Cohen, Krishnamoorthy, & Wright, 2002; Richard, 2006; Knechel et al., 2013), thereby contributing to improvements in audit quality (IAASB, 2013).

Frequent interactions between these parties also benefit all parties especially external auditors to acquire the information they need to perform their tasks in overseeing and conducting the audit process (Cohen et al., 2002). Notwithstanding formal interaction, the literature also establishes that informal interaction between these key players is important to improve audit quality particularly on the audit process (Turley & Zaman, 2007; Beasley, Carcello, Hermanson, & Neal, 2009; Salleh & Steward, 2012b). It may help to build rapport and trust between the parties (Mat Zain & Subramaniam, 2007) and more audit issues can be solved in a timely fashion thereby enhancing audit quality. The frequent interactions between the parties can also ensure the audit committee and internal audit function have complete understanding of the audit process (i.e. audit plan, evidence gathering, risk assessments) and provide information, ask questions or express concerns

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<sup>2</sup> International Standards on Auditing (ISA) are professional standards for the performance of financial audit of financial information and to be applied in the audit of financial statements under all reporting frameworks. Reporting frameworks are determined by legislation, regulations and promulgation of the Malaysian Institute of Accountants (MIA). ISA are also to be applied when necessary, to the audit of other information and to related services.

on key auditing issues which may give rise to greater risk of material misstatement of the financial statements (IAASB, 2013).

Most studies have focused on the associations between the key parties' characteristics to the certain proxies of audit quality by relying on publicly available information (Al-Ajmi, 2009; Lin & Hwang, 2010; Francis, 2011; Knechel et al., 2013). These studies have provided important contributions to the literature, however, utilising publicly available information rarely reflects the practical reality of the interactions between the parties and how it affects the audit quality. In addition, the reliance on key players' characteristics and audit quality based on certain proxies often do not capture the underlying substance (MacAvoy & Millstein, 2004) as evidenced by the conflicting results of the studies. The review of extant literature establishes that limited studies provide evidence on the nature of the interaction between these key players in practice (Cohen et al., 2007; Beasley et al., 2009) and how the interaction influences the audit quality (Bame-Aldred, Brandon, Messier, Rittenberg, & Stefaniak, 2013).

Studies have urged and called for more studies to engage directly with the key participants as it can help to open up the "black box" of the interactions between the key players (Bluhm, Harman, Lee, & Mitchell, 2011; McNulty, Zattoni, & Douglas, 2013), in order to shed light on the influence of the interaction on the quality of audit (Bame-Aldred et al., 2013; Knechel et al., 2013). Despite the existence of a fairly limited number of studies that obtain direct evidence from the key participants on the governance practices (see for example Cohen et al., 2002; Gendron & Bedard, 2006; Beasley et al., 2009; Cohen, Krishnamoorthy, & Wright, 2010; Dobija, 2015), research which focused directly on the interactions between the key governance players and the impact of the interactions on audit quality remains rare. These studies focused mainly on the audit committee effectiveness and highlight mixed views on the interactions between these key

players (i.e. external auditor, audit committee and internal audit function). Hence, this study seeks to understand the interactions between the external auditor with audit committee and internal audit function, and the influence of the interaction on the audit quality.

### **1.3 Research Objectives and Research Questions**

The extant literature established that interaction between the key governance players is one of the key elements which can enhance the quality of audits (Bedard, Johnstone, & Smith, 2010; Schilder, Gunn, & Siong, 2011). The purpose of this study is to provide insights on the nature of interactions between key governance players (i.e. external auditor, audit committee and internal audit function) and influence of the interactions on the audit quality.

Among the key amendments in the revised MCCG (2007; 2012; 2017) is the important roles of the audit committee and internal audit function in monitoring and assisting audit function (Securities Commission, 2007). The revised MCCG (2007; 2012; 2017) also encourages a greater exchange of free and honest views and opinions between the external auditor, audit committee, and internal audit function. Similarly, the findings of various studies have revealed that the relationship or interaction between the external auditor with other key governance players can enhance audit quality (Cohen & Hanno, 2000; DeFond & Francis, 2005; Cohen et al., 2007). Having monitoring roles on audit function, the audit committee can provide suggestions to the external auditor (Beasley et al., 2009; Cohen, Krishnamoorthy, & Wright, 2010) applicable in the audit planning and risk assessments (Bedard & Johnstone, 2004; Cohen, Krishnamoorthy, & Wright, 2007; Cohen et al., 2010). The internal audit function is responsible for providing insights on the level of compliance with the firm's internal control system (Suwaidan & Qasim, 2010; Farkas & Hirsch, 2016) and may influence the external auditor's decision-making associated with

the internal control system of the firm (Malaescu & Sutton, 2015). Therefore, this study attempts to provide greater insights into the nature of interaction conducted (formal and informal) in practice as well as audit committee and internal audit function involvement in the external audit process during the interaction (i.e. reviews of the external audit plan, internal control, risk assessment, etc.).

Further, the study attempts to understand how the interactions between external auditors with audit committee and internal audit function influence the quality of the audit. Given the importance of the interactions between these parties in improving audit quality which have been stipulated in the standards (i.e. ISA 260, ISA 315, ISA 610), the study aims to understand how the interactions may enhance and facilitate the performance and execution of audit process from the perspectives of the key actors (audit partners or senior managers, audit committee members and the head of the internal audit function) involved in the audit function. In summary, the specific objectives of this study are to:

- 1) Understand the nature of interactions between external auditor with audit committee and internal audit function in practice
- 2) Understand the impacts of the interactions between external auditor with audit committee and internal audit function in practice on the audit quality.

In parallel with the objectives of the study, the research questions of the study are highlighted as below.

**Research Question One (RQ1):** How do interactions between external auditor with audit committee and internal audit function take place in companies?

**Research Question Two (RQ2):** How do interactions between external auditor with audit committee and internal audit function influence external auditor's execution and performance of the audit process in practice?



The first research question seeks to explore the external auditor, audit committee and internal audit function views on how their interactions took place in practice. In particular, greater insight is sought on the meeting conducted (formal and informal); issues discussed which generate significant debate between the parties; audit committee involvement in the reviews of external audit plans, risk assessment; internal audit function's contribution to the external audit process; and overall interactions between external auditor with audit committee and internal audit function. The study is also concerned with how the interactions between these parties influence the quality of audit performance.

#### **1.4 Motivations of the Study**

The importance of the interactions between the key governance mechanisms has been discussed and emphasised in the standards and regulations (ISA 260, ISA 610, MCCG 2017, White, Cedarbaum, Davison, & Wolfman, 2012). The interactions have also been documented as one of the contributing factors towards enhancing the audit quality (IAASB, 2013). There are considerable studies which look into the associations between the corporate governance mechanisms and the audit quality (Abbott et al., 2003; Yatim, Kent, & Clarkson, 2006; Mansouri, Pirayesh, & Salehi, 2009; Dehkordi & Makarem, 2011). However, there is a lack of studies that explore the interactions between the key governance mechanisms in practice and the influence of the interactions on the audit quality. Hence, this study is motivated by the scarcity of evidence and lack of in-depth research on the subject.

The study contributes to the body of knowledge by explore how audit committee members and internal audit function react to information require under ISAs and MCCG (2007; 2012; 2017) in greater depth. For example, ISA 260 requires external auditors to have interaction with those charge with governance including audit committee in

conducting their audit, while ISA 315 and ISA 610 encourages the interaction between external audit with internal audit function. Under these standards, the external auditors now need to have greater communication and interaction with both parties in ensuring better audit quality by the external auditor.

Similarly, the literature has highlighted the significant demand for more studies exploring the interactions involved in the corporate governance practices and actual audit process in practice (Carcello, Hermanson, & Ye, 2011; McNulty et al., 2013). Further, most prior studies that explore process issues in corporate governance have focused on the audit committee effectiveness and practices in performing their roles (Gendron, Bedard, & Gosselin, 2004; Gendron & Bedard, 2006; Turley & Zaman, 2007; Beasley et al., 2009) and the relationships or interactions between audit committee with internal audit function (Mat Zain & Subramaniam, 2007; Sarens, De Beelde, & Everaert, 2009). There is a need for in-depth studies which simultaneously consider the interactions between the key governance mechanisms such as external auditor, audit committee and internal audit function and how the interactions can contribute to the audit quality.

Also, Power (2003a) and Humphrey (2008) argued that there are limited studies exploring the “back stage” of audit practice contributing to the lack of evidence on the factors that enhance the audit quality. The audit committee and internal audit function are two key players involved directly in audit function. Considering their monitoring and coordinating roles, both parties will contribute to the audit process. The monitoring roles of the audit committee in the audit process have been stipulated in the standards and governance codes (i.e. Sarbanes-Oxley Act, 2000; MCCG, 2000; 2007; 2012; 2017) which provide the audit committee with the authority to ensure that audit processes have been conducted at their best quality. Similarly, the internal audit function contributes significantly to assisting the external auditors in performing their duties (Gramling et al.,

2004; Mat Zain, Subramaniam, & Stewart, 2006), and accordingly affect audit quality. With their authority and knowledge, both parties may contribute significantly to the audit process. However, previous research has focused primarily on the relations or associations of both parties with the external audit without considering their interactions in practice and the influence of the interactions on the quality of the audit (Carcello et al., 2011). The effects of the interactions between the parties on the audit quality remain unclear.

Therefore, in response to the suggestion by prior studies for more in-depth studies in this area (Power, 2003a; Humphrey, 2008; Carcello et al., 2011; Knechel et al., 2013), this study explores the interactions between the external auditor with audit committee and internal audit functions and how the interactions influence the audit quality. Given the importance of the interaction as a factor that enhances the audit quality, this study complements prior studies by exploring how the roles played by the audit committee, and internal audit function may enhance the audit quality which possibly mitigates the potential corporate collapses in the future. Overall, the study is motivated by two key factors (1) the lack of prior studies that explore the interactions between the external audit with the audit committee and internal audit function in practice, and (2) the lack of prior studies that focus on the effects of the interactions in practice on the quality of audit. The study addresses the need for additional theoretical work to explain the roles play by the three key parties through the interactions between them and how the interactions can influence the audit quality.

### **1.5 Theoretical perspectives and research methodology**

The study extends and confirms prior study such as Beasley et al. (2009) that agency theory alone cannot fully explain the substantive monitoring of audit quality, therefore additional theoretical work is needed. The research questions discussed in this study

extend the agency theory and guided by power theory and source credibility theory. Power theory (French & Raven, 1959; Raven, 1965; Raven 1992; Kalbers and Fogarty, 1993; Erchul and Raven, 1997) offers potential explanations of power hold by the external auditor, audit committee and internal audit function and recognises the important role of these parties in enhancing the exchange of information sharing in the interactions between these parties which eventually influence the audit process. The active monitoring and oversight roles played by the audit committee and internal audit function during the interactions can enhance the audit process. The information and knowledge shared by both parties during the interactions may influence the external auditors' judgements on audit plan, risk assessments and evidence gathering in which the best audit approach is adopted to reduce the risk of material misstatements. Similarly, insights provided by the external auditor on the financial reporting standards may enable the audit committee and internal audit function to perform their monitoring and oversight roles effectively, thus enhancing the overall audit quality.

Meanwhile, the source credibility theory (Hovland & Weiss, 1951) is found to be relevant to the study as it explains the elements of trustworthiness and expertise (Hovland & Weiss, 1951; McGinnies & Ward, 1980; O' Keefe, 1990) which are important in the interaction between the parties. The trust established between the parties have been identified to affect the behaviour of the parties in the interaction. In the context of this study, both elements illustrate how the external auditors evaluate the information suggested or shared by the audit committee and internal audit function in the audit meetings, private meetings, report and other channels of interaction.

The information which perceived as credible by the external auditors may help the external auditors in the conduct of their audit, thereby reducing the risks of material misstatements. Although DeZoort, Hermanson, and Houston (2003), for instance, applied

source credibility in examining audit committee's evaluation of information provided by management and external auditor, the theory has not been widely used in auditing and corporate governance research. The adoption of this theory in this study is, therefore, an essential addition to this field and complements the predominant use of agency theory in the literature.

The simultaneous adoption of both power theory and source credibility theory in this study suggest that power hold by all the three parties particularly expert power have consequences on perceived credibility of the information shared during the interaction. Depending on the way power is exerted, it may influence the perceived credibility of information exchange and trust between the parties (Castelfranchi & Falcone, 2010). Trust is important in the interaction between these parties as it will influence the level of reliance on the information provided by the parties which are potentially significant for the external auditors' execution and performance of audit process. Finally, the use of both theories facilitates greater understanding of the role of power and source credibility in understanding the nature of the interactions of the key parties in practice and how the interactions can affect the audit quality.

The qualitative research approach is employed as the main research method to answer the research questions. The use of qualitative approach in the study enables to verify actual perceptions of the audit committee, internal audit function and external audit, rather than treating them as a "black box" (Forbes & Milliken, 1999). The ambiguous nature of the interactions between external audit with audit committee and internal audit function may offer a fruitful area through the application of qualitative research methods (Knechel et al., 2013). Qualitative data gathered through open-ended questions were analysed to provide the final findings of the study.

## **1.6 Significance of the Study**

The study is significant as it has several contributions to research. As mentioned earlier, a review of literature evidences limited studies which explore the “back stage” of interaction between the parties and their influence on the audit quality. Most of these studies (see for example Gendron et al., 2004; Gendron & Bedard, 2006; Turley & Zaman, 2007; Beasley et al., 2009) have focused on the audit committee effectiveness which partly discussed the interaction between audit committee with other parties such as external auditor and internal audit function. By incorporating multiple key governance mechanisms’ views (external auditor, audit committee and internal audit function) simultaneously into their interactions and audit quality, the study extends prior literature to provide a more comprehensive view of this area.

The study provides further evidence of the attributes (i.e. knowledge, expertise, experience), behaviour (i.e. willingness to exercise the authority and to share the information between the parties, ask challenging questions, etc.) and activities (i.e. social interaction between the parties) that take place during the interaction that potentially influence the quality of the audit. For example, this study complements the prior studies (Gendron & Bedard, 2006; Turley & Zaman, 2007; Zaman & Sarens, 2013) on the importance of informal channels of interaction in which this study revealed the importance of social meetings that allow for more interaction and information exchange between the parties and further enhances the audit process. Hence, this study can provide a better understanding of how the interaction between the parties can enhance the audit quality.

The findings of this study promise to provide feedback to the companies and regulators (i.e., Securities Commission and Bursa Malaysia) on the need for policies that support the link between the external auditors, audit committee and internal audit function. It will

help the regulators and practitioners to gain a better understanding of the nature and factors that might affect the interaction between the parties and audit quality. For example, a greater understanding of the roles of the audit committee and internal audit function are important for improvements in quality and enhancing the internal audit service (Gramling et al., 2004; Cohen et al., 2010). It is, therefore, through this study, that practitioners and regulators can have better insights on the real contribution of the audit committee and internal audit function in enhancing the quality of audit through their interactions with the external auditors. Gaining an understanding of the interactions between these parties will provide important insights on how the regulators and practitioners can improve the performance of both parties. Considering the importance of both parties' performance to enhance the interaction and audit quality, low-quality performance may require changes in the structure of the parties and more ways to improve the performance of both parties need to be explored. Hence, this study contributes to assisting the policy-makers and practitioners in formulating standards and objectives towards improving both corporate governance practices and audit quality.

The findings from this study suggest prior quantitative research does not identify personal behaviour and values as bearing an influence on the interactions between the parties and the audit process. This possibly fills part of the gap in the audit quality and corporate governance literature and provides useful findings by indicating potential attributes and values to attain high levels of audit quality. Regulators and the companies can consider key attributes and personal behaviour such as experience, professionalism, personal values of the external auditors, audit committee and internal audit function in enhancing their interactions. Following this, policy-makers can ensure mechanisms are in place to train all the three parties to acquire the attributes and personal values required, and hence add value to the interaction between the parties and finally quality of the audit.

In addition, the market regulators can determine ways to enhance the performance of all three parties and improve the reliability of audit quality.

The study extends audit quality and corporate governance research using power theory and source credibility theory. The use of these two theories extend the agency and institutional theories that have been used widely in the corporate governance literature, and thus confirms that additional theoretical work is needed in corporate governance area (Cohen, Krishnamoorthy, & Wright, 2008; Beasley et al., 2009; Dobija, 2015). Hence, the application of power theory and source credibility theory is also a key contribution to extant literature. The inclusion of power theory explains the importance of the expertise and willingness of both parties (audit committee and internal audit function) as the provider of information to the external auditor to enhance the level and quality of interactions between the parties. Meanwhile, the source credibility theory explains how the trustworthiness and expertise of the key parties may establish trust between the parties and enhance the interaction which finally contributes to the audit quality. These two theories allow the researcher to consider the broader values of all three key parties (external audit, audit committee and internal audit function), including their personal values (i.e. honesty, humbleness, etc.) in that impinge upon the active interactions and finally affects the quality of the audit. Theories provide a different perspective to view the important contribution of the audit committee and internal audit function in enhancing the audit quality.

## **1.7 Organization of the Thesis**

This thesis is categorised into three different phases: literature review, data collection process, and discussion of the findings. These phases are organised into five chapters as follows:



## ***CHAPTER ONE: INTRODUCTION***

The chapter provides an overview of the research. It describes the background of the study detailing the research objectives and research questions as well as the scope of the study. It also provides justification and motivation for the research as well as the organisation of thesis.

## ***CHAPTER TWO: LITERATURE REVIEW***

Chapter 2 provides a general understanding of the various ways and methods of audit quality discussed in the literature. Once this is established, the chapter discusses the interactions among the key parties in governance and their relations to the audit quality. The corporate governance framework is also discussed, which provides a critical and comprehensive review of the key governance players' roles and the importance of the interactions among them. This chapter also sets the scene for the thesis by providing a review of theory employed in the study and related methodological issues in the prior literature. The review of the prior studies in the related area concludes with identifying the gap in the literature and suggestions to bridge the gap.

## ***CHAPTER THREE: THEORETICAL FRAMEWORK AND RESEARCH DESIGN***

The chapter outlines the research design of the study. It presents methods and approaches employed, data collection processes as well as the data analysis conducted in this study. The choices of the methods chosen and procedures followed are justified.

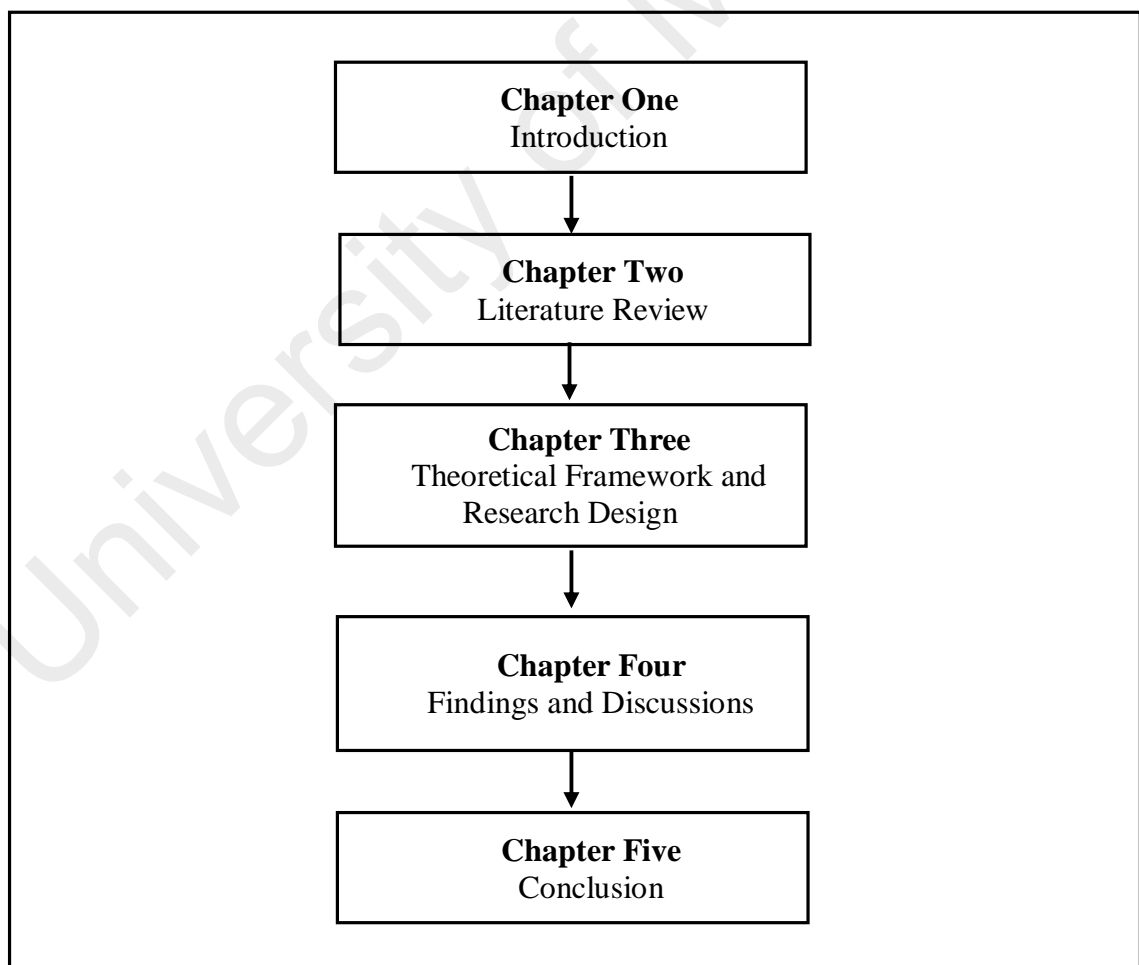
## ***CHAPTER FOUR: FINDINGS AND DISCUSSIONS***

This chapter provides the findings from the empirical work undertaken. First, it presents the background information of interviewees; and the results of a detailed analysis of the interviews on the nature of the interaction between the external audit with audit committee and internal audit function. The aim of this analysis is to answer the first research question in this study. The second research question formulated in the study is

then discussed by presenting the results of a detailed analysis of interviews on the impact of the interaction on the audit quality. It also provides a discussion of the overall findings of the study.

### ***CHAPTER FIVE: CONCLUSION***

This chapter summarises thesis and the conclusions and implications of the study are drawn. The nature of the interactions between the key players in practice and their influence on the audit quality are highlighted. This chapter concludes thesis by highlighting the potential limitations of the study, offering a number of recommendations and making suggestions for future research. For the purpose of clarity, Figure 1.1 summarises the organisation and the flow of discussion in the chapters in the thesis.



**Figure 1-1: Overview of the Thesis**

## CHAPTER 2: LITERATURE REVIEW

### 2.1 Introduction

The first chapter provided a brief overview of the research under study. It presented the background and research area of the study. This chapter provides a review of the audit quality as well as the reports and standards related to audit quality. The audit quality studies are explored to gain an understanding of how it has been applied in the literature. The importance of interactions between key parties (i.e. external audit, audit committee and internal audit function) in improving audit quality are also explored. Once this is established, the chapter discussed the interactions between the key parties in the literature and illustrated how the interactions between the governance mechanisms will influence the audit quality. Evaluation of studies in this area has contributed to our understanding of the importance of the interactions between the governance mechanisms in improving the audit quality.

This chapter also discusses various approaches used by the researchers in studying the audit quality and interactions between governance mechanisms. The purpose is to provide a broader viewpoint and debates of the different approaches or methods used in the literature and how it will influence the audit quality and corporate governance in practice. Evidence reveals that most of the published articles in governance are using quantitative method (archival which usually using publicly available data or questionnaires) and limited studies appear to use qualitative method (fieldwork, interviews, observation, etc.) in investigating this area. Overall, the purpose of this chapter is to provide a comprehensive review of the corporate governance and audit quality issue. The review in this area concludes with identifying the literature gap focusing on research contributions to extant audit quality and corporate governance literature and suggestions to bridge this gap.

The remainder of the chapter is organised as follows. Section 2.2 reviews prior studies related to audit quality. In particular, the approaches in investigating audit quality are discussed, thus emphasising the need for a qualitative study on audit quality. Section 2.3 provides a review of the relation of the interactions on audit quality including prior research on the interactions between external auditor with audit committee and internal audit function. This section also discusses the regulation requirements on the interactions between the parties. Section 2.4 presents the implications of the prior literature review for the current study. It highlights the gap in the literature within this area and developing the research questions and research objectives of the study. The chapter ends in Section 2.5 with a summary and conclusion.

## **2.2 The Audit Quality**

The function of auditing is to provide reasonable assurance that the financial statements are prepared and presented in a true and fair view and free from material misstatements. Audit offers a solution to the information asymmetry problem between the management and the shareholders as well as other stakeholders (Jensen & Meckling, 1976, DeFond, 1992). As a mechanism of governance, the external audit has a role to reduce agency costs and to ensure the reliability of the financial information communicated to the shareholders. From the agency theory perspective, owners incur monitoring costs such as the cost of the external audit of financial statements to minimise the risks that the managers act for their own interests rather than shareholders' interests (Jensen & Meckling, 1976). External audits serve a vital economic purpose and play an important role in serving the public interest by strengthening accountability and reinforce trust and confidence in financial reporting. An external audit provides an independent check on the work of management and the information provided by the management, which helps to maintain the shareholder's confidence and trust. Accordingly, the interests of the shareholders can be protected.

DeAngelo (1981) and Watts and Zimmerman (1983) had established a line of research that uses the agency theory to address the role of external auditing in organisations. The studies suggest that audited financial statement is an effective monitoring response to agency costs. The audit reports and audited financial statements are important and used extensively by various groups of stakeholders for the purpose of decision making. The audit reports act as the external auditor's verification and add credibility to the financial statements prepared by the management (Francis, 2004, 2011). Therefore, audit quality is important as it may affect the credibility of the financial statements. High audit quality is a necessary criterion to build stakeholder's confidence in the audit profession. Even though the literature provides differing views on the definition of audit quality, however, it is clear that shareholders, audit committee members, auditors and regulators all agree that quality audit is essential to business and capital market confidence (Kilgore et al., 2011).

Given its significance, various studies have been conducted to examine audit quality. At the same time, there are also numerous definitions present for audit quality. Traditionally, audit quality has been defined by DeAngelo (1981) as the market-assessed probability that the financial statement contains material errors and the auditor will both detect and report errors and irregularities in the financial statement. Under such a definition, there are two main features in audit quality, which are the competence of auditors by possessing the necessary knowledge to make a correct judgement or discover problems on client's accounting system; and the independence of auditors to disclose these problems. However, the two aspects of DeAngelo (1981) definition were critique as unobservable (Krishnan & Schauer, 2000) and very difficult to measure. Krishnan and Schauer (2001) appears to have captured the essence of audit quality by defining it as the degree to which audit performed in accordance with applicable auditing standards.

Likewise, Davidson and Neu (1993) defined audit quality as the accuracy of the information reported on by auditors. This is supported further by Lin and Hwang (2010) who documented that audit quality is expected to reduce information risk that the financial statements containing material errors. However, Carcello, Hermanson, and Riley (2002) argue that audit quality is associated with the total of audit work. More audit work is required to improve the audit quality. Even though there is a vast body of literature examining audit quality, there remains no single unified definition or measure of audit quality. Most of the audit quality literature cite DeAngelo (1981) definition of audit quality. Regardless of the definition adopted, audit quality is inherently unobservable.

Since audit quality is something that is intangible and unobservable, it has been investigated within a variety of perspectives. Further, all stakeholders in the financial reporting process have different views as to what constitutes audit quality which contributes to the different interpretation of audit quality (Sutton, 1993). Accordingly, different stakeholders tend to understand the audit quality differently and used different ways in measuring audit quality which contributed to the ambiguity and subjectivity in the term audit quality (Watkins, Hillison, & Morecroft, 2004). For instance, the user of financial reports (i.e. investors or shareholders, etc.) may understand high-quality audit in the absence of material misstatements (Knechel et al., 2013). Meanwhile, the regulators may interpret the high audit quality based on its compliance with professional standards (Francis, 2004; Peecher & Piercey, 2008; Casterella, Jensen, & Knechel, 2009). The literature evidenced that most of the studies defined audit quality as an outcome conditional on the presence of certain attributes of auditors (Knechel et al., 2013). Due to the differences in the definition of audit quality, the scholars in this area argued that a framework should be developed to gauge overall audit quality (Francis, 2011; Knechel et al., 2013).

Numerous researchers conducted synthesis studies reviewing and evaluating theory and empirical research of audit quality (Watkins et al., 2004; Francis, 2011; Knechel et al., 2013). These studies developed different frameworks on how the audit quality has been studied in the literature. Notable examples include Watkins et al. (2004) who provides the framework that captures the relation between the various dimensions of audit quality. Throughout the framework, the authors illustrate the relation between the demand and supply drivers, components of audit quality, the products of audit quality, and their influence on financial statement information derived from the professional and academic literature. In their framework, the authors explained the importance of information credibility and information quality as products of audit quality. It relates to how well financial statement information reflects the true economic circumstances of the company.

The literature has evidenced most of the studies relate the information quality with the auditor characteristics such as auditor reputation or brand name auditor (Craswell, Francis, & Taylor, 1995; Abbott & Parker, 2000) with the assumption that the external auditors hold important roles in ensuring information quality and reflects the true and fair view of the financial reporting. However, while the primary responsibility for performing quality audits rests with auditors and the auditor reputations are important for information quality, the external auditor needs support from other key governance mechanisms for quality information (IAASB, 2013). This is because the quality of the auditor's information may be achieved fully when the external auditor is surrounded by channels of communications permitting the sharing of information and matters of concern to be discussed. Hence, external auditors must work with other key mechanisms in the corporate governance structure (i.e. audit committee and internal audit function) to improve audit quality and ensure stakeholders receive the high-quality financial reports.

While Watkins et al. (2004) capture the relation between the various dimensions of audit quality, Francis (2011) presents a general framework for studying factors associated with audit quality at engagement level. The central point of the framework is that audit quality is affected by the units of analysis (audit inputs, audit processes, accounting firms, audit industry and audit markets, institutions and economic consequences of audit outcomes). In this framework, the author illustrates how audit quality is affected at each level of units of analysis. At the input level, the authors illustrate the competent and independent person to implement audit tests are important in ensuring the testing procedures used are capable of producing reliable and relevant evidence. This affects the audit process, in which good decisions regarding the specific tests to be implemented are made and evidenced from the tests are properly evaluated and documented in the audit report. The audit quality is also claimed to be affected by the accounting firm in which the auditors work. The incentives offered to the auditors affect the behaviour of engagement team personnel which affect the quality audit provided to the clients. Finally, the existence of the institutions that regulate auditing and punish auditors and accounting firms for misconduct and low-quality audits that affect the incentives of accounting firms and individual auditors to produce high-quality audits.

More recently, Knechel et al. (2013) established audit a quality framework based on the primary attributes of an audit (incentives, uniqueness, process, uncertainty, and judgement), and from the indicators of audit quality discussed in the literature (inputs, process, outcomes and context). The inputs category looks into individual characteristics of the audit team such as expertise and independence, which have a certain influence on the audit quality. The characteristics inherent to the audit process including risk assessment, analytical procedures, work paper review and others were also considered in the framework which has evidenced a contribution to high audit quality. Various observable characteristics such as restatements and financial reporting quality were

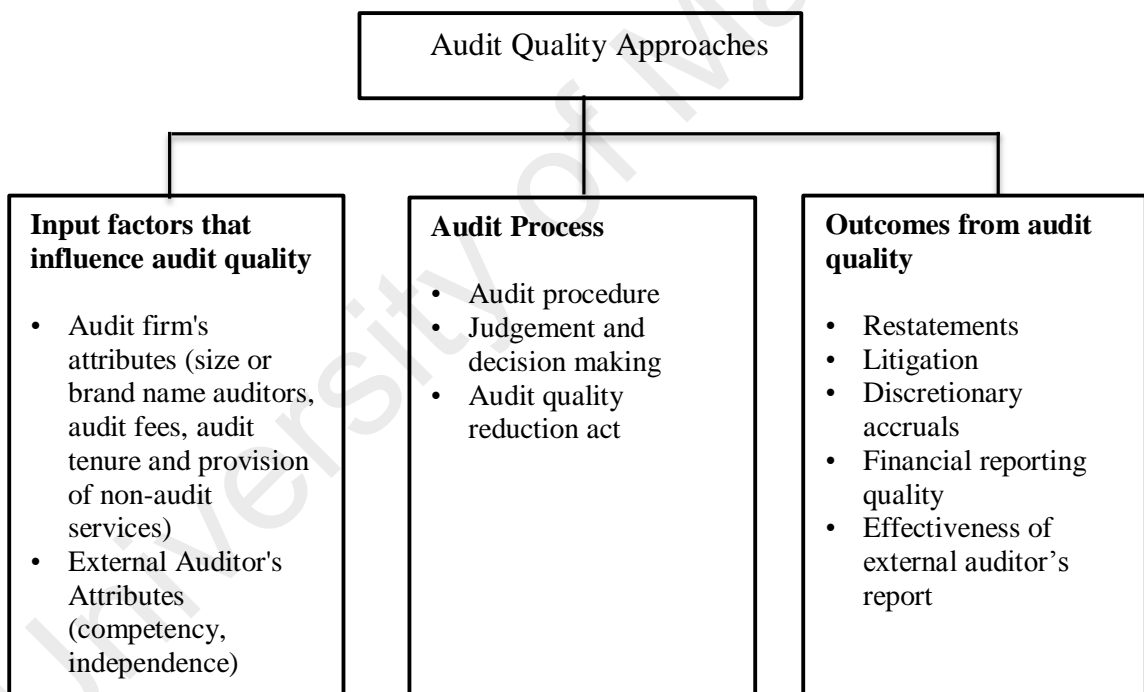


considered as outcomes of the audit quality in the framework. Finally, the indicators associated with the context of audits such as abnormal audit fees and audit fee premiums were considered which may influence auditor incentives and finally the audit quality.

While the academicians have developed different audit quality frameworks based on the findings in the literature, the regulators have also discussed the audit quality in different framework. The regulators have conducted various initiatives in enhancing audit quality (audit quality from regulatory perspectives is discussed in Section 2.3), with the objectives of enhancing overall audit performance and secure the stakeholders' best interests.

These frameworks evidenced the different ways and approaches that the researchers used in examined the audit quality since there is no single accepted definition and it is unobservable. Since various factors may affect audit quality, it is not surprising that researchers have used various observable proxies to examine audit quality (Balsam, Krishnan, & Yoon, 2003; Watkins et al., 2004; Lin & Hwang, 2010). The literature demonstrates a notable lack of consensus as to the proper measures to use as proxies for audit quality. Further, the use of different proxies in the audit quality studies have led to variations in findings. For example, the findings of the studies that used audit fee as a proxy are likely to differ from the studies that used restatements as a proxy. This suggests that extant proxies for audit quality used in the literature are tapping into different concepts. In particular, most studies analysed the audit quality in terms of certain attributes of the external auditor and audit firms. However, some studies used different measures of audit quality other than external auditors and audit firm's attributes. This includes restatements, financial reporting quality, the accuracy of audit reports, and others.

Prior research on audit quality can be categorised based on three main approaches- input, process and outcome measures. This is consistent with the synthesis study on audit quality conducted by Knechel et al. (2013) and Bedard et al. (2010). The input category of audit quality is reflected in the external auditor's or audit firm characteristics (expertise of external auditor, the size of audit firm, etc.). Meanwhile, the process is reflected in the characteristics of the audit process (i.e. risk assessments, judgement and decision making, etc.) and finally outcome measures may be reflected in various observable characteristics (earnings management, restatements, etc.). The discussions on each of the audit quality measures are discussed in the following subsections and summarised in Figure 2-1 below.



**Figure 2-1: Audit Quality Approaches**

### 2.2.1 Input

A number of strands of research that focus on the input measures of audit quality that largely built on DeAngelo's definition of audit quality can be recognised in the literature. The main focus of research in this area involves the proxies of audit firm's attributes and external auditor's attributes which discusses further below.

### 2.2.1.1 Audit Firm's Attributes

Among the input factors of audit quality used in the literature are audit firm size or brand name auditors (DeAngelo, 1981; Palmrose, 1986; Francis & Simon, 1987; Craswell et al., 1995; Sundgren & Svanström, 2013; Sundgren & Svanström, 2014), audit fees (O'Sullivan, 2000; Salleh, Steward, & Manson, 2006; Bliss, Gul, & Majid, 2011), auditor tenure (Shockley, 1981; Deis & Giroux, 1992) and provision of non-audit services (Glezen & Millar, 1985; Frankel, Johnson, & Nelson, 2002; Jenkins & Krawczyk, 2002; Raghunandan, 2003). These studies examine only one measure in each study.

Since a few decades ago, the literature examines the audit quality using audit firm characteristics as a proxy. For example, a higher quality audit is perceived to be associated with audit firm size or brand name auditors (DeAngelo, 1981; Palmrose, 1986; Craswell et al., 1995; Chen, Moroney, & Houghton, 2005; Abdullah, Ismail, & Jamaluddin, 2008; Guy, Ahmed, & Randal, 2010; DeFond & Lennox, 2011; Sundgren & Svanström, 2013; Sundgren & Svanström, 2014). Audit firms that are sizable are expected to have more competencies as compared to small audit firms. The large size of an audit firm is also claimed to have the greater in-house expertise and finally greater capacity to deliver higher quality audits (Davidson & Neu, 1993; Lowensohn, Johnson, Elder, & Davies, 2007; Al-Ajmi, 2009). However, since the audit failure case (Enron) in the early 2000s involved big sized audit firm (Arthur Anderson), the use of auditor size as a proxy for audit quality has been questioned. It also implies that large audit firms may not be of higher quality in all contexts.

Other than size, extensive empirical research documents the external audit fees as a proxy for audit quality (O'Sullivan, 2000; Goodwin-Stewart & Kent, 2006; Salleh et al., 2006; Yatim et al., 2006; Mitra, Hossain, & Deis, 2007; Bliss et al., 2011). Based on these studies, there are two common views on the audit fees as a proxy for audit quality. The

first view on audit fees suggests that a higher amount of audit fees indicates that auditors provide more efficient audit services to the firm compared to lower audit fees. Higher audit fees signalling higher quality audit as greater audit effort is required to ensure that financial statements are free from material misstatement (Deis & Giroux, 1996). On the contrary, low audit fees could harm audit quality as it demonstrates less audit work conducted by the external auditor (Eshleman & Guo, 2014). However, some studies suggest that the total amount of audit fees paid to the external auditors has no effects on the audit performance or audit quality (DeFond, Raghunandan, & Subramanyam, 2002; Ashbaugh, LaFond, & Mayhew, 2003) .

On the other hand, the second views on the audit fees as a proxy for audit quality are that the firm which pays high audit fees will reduce the level of independence of the external auditor and leads to the questionable accounting practices by the management (DeAngelo, 1981). This is supported by Asthana and Boone (2012) who find a positive relationship between audit fees and magnitude of discretionary accruals. Overall, prior studies that use audit fees as a proxy for audit quality offer mixed evidence which brings a different view on the audit fees as a proxy for audit quality (i.e. DeFond et al., 2002; Reynolds, Deis, & Francis, 2004; Eshleman & Guo, 2014).

Other than audit fees as a proxy for audit quality, some studies use non-audit services as a proxy for audit quality. Audit quality might be impaired if the external auditor provides joint services of auditing and non-auditing services to the clients. It is argued that joint services of auditing and non-auditing services will negatively affect the audit performance of the external auditors, weakening their independence and finally worsen the quality of an audit (Wines, 1994; Elstein, 2001; Frankel et al., 2002; Jenkins & Krawczyk, 2002; Raghunandan, 2003). This is because as the client pays a high amount of non-audit fees, the external auditor tends to give more flexibility to the client's

management in adjusting discretionary reserves which finally leads to the manipulation of financial figures (Elstein, 2001).

However, a syntheses study by Beattie and Fearnley (2002) shows no evidence that the joint services of audit and non-audit services could threaten auditor independence and audit quality. Thus, the finding by Frankel et al. (2002) fails to find convincing evidence that the non-audit services may impair auditor independence. Antle, Griffin, Teece, and Williamson (1997) documented that joint audit and non-audit services will not impair the auditor independence and otherwise it will improve audit quality. This is because of knowledge spillover whereby the external auditors have sufficient information about the clients and accordingly, it will improve the audit performance (Wallman, 1996). From the discussion above, it shows that the prior studies offer inconclusive evidence.

Some other input proxies used in the literature as a measure of audit quality include auditor tenure. There are two contradict views on the auditor tenure as a proxy for audit quality. Firstly, longer auditor tenure will improve the audit quality as the external auditors have a better understanding of the client's business and thus, the probability of the external auditor to detect misstatements and earnings management will be higher (Myers, Myers, & Omer, 2003; Ghosh & Moon, 2005; Knechel & Vanstraelen, 2007). Secondly, it is argued that short association between the external auditor and its client will produce lower audit quality as the external auditors who are new or auditing the client for the first time need more time to understand the client's operation in performing the audit. Accordingly, it will increase the risk of material misstatement. While long auditor tenure is found to improve the audit quality, it also may produce a poorer quality audit. The long auditor tenure will impair the external auditor's independence as it will reduce external auditor's diligence in gathering audit evidence (Deis & Giroux, 1992).

### **2.2.1.2 External Auditor's Attributes**

Other than audit firm's attributes, there are a lot of studies that used external auditor's attributes as a proxy for audit quality (i.e. Colbert & Murray, 1998; Solomon, Shields, & Whittington, 1999; Beattie & Fearnley, 2002; Zerni, 2008). In general, most prior studies used external auditor's professional qualification, training and practical experience as a proxy for audit quality. These characteristics or attributes are claimed to be important for the external auditors in performing a quality audit. The external auditors need to have an in-depth understanding of the business operations and financial reporting requirements in gathering evidence necessary to form an audit opinion. External auditors with more domain-specific knowledge have a higher consensus level and thus make decisions that are more consistent with professional standards (Bedard, 1989; Bedard & Wright, 1994; Low, 2004; Robyn, 2007). Thus, the professional qualification, training and practical experience are deemed necessary in performing quality audits.

Solomon et al. (1999) documented that there is a positive relationship between external auditors with specialist knowledge and their ability to detect material misstatements. Likewise, Owoso, Messier, and Lynch (2002) provide evidence that external auditor's knowledge influences their ability in detecting mechanical and conceptual errors in the financial statements. In their study, the authors suggest that external auditors with industry specialisation outperform non-specialists in error detection. Zerni (2008) documented that factors such as competence, knowledge and experience have a significant influence on the audit quality, and the external auditors should acquire these elements in performing the high quality audit. This is supported further by UK's Financial Reporting Council (FRC, 2008a) which documented that skills and personal qualities of partners and staff are key drivers in audit quality framework.

From the discussions above, all of these input measures examine the audit quality from the characteristics of the external auditors and audit firms' quality. In general, it shows that audit quality depends on how well the external auditors and audit teams function (Al-Ajmi, 2009). However, the findings of the studies offer inconclusive evidence on the best proxy for measuring the audit quality. Further, the occurrence of audit failures involving big audit firm has raised some needs to investigate the audit quality further in this perspectives as it leaves the question on how to improve overall audit quality unanswered. The following subsection discusses the audit quality approaches in the lens of the audit process.

### **2.2.2 Audit Process**

Apart from input to audit quality, studies have examined how the audit process enhances understanding of audit quality (O'Keefe, Simunic, & Stein, 1994; Nelson & Tan, 2005; Knechel, Rouse, & Schelleman, 2009). The focus on audit process is significant as it provides an avenue to identify weaknesses in the audit process and eventually reduce the probability of audit failure (Sutton, 1993). The improved audit process can further enhance outcome quality as required by the stakeholders. The studies in the audit process view the audit process as a production function (Francis, 2011), in which it involves the audit procedures as well as decisions and judgements that applied by the audit engagement team in conducting the audit. Sutton (1993) suggests that audit process begins after the audit engagement has been secured (which is before the development of the audit plan) and end at the issuance of audit reports. Adopting a specialised form of the nominal group techniques involving auditors from industry, Sutton (1993) has classified the audit process into four phases including engagement planning, interim fieldwork, year-end fieldwork and final administration, which is consistent with Sutton and Lampe (1991). Both of these studies found 19 factors that influence the audit process including client based factors (i.e. changes in client,

understanding of client systems), client environmental factor (i.e. client competence, client preparedness, client rapport and client reaction), audit team or firm based factors (i.e. staff expertise and availability of total firm resources) and actual audit procedures based factors (i.e. risk assessment, thoroughness of review process).

While, Cohen et al. (2002) and Cohen et al. (2010) categorised the audit process into three stages including audit planning stage, field-testing stage and review stage. In the most recent study, Knechel et al. (2013) have categorised the audit process into few different phases which are a risk assessment, internal control evaluation, testing, and review. In each of these phases, it involves the external auditors' judgements which influence the quality of the audit process. In an earlier study, Richard (2006) has divided the audit process into four steps including (1) audit strategy planning, (2) evaluation of the internal system of control, (3) direct control of accounts and (4) concluding work. In support to Knechel et al. (2013), auditors' judgements are important in each step. In the audit strategy planning, the direction of the audit is discussed, and proper audit plan is produced. The audit plan is then used in conducting the audit, thereby the external auditors' understanding of the client operations and activities are deemed important as it may influence the overall quality of the audit. Thus, sufficient and appropriate information on the client's activities is significant to produce good audit planning.

The literature has clearly stressed the importance of the audit planning (Sutton, 1993; Salleh & Steward, 2012b; Knechel et al., 2013) and has been considered as a critical condition of a quality audit (Richard, 2006, p. 158). The audit planning will then influence the next steps in the audit process as it involves the action plan, the identification of areas to be audited, extent of the risk assessment procedures, extent of tests of controls and substantive procedures in the audit (Davidson & Gist, 1996; Cohen & Hanno, 2000; Allen, Hermanson, Kozloski, & Ramsay, 2006) . For example, high risk identified during



the initial audit planning will lead to more audit testing (Guess, Louwers, & Strawser, 2000) and audit effort (Walo, 1995; Beaulieu, 2001; Bedard & Johnstone, 2004). The audit planning will affect the whole audit process, and sufficient information is important in this step to ensure that proper audit plan is produced. However, there might be some changes in the audit plan due to the information gained or evidence gathered throughout the audit process. In particular, new evidence uncovered during the audit may affect the external auditors' risk assessments and finally the audit plan (Allen et al., 2006).

A review of the literature on audit quality reveals a lack of studies that investigate the audit process due to its unobservable feature (Sutton & Lampe, 1991; Krishnan & Schauer, 2000; Richard, 2006). Nonetheless, some studies provide evidence about the quality of the audit process. These studies have focused on certain areas in the audit process in investigating the audit quality. In particular, some studies covered the audit procedures adopted by the external auditor in conducting the audit which finally enhances or determines the audit quality. As an audit has been defined as a process of judgement (Humphrey, 1997, p. 4), some studies have investigated the audit process in the form of judgement decision making by the external auditor. Finally, some studies have focused on certain behaviours which may influence the audit quality. In sum, these studies focused on audit procedures, judgement and decision making and audit quality reduction acts in understanding the audit process (Sulaiman, 2011) (each area is discussed briefly in the following subsections). These studies have addressed the importance of investigating the audit process to enhance the understanding of audit quality and called for more studies to explore the audit process (Nelson & Tan, 2005; Knechel et al., 2013). More discussions which focus on interaction and audit process will be discussed in subsection 2.3.2.2 (page 70).

### **2.2.2.1 Audit procedure**

The literature has examined various perspectives of audit procedures and their effects on audit performance and overall audit process. It includes the audit methods used in conducting the audit, the effects of the audit methods applied as well as decision aids applied in practice to develop new audit methods or procedures (Curtis, 2006).

The audit methods applied during the audit may differ from firm to firm. In general, audit methods are applied in the audit process including during the audit planning, evidence gathering as well as substantive tests in order to meet the broad requirement of audit standards. It is specifically adopted to direct and help an audit team to conduct the audit in a systematic manner (Knechel et al., 2013). Cushing and Loebbecke (1986) has discovered the differences in audit approaches structure between the audit firms and classified the audit methodology into structured, semi-structured, partially structured and unstructured.

The various audit methods used may have a different influence on the audit performance. For example, Chow, Ho, and Mo (2006) examined the effect of the differences in the structure of the audit process between Big Four firms and national firms in China. Their results demonstrated that the differences in the structure of audit process had caused the inconsistency in audit performance. In a related vein, the approach applied in assessing risks can result in different assessments. Using experimental approach, Wilks and Zimbelman (2004) found that the used of a holistic approach in assessing the risks would results in an understatement of fraud risk assessments compared to the used of approach that separately assesses the risks of fraud for different components.

The decision aids used in the audit may influence the audit procedures. Eining, Donald, and James (1997) investigated the use of different decision aids in the assessment of management fraud risk. Using the experimental approach, the findings evidenced that the

use of expert system assists the auditors to differentiate the varying risk of management fraud better compared to the use of simple decision aid. On the other hand, the findings in Arnold and Sutton (1998) and Asare and Wright (2004) have evidenced that the used of decision aids and standardised checklists in the audit may reduce auditor performance. The external auditors tend to rely on the recommendations provided in the decision aids and checklists instead of using their professional judgement when it is needed. On the other hand, Agoglia, Beaudoin, and Tsakumis (2009) focused on the effects of different audit review format on the reviewer's judgements quality. The findings of the study have highlighted that face-to-face review and electronic review provided to the reviewers have a different impact on the reviewer's judgements. The study concluded that different review formats could influence the judgements and finally affect the audit process.

The studies have evidenced different methods or decision aids used in audit procedure may potentially influence the audit performance (Arnold & Sutton, 1998; Wilks & Zimelman, 2004; Chow et al., 2006; Agoglia et al., 2009). The external auditors should apply the most appropriate method in conducting the audit to deliver high-quality audit. For example, the use of the appropriate approach is important in assessing the risks as the good risk assessment in the audit was found to be a major factor in improving the quality of the audit (Sutton, 1993). Therefore, sufficient information is needed by the external auditors to ensure that the audit quality can be enhanced.

#### **2.2.2.2 Judgement and decision making in the audit process**

The studies on audit process also include judgement decision making (JDM) in understanding audit quality. The studies on JDM focus on auditor's judgement and decision-making process during audit planning, risk assessment, group decision processes, the audit review process, and audit quality control review (J. R. Francis, 2011).

It is important for the external auditors in making good quality judgements during the audit as it potentially affects the audit quality.

Few studies that review the judgement decision-making literature. For example, Libby and Luft (1993) focus on the potential factors that could affect auditor performance which include knowledge, ability, motivation, and the environment. These factors were identified as a major influence on the auditor performance in making a decision. On the other hand, by reviewing studies on audit process literature, Solomon and Trotman (2003) found several other elements that affect the auditor's judgement and decision making which include multi-person judgement, heuristics and biases, knowledge and memory, probabilistic judgement, environment and motivation, and policy capturing. All of these elements were considered necessary for making judgements during the audit.

Nelson and Tan (2005) conducted a review research in judgement and decision making in auditing in this area for the past 25 years. This study uses psychological perspectives to understand, evaluate, and improve judgements, decisions, or choices in an auditing setting. The authors classify extant auditing JDM literature in three broad areas which includes the audit task (i.e. risk assessments, analytical procedures and evidence evaluation, auditor's correction decision, going concern judgement); the auditor and his/her attributes (i.e. knowledge and expertise, skill and personality, cognitive limitations and decision aids); and interaction between auditor and other stakeholders in task performance. More recently, Mala and Chand (2015) provides a review of the JDM research highlights three major determinants of JDM including person, task and environment variables. The study has specifically addressed the progress in the literature identified the limitations in the JDM research in the literature.

In a review of the literature, various factors or elements were found to contribute to external auditors' judgements in conducting the audit. Kaplan (1985) highlighted that

auditor's assessment of internal control strength has a significant influence on the auditors' budgeted number of audit hours, particularly in more dynamic environments. Gramling (1999) documented that audit fee pressure has an influence on the auditors' reliance decisions on internal audit function. In particular, the study finds that audit managers under high fee pressure tend to rely more on internal auditors' work compared to the audit managers which not under audit fee pressure.

Focusing on the effect of expertise and knowledge differences on auditors' judgements, Earley (2002) evidenced that the auditors with more experience provide a better judgement decision on the discount rates in real estate valuation compared to the auditors with less experience. In a related vein, Lehmann and Norman (2006) highlighted that auditors with more experience tend to solve complex problems effectively compared to the auditors with less experience due to the different knowledge structures.

Using an experimental approach, Ng and Tan (2003) evidenced that authoritative guidance and audit committee effectiveness has influenced the auditors' perceived negotiation. The findings revealed that the authoritative guidance availability has a greater influence on the auditors' perceived negotiation outcomes (i.e. aggressive reporting) without the existence of effective audit committee. Brown and Johnstone (2004) provide evidence on the effects of negotiation experience on auditor's approach and outcome. Specifically, the study found that auditors with more experience are more contentious in their negotiation approach which leads to higher satisfaction with negotiation outcomes.

In a more recent study, Kang, Trotman, and Trotman (2015) found that the regulatory framework for evaluating auditors' judgements (Audit Judgement Rule) has effect on the oversight process of the audit committee members', in which it improves audit committee members' perceived accountability in ensuring the reasonableness of the financial

statements, which affect the audit procedures. Further, the finding suggests that the Audit Judgement Rule (AJR) increases the audit committee members' perceived overall comfort regarding the treatment of the accounting estimate. While, Brown-Liburd, Issa, and Lombardi (2015) found that the use of information systems in collecting data (Big Data) has changed the way auditors make decisions and collect audit evidence, in which it will increase the ability to collect, manage, and analyse data, thus leading to better judgement and decision-making. The finding also argued that major challenge in using the Big Data (i.e. information overload, irrelevant information, pattern recognition, and ambiguity) can be overcome through the use of tools such as expert systems, predictive analytics, etc. which help to mitigate these limitations and improve audit efficiency and effectiveness.

Due to the differences in the types of work performed by the auditors and the absence of definitive measures of the quality of audit judgements, the findings of the studies may not be generalisable and applied in various situations (Ashton & Ashton, 1995; Nolder & Riley, 2014). Most studies on JDM have applied experimental or survey approaches to investigate the JDM in the audit process (Mala & Chand, 2015). There is a lack of studies that explore JDM in practice. The need for more studies which explore the auditor interactions in JDM has been highlighted as the review found that this area is the most under-researched in auditing compared to the work involving audit tasks and auditor attributes (Nelson & Tan, 2005). In particular, Nelson and Tan (2005) suggested studies explore how audit committees interact with auditors while considering the growing importance of the audit committee in corporate governance.

### **2.2.2.3 Audit quality reduction behaviour**

Audit quality reduction behaviour refers to the actions taken by an auditor during an engagement that reduces evidence gathering effectiveness inappropriately (Herrbach,

2001) or the auditors' failure to properly execute audit steps (Malone & Roberts, 1996; Bedard, Deis, Curtis, & Jenkins, 2008). The literature has evidenced a number of variables that have been recognised as actions that could impair the auditor performance. These include a wide range of auditors' activities including overreliance on client work, sample selection bias, reduction in sample size, failing to research accounting principles, premature sign-offs, in which the auditors usually involved in order to cope with what they perceive as excessively tight time constraints (Herrbach, 2001; Coram, Ng, & Woodliff, 2004). These actions would have significant negative impact on audit quality which eventually could seriously damage the audit profession (Pierce & Sweeney, 2006). Recognising the important of this subject, the factors that affect the likelihood of audit quality reduction behaviours have been heavily studied, largely in the form of questionnaires and surveys (Sweeney & Pierce, 2004).

Literature has documented few factors that lead to audit quality reduction behaviour, which includes situational variables, auditors personal characteristics, and the reviewer and audit firms' characteristics (Peytcheva & Gillett, 2012). The time pressure was found to be the main situational factor that associated with the occurrence of audit quality reduction behaviour. For example, Willett and Page (1996) has documented that auditors perceived the time pressure significantly influences the likelihood of audit quality reduction behaviour. Similarly, Otley and Pierce (1996) has found that tight budgets time pressure has leads the auditors to under-report time worked on engagements which eventually may contribute to the material misstatements. In contrast, Lee (2002) who conducted in-depth interviews with junior auditors found that quality reduction acts occur in immaterial areas of audit. In the situation of intense time pressure, junior audit staff illustrated that they would usually use their own time to complete the audit tasks.

Peytcheva and Gillett (2012) examined the effect of auditors' prior involvement under relatively higher and lower levels of time pressure on the audit quality reductions act. Using experimental approach, the study evidenced that an auditor with prior involvement in the audit work to be more likely to suppress audit evidence than an auditor with no prior involvement which is explained by the personal reputation threats from the prior involvement. Focusing on the auditors' characteristics, Kelley and Margheim (1990) examined the impact of the audit senior team characteristics on the behaviour of the staff auditors. In particular, the study investigated the effect of senior audit characteristics on the dysfunctional behaviour of staff auditors caused by time budget pressure. The results evidenced limited influence of characteristics of audit senior on the dysfunctional behaviour of the staff auditors since the findings found high occurrence of audit quality reduction behaviour (i.e. premature sign-off audit report, reduces the amount of work that would be considered appropriate, failure to research accounting principles and make superficial reviews of client documents) in practice among the staff auditors.

Dowling and Leech (2014) examined the impact of audit support systems or information technology on auditor behaviour. Using the internal documents and interviews with auditors at a Big Four firm to analyse auditors' reactions to the firm's new audit support system, the findings of the study documented that the audit support system is not associate with the likelihood of audit quality reduction acts. The findings evidenced that the mandatory sign-offs and the real-time connectivity of the system increased the frequency and timeliness of preparer and reviewer interaction which accordingly increase the audit quality. In sum, the review of the literature on audit quality reduction behaviour shows that various other factors that could influence the audit quality regarding audit process. These studies provide evidence on the factors beyond the characteristics of the auditors which affect the audit quality.



### 2.2.3 Outcomes

Changes in the professional auditing environment have direct attention of the researchers to consider outcome indicators in studying audit quality (Bedard et al., 2010). In general, studies examine the relationship between input measures and outcome measures in determining the audit quality. The researchers do not focus on a single proxy or indicator, but rather on a number of different indicators. The combination of various indicators in one study gives a multi-dimensional picture of audit quality. Like the input measures, the outcome measures of audit quality are also unobservable. The common outcome indicators for audit quality used in the literature include restatements (Stanley & DeZoort, 2007; Chin & Chi, 2009; Li & Chen, 2011; Blankley, Hurtt, & MacGregor, 2012), litigation (Palmrose, 1988; Fuerman, 2012), discretionary accruals, financial reporting quality (Davidson & Neu, 1993; McDaniel, Martin, & Maines, 2002; Kim, Chung, & Firth, 2003; Ruiz-Barbadillo, Gomez-Aguilar, Fuentes-Barbera, & Garcia-Beneu, 2004; Behn, Choi, & Kang, 2008; Reichelt & Wang, 2010) and effectiveness of external auditor's report (Church, Davis, & McCracken, 2008; Mock et al., 2013).

Over the last couple of years, restatements have been used widely by the researchers as an outcome measure of audit quality. Studies provide evidence that poor audit quality is associated with a higher probability of accounting restatements and vice versa. Blankley et al. (2012) found a negative relationship between abnormal audit fees and the likelihood of issuing an accounting restatement. Through their study, the authors noted that external auditors are receiving low fees performing less thorough audits, thus leading to a higher likelihood of earnings restatements.

The literature also shows an association between accounting restatements with other measures of audit quality. For example, Li and Chen (2011) found a negative association between auditor's experiences with the restatements. Similarly, Chin and Chi (2009)

documented that higher level of auditor industry expertise is associated negatively with accounting restatements. This is supported further by Stanley and DeZoort (2007) who noted a negative association between accounting restatements with auditor tenure. Even though the sample size for the studies on accounting restatements claimed to be small (J. R. Francis, 2004), the evidence on the findings from the studies can be acknowledged. These studies are important because they establish a link between the low level of audit quality (based on various proxies of audit quality) and a high likelihood of accounting restatements.

Litigation against external auditors is often viewed as a signal of audit quality. Higher audit quality is expected to have a negative association with litigation cases against external auditors. The external auditor's ability to detect material misstatements will reduce the likelihood of audit failure and accordingly it reduces the likelihood of the litigation against the external auditor. However, the findings in the prior studies document relatively few litigation cases against external auditors (J. R. Francis, 2011). This is because the external auditors resolve the audit allegations or disputes out of court before a case goes to trial. This is supported by Palmrose (1988) who indicates that the litigation cases against external auditors in public listed companies are less than 1% of audit engagements. Using 472 samples of legal cases related to audit related litigation against Big Eight and non-Big Eight firms in the US, the author documents that Big Eight audit firms were associated with lower incidence of litigation than non-Big Eight audit firms. More recently, Fuerman (2012) documents that the sue cases by the clients on external auditors have decreased since the year 2002 (after Sarbanes-Oxley Act).

Financial reporting quality also received considerable attention from researchers as an outcome measure of audit quality (Behn et al., 2008). Most of the studies link the financial reporting measures with other input proxies of audit quality includes audit firm and

external auditor's characteristics. For example, it is expected that clients with big size audit firm produce more accurate financial information and fewer earnings management compared to clients with small audit firms. Big Four audit firms are more likely to detect material misstatements and provide a more accurate opinion, and thus the clients are less likely to be subject to regulatory sanction (Feroz, Park, & Pastena, 1991). This is proven in the study conducted by Kim et al. (2003) who documented a negative relationship between the size of the audit firm and earnings management. The authors concluded that big size audit firms have more incentive to prevent aggressive earnings management when there is a conflict of reporting incentives between corporate managers and external auditors, and there is high litigation risk for failure to detect income overstatement. However, Jeong and Rho (2004) documented no significant relation between the reported discretionary accruals of companies audited with the size of audit firms.

The literature also shows significant associations between financial reporting quality measures with other input measures of audit quality. This includes auditor tenure (Myers et al., 2003; Reichelt & Wang, 2010) and auditor specialisation (Balsam et al., 2003; Chi, Lisic, & Pevzner, 2011; Jaggi, Gul, & Chiu Lau, 2012). Reichelt and Wang (2010) suggests that clients with higher levels of industry experience and long auditor tenure would lower abnormal accruals. Similarly, Chi et al. (2011) and Jaggi et al. (2012) showed significant relationships between industry specialist auditors and earnings quality and management. More recently, findings by Francis and Michas (2013) suggested that audit firm with a history of past audit failure is related to a higher likelihood of future earnings management.

Another outcome that measures for audit quality that as used in the literature includes the effectiveness of external audit's report. Through the external auditor's report, the researchers examine the content of the report and as such it measures the audit quality.

However, there is an issue with this measure as it is limited to the content of the report. This is supported by the Mock et al. (2013) who pointed out that there is information gap in the report between external audits and users. Similarly, an earlier synthesis study by Church et al. (2008) provides evidence that the external auditor's report provide little communicative value, and thus it show a limitation in using the report as a measure of audit quality.

From the discussion above, the output measures of audit quality are measurable but indirect and unobservable. The measures also have limitations as proxies for audit quality (Knechel et al., 2013). Despite the contribution of these studies in enhancing our understanding audit quality, it provides limited information on audit practices and its contribution to quality audit. Therefore, it suggests for additional research in this area which examines the audit quality based on the perceptions of the practitioners that may enhance the findings established in the literature.

#### **2.2.4 The Limits of the Approaches to Audit Quality**

The discussion in the previous sections (Sections 2.2.1, 2.2.2 and 2.2.3) show that previous research approaches on audit quality have focused on the characteristics of the external auditor particularly on competence and independence of external auditor as suggested by DeAngelo (1981). However, it is difficult to assess the possible proxies of external auditor's characteristics that truly reflects the audit quality especially the independence of the external auditor. Even though the independence of external auditor can be related to various aspects such as audit tenure and non-audit service fee, the proxies may not truly reflect the audit quality in practice.

Further, the focus on the independence and competence characteristics alone is not adequate to understand the audit quality. Similarly, the use of the indicators or proxies in determining the audit quality outcomes (i.e. audit firm characteristics, external auditor

characteristics, financial reporting quality, etc.) does not guarantee the quality of audit performance. This is because the proxies or indicators cannot be defined in strictly quantitative terms (Knechel et al., 2013) and the proxies used are inconclusive. This is supported further by the inconclusive findings of the prior studies using proxies or indicators in examine the audit quality (Antle, Griffin, Teece, & Williamson, 1997; Ashbaugh, LaFond, & Mayhew, 2003; Frankel, Johnson, & Nelson, 2002; Goodwin-Stewart & Kent, 2006; O'Sullivan, 2000).

In terms of the audit process, the quality of the audit process appears to be an important element that is frequently overlooked. Limited attention has been given to the audit process in understanding the audit quality. The prior literature has called for more studies to explore the audit quality regarding the audit process in which can help to improve overall audit quality (Francis, 2011; Knechel et al., 2013; Nelson & Tan, 2005). This is supported by the UK Financial Reporting Council (FRC, 2008a) which identified the effectiveness of audit process as one of the key drivers of audit quality. It is important to realise that assessing the audit process can help to improve understanding of the auditing in practice (what external auditors and clients perform and how they do it), and it goes beyond the inputs and outcomes indicators as proxies for audit quality.

From a methodological perspective, most of the literature is based on quantitative approaches which used publicly available information. Similarly, the audit process was studied using a quantitative approaches such as surveys and laboratory experiments. It can be argued that most of the literature does not address the actual audit process in practice. Even though these studies have provided and enhanced understanding of audit quality, these studies are unlikely to capture the actual audit practices which important in further understand the audit quality. Therefore, more studies that explore the actual audit practices which can best capture using the qualitative approach is clearly warranted to

complement the findings in the literature. The next section will discuss the relation of interactions on audit quality that contributes to the development of the underlying concerns of this thesis.

### **2.3 Interaction in Relation to Audit Quality**

In the event of audit failure, the external auditor was often in the spotlight as the party was held responsible for ensuring high-quality audit. Even though the external auditor holds primary responsibility for audit quality, the external auditor need support from other parties to achieved best audit quality (Haron, Chambers, & Ismail, 2004; IAASB, 2013; Mihret & Admassu, 2011). Due to large amounts of uncertainty during the audit process, the external auditors need sufficient information to ensure that they made sound judgements for the audit processes (Davies & Webber, 1998; Brown-Liburd et al., 2015). For example, the external auditors may face uncertainty regarding the materiality of misstatements. Measuring materiality requires complex judgement and the external auditors may make a wrong judgement without sufficient information. The external auditors may underestimate the materiality and thus open the door to errors and finally leads to poor audit quality. Hence, due to the complex nature of the accounting and financial matters reviewed as well as time and effort constraints, it is widely agreed that external auditors need significant resources in performing the audit activities (IAASB, 2013).

This is supported further by Knechel et al. (2013) who claimed that the quality of an audit is greatly influenced by the level of resources and information provided to external auditors into the audit process. Similarly, IAASB stated that a quality audit is likely to be achieved if the auditor's opinion on the financial statement derived from sufficient appropriate audit evidence obtained by an engagement team. Thus, it is important for the external auditor to be surrounded by channels of communication permitting the sharing

of information and matters of concern to be discussed candidly to achieve high audit quality (IFAC, 2008).

Recognising the importance of sufficient and appropriate information for the audit process (Sutton, 1993; Brown-Liburd et al., 2015), the better the relationship and interactions between the client and external audit will lead to the better audit performance. Through the interactions, it is expected that the clients provide sufficient appropriate audit information needed and the information will be utilised effectively by the external auditors in the audit process (Sutton & Lampe, 1991). In general, the interactions enable the knowledge exchange and sharing among organisation members (Roberts, McNulty, & Stiles, 2005), thereby potential significant risks are not overlooked (Turpen & Dyer, 2015).

External auditors usually rely on information sources provided by the clients through a formal process (regular meetings and specified formal responsibilities) and informal process (establishment of processes outside those recognised in the formal structures) (Turley & Zaman, 2007; Sarens, Christopher, & Zaman, 2013; Zaman & Sarens, 2013). In particular, formal interaction is guided by the governance requirements and guidelines that need to comply by the organisation which create formal communication channels through which organisational knowledge can be channelled between the parties (Sarens et al., 2013). While, informal interaction is influenced by the existence of a certain set of informal values shared among individuals of a group which allow cooperation between the groups (Fukuyama, 1995). It also lacks pre-specification (Kraut, Fish, Root, & Chalfonte, 2002) and tends to be unscheduled without an arranged formal agenda (Zaman & Sarens, 2013). Both interactions can influence the behaviour and views of external auditors and thereby contribute to improvements in audit quality.

Each participant in the financial reporting supply chain plays an important role in producing high-quality financial reporting, and thus the nature of interactions between the participants have a particular impact on audit quality (IAASB, 2013). In particular, the current framework and standards released by regulators have emphasised on the interactions between the external auditor with audit committee and internal audit function (see for example ISA 260, ISA 315, ISA 610, MCCG 2017). These parties are independent parties with monitoring roles directly involved in the audit function. For example, the framework on audit quality by IAASB (2013) suggests that the interactions between the external auditors with those charged with governance (i.e. audit committee and internal audit function) at the planning phase can affect the use of expert with required skills and finally, influence the form and content of the auditor's report. Therefore, the interaction between these parties is important to enhance the overall quality of the audit. The objectives of these three parties are important as it will influence the nature and extent of the interactions between the parties. An open and constructive relationship with these parties will assist the auditor in identifying, assessing and responding to the risks of material misstatement (Cohen & Hanno, 2000; Gramling et al., 2004; Mat Zain & Subramaniam, 2007), thereby improve the audit quality. In the absence of cooperation and open dialogue between these parties, the probability of producing poor quality audit is higher as the external auditor might miss out the important information needed for the audit (Stvilia et al., 2007).

Through its ISAs, IAASB has identified the importance of transparent dialogue between external auditors and those charged with governance (i.e. board of directors and audit committee) in improving the audit quality.<sup>3</sup> The interactions are undertaken often

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<sup>3</sup> See ISA 260 Communication with Those Charged with Governance (briefly discussed in section 2.4)



between external auditors with the audit committee whereby the audit committee has a responsibility to oversee the entity's financial reporting process (MCCG, 2017). The interactions between external auditors and the audit committee on matters such as qualitative aspects of the entity's financial reporting practices and deficiencies in internal control can influence audit quality positively (Sutton & Lampe, 1991; Sutton, 1993).

Both types of interactions, formal and informal interactions (Turley & Zaman, 2007; Sarens et al., 2013; Zaman & Sarens, 2013), will influence the use of knowledge, expertise and skills of the audit committee members and accordingly will affect the external auditor performance (Cohen et al., 2010). Therefore, it is expected that active involvement of a high-quality audit committee will have a positive impact on audit quality (IAASB, 2013; Beattie, Fearnley, & Hines, 2013). This is further supported by Centre for Audit Quality (CAQ) in the US which reinforces the importance of the external auditor's communications with audit committees, by providing additional relevant information about the audit to the external auditor.

The interactions between external audit and audit committee not only help the external auditors in performing the audit, but effective two-way communication between both parties can assist audit committees in fulfilling their responsibilities (Cohen et al., 2004; Cohen et al., 2007; ISA 260). In particular, the external auditor's opinion and information on significant matters such as financial reporting risks and weaknesses in internal financial controls will benefit the audit committee in performing its responsibility. The information is essential if the management failed to report the information to the audit committee. With this information, the audit committee can make sound conclusion on the fair presentation of the financial statements. On the other hand, the audit committee may assist the external auditor in understanding the entity and its environment, and in

providing information about specific transactions or events that warrant particular audit attention (Cohen et al., 2010).

The external auditor communicates with audit committee to discuss audit planning (before the audit starts) and to discuss the significant findings (before the audit completed). Through its ISA 260, IAASB emphasised that the external auditor should communicate with the audit committee an overview of the planned scope and timing of the audit.<sup>4</sup> There are various ways of interactions between both parties including through meetings and in writing (i.e. external auditor's report). Most global codes of corporate governance emphasise private meetings between external auditors and audit committee without the presence of management (see, for example, ASX Corporate Governance Council, 2003; MCCG, 2007; 2012; 2017). It is expected that the external auditor and audit committee may discuss and give honest views on significant financial reporting matters during the meeting without management in attendance (Gendron et al., 2004). If the external auditors find that the oral communications through meetings are not sufficient, thus the external auditors shall communicate in writing regarding significant findings from the audit.<sup>5</sup>

Other than audit committee, interaction with others involved in the audit is essential and includes, where applicable, internal auditors (Bame-Aldred et al., 2013). As an independent party from the organisations, the sources of information from the internal audit function is considered essential in the audit process (Engle, 1999; Suwaidan & Qasim, 2010). ISA 610 (Revised)<sup>6</sup> emphasized the importance of the interactions between external auditors and internal audit function. In this standard, the external auditor is

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<sup>4</sup> See ISA 260 (Para. A11-A15)

<sup>5</sup> See ISA 260 (Para. A37-A39)

<sup>6</sup> ISA 610(Revised) : Using the Work of Internal Auditors

encouraged to have discussions with internal audit function at appropriate intervals throughout the period. The interactions between both parties help the internal audit function to be informed of significant matters that may affect the function (Cannon & Perreault, 1999). Likewise, it will help the external auditor to be notified of any significant matter that comes to the attention of the internal audit function when such matters may affect the work of the external auditor.<sup>7</sup> Thus, the external auditor can consider the implications of such matters for the audit engagement.<sup>8</sup>

There are two distinct ways or approaches that the external auditor can interact with internal audit function, (1) internal audit staff provides direct assistance; and (2) indirect assistance through the internal audit function (Mat Zain et al., 2006). The first approach requires internal auditors to work under direct supervision of the external auditors as their assistant; and the second approach is to rely on the relevant work carried out by internal auditors (i.e. when obtaining an understanding of the client's internal control structure or when assessing control risk, and substantive procedures that the external auditor performs). Using the second approach, the external auditor may rely on the information provided by the internal audit function which may influence the procedures performed by the external auditor. For example, the work of the internal audit function can provide assistance in the external auditors' risk assessments process.

During the interactions, the external auditor should be able to access internal auditors' working papers, reports and plans to reduce the duplication of the work performed by both parties. For example, during the audit planning stage, external auditor should be able to access to internal auditor's audit plan to coordinate their audit plan and to minimise

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<sup>7</sup> ISA 315(Revised): Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

<sup>8</sup> See ISA 610 (Para. A25)

any duplication of audit work. Both parties may share ideas and recommendations on ways to improve the audit plan. Further, the external auditors can assess the internal auditor's reports in the conduct of their audit (Clark, Gibbs, & Schroeder, 1981). Prior studies (Felix et al., 1998; Al-Twajry, Brierley, & Gwilliam, 2004) provide evidence of substantial interactions between the internal and external auditors, including the planning of audit work and assessing each other's working papers and reports. Through these interactions, the internal audit function has greater potential to aid the external auditors in their conduct of audit (Williamson, Rogerson, & Vella, 1996; Mat Zain et al., 2006).

In sum, the interactions between external auditor with the audit committee and internal audit function are deemed necessary in improving overall audit quality. Detailed discussions on the interaction between the external auditor and two other key players will be discussed in Section 2.3.2.

### **2.3.1 Corporate Governance Framework**

Corporate governance has gained attention since the tragic corporate collapses which reinforced the critical need to improve the corporate governance system around the world including developing countries. In the US, the role of governance key players in providing assistance to prevent financial reporting fraud have been emphasised in the corporate governance systems even since 15 years before the huge corporate collapses, i.e. in the early 2000s. It has been claimed that the failure of the external auditors, audit committee as well as the management to follow the recommendations provided in the corporate governance have caused the collapse of major corporations in the US (Barrier, 2002). Thus, since the corporate collapses the corporate governance have been strengthened and given further attention by the regulators (Turley & Zaman, 2004).

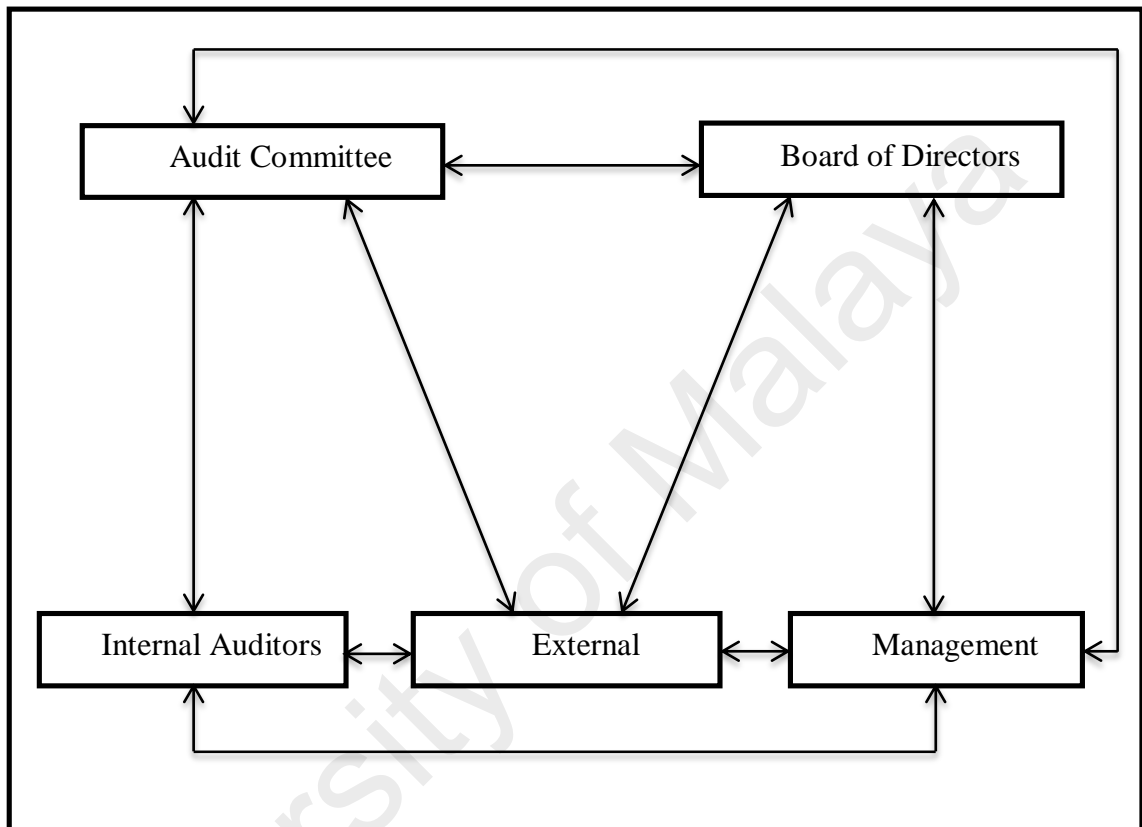
Corporate governance has been defined as "*the system by which companies are directed and controlled*" (Cadbury Committee, 1992). In particular, the framework

involves a set of relationships between a company's management, its board, its shareholders and other stakeholders (OECD Principles of Corporate Governance, 2004) which protect the shareholders' interests. It comprises the procedures and activities employed by the representatives of an organisation's stakeholders (shareholders, investors, employees and creditors) to provide oversight of risk and control processes administered by management (Gramling et al., 2004). An effective corporate governance is important to ensure the truthfulness of management reporting (i.e., reporting on financial results) and effective internal controls (Institute of Internal Auditors, 2003a). Therefore, to ensure effective governance, good mechanisms and effective key governance players should be in place to help management control their companies.

Gramling et al. (2004) and Cohen et al. (2004) documented four important mechanisms of corporate governance which include management, boards of directors and audit committee, internal audit functions and external audit. In their study, Cohen et al. (2004) highlighted the interrelationships between the key players in corporate governance which contributed to several outcomes. For example, the interactions among these players are essential for effective governance and to improving quality financial reporting (Sarbanes-Oxley Act 2002).

In support to Gramling et al. (2004) and Cohen et al. (2004), the Institute of Internal Auditors' (2003) model has indicated the audit committee, senior management, external audit as well as internal audit function as four cornerstones of high-quality corporate governance. This is partly consistent with the Blue Ribbon Committee (1999) report which documented that audit committee, internal audit functions and external audit as a three-legged-stool of corporate governance which can help to ensure the reliability of financial reporting. The key governance players and their interrelationship are shown in Figure 2-2 below. It highlights the potential interactions between the key players, and

suggests the potential impacts of governance process on financial reporting quality as well as auditing quality. Therefore, consistent with Zaman and Sarens (2013), corporate governance in this study is viewed as a process in which various actors interact with one another both formally and informally.



**Figure 2-2: Key Corporate Governance Mechanisms**

Source: Cohen et al. (2004)

The audit committee is an important board committee that plays a crucial role in effective corporate governance (Blue Ribbon Committee, 1999; Sarbanes-Oxley Act, 2002). In most developed countries (i.e. US, UK, etc.) the audit committee is viewed as enhancing the board of directors' capacity to monitor management in the financial reporting process. To monitor the financial reporting process, the audit committee needs to oversee internal and external audit performance, which eventually can enhance the audit quality (OECD, 2004). However, the audit committee needs other mechanisms such as external auditor and internal audit function in order fulfil its responsibilities (Cohen et

al., 2004; Mat Zain & Subramaniam, 2007; Sarens et al., 2009) and enhance the audit quality. These three key players are considered independent parties to the organisation and have important roles in monitoring the financial reporting and audit function. Therefore, the interactions among these three mechanisms are crucial for effective governance and will improve the audit quality (Cohen et al., 2004). Recognising the potential impact on the financial reporting and auditing quality, the roles of these three key players have evolved and have been seen as part of a wider agenda in corporate governance internationally.

In Malaysia, the Malaysian Code on Corporate Governance (MCCG) stresses the importance of the roles played by these three key players. The MCCG (2017) recommended the establishment of an audit committee as an important feature of the code of best practice for corporate governance. This is supported by Bursa Malaysia Listing Requirements which mandated all publicly listed companies in Malaysia to establish an audit committee.<sup>9</sup> The audit committees should comprise at least three members, with a majority of independent members and an independent chair.

The MCCG (2000) also outlines several roles of the audit committee which include discussing the audit plan, the scope of the audit and the audit report, and reviewing the financial statements focusing on accounting policy changes, significant audit adjustments and compliance with accounting standards with external auditors.<sup>10</sup> The audit committee is also responsible for the appointment, reappointment and removal of the external auditor.<sup>11</sup> In cases where the board does not recognise the audit committee's recommendation, the matter should be disclosed fully in the annual report. This

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<sup>9</sup> See Corporate Disclosure-Listing Requirement (Section 344A), as issued by the KLSE

<sup>10</sup> See Revised MCCG (2007), Part 2 (BB,II)

<sup>11</sup> See MCCG (2000), Part 2 (BB, II (i))

requirement illustrates the authority that the audit committee holds towards the external auditor. The mandatory reporting of compliance with the MCCG has enabled the stakeholders to assess and determine the standards of corporate governance by listed companies. The compliance with the MCCG requirements is important as it is able to protect shareholders from expropriation by managers (Mitton, 2002).

In the year 2007, the MCCG was revised for greater clarity of the roles of the boards of directors and audit committees, and ensuring that they discharge their duties effectively. In particular, the revised Code spells out the eligibility criteria for the appointment of directors, composition of the board of directors and role of nominating committee. Independent non-executive directors are expected to provide a more meaningful and independent oversight function. The revised MCCG 2007 has highlighted the significance of a quality relationship between the audit committee and the internal audit function. For example, to recognise and manage risks of the organisation, the MCCG mandating an entity to establish an internal audit function<sup>12</sup> and the internal audit function is expected to interact with the audit committee by providing the committee with on-going assessments of the company's risk management processes and system of internal control.

In terms of external audit, the corporate governance has clearly spelt out the responsibilities of external auditor in ensuring the quality of the financial statement.<sup>13</sup> As discussed earlier, the corporate governance has specified the role and responsibilities of the audit committee with regards to the external audit process. Apart from the appointment, re-appointment and dismissal of the external auditor, the audit committee

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<sup>12</sup> See Revised MCCG (2007), Part 2 (BB,VII)

<sup>13</sup> See for example, MCCG (2000), Part 3 (IV)



should discuss with the external auditors the findings of their work and discuss the effectiveness of the audit process. In assessing external audit's works, the audit committee should discuss with the external auditor any major issue that arose during the course of the audit and the content of the external auditor's management letter should be monitored in ensuring the recommendations have been acted upon. The revised MCCG (2007) encourages a greater exchange of free and honest views and opinions between audit committee and external audit whereby the audit committee have rights to convene meetings with external auditor excluding the attendance of other directors and other employees. This shows that the external auditor's duties and audit committee's responsibilities complement each other in accomplishing desired goals of corporate governance.

Based on the discussions above, the external auditor, audit committee and internal audit function have been emphasised in the corporate governance as independent parties who play monitoring roles in governance which responsible in ensuring better financial reporting and internal control system. The summary of the roles and responsibilities of these three parties stipulated in MCCG is shown in Table 2-1 below. This study focuses on the audit committee as the representative of the board of directors, internal audit function and external audit as these mechanisms involve directly in the audit function. The literature on the audit committee, internal audit function and external audit in corporate governance is reviewed in the following subtopic, which also provides a comprehensive review of the roles of these corporate governance mechanisms.

**Table 2-1: Summary of the MCCG related to audit committee, internal audit function and external audit**

<b>Regulations</b>	<b>Description</b>
<b>Audit Committee</b>	
<b>Audit committee duties towards external audit</b>	<p>- The duties of the audit committee should include the following –</p> <p>(i) To consider the appointment of the external auditor, the audit fee and any questions of resignation or dismissal;</p> <p>(ii) To discuss with the external auditor before the audit commences, the nature and scope of the audit, and ensure co-ordination where more than one audit firm is involved;</p> <p>(iii) To review the quarterly and year-end financial statements of the company, focusing particularly on- Any changes in accounting policies and practices; Significant adjustments arising from the audit; The going concern assumption; Compliance with accounting standards and other legal requirements;</p> <p>(iv) To discuss problems and reservations arising from the interim and final audits, and any matter the auditor may wish to discuss (in the absence of management where necessary);</p> <p>(v) To review the external auditor’s management letter and management’s response <b>(Part 2: BB (II))</b></p> <p>- At least once a year the committee shall meet with the external auditors without executive board members present. <b>(Part 2: BB (III))</b></p> <p>- The duties of the audit committee required by the Listing Requirements should include keeping under review the scope and results of the audit and its cost effectiveness, and the independence and objectivity of the auditors. <b>(Part 4: D (III))</b></p>
<b>Audit committee duties towards internal audit function</b>	<p>- To do the following on the internal audit function:</p> <ul style="list-style-type: none"> <li>• review the adequacy of the scope, functions and resources of the internal audit function, and that it has the necessary authority to carry out its work;</li> <li>• review the internal audit programme and results of the internal audit process and where necessary ensure that appropriate action is taken on the recommendations of the internal audit function;</li> <li>• review any appraisal or assessment of the performance of members of the internal audit function;</li> <li>• approve any appointment or termination of senior staff members of the internal audit function;</li> <li>• inform itself of resignations of internal audit staff members and provide the resigning staff member an opportunity to submit his reasons for resigning.</li> </ul>
<b>Internal Audit Function</b>	
<b>Internal audit roles</b>	<p>The internal audit function should be independent of the activities they audit and should be performed with impartiality, proficiency and due professional care. The board or the audit committee should determine the remit of the internal audit function. <b>(Part 2: BB (VIII))</b></p>
<b>External Audit</b>	
<b>External audit roles</b>	<p>The external auditors should independently report to shareholders in accordance with statutory and professional requirements and independently assure the board on the discharge of its responsibilities in accordance with professional guidance. <b>(Part 3: (IV))</b></p>

Source: MCCG (2000, 2007, 2012, 2017)

### **2.3.2 Interaction between External Auditor and Audit Committee: Insights from Previous Studies**

Audit committee plays vital roles in corporate governance by provides insights of companies' financial reporting and auditing processes (DeZoort et al., 2002; Cohen et al., 2007). The importance of the audit committee in financial reporting has been acknowledged even before the corporate collapses in the early 2000s. This is proven by the requirements by NYSE in the 1980s which required all companies listed on the major American stock exchanges to establish an audit committee. The audit committee was seen as a monitoring function (Johl et al., 2012) which will protect the investors' interests (Mitchell, Singh, & Singh, 2008).

Since the enactment of the Sarbanes-Oxley (SOX) legislation, the role of the audit committee has been given greater emphasis and evolving over time. The evolving role of the audit committee is due to its value to the board of directors and organisation as well as the need to meet the challenges of the constantly changing business, social and economic environment (Cohen et al., 2007). The evolution of the role of the audit committee in the United States has led to growing numbers of organisations forming audit committees voluntarily to provide more effective communication between the board of directors and external auditors (Rezaee & Lander, 1993). Due to the growing importance of the audit committee, most of the regulations globally have highlighted the need to strengthen audit committee effectiveness (Cohen et al., 2010).

Likewise, there is a growing study examining audit committee effectiveness in improving both financial reporting quality and audit quality on an international scale (see for example McMullen, 1996; Porter, 1998; Spira, 1999; Beasley, Carcello, Hermanson, & Lapedes, 2000; Abbott, Parker, & Peters, 2004; Turley & Zaman, 2007; Zhang, Zhou, & Zhou, 2007; Beasley et al., 2009; Cohen et al., 2010; Beattie et al., 2013). The potential

influence that the audit committee may have on the external audit has also been discussed in the academic literature and legislation. Audit committee is one of the fundamental parties responsible for overseeing the external audit function (Johl et al., 2012; Beattie et al., 2013). As emphasised by corporate governance codes (i.e. the UK Corporate Governance Code, MCCG), audit committee is important to evaluate numerous elements of the external auditor's work including the effectiveness of the audit process.

Since the audit committee has a responsibility to provide oversight on the quality of financial reporting and the audit, it is expected that the audit committee may affect the audit process and consequently audit quality (SOX, 2002; Carcello et al., 2002; Abbott et al., 2003; Beattie et al., 2013). Thus, this section provides an understanding of the relationship and interactions between audit committee and external audit as well as various effects of the audit committee on the audit quality which documented in the literature. It will also provide a broader insight of the various debates that affect the focus of investigation in this study. The prior studies on the association between the audit committee and audit quality as well as other literature relevant to the audit committee will be reviewed in this section.

### **2.3.2.1 The association between external auditor and audit committee**

Historically, the audit committee has the responsibility to provide oversight of the financial reporting quality (Soltani, 2007; Johl et al., 2012). Yet, the role of the audit committee has evolved to overseeing auditor activities (DeZoort et al., 2002; Alzeban & Sawan, 2015) as well as to ensure strong internal controls and risk management (McDaniel et al., 2002; Soltani, 2007; Abbott, Parker, & Peters, 2010). In particular, the audit committee has responsibilities and authority over the audit function including the relationship of the organisation with its auditors. However, in performing these monitoring and oversight roles, the effectiveness of the audit committee is deemed

necessary (Cohen et al., 2002; Beasley et al., 2009). With the expanding roles and the importance of the audit committee effectiveness in delivering their roles, the audit committee effectiveness has been the centre of various researcher' interests.

The effectiveness of an audit committee has been defined and studied in various ways in the literature. For example, Krishnamoorthy, Wright, and Cohen (2002a) have conducted a survey to understand audit partners and managers perceptions on the factors that influence the effectiveness of the audit committees. The authors found that the expertise and willingness of the audit committee members to challenge management are the primary factors that affect the effectiveness of the audit committees. On the other hand, Kalbers and Fogarty (1993) examined audit committee effectiveness through the nature and extent of the audit committee power in the organisation. In support of power theory, the finding suggests that formal, written authority coupled with observable support from top management play the most important roles in audit committee power as it relates to audit committee's effectiveness.

Meanwhile, DeZoort et al. (2002) defined effective audit committee as a committee which has qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts. This is consistent with the vast majority of literature which looks into various aspects including as a non-executive director or board independence (Beasley & Salterio, 2001; Chen et al., 2005; Baxter & Cotter, 2009), number of meetings (Abbott et al., 2003; Goodwin-Stewart & Kent, 2006), and a financial expert or having accounting and finance background (Carcello et al., 2002; Abbott et al., 2003; Goodwin-Stewart & Kent, 2006; Yatim et al., 2006; Dhaliwal et al., 2010; Singh & Newby, 2010) in measuring audit committee's effectiveness.

These characteristics are reflected in codes of corporate governance. For example, to ensure that the audit committee serves as an effective check on the management of a company, the revised MCCG 2017 details the composition of the audit committees, the frequency of meetings and the need for audit committee members to attend continuous training to keep abreast with developments in relevant financial and other related developments. Also, executive directors will no longer be allowed to become members of the audit committee to preserve the independence of the committee (Securities Commission, 2017).

Prior research provides evidence that these characteristics are related to audit quality. An interesting aspect of research on this relationship (audit committee characteristics on the audit quality) is the manner in which proxies for audit quality are created since the audit quality is itself not directly observable (as previously discussed in Section 2.1). Drawing on prior work, it is claimed that more effective and resourceful audit committees (i.e. diligence, independent and financial expertise) are likely to engage in greater levels of external audit to ensure the good audit quality of the firm (Carcello et al., 2002; Abbott et al., 2003; Goodwin-Stewart & Kent, 2006). Carcello et al. (2002) investigate the association between audit committee characteristics and audit fees within a sample comprised of 1,000 companies audited by the Big Six auditors. The authors find that audit fees are positively associated with the independence and expertise of the audit committee.

Similarly, Abbott et al. (2003) examine this association for a sample of 492 non-regulated firms audited by the Big Five auditors. They find that in addition to board independence and expertise, audit committee diligence is also positively associated with audit fees. Likewise, based on a sample of 401 Australian companies, Goodwin and Kent (2006) provided evidence that there is a positive relation between the frequency of the audit committee meetings and the audit fees. Thus, the presence of more effective audit

committees may result in higher audit fees. The results suggest that audit committees with members possessing the financial expertise and meet frequently have more skills, and are more likely to be informed of current auditing issues; thus, they are more likely to seek in-depth audit coverage. Accordingly, it would increase the audit quality indicated by the high external audit fees. A higher amount of audit fees indicates that auditors provide more and efficient audit services to the firm compared to lower audit fees.

In a related vein, Abbott and Parker (2000) studied the relationship between the frequency of meetings and the quality of the external auditor. The authors argued that the organisations with the audit committee which met at least twice a year were more likely to appoint a Big Four audit firm as their auditor. The authors also claimed that better audit committees will demand higher audit quality (e.g. a specialist auditor), to avoid personal monetary or reputational losses. Some researchers have studied the relationship between audit committee characteristics and financial reporting outputs (i.e. restatements, frauds, auditor going concern reporting, etc.), which may have an influence on the audit quality. Most of the studies argue that the existence of independent directors, frequency of the audit committee meetings and financial experts in the audit committee increases the quality and credibility of financial statements (Abbott et al., 2004; Bedard, Chtourou, & Courteau, 2004; Bradbury, Mak, & Tan, 2004; Krishnan, 2005; Zhang et al., 2007; Naiker & Sharma, 2009; Huang & Chan, 2013; Knyazeva, Knyazeva, & Masulis, 2013; Cohen, Hoitash, Krishnamoorthy, & Wright, 2014), and thereby reflects the audit quality.

For example, Bradbury et al. (2004) found audit committee independence was related to higher quality accounting. Meanwhile, Abbott et al. (2004) and Bedard et al. (2004) found that the existence of financial experts on the audit committee is associated with fewer earnings restatements and earnings management. Similarly, Naiker and Sharma (2009) documented that the presence of financial experts on the audit committee is

positively associated with the quality of financial reporting. This is further supported by Xie, Davidson, and DaDalt (2003) who argued that the number of the audit committee meetings is associated with reduced levels of discretionary current accruals. Using a sample of 282 US firms for the years 1992, 1994 and 1996, the authors find that the frequency of the audit committee meetings is associated with reduced levels of earnings management. DeFond and Francis (2005) claimed that existing research indicates greater financial expertise and more frequent audit committee meetings are associated with improved reporting.

In contrast to other studies, McDaniel et al. (2002) focused on how the expertise and financial literacy of the audit committee members potentially affect the quality of the financial reporting process. In response to the Blue Ribbon Committee (BRC, 1999) recommendations, the authors compared how the audit committee members with financial expertise may differ from the members who are financial literates in evaluating the quality of financial reporting items. Throughout their studies, the authors found that there is a difference between financial expertise and financial literates in evaluating the quality of financial reporting items. The audit committee with financial expertise assesses the quality of financial reporting based on the relevance and reliability elements. The financial experts also identified reporting concerns that were recurring in nature, and that might receive little business press. In contrast, the audit committee members who are financially literate focus on the issues of high salience items those were nonrecurring in nature and those that might receive greater attention from the press.

The audit committees with financial expertise have better interaction with internal audit function (Mat Zain et al., 2006; Dhaliwal et al., 2010; Adel & Maissa, 2013) to provide support for external auditors (DeZoort & Salterio, 2001) and ensure the credibility of the financial statement (Burrowes & Hendriks, 2005). Further, it has been



documented that the market appreciates audit committee financial expertise as there is a positive market reaction to the announcement of the audit committee members with accounting expertise (DeFond & Francis, 2005). Additionally, Abdul Rahman and Ali (2006) claimed the importance of competent and experienced audit committee members, particularly in financial aspects. This characteristic is particularly essential as the primary function of audit committee is to monitor the financial reporting process of an organisation. However, the authors find insufficient evidence to support the negative association between the competence of the audit committee members and earnings management. This result may be explained by the small sample used in their study which is only 97 companies for years 2002 and 2003.

Collectively, these results suggest that audit committees with financial expertise, independent members and frequent meetings are effective at restraining earnings management and improved financial reporting quality. Based on these findings, it is suggested that audit committees with more financial experts and frequent meetings are more likely to understand complex accounting issues and thus, the auditors may perform inquiries to increase their level of assurance that the financial statements do not contain material misstatements. Indeed, audit committee members with financial expertise may help the committee to have a better understanding of the audit risks. These studies also suggest that more experienced and knowledgeable audit committee may contribute to better cooperation with the external auditor. This is because the committee can communicate with external auditors on internal control weaknesses and coverage of audit risks (Maines, Martin, & McDaniel, 2001). This is consistent with Carcello et al. (2002) who claimed that the audit committee are serving a role that is a complement to the role of external auditors.

However, it has been claimed that these studies have focused on the composition of the audit committee (Abbott et al., 2003; Goodwin-Stewart & Kent, 2006; Beasley et al., 2009; Bliss et al., 2011) and has been based on large samples, utilising publicly available information which rarely reflects the practical reality of interaction and effectiveness of both parties (Knechel et al., 2013; McNulty et al., 2013). This may be one possible explanation for the conflicting results on the effect of the audit committee on audit quality in the literature. For example, the mixed findings on the effect of the frequency of the audit committee meetings could be because the number of the audit committee meetings may not reflect audit committee diligence in practice, and thus produced inconclusive results on the relationship. The frequency of the audit committee meetings is a very basic measure of activity which may not represent the overall scope of the audit committee activities and performance.

The mere existence and the use of proxies in measuring the audit committee effectiveness and its interactions with the external auditor, without investigating the practical reality of these parties, cannot guarantee the efficiency of the monitoring process or its ability to improve audit quality. Audit committee may be established mainly for cosmetic reasons to make the stakeholders comfortable with the company financial reporting. The stakeholders may assume that the establishment of the audit committee may improve the financial reporting and auditing quality as the audit committee plays their roles in providing insights and monitoring the financial reporting function effectively. The mere composition of the audit committee and recording of activities may be symbolic, or a means of submitting with regulation by regulators (Cohen et al., 2004).

Further, most of the findings illustrate an agency theory which shows that audit committee with more independence and have financial expertise members interact more extensively with external audit. This is supported by Cohen et al. (2008) who found that

most governance studies are based on agency theory even though there is multiple other theories applicable in the governance, i.e. resource dependence theory, institutional theory and managerial hegemony theory. However, the studies which investigate the governance process evidenced diverse theories employed simultaneously to describe a given reality (Cohen et al., 2008; Beasley et al., 2009; Hermanson et al., 2011; Dobija, 2015). This illustrates that the studies that focus on the governance process can complement the prior findings by employing theories in other fields such as sociology to study corporate governance and audit committee and external audit practices in particular. The following subsection discusses the audit committee activities in practice and its relation to the audit quality.

#### **2.3.2.2 Process issues**

Few studies investigate how the activities of the audit committee influence the external audit process. One of earlier study on the process issue on audit committee and external auditors were conducted by Cohen and Hanno (2000) who documented that management control philosophy and governance structure (audit committee and board) affected audit process. In particular, the findings show that both corporate governance and management control philosophy have a significant influence on auditor assessment of client business risk which accordingly affects auditor consideration on client acceptance process. Besides, both elements also have a significant effect on auditor planning judgement; subsequent substantive testing and subsequent control risk assessments. In general, the findings show the importance of having strong corporate governance mechanisms which influence audit quality and financial reporting quality.

Later, Cohen et al. (2002) studied the influence of various corporate governance on the audit process including the role played by the audit committee. Cohen et al. (2002) can be regarded as a pioneer study which directly captures auditor experiences concerning

their interactions with audit committees and boards of directors and the resulting effect on the audit process. The findings highlight that the auditors used the governance information to the specific stage of audit process (i.e. audit planning, field-testing and review stage), as the governance has potential to influence the clients' business risks. The study found that auditors perceived audit committees are weak and ineffective in the post-SOX era. Based on their interviews with 36 auditors, the findings indicated that auditors found audit committee members lacked expertise, power, and scepticism that would make them effective. Even though the attitude and questioning skills of the audit committee were claimed to be important (Sommer, 1991; Spira, 1999), auditors frequently found audit committees play a passive role, in which the findings found that audit committee meetings were characterised as entailing the auditor reporting on significant audit issues, instead of two-way interaction between external auditor and audit committee members. The discussions between the external auditors with audit committee were found to have an impact on risk assessments and in the audit planning phase leading to increased audit scope.

Meanwhile, Gendron et al. (2004) examined the practices in the audit committee meetings, which include the meetings where audit committee members meet privately with auditors. The interviews were conducted in three large Canadian public corporations listed on the Toronto Stock Exchange, and the interviewees include CEO, CFO, chief internal auditor, a partner in charge of the external audit engagement, chairperson of the audit committee, and audit committee members. The interviews were conducted in 2000 and 2001 which is shortly before the collapse of Enron and Andersen. From the interviews, they found that audit committee members place significant attention on a few matters during meetings, namely, the accuracy of financial statements; appropriateness of the wording used in financial reports; effectiveness of internal controls; and the quality of the work performed by auditors. They also found that the audit committee is asking

challenging questions and assessing responses provided by managers and auditors during the meetings. By asking challenging questions, the audit committee members can assess the trustworthiness and credibility of the auditor through the degree of consistency across responses provided by the auditor. Thus, the audit committee deriving comfort on audit plans, in which it ensure that audit risks are be properly addressed in the conduct of the audit. This is consistent with DeZoort et al. (2003) who suggests that the information from a more credible auditor, will have a greater influence on audit committee decisions. They concluded that audit committee members have an awareness to fulfil their responsibilities, and they are dependent on the quality of the work performed by the company's internal and external auditors in fulfilling their responsibilities.

In an extension of their earlier study, Gendron and Bedard (2006) carried out additional interviews in the year 2004 to develop an understanding of how the collapses Enron and Andersen impacted attendee's sense of the audit committee effectiveness. From the interviews, they describe that the attendee's configurations of meaning regarding audit committee effectiveness are constructed through four categories of processes. Among others, (1) the background of the audit committee members; (2) ceremonial features of the audit committee meetings; (3) reflective interpretations of substantive practices and activities taking place during audit committee meetings; and (4) reflective understandings of informal practices taking place outside meetings were important in understanding their effectiveness. The findings of the study also show that audit committees' questioning skill is a key in establishing their self-confidence in performing their monitoring role and constructing their legitimacy. The study concluded that audit committee members carry out diverse practices to become comfortable with their company's internal controls.

Turley and Zaman (2007) conducted a case study at a UK listed financial services company to examine the conditions and processes affecting the operation and potential

effectiveness of the audit committees. The study focuses on the interaction between the audit committee, internal audit functions, external auditors as well as management in providing an understanding of the audit committee effectiveness. The findings revealed that audit committee has a limited role in internal control matters due to its lack of detailed knowledge. However, the study provides evidence of the significance of informal processes around the audit committee through which concerns might be raised. The informal process allows auditors and audit committee members to communicate matters of interest comfortably. The findings also documented the influence of the audit committee's power on other governance participants, in which it provides evidence on how audit committees are used as a threat, as an ally, or as an arbiter to modify the nature of power relationships within the company and finally influence governance outcomes. The importance of the relationship between the audit committee with the internal audit functions and external auditors is also evidenced in the study.

In support of Turley and Zaman (2007) suggestion for more qualitative research on the audit committee process, Beasley et al. (2009) used interviews as a method to examine the audit committee oversight process in the post-SOX era within 42 US public companies. Through the interviews, the authors found that audit committees are dependent upon both internal and external auditors in evaluating the effectiveness of internal control over financial reporting. In some cases, the findings illustrate institutional theory in which there is evidence of the audit committee performing ceremonial roles. Overall, the findings support agency theory whereby audit committee members perceived that audit committees have the requisite financial expertise, frequently meet and for long periods, and ask probing questions of management.

Additionally, a recent interview with auditors was conducted by Cohen et al. (2010) to gain insights on the audit process and the interactions between auditors and other

corporate governance parties in the post-SOX environment. The study focuses on how the interactions between auditors and other corporate governance parties (i.e. audit committee, board, and internal auditors) affect the audit process (i.e. risk assessments and resolution of contentious accounting issues) and the audit environment (i.e. appointment and termination of auditors). The findings documented that the auditors indicate significant changes in the corporate governance environment. In contrast to the findings in Cohen et al. (2002), the auditors note that audit committees have greater expertise and power as well as more conservative in fulfilling their duties. The audit committee members also play significant roles in overseeing internal controls, focusing on reporting quality, identifying risks, asking challenging questions, and overseeing the whistleblowing process. However, many auditors indicate that audit committees continue to play a passive role in resolving disputes with management. Consistent with Cohen et al. (2002), the discussions between auditors with audit committees were found to influence audit risk assessment and programme planning process.

Meanwhile, Salleh and Steward (2012b) conducted a case study in seven public listed companies in Malaysia provides evidence on the audit committee effectiveness through their behaviour and conduct in resolving a dispute between management and the external auditor. Based on the interviews conducted with key parties in governance (i.e. CFOs/finance managers, external auditors and audit committee members), the authors found that the audit committee provides assistance to resolve the dispute between management and auditor when the issue is very material. This is particularly on the contentious accounting matters that require professional judgement. The understanding of their responsibilities, awareness of possible issues and the members' accounting and business expertise were documented to be the main factors that contribute to the audit committee act as a mediator. The study concluded that the effectiveness of the audit

committee could be seen through the use audit committee members of accounting and business expertise to provide assistance in resolving contentious accounting issues.

Dobija (2015) investigated audit committee practices in relation to the oversight of financial reporting and external auditors. The findings support the importance of having experience and skills among audit committee members in enhancing their effectiveness. With the adequate knowledge and experience particularly in the fields of accounting, financial auditing and finance, the audit committee can improve their monitoring control over the external auditor. Accordingly, the audit committee may have access to sufficient information in performing their responsibilities. The findings also documented the power of the audit committee chairman is a critical factor for an effective audit committee. The chairman has responsibilities such as to sets the agenda, chairs the meeting, gives voice to the members of the audit committee during the meeting, and decides in some cases on the need for and type of voting, and therefore these set the overall responsibilities of chairman to ensure the quality of work performed by the members. The power possessed by the chairman can give support to other audit committee members and push things forward.

The finding in Dobija (2015) illustrates the agency theory in which the audit committees were observed attempt to be effective monitors of management using the skills and experience they have. The study also illustrates the institutional theory in which in certain cases the audit committees were found play a more ceremonial role and can be considered an ineffective tool in the oversight of financial reports and external auditors. The existence of an audit committee in these cases are only to meet the requirements of the new regulations as for where the company wants to comply with the letter of the law. The finding was explained through the lens of efficiency theory (Bohm, Bollen, & Hassink, 2013) in which the audit committee existence first began as symbolic oversight



and eventually it was found useful for monitoring a company's activities. The study concluded that the perceived audit committee efficiency had increased which largely associated with the power of the audit committee members.

Based on the discussions above, the literature has highlighted how the corporate governance impacts the interactions between audit committee and external audit as these interactions are influenced by the role played by the corporate governance mechanisms (i.e. the use of power, participation and activities in the meeting). Most of these studies highlighted the importance of the power, expertise, knowledge and experience of the audit committee members and external auditors to deliver their roles (see for example Gendron et al., 2004; Gendron & Bedard, 2006; Cohen et al., 2010) which enhance the conduct of the audit. The expertise, knowledge and experience of external auditors bring comfort to the audit committee on the audit performed by the external auditors. For example, the act of the audit committees in asking challenging questions during their interaction with external auditor can help the audit committee members to assess the credibility of external auditors, thus illustrate their trustworthiness (Gendron et al., 2004).

Likewise, it also develops trust in external auditor in the ability and expertise of the audit committee members; thereby it will influence the audit process through frequent interactions and information exchange between the parties. The frequency of the interaction is determined by the level of trust between the parties (Cross, Parker, Prusak, & Borgatti, 2001; Borgatti & Cross, 2003) that allows for the exchange of more confidential information (Libby & Luft, 1993), which is particularly important for the external auditor to conduct the audit. The power, knowledge, expertise of both parties (i.e. audit committee and external auditor) is believed can put more confidence in the ability of each party. Eventually, the interactions between the parties can be enhanced and contribute to the audit quality.

Overall, the findings show conflicting results possibly due to the differences in selection of dates, a sample of firms and statistical methods. For example, Cohen et al. (2002) found that the audit committee members lacked expertise, power, and scepticism that would make them effective in the interaction with the external auditor. In contrast, Beasley et al. (2009), Cohen et al. (2010) and Salleh and Steward (2012b) documented that audit committees have greater expertise and power and were more conservative in fulfilling their duties. The audit committee members played significant roles in overseeing internal controls, focusing on reporting quality, identifying risks, asking challenging questions, and overseeing the whistleblowing process. The findings of these studies (Turley & Zaman, 2007; Beasley et al., 2009; Cohen et al., 2010; Salleh & Steward, 2012a) demonstrated that the audit committee holds authority or power in governance practices and it may influence the activities carried out in audit committee interaction with the external auditor. However, it depends on the audit committee willingness to perform such roles and responsibilities.

The conflicting results from the prior studies and given the importance of the interaction between external auditor with audit committee provides an avenue for more research, particularly on how the interaction between audit committee and external audit will impact audit quality in practice. This is supported by Cohen et al. (2007) who conducted a review academic literature on auditor communications with audit committees, and board of directors concluded that increased interactions between the governance mechanisms, including external auditors and the audit committee, would enhance financial reporting quality. Collectively, the financial reporting will be improved if the effective interaction and communication occur among the crucial players of corporate governance, including external auditors and the audit committee. This is because increased interaction may increase financial literacy, provide a better

understanding of management's objectives, mitigate the influence of non-independent directors as well as increase overall involvement (Cohen et al., 2007).

Therefore, qualitative research methods incorporating interviews provide significant potential for researching the interactions and communications in the organisational context in which they operate. With the growing importance of the interactions between audit committee and external audit, in-depth study on how the interactions and communications between audit committee and external audit might affect the performance of audit process is particularly important. It is essential to investigate what happens in the audit committee meetings and interactions with both internal and external auditors to determine if its recording activities are effective (Cohen et al., 2004) and affects the audit quality.

Further, most of the qualitative studies were undertaken in strong and sophisticated capital markets, such as the USA, UK and Australia (Turley & Zaman, 2007; Beasley et al., 2009; Cohen et al., 2010). Thus, there is still need to conduct the study in developing countries. In particular, in countries where capital markets are still emerging, the practicalities of establishing more sophisticated governance systems can be impeded by a lack of technological know-how and experience (Mat Zain & Subramaniam, 2007). Hence, the study further addresses Carcello, Hermanson, et al. (2011) call for qualitative-based research to examine interactions between audit committees and external auditor; and exploring how such interactions may be associated with audit quality particularly in Malaysia.

### **2.3.3 Interaction between External Auditor and Internal Audit Function: Insights from Previous Studies**

Most of the regulations and "best practices" guidelines have highlighted the importance of the relationship between the internal audit function and external audit in

corporate governance (i.e. ISA 610). Consequently, there is a need for a deeper understanding of how the external auditor interacts with internal audit function to achieve quality corporate governance practices and audit. This section provides an extensive understanding of the internal audit function and its relations with the external audit by reviewing the relevant academic and professional literature. The effects of the effectiveness of the internal audit function on the external audit also will be discussed in this section.

The literature documented that the internal audit function can improve corporate governance and there is growing importance and expanded roles of the internal audit function in ensuring the quality of corporate governance (Gramling et al., 2004). Historically, internal audit function has not necessarily been the focus on responses to the corporate collapses and scandals. However, nowadays, the internal audit function has been considered as one of the key elements in the solution to a perceived breakdown in the systems of business reporting and internal control (Bailey, Gramling, & Ramamoorti, 2003). Studies have also revealed the ability of the internal audit function to contribute towards quality corporate governance through its oversight role, its improvements to the control and monitoring environment (Coram, Ferguson, & Moroney, 2008). Thus, the increasing emphasis on the roles of the internal audit function in audit and corporate governance increases the need for it to be better understood (Desai, Roberts, & Srivastava, 2010).

The role and activities of the internal audit function have changed (Allegrini, D'Onza, Paape, Melville, & Sarens, 2006; Selim, Woodward, & Allegrini, 2009) and been extended from more accounting and financial control to operational control, risk management and corporate governance (Spira & Page, 2003). Further, with the expanded role of the internal audit function in corporate governance, the relationship between

internal audit function with the other key mechanisms including external audit and audit committee also has changed (Spira, 2003; Carcello, Hermanson, & Raghunandan, 2005). This is because the internal audit function can assist the audit committee and external auditors in performing their duties (Gramling et al., 2004; Mat Zain & Subramaniam, 2007; Sarens et al., 2009; Adel & Maissa, 2013). For example, the internal audit function assurance to the audit committee in compliance, financial reporting integrity and internal control (Scarborough, Rama, & Raghunandan, 1998; Beasley et al., 2009).

The internal audit function and external audit share a common secondary objective which is to provide insights and ensure the adequacy of the internal control system which has resulted in a deeper relationship between both parties (Pickett, 2004). The external audit can conduct their audit more efficiently and provide higher assurance level through the contributions from internal audit function. With the profound understanding of the risks facing the organisations as well as knowledge of the process and activity of the business (Sarens et al., 2009), the internal audit function may contribute significantly to the external audit performance (Hunt, 1997). Therefore, both parties should maintain good cooperation between them for the benefit of both parties.

Cooperation between two parties can be defined as the expectations that the two exchanging parties have concerning working together to achieve mutual and individual goals jointly (Cannon & Perreault, 1999). Based on this definition, it shows that both parties must work together instead of only one party striving to accommodate another party's needs (Cannon & Perreault, 1999). Heide and Miner (1992) documented that cooperation contains two dimensions which include flexibility and share problem solving. In terms of flexibility, it refers to the degree to which both parties are willing to adjust their behaviour to accommodate the needs of the other. While, the shared problem solving

refers to the degree to which both parties share their responsibility towards the problems solving that arise as time goes on (Heide & Miner, 1992).

Through the cooperation, the external auditors have the opportunity to increase efficiency and credibility of financial statements; while the internal auditors can obtain essential information in the assessment of risks control. The internal audit function may help the external auditor to understand the firm's internal control system and the level of compliance with the system (Hunt, 1997; Suwaidan & Qasim, 2010). This is supported by The International Federation of Accountants (2007)<sup>14</sup> which highlighted the need for coordinating the efforts of both internal and external auditors. Likewise, Mihret and Admassu (2011) found that organisations can enhance corporate governance effectiveness by strengthening internal audit and fostering internal-external auditor coordination.

Studies have also provided support for the importance of internal audit and external audit linkages (Morrill & Morrill, 2003; Goodwin-Stewart, 2004; Arena & Azzone, 2009; Mihret, 2010) because cooperation between the internal and external auditors can provide more efficient and effective total audit coverage (Engle, 1999; Sarens & De Beelde, 2006). Besides, the value internal audit can add to the organisation is affected by the coordination between the internal and external audit through reduced external audit fees (Felix, Gramling, & Maletta, 2001; Al-Twaijry et al., 2004; Haron et al., 2004; Mat Zain et al., 2006; Mat Zain & Subramaniam, 2007). The internal audit function may affect the nature, timing, and extent of the annual audit work which includes procedures the external auditor performs when obtaining an understanding of the entity's internal control,

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<sup>14</sup> IFAC is a global organisation for the accountancy profession founded in 1977, and comprised of over 175 members and associates in more than 130 countries and jurisdictions.

assessing risk and gathering substantive evidence (IFAC, 2007). This is supported by Felix et al. (1998) who documented the importance of the strong relationship between the internal audit function and external auditors regarding share information on risk analysis as well as coordinate audit plans. The external auditor may rely on work performed by the internal audit function and or request direct assistance from the internal audit function when conducting the audit.

The ISA 610 provides guidelines on external auditors' consideration of internal audit work in the conduct of financial statement audits. Among the internal audit procedures which the external auditors may rely on includes testing of internal controls and substantive testing procedures. The external auditor reliance on the work performed by the internal auditor may affect the efficiency and effectiveness of the external auditor (Schneider, 2009) as it can reduce external audit work (Felix et al., 2001; Messier, Reynolds, Simon, & Wood, 2011; Abbott, Parker, & Peters, 2012; Saidin, 2014) and improve the level of assurance and integrity of financial statements (Prawitt, Smith, & Wood, 2009). For example, Coram et al. (2008) argued that internal audit function can improve the level of detection by increasing audit coverage and thus improve the overall external audit effectiveness.

However, there are various factors that need to be considered before any parties decide to rely on internal audit function. For example, the literature documented that the stakeholders' decision to rely on the internal audit function depends on the quality of the work performed by the internal audit function itself (Desai et al., 2010; Burton, Emett, Simon, & Wood, 2012). Similarly, the quality of the internal audit function is considered before external auditor makes decisions to rely on the internal audit function. If the external auditors perceive internal audit function quality to be low, they will not rely on the work performed by the internal audit function (Gramling et al., 2004; Prawitt et al.,

2009). Hence, it is essential to have a better understanding of how external auditors determine internal audit function quality.

Based on the standards discussed around the world, there are three factors that external auditors should consider when they decide to rely on the work performed by the internal audit function (PCAOB, 2007; IFAC, 2009; MIA, 2012). The three factors prescribed include competence, objectivity and work performance (nature and scope of activities). This is further supported by the academic literature which documented these three factors need to be considered in making decisions on reliance to internal audit function (Gramling et al., 2004; Desai et al., 2010) which is based largely on the external auditors' perspectives. These three factors are important in evaluating the internal audit function quality. Other than these three factors (competence, objectivity and work performance), literature also identified other factors that influences the external audit assessment of the internal audit function. This would include audit committee effectiveness (Cohen et al., 2007; Desai et al., 2010). The authors documented that corporate governance quality is considered as one of the important factors that will affect the external audit assessment and decision to rely on the work performed by the internal audit function. The external auditor assessments of the internal audit function quality are affected by the strength of the governance of the organisation and audit committee expertise.

The internal audit function helps an organisation to assess and improve the effectiveness of risk management, control (Farkas & Hirsch, 2016) as well as governance processes (Sarens & De Beelde, 2006; Institute of Internal Auditors, 2011c). Carey, Subramaniam, and Ching (2006) and Farkas and Hirsch (2016) documented that internal audit function is an important tool for the organisation to gain insights and understanding of internal controls and risk management. It provides assurances in controlling and generating reliable, appropriate reporting and classification of risks (Matyjewicz &



D'Arcangelo, 2004) and thus, the external auditors may rely on work performed by the internal audit function. It would result in an improved cooperation between the internal audit function and external auditor and finally leads to more effective organisational governance (Felix et al., 1998). However, trust should be established between the parties before coordination between the parties can be established and the external auditor may rely on the internal audit function.

In fact, the reliance on the other parties is often related to the definition of trust whereby the scholars have defined trust as a willingness to rely on an exchange partner in whom one has confidence (Golembiewski & McConkie, 1975; Moorman, Deshpande, & Zaltman, 1993; Morgan & Hunt, 1994). Gambetta (1988) defined trust as "*the probability that this one carries out an action that is beneficial or at least non-prejudicial is rather strong according to us to consider that we can engage in the form of cooperation with him*" (p. 217). Meanwhile, Larzelere and Huston (1980) defined trust as "a belief of a person in the integrity of another person" (p. 595). These definitions illustrate the importance of trust in interactions as it will affect the level of information sharing between the parties.

In the social exchange literature, Delgado-Márquez, Aragón-Correa, Hurtado-Torres, and Aguilera-Caracuel (2015) documented that a person is willing to generate productive interactions and coordination only if he trusts another party. Trust is also recognised as an important determinant of the effectiveness of many relationship (Kang & Stewart, 2007; Delgado-Márquez et al., 2015) which can affect a person's attitudes (Hameed, Arain, & Farroq, 2013), behaviour (Wong, Wong, & Ngo, 2012) and performance (Mayer & Gavin, 2005). This is supported by Granovetter (1985) who found that the formation of trust will lead to the repeated interactions which eventually enhance the information sharing between the parties. This is supported further by Richard (2006)

who documented the importance to establish the trust relationship between external audit and finance director who can influence the performance and exchange of information between both parties, thereby reflects the quality of the audit. The auditor tries to establish trust with the other parties which can influence the performance of the provided services and the exchange of information (Richard, 2006).

Similarly, the external auditor would only rely on the internal audit function if the trust is established between the parties. The trust could be established based on the factors discussed earlier (i.e. competence, objectivity and work performance, governance effectiveness) which the external auditor then decides whether or not to rely on the internal audit function. The initial interaction between the parties also important to determine whether the trust can be established and high-quality information exchanges can be developed between the parties (Uhl-Bien, Graen, & Scandura, 2000). In the event that the external auditor believes internal audit function and satisfied with the response provided during the initial interaction, the frequency of the interaction may evolve, and information exchange between the parties may continue. In contrast, if the information exchange between both sides is not positive during the initial interaction, opportunities to develop high-quality information exchanges are limited and affect their performance (Dienesch & Linden, 1986; Uhl-Bien et al., 2000) and reliance decision by the external auditor on the internal audit function. The reliance of the external auditor on the internal audit function may improve cooperation and coordination between both parties and eventually helps the audit committee to effectively oversee the financial reporting and audit process (Braiotta & Marsh, 1992). Therefore, effective corporate governance can be sustained through a strong cooperation and relationship between internal audit function and external audit.

The internal audit function needs sufficient resources to perform its duties effectively. A primary feature that is essential for the internal audit function to be able to carry out its duties is the availability of a sufficient number of skilled and expert in the department (Turnbull, 1999). This feature is often used by the external auditor to evaluate internal audit function quality as size of the internal audit function can determine the amount of time that internal auditors use in performing their audit activities (Felix et al., 2001; Al-Twajjry et al., 2004; Mat Zain et al., 2006). Further, experienced internal auditors are better in providing insights and advice to improve the internal control system (Mat Zain et al., 2006). This feature directly reflects the competence level of internal auditors. Using their prior experience, these skilled internal auditors can better find consistent solutions to any issues raised and better in dealing with complex and conflicting situations (Flesher & Zanzig, 2000).

Arena and Azzone (2009) suggests that the internal auditors require new skills in performing the roles which more related to risk management. The skills related to risk management were important to help the internal auditors to deal with different sources of risk in the organisation. Without enough skilled internal auditors in the department, it will reduce the recognition of their role within the organisation. For example, the literature evidenced that the management often perceived the internal audit cannot provide useful assistance if the internal auditors do not have sufficient knowledge and experience (Griffiths, 1999). Accordingly, the management does not take into account the advice of the internal audit function thereby reducing the effectiveness of the internal audit function (Arena & Azzone, 2009).

Similarly, the external auditor would not rely on the internal audit function if the competence level of the internal audit function considered to be low (Al-Twajjry et al., 2004). The competency of the internal audit function is important in demonstrating the

credibility of the internal audit function and quality of information shared by the party which eventually affect the external auditors' decisions to rely on the internal audit function. The credibility of the internal audit function is also important to establish trust between the parties before the external auditor can rely on the internal audit function. This is supported by Doney and Cannon (1997) who documented that an assessment of the other party's credibility is important to establish trust between two parties.

The interaction and relation between the internal audit function and external audit is an area that has been studied previously with various methodologies that present apparently mixed results (Bame-Aldred et al., 2013). The most extensive area of the internal auditing literature highlights the importance of the relationship between the external auditor and the internal audit function to corporate governance. This area of literature relies extensively on the survey and experimental methods which focus on the role that the internal audit function can play in the financial statement audit through the external auditor's reliance on the work performed by internal audit function (A. Schneider, 1985; Margheim, 1986). Most of the studies focus on the objectivity, work performance and competence of the internal audit function (Brown, 1983; Krishnamoorthy, 1994; Messier and Schneider, 1988; Schneider, 1984). In their reviews of the extant literature of the external auditors' reliance on internal audit function, Bame-Aldred et al. (2013) found that the scholars in this area have made some clear progress in understanding the influence of external auditors' evaluations of the internal audit function quality factors (e.g., competence, objectivity, and work performance) in deciding to rely on the internal audit function.

Using survey as a methodological approach, Al-Twaijry et al. (2004) documented that external auditors in Saudi Arabia perceived the cooperation with the internal audit function is dependent on several factors, including the extent to which internal auditors

are perceived to be trustworthy professionals who understand the external auditor's work; the extent to which internal audit staff are perceived as good professionals; and the extent to which internal auditors are independent. A. Schneider (1985) examined the relative importance of the three factors (competence, work performance and objectivity) as perceived by external auditors. Twenty managers and supervisors were asked to evaluate the strength of 16 profiles of existing companies. The results of the study suggest that external auditors rely on internal audit to reduce their external audit work. It also suggests that competence and work performance were perceived as almost equally important in evaluating internal audit strength.

Likewise, Margheim (1986) explored whether auditors adjust the nature and extent of audit procedures due to reliance on internal auditors. The results of the study indicate that high level of competence-work performance by internal auditors may reduce external auditor's planned audit hours. The study also documented that external auditors did not modify their assessments if there are changes in the degree of internal auditor objectivity. Meanwhile, Felix et al. (2001) investigated the impact of the contribution of the internal audit function on the external audit work in respect of audit fees and the factors that influence the contribution. In this study, the authors investigate four factors which are potentially affecting the internal audit function's contribution to the external audit. The factors are the availability of internal audit, internal audit quality, coordination between the internal audit function and external audit, and the level of risk in the audit. Using audited companies and external auditors as a sample of the study, the findings documented that availability and quality of internal audit are the most important factors in defining the level of contribution made by internal audit to the external audit work. The quality of an internal audit is considered as a substitute for an external audit whereby the higher contribution of the internal audit function, the lower the external audit fee charged to the clients. The findings of this study supported Arena and Azzone (2009) which

documented that the characteristics and quality of the internal audit function influence the effectiveness of internal auditing.

In a related vein, Prawitt, Sharp, and Wood (2010) find that the amount of time spent by the internal audit function directly assisting the external audit have a negative association with external audit fees. The more time spent by the internal audit function in assisting the external audit, the lower the external audit fees charged to the organisation. Consistent with Felix et al. (2001), the study find that the reliance on the work of internal auditors can reduce the external audit fee by substituting the effort of the internal audit function to the external auditor. However, the authors find no evidence that the external auditor's fees are reduced by relying on the work previously performed by the internal audit function.

Instead of focusing solely on the internal audit characteristics on determining the reliance of external auditors' on the internal audit function, Desai et al. (2010) and Krishnamoorthy and Maletta (2012) explore the influence of organisational factors on the level of reliance. In their study, Desai et al. (2010) documented the important of the audit committee quality in determining of the external auditors' decisions to rely on internal audit function. The results suggest that the external auditor will consider the internal audit function is weak in absent of the audit committee quality, and thus, no reliance on the internal audit function. Similarly, Krishnamoorthy and Maletta (2012) found that accounting expertise of the audit committee members is related positively to the level of coordination between the two parties. The results of these studies illustrate the internal audit function reporting line to the audit committee is important (Gramling et al., 2004) in ensuring the internal audit function effectively perform their roles and contribute to the effective governance which eventually influences the reliance of the external auditors on the internal audit function.

In the discussion of the development of the reliance of external auditor on internal audit function, Cohen et al. (2010) found that 85% of the external auditors in the sample indicate that the nature and extent of reliance on internal audit work have increased considerably in the post-SOX environment. Most of the external auditors believe that the stature of the internal audit functions has increased, resulting in increased reliance on internal audit work. A number of respondents commented on how the internal audit function in the post-SOX environment frequently reports directly to the audit committee, which has helped strengthen the independence and reliability of the work generated by the internal audit function.

Overall, most of the literature focus mainly on the factors considered by the external auditor when making reliance decisions (Al-Twaijry et al., 2004; Desai et al., 2010; Suwaidan & Qasim, 2010; Bame-Aldred et al., 2013), the nature and extent of the internal audit work relied on by the external auditor (Ho & Hutchinson, 2010) and other areas of the audit that are affected by the internal audit function having a role in the financial statement audit (Gramling et al., 2004; Arena & Azzone, 2009; Anderson, Christ, Johnstone, & Rittenberg, 2012). Even though extensive literature investigates the factors influence the interaction and the extent of the external auditor reliance on the internal audit function, the study on the effects of the external auditor interaction and reliance on the internal audit function remains limited (Bame-Aldred et al., 2013). The literature has begun answering some important questions related to the effects of external auditors' reliance on internal audit function such as on litigation risk, audit efficiency, and audit fees. However, it is claimed that there is a lack of research which directly explore the effects of external audits' reliance on internal audit function regarding external audit quality (Bame-Aldred et al., 2013).

Besides, even though most the studies focused mainly on the characteristics of the internal audit function and factors considered in external auditor's reliance on internal audit function, these studies also evidence and suggest that the internal audit function may not always be effective (Al-Twajjry, Brierley, & Gwilliam, 2003; Mihret & Yismaw, 2007; Mihret, James, & Mula, 2010) and not contribute to the financial reporting and audit process. Despite the centre position in the organisation in monitoring the internal control system and risk management of the organisation, these studies found the internal audit function is ineffective in performing the roles. This is found especially in the studies of developing countries since the organisations do not recognise the importance of the internal audit value as practised in the developed countries.

For example, Al-Twajjry et al. (2003) documented that the actual operations of internal audit department are decoupled from the expectations of how they should operate as recommended by the standard. The results of the study show that internal audit function in the Saudi Arabian corporate sector is ineffective, and it is not a value adding service to organisations. The authors conclude that not all the organisations that established internal audit function have to function according to the standard and performing its roles and responsibilities. Similarly, Mihret and Yismaw (2007) found that internal audit function is ineffective in carrying out its roles. Investigating the internal audit function effectiveness in public sector higher educational institutions in Ethiopia, the results suggest that the internal audit function is ineffective in terms of proficiency, planning, recommendations and limitations to the scope of work. The ineffective internal audit function will impair the confidence of the external audit function which eventually impact the reliance and coordination between the parties.

Moving beyond an experimental approach, this study uses the qualitative approach to study the interactions between internal audit function and external audit. The internal



auditors' knowledge on risk management and internal control of their organisations could provide external auditors with a possibility to enhance the audit process. The interaction between the parties in real practice and the contribution of the interaction will be explored. Thus, as suggested by Bame-Aldred et al. (2013), testing internal-external audit interaction using different methodological approach and in diverse settings would provide useful insights of practical value for corporate governance.

## **2.4 Research Gap**

From the review of the literature, several fundamental questions remain unclear and need further investigation, and thus, four main gaps are identified:

1. Most of the audit quality literature used the proxies in measuring the inputs (see for example Owghoso et al., 2002; Balsam et al., 2003; Bliss et al., 2011) and outcomes of audit quality (see for example Stanley & DeZoort, 2007; Li & Chen, 2011; Blankley et al., 2012). However, it was documented that the proxies used are inconclusive and do not guarantee the quality of audit performance (Knechel et al., 2013). The literature also evidenced limited studies which investigate the audit process in understanding audit quality (J. R. Francis, 2011; Knechel et al., 2013). The framework of audit quality provided by Financial Reporting Quality (2008) discovered the importance of audit process as one of important elements in the audit quality (FRC, 2008a; IAASB, 2013). Given the importance of audit process and lack of studies which explore audit process in understanding the audit quality, more studies that look into this area is clearly needed.

The literature also documented limited evidence of audit process in practice. Most of the studies that focus on the audit process largely focused on the surveys and laboratory experiments which were argued do not address the actual audit process in practice. In response to the gap in the literature, the study investigates the audit quality by capturing

the perceptions of the key parties involved in the audit function and thus enhance the understanding of the actual audit process in practice.

2. Prior literature has attempted to investigate the relationship between audit committee with an external audit in the perspective of the audit committee characteristics and compositions. Most of these empirical studies focus on externally observable characteristics of the audit committee (i.e. audit committee existence, expertise, diligence etc.) and how these characteristics impact audit quality by relying on certain proxies (Raghunandan, Read, & Rama, 2001; Abbott et al., 2003; Goodwin-Stewart & Kent, 2006). In general, the findings of these studies documented the important contribution of the relationship between the parties on audit performance as well as corporate governance practices (Carcello, Hermanson, et al., 2011; Knechel et al., 2013).

Meanwhile, the interactions between internal audit function with external audit has been discussed in the literature mostly in the context of the external auditor's reliance on the work performed by internal audit function (Bame-Aldred et al., 2013). Similarly, the findings of these studies also demonstrate the importance of the reliance of external auditors on the internal audit function and interaction between these two parties in enhancing audit performance (Felix et al., 2001; Al-Twaijry et al., 2004; Ho & Hutchinson, 2010; Mohamed, 2013).

The regulators also recognise the importance of the interactions between the parties in enhancing the audit quality as stipulated in the reports (i.e. Framework of Audit Quality by IAASB, 2013) and standards (i.e. ISA 260, ISA 315 and ISA 610). Despite its important contribution, there is a lack of research that explores how the interactions take place in practice and how such interaction contributes to the audit quality. Prior studies usually ignore the processes associated with the audit committee and internal audit function operations, including their interactions with the external auditor, without going

deeper into the nature of these interactions in practice. Therefore, this study goes beyond the characteristics of the audit committee and internal audit function in understanding their relationship by investigating the interactions between these three key parties and their influence on audit quality.

3. Most of the prior studies have used an archival studies method to explore the audit quality and associations between external auditor with audit committee and internal audit function. Despite significant contributions to the studies, there is a paucity of in-depth research on the issue. For example, the studies presented in the previous subsection provide evidence that positive relationship between key governance players influences the audit quality (Abbott et al., 2003; Goodwin-Stewart & Kent, 2006; Carcello, Neal, Palmrose, & Scholz, 2011). However, these studies do not provide evidence on how the interactions between key governance players happened in practice and their influence audit quality. Therefore, qualitative studies are important particularly in exploring this area. This study undertakes a qualitative approach whereby semi-structured interviews are conducted to gather a more in-depth understanding of the interactions between external auditor with audit committee and internal audit function and their influence on the audit quality.

As clearly expressed by Turley and Zaman (2004), using the questionnaire surveys and analysis of databases solely is not sufficient to investigate and understand the impact of the audit committee. This is supported further by Gendron and Bedard (2006) and Beasley et al. (2009) which documented that context-based studies of the audit committee practices just begins to develop and thus, more qualitative studies are essential to improve understandings of the activities and practices of the audit committee and its influence on audit outcomes. An in-depth understanding of this area will provide valuable information base to improve the performance of all the three parties (audit committee, internal audit

function and external audit), and accordingly, it helps to expand the findings from prior quantitative literature (Raghunandan et al., 2001; Mat Zain & Subramaniam, 2007; McNulty et al., 2013).

Therefore, this study complements the existing studies in this area which mainly using the quantitative approach (DeZoort et al., 2002; Abbott et al., 2004; Cohen et al., 2004; Goodwin-Stewart & Kent, 2006) by relying on qualitative data derived from semi-structured interviews involving audit committee, internal audit function and external audit in Malaysia. This study also extends previous studies by providing evidence from all the three key parties' perspective simultaneously and how the interactions affect the audit quality. For example, Turley and Zaman (2007) conducted a case study by focusing on the audit committee effectiveness involving audit committee chair, external auditors, internal auditors, and senior management without investigating the effects on the audit quality. Gendron et al. (2004) used the interview as a method and get responses from 22 interviewees in investigating the audit committee practices in three different public corporations. Beasley et al. (2009), however, interviewed a larger group of the audit committee members with 42 individuals serving on at least one public company audit committee without gain perceptions from other parties. Therefore, answering the calls from prior studies (Bame-Aldred et al., 2013; McNulty et al., 2013), this study investigates the effects of the interactions between external audit with audit committee and internal audit function on the audit quality by gaining the perceptions of all the three key parties.

4. The literature has focused on agency theory in understanding audit committee, internal audit function and external audit. The studies examine how these parties play their monitoring roles in protecting the shareholders' rights according to the agency theory. Despite many useful insights provided by agency theory, it is argued that the

proxies used in the literature on audit committee, internal audit function and external audit characteristics not capture the underlying substance (MacAvoy & Millstein, 2004; Cohen et al., 2008), and thus these key players may not necessarily perform their roles effectively in protecting shareholders' interests. In consequence, the studies that investigate the three parties in governance merely from the agency perspective may not fully identify whether these parties do perform their monitoring and oversight roles. Therefore, the use of other theories may provide additional perspectives which can help to capture a greater understanding of the key players' practices.

Gendron (2009) suggested that the use of multiple theories simultaneously in a study may help to describe a given reality instead of focusing on merely one theory. Some of the scholars in corporate governance have used a number of theoretical approaches in explaining the audit committee, internal audit function and external audit practices. Among others, Beasley et al. (2009) and Cohen et al. (2010) have employed agency theory and institutional theory in explaining audit committee effectiveness in practice. More recently, Dobija (2015) utilised three theories simultaneously (i.e. agency theory, institutional theory and efficiency theory) in understanding the audit committee effectiveness. Therefore, the study extends the literature in this area by employing two theories simultaneously in explaining the interactions between audit committee and internal audit function with external audit, and their contributions to the audit quality.

The application of power theory and source credibility theory extend the agency theory that has been used widely in the corporate governance literature. In general, the agency theory is found to be related to this study and helps to explain the audit committee, internal audit function and external audit, which functions as monitoring mechanisms to reduce agency costs (Menon & Williams, 1994). The power theory provides better insights on the monitoring roles by these parties through the power possessed and exercised during

the interactions. Meanwhile, the source credibility theory help to explain the trust established during the interactions due to the power exercised by these parties which important to enhance the quality of audit process. These theories provide a different perspective to view the important contribution of the interactions between the three key parties in enhancing the audit quality. These theories are further explained in the following chapter.

## **2.5 Summary**

The main premise of the thesis is that the audit committee, internal audit function and external auditor are independent parties who play monitoring roles in the corporate governance practices, and thus, the interaction between the parties is significant in contributing to the audit quality. This study seeks to investigate how the interaction between the external audit with audit committee and internal audit function take place in practice and how the interaction can contribute to the audit quality. Rather than viewing the relationship between the parties in terms of the characteristics of each party, it explores the way the interaction and coordination between the parties are established as well as how the interaction can finally contribute to the audit quality. Hence, an interpretive approach and qualitative methodology were selected to provide better insights into the subject under study. The methodology selected for this study will be discussed in the following chapter.

## **CHAPTER 3: THEORETICAL FRAMEWORK AND RESEARCH DESIGN**

### **3.1 Introduction**

The review of literature discussed in Chapter 2 has contributed to the selection of methodology used in this study. The chapter has identified that there is limited understanding of the interaction between external audit with audit committee and internal audit function and how the interactions between them can influence the performance of the external auditor. This chapter discusses the qualitative methodology employed in this study to address the research questions formulated in Chapter 1 (Section 1.3). The study employs semi-structured interviews, which is discussed further in the following section.

The chapter is set out as follows: Section 3.2 briefly discusses three main research approach in accounting and auditing research. Section 3.3 discusses about the theoretical framework informing the analysis. Section 3.4 explains the research methods used in the study, followed by the sample and interviewees involved in Section 3.5. Section 3.6 describes interview procedure and protocol followed in the interview sessions, including how the interview was conducted and the instrument used in the interview. Validity and reliability and data analysis are discussed in Sections 3.7 and 3.8 accordingly. Finally, Section 3.9 provides a summary of the chapter.

### **3.2 Research Methodology**

Generally, there are three types of methodological approach in accounting and auditing research, which are the perspective, interpretive perspective and critical perspective (Chua, 1986). The philosophy of each research is determined based on the researcher's philosophical thinking, whether it categorised under positivist, interpretive or critical perspectives (Saunders & Lewis, 2003). Weaver and Olson (2006) theorised that the positivist perspective is based on rigid rules of logic and measurement, truth, absolute

principles and prediction. This perspective also assumes that reality or society is objective and independent of observers. In other words, the theory is external to the subject and separated from observations. Based on the literature, the mainstream accounting research is dominated by a belief of physical realism, where the world is seen as an objective reality and exists independently of human beings (Chua, 1986). This approach is usually described by scientific approach or quantitative methods (hypothetical-deductive accounts) to explain, predict and analyse testable hypotheses with regards to the relationship between various variables. It favours the data collection by archival methods, surveys and experiments to understand the social reality which leads to generalisations of findings in the study.

Meanwhile, the interpretive perspective sees human actions as the result of external influences that have both intentions and reflections which take place within a structure of rules that binds the participants. It believes that reality is subjective or dependent on observers since they are part of what is being observed (Patton, 2002). In other words, this perspective is contradicted with the positivist perspective whereby the interpretive approach focuses on individual's perceptions of reality rather than any independent reality that might exist externally to them (Hopper & Powell, 1985). Morgan and Smircich (1980) documented that this perspective assumes a social reality that happens in society is understood from the point of view of the participant or actor rather than the observer. Based on this approach, the social phenomenon is influenced by the interaction between the participant and the society or environment including the social, economic and institutional arrangements in which they operate. This paradigm usually favours qualitative approaches and may explain the uniqueness of particular situations which may not explain the positivist approach as the positivist approach is focused more on generalisations based findings.



Conversely, the critical perspective grows on the scope of the interpretive approach by focusing on the ownership of knowledge and the associated social, economic and political implications (Smith, 2003). This approach views human beings as having inner potentialities that are alienated through a restrictive mechanism (Chua, 1986). This approach is dominated by historical, ethnographic and case studies as methods of data collection to understand social reality.

In this study, interpretive research will be applied to gain a deeper understanding of how the interactions and communications between audit committee and internal audit function in practice influence the audit quality. As discussed in Chapter 2, audit quality is hardly defined and unobservable. The audit process involves several phases which require external auditors to planning, assessing and making decisions which influence the scope of the audit. The audit process depends on the sound judgement made for each phase such as in gathering and evaluating audit evidence (Knechel et al., 2013). Therefore, the external auditors need sufficient information from other parties to ensure that they made sound judgements for the audit processes. To have sufficient information, the external auditors need to interact with various constituents in auditing settings such as internal audit function and audit committee; and the information may be utilised effectively by the external auditors in the audit process. These interactions may reflect particular planning and decision-making processes that may, in turn, affect the audit process and, consequently, the audit quality. Eventually, this highlights the subjective dimension of the reality of interactions between external audit with audit committee and internal audit function as well as audit quality in practice.

Furthermore, most of the corporate governance and auditing literature applied positive accounting research which fails to assess and explore the social construction of audit practice (Humphrey, 2008). There is limited evidence on how external auditors interacts

with other parties and carry out their audits and the effects on the audit practice (Sikka, Filling, & Liew, 2009; Bame-Aldred et al., 2013). Therefore, a growing number of scholars have called for research on audit practice from the institutional, organisational and societal context of auditing (Turley & Zaman, 2004; DeFond & Francis, 2005; Turley & Zaman, 2007; Humphrey, 2008; Bame-Aldred et al., 2013; McNulty et al., 2013).

This study aims to contribute to the literature by responding to these calls and providing evidence on how the interactions between external audit with audit committee and internal audit function in practice. It also provides insights on how these interactions influence the audit quality. The next section will discuss the research design that underpins the analysis of the study.

### **3.3 Theoretical Perspectives**

A review of the literature has shown the wide used of agency theory in corporate governance studies (Carcello, Hermanson, et al., 2011). However, recent studies have suggested other theories that can apply in this field which explains behaviour and processes related to corporate governance players such as external auditor, audit committee and internal audit function. For example, Beasley et al. (2009) illustrate agency and institutional theory to explain audit committee processes. Meanwhile, Hermanson, Tompkins, Veliyath, and Ye (2012) find agency, resource dependency and institutional theories illustrate processes of the compensation committee. Collectively, these studies illustrate the need for more research to investigate corporate governance beyond the agency theory (Hermanson et al., 2012) in which the focus on the agency theory alone may limit the richness of corporate governance perspectives (Cohen et al., 2008). These studies also illustrate the use of multiple theories help to explain corporate behaviours and processes, particularly on audit committee practices. This is supported by Gendron (2009) who suggests that diverse theories can be employed simultaneously to describe a

given reality as a single theory should not be expected to explain the results obtained in a study. Gendron and Bedard (2006) suggested the application of other perspectives to study corporate governance as it may bring a different perspective of the corporate governance could offer.

In the present study, the agency theory helps to explain the fundamental basis of a view of audit committee, internal audit function and external auditor as effective mechanisms to monitor agent behaviour on behalf of the shareholders' interest (Shapiro, 2005). Agency theory suggests that a company consists of a nexus of contracts between the owners of economic resources (the principals) and managers (the agents) who are charged with using and controlling those resources (Jensen & Meckling, 1976). Narrowly defined, an agency's relationship is a contract in which the principal(s) engage the agent to take actions on behalf of the principal(s) which involves the delegation of some decision-making authority to the agent. Agency theory posits that agents have more information than principals and accordingly this information asymmetry adversely affects the principal's ability to monitor whether or not their interests are being properly served by agents. Thus, the clear implication in the agency theory perspective is that adequate monitoring from the audit committee, internal audit function and external auditor needs to be established to protect management's conflict of interest (Fama & Jensen, 1983).

In agency theory, companies with good corporate governance practices may reduce the agency costs problem by providing reliable information signals. The agency theory suggests that firms with higher agency costs will attempt to lower them by showing good quality financial reporting and audit quality, possibly by appointing an audit committee, establishing internal audit function and hiring external auditor. The audit committee, as part of the board of directors, is viewed as a monitoring device and used to prevent opportunistic behaviour and strengthen the quality of financial reporting and audit quality,

as well as to mitigate agency conflicts between preparers of financial statements and outside shareholders (Piot, 2004).

A part from that, the role of the internal audit on the statutory audit reduces monitoring cost and provides a signal to owners that the quality of financial reporting and audit is not reduced. Specifically, internal auditing is considered a bonding cost borne by agents to satisfy the principals' demands for accountability (Watts, 1988). Managers incur bonding costs, such as the cost of internal audit, to signal to the principals that they are acting responsibly or as a monitoring cost incurred by principal/ owners to protect their economic interests (Adams, 1994). Like any cost of running the business, the cost of the internal audit function is paid by principals to protect their economic interests.

Furthermore, owners incur monitoring costs such as the cost of the external audit of financial statements to minimize the risks that the managers act for their own interests rather than shareholders' interests. External audit serves a vital economic purpose and play an important role in serving the public interest to strengthen accountability and reinforce trust and confidence in financial reporting. An external audit provides an independent check on the work of agents and of the information provided by an agent, which helps to maintain confidence and trust. Accordingly, the interests of the shareholders can be protected.

In general, in order to reduce the agency's costs between the shareholders and managers, the firm may appoint qualified audit committee members, internal audit function and external auditors to ensure the reliability of financial reporting and audit quality. These parties should have required skills and knowledge in performing efficient corporate monitoring. Furthermore, for good monitoring to take place, there should be active participation of these parties in fostering continuous improvements such as during the interactions between these parties in practice (Safieddine, 2009).

To enhance understanding of the monitoring roles played by these three parties it can be explained further by the power possessed and exercise by these parties. This is because the power possessed and exercise by these parties may illustrates their effectiveness in performing the monitoring roles (Kalbers & Fogarty, 1993) which may be demonstrated through the interactions between them. The power of these key parties also much related to the trust established during the interactions. The power exercised during the interactions signalling the monitoring roles by these key parties and eventually reflects the credibility of information exchange. Finally it will affect the potential outcomes such as increase the quality of audit process.

In conclusion, the agency theory helps to explain the rationale for establishing audit committee and internal audit function and hiring the external auditor. This study extends the agency theory by incorporating the role of power and trust perspective in explaining the monitoring roles played by these key parties. Thus, to explore the role of power and trust in the interaction between external auditor with audit committee and internal audit function, this study integrates two theoretical lenses-power and source credibility theory. Power theory (French & Raven, 1959) and source credibility theory (Hovland & Weiss, 1951) recognises the importance of power and trust in ensuring the information sharing in the interaction between the parties which eventually influence the quality of the audit.

### **3.3.1 Power Theory**

Power is often considered an implicit component in control of organisational action (Pfeffer, 1981). There are various definitions of power, and among others, Weber (1986) defined power as the ability to act effectively even against the resistance of others. Meanwhile, Astley and Sachdeva (1984) define power as the “capacity of social actors (organisational members) to achieve desired objectives or results” (p. 104). Overall, it can be concluded that power is the ability to act efficiently and influence the people to

achieve the goals. Power may decide who gets what, when and how in the implementation process (Wilson, 1999).

The more general concept of power has long been an important subject of study especially in organisational behaviour (Drea, Bruner, & Hensel, 1993), in which bases of power typology suggested by French and Raven (1959) are among the most popularly applied in research (Cobb, 1980; Frost & Stahelski, 1988; Rahim, Antonioni, Krumov, & Illieva, 2000). French and Raven were among the first to explore power research in the development of the bases of power. French and Raven (1959) identified six bases of power including reward, coercive, legitimate, expert, and referent. The subsequent study by Raven (1965) has added a new type of power to the list which is informational power.

According to French and Raven (1959), reward power base refers to the ability of one party to mediate rewards to another party, in which it is derived from the ability to facilitate the attainment of desired outcomes by others (Lee, 2008). Meanwhile, coercive power base explains how one party has the ability to mediate punishment over another party. It involves the concept of the punishment for failure to conform to an influence attempt. This base is argued can direct surveillance of behaviour to be effective. In terms of referent base of power, French and Raven (1959) define it as “a feeling of oneness or a desire for such an identity”, in which it reflects the idea of “attractiveness” for a social setting or the individuals within it (Lee, 2008). Expert base refers to the perception that one party holds information, knowledge or expertise that is valued and useful by another party. Further, French and Raven (1959) argued that the role of the expert is subject to the ‘trust’ climate of the recipient in which it is dependent on the perception of the recipient on the expertise of the potential wield influence. Legitimate base in the power theory refers to natural rights of one party to influence the other party. It depends on the relationship between social positions and does not take into account the personal qualities

of the person. Finally, the information power refers to the potential influence by one party (first party) to the other party (second party) due to the relevance information contained in the first party's messages. In this perspective, the informational power is attributed to first party by providing second party with a logical explanation or new information favouring change (Raven, 1965). However, in order for informational power to bring about change in the second party, the second party must judge the content of the message to be highly useful and relevant to his or her situation (Raven, 1965).

Raven (1992) has revised and expanded the typology of social power by French and Raven (1959) and Raven (1965), which describe as a power–interaction model of interpersonal influence. Besides the new typology of power bases, the study also discusses the motivation for influence and the use of power, the factors which lead to choice of power strategy, preparatory devices for implementing the bases of power, the manner in which a power strategy is utilized, the effective changes or lack of change in the target of influence, the after-effects, and the readjustment of the perceptions and choices of future strategies by the agent. Specifically, the study has provided detailed explanations and examples in the perspective of school consultation relationship. In this revised model, 14 bases of power are described based on the original typology power bases. It includes coercive (personal and impersonal), reward (personal and impersonal), legitimate (position, reciprocity, equity and responsibility), expert (positive and negative), referent (positive and negative), and informational (direct and indirect) power bases.

In this model, impersonal forms of coercive and reward power refers to the original forms of coercive and reward power. Raven (1992) labelled coercive and reward power when approval from someone whom we like can be rewarding, just as a tangible reward can be. Likewise, refusal or disapproval from someone whom we like is referred to

coercive power. In relation to the legitimate power, legitimate position power is the power held by a person who is in a superior position in a formal or informal social structure. Meanwhile, legitimate power of reciprocity is a situation where we feel obligation to reciprocate when someone does something that is beneficial to us. Legitimate power of equity refers to where we feel obligation to respond to a person's request due to an imbalance of expended effort and possible inconvenience incurred previously by that person. Lastly, legitimate power of dependence is where we feel obligation to help people who cannot help themselves and who are dependent upon others.

In terms of expert and referent power, French and Raven (1959) originally presented both of these bases of power only in their positive forms. Raven (1992) has suggested the negative expert power whereby it exists when we recognize the expertise of the influencers, but distrust them and assume they are using their superior knowledge for their own best interests, rather than ours. Similarly, negative referent power exists when we see the influencers as someone whom we dislike, someone from whom we would prefer to disidentify ourselves. Finally, the informational power has been categorised into two forms direct and indirect. The direct form is where an influencer agent directly telling a target what he or she wants, and conversely, the indirect form is where the influencer agent doing so through hints and suggestions. More recently, Erchul and Raven (1997) has updated view of French and Raven's (1959) bases of social power model and describes Raven's (1992) power/interaction model of interpersonal influence.

Power theory (French & Raven, 1959; Raven, 1965) also has been applied in auditing and accounting research. For example, Kalbers and Fogarty (1993) investigate the nature and extent of the audit committee power to understand its effectiveness. The study applied six bases of the power theory (French & Raven, 1959; Raven, 1965) whereby two basic modifications to French and Raven's typology have been made. First, the reward and



coercive power were merged as sanctionary power and second, the study has added will power to the list based on Mintzberg (1983). The will base of power refers to the willingness of the party to exercise the power. The power exists only when it is exercised, and it is dependent on a person's will (Wilson, 1999). Mintzberg (1983) documented that the power holder must have the will to act to exercise the power. A person with a potential power may behave indifferently if he did not exercise the power than those who do not have power (Dahl, 1958). The findings of the study demonstrated that the audit committee expertise and a desire to carry out their duties are significantly related to the quality of financial reporting. Furthermore, the sanctionary power<sup>15</sup> of the audit committee would influence the external and internal auditing effectiveness, in which audit committees have the power to modify compensation and audit scope for both internal and external auditing activities.

In this study, power theory (French & Raven, 1959; Raven, 1965; Raven 1992; Erchul and Raven, 1997) is applied. The study also applies the power theory as adapted by Kalbers and Fogarty (1993) in which will power has included to the list. As listed in Table 3-1 below, the bases in the power theory explain the perceived reasons and how the audit committee may hold authority over external auditor which affect the interaction between the parties and audit quality.

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<sup>15</sup> In Kalbers and Fogarty (1993) study, reward and coercive power are merged as sanctionary power, which can be defined as the ability to manipulate both rewards and punishments.

**Table 3-1: Summary of Power Bases Applied in the Study**

<b>Power Base</b>	<b>Description</b>	<b>Relation to audit committee - external audit interaction</b>
<b>Coercion</b>	Power holder holds the ability to mediate punishment to target	The audit committee has the authority to appoint or dismiss the external auditor
<b>Expert<sup>16</sup></b>	Source has access to knowledge and skills desired by target	The audit committee holds information or expertise (such as on the organisation and skills gained from experience) that is valued by the external auditor in conducting the audit. The external auditor and internal auditor also hold expertise that is valued by the audit committee in performing its monitoring roles
<b>Legitimate<sup>17</sup></b>	Power holder retains judiciary right to influence target	The audit committee holds authority in providing oversights and monitor the exercise of the external auditor
<b>Referent<sup>18</sup></b>	Personal qualities of the power holder leading to deferential behaviour of others.	The respect, values, and leadership qualities attributed to the audit committee members during the interaction between both parties may influence the conduct of the audit by external auditor
<b>Informational</b>	Power holder has access to vital communication flow	The audit committee holds organizational position and has access to vital communications with internal audit function. It is valued by the external auditor in conducting the audit.
<b>Will<sup>19</sup></b>	The will of power holder to act to exercise the power	The audit committee's willingness to exercise the power by sharing the information and providing recommendations to the external auditor through the interaction

Based on the discussion above, power theory explains how one party has power over another which can shape the outcomes or goals of the relationship between the parties. Most power theoreticians (Emerson, 1962; Nagel, 1968) agrees that the power of individual refers to the ability to control others and to exercise discretion. The use of power theory in this study not only recognises the power hold by an external auditor, audit committee and internal audit function, it is also consistent with the roles of these key

<sup>16</sup> Mintzberg (1983) describes this as "technical skill."

<sup>17</sup> Mintzberg (1983) calls this as "legal prerogatives."

<sup>18</sup> Mintzberg (1983) describes this as "political skill."

<sup>19</sup> Will is refer as "diligence" in Kalbers & Fogarty (1993)

players emphasised in the regulation as discussed in Chapter 2 (Section 2.3.1). In relation to this study, audit committees hold important roles and responsibilities in corporate organisations which assigned to the audit committee with the legitimate position power of oversight and monitoring. Under the expert base of power theory, audit committee members with knowledge, skills and expertise in areas such as accounting, auditing, and finance could be expected to contribute to the effectiveness of the committee (Kalbers & Fogarty, 1993), thus illustrates positive expert power. The referent base of power theory illustrates the leadership skills of the audit committee members that may influence the way external auditor conduct their audit (Kalbers & Fogarty, 1993).

Having legitimate position and positive expert power, the audit committee has the authority to perform their monitoring roles such as probing into challenging questions and provide suggestions on the audit issues (Beasley et al., 2009; Cohen et al., 2010) during the interaction with external auditor which influences various phases of audit process including programme planning process (Bedard & Johnstone, 2004; Cohen et al., 2007; Cohen et al., 2010) and audit risk assessment (Cohen et al., 2010). For example, higher control risk assessments and increased planned audit effort will be conducted when the auditors perceived the audit committee is weak in performing their roles (Cohen et al., 2007).

In the event the audit committee is not satisfied with the performance of the external auditor, it has the authority to dismiss the external auditor. It is therefore, the audit committee has the authority to ensure the relevant suggestions suggested during the audit committee meetings (Cohen, et al., 2007; Cohen et al., 2010) are considered by the external auditors in ensuring the performance of audit process such as audit planning and risk assessments (Cohen, Krishnamoorthy, et al., 2007; Knechel et al., 2013).

Meanwhile, internal audit function is well positioned to play a key role in the organisation as it has unique skills, knowledge and capabilities especially in risk management and internal control (Al-Twaijry et al., 2004; Sarens & De Beelde, 2006; Arena & Azzone, 2009; Sarens et al., 2009). With such knowledge, the internal auditor holds positive expert power if they share the information during the interaction which can influence the audit process. In this perspective, the internal audit function can assist the external auditors in their duties, especially on the internal control system (Gramling et al., 2004; Mat Zain & Subramaniam, 2007) and risk management (Arena & Azzone, 2009) which are possibly important in the conduct of the audit.

In relation to the informational power, the audit committee needs to obtain information in order to perform its monitoring roles. In the current practice, the internal audit function needs to communicate and report directly to the audit committee (MCCG, 2017). Through these direct reporting lines, the audit committee has an ability to obtain the information from the internal audit function to make decisions and to achieve audit committee objectives (Kalbers and Fogarty, 1993). In this perspective, informational power is attributed to the audit committee. The audit committee has a potential influence over the external auditor due to the relevance of information that they have which is important for the external auditor in conducting the audit.

Will power supports the assumption that the audit committee members have a sheer desire to act to exercise their power that reflects their effectiveness (Kalbers & Fogarty, 1993) which may influence the audit quality. The power of the audit committee in the interaction with the external auditor depends on the willingness to exercise it, and the ability to do so may change the nature of the influence of the audit committee on the quality of the audit. The will base of power theory highlights the necessity to differentiate between potential and realised power, whereby the audit committees can realise the power

bases only if they behave proactively in the interaction, and the exchange of information can take place with the external auditor. This will eventually affect the conduct of audit in which the external auditor may use or consider the information provided during the interaction in their audit tasks.

The will power is found to be related to other bases in power theory (French & Raven, 1959; Raven, 1965; Raven 1992; Erchul and Raven, 1997). For example, it relates to the positive expert power if the audit committee member willing to share their knowledge and experience with the external auditor during the interactions. Similarly, it also relates to negative expert power in situations where the audit committee members refuse to share their knowledge with the external auditor. In addition, it also relates to the informational power. In order to obtain and share the information, the audit committee needs to have the will to do so. Without the willingness to obtain information, the audit committee may not be able to see the bigger picture to perform their monitoring roles and share the information with the external auditor.

Power theory (French & Raven, 1959; Raven, 1965; Raven 1992; Erchul and Raven, 1997) is found to be relevant to this study for two reasons. Firstly, the theory encompasses audit committee power which is important in delivering the roles and responsibilities. The monitoring and oversight roles of the audit committee in financial reporting which have been emphasised in the regulations (i.e. MCGG 2000; 2007; 2012; 2017; Bursa Malaysia Listing Requirements) illustrate the legitimate position power that the audit committee have towards the external auditor. It also encompasses the expert power of the key parties (i.e. external auditor, audit committee and internal audit function) which is important in the audit function. Secondly, it helps to explain how the authority or power of the audit committees have towards external auditor, and the expert power of these three key parties

(i.e. external auditor, audit committee and internal audit function) can direct their behaviour in the interactions and contribute to the audit quality.

In conclusion, power theory is deemed to be relevant for this study and, more specifically, it is considered to be appropriate for interaction in corporate governance research. It also extended the application of agency theory in understanding the monitoring roles by these three key parties to reduce agency cost. Source credibility theory which explains the demand for trustworthiness and expertise in the interaction between the parties supports power theory's implication in audit practices. Power theory emphasizes on the possible power hold by these three key players which are intrinsic to establish trust between the parties and affect source credibility during their interactions. The relations of these two theories will become apparent in the following subsection in which insights from power theory are related to a key component of the source credibility theory.

### **3.3.2 Source Credibility Theory**

Source credibility theory further develops the understanding of the role of trust in the interaction between external auditor with audit committee and internal audit function; and its influences on the audit quality. In particular, theory helps to explain how the information sharing between the parties affect the trust between the parties and finally the audit quality. In this light, judgements of source credibility are important in the audit process as the value of information is often considered in light of its source (Hirst, 1994) and determine the trust between the parties. The central ideas of source credibility theory were developed by Hovland and Weiss (1951) in "The Influence of Source Credibility on Communication Effectiveness". Through the model developed, the authors describe source credibility theory as for how an audience develops attitudes and perceptions about

a presenter in the communication or interaction, including what it may mean for message acceptance and trust.

This theory identifies trustworthiness and expertise as two elements that affect the credibility of an information source (McGinnies & Ward, 1980; O' Keefe, 1990).<sup>20</sup> According to Hovland and Weiss (1951), trustworthiness refers to an objective opinion and information provided by an individual about the communication topic which contains no bias or underlying motives. This element may reflect the degree to which the receiver accepts the information provided. Meanwhile, expertise element refers to the extent to which the source's informer is perceived competence and knowledgeable about a subject. In this perspective, information from a highly competent individual would typically considered more credible than information from a less competent individual (Anderson, Koonce, & Marchant, 1994). These two elements (i.e. trustworthiness and expertise) indicates that individuals are more credible when the information provided no bias, and they possess greater expertise, thereby established the trust in the relationship between the parties. These elements also illustrate that highly trustworthy and expert source of information induces a greater positive attitude in the communication or interaction than a source of information with less credibility (Sternthal, Dholakia, & Leavitt, 1978).

The theory is developed, and more elements have been added to its model. For example, Ohanian (1991) included an element of attractiveness in her study, in which the author argue that physical attractiveness affects source credibility illustrates by the growing numbers of advertisers that uses attractive models in their advertisements. Later, Goldsmith, Lafferty, and Newell (2000) included the element of likability which defines

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<sup>20</sup> Birnbaum and Stegner (1979) and DeZoort et al. (2003) describe source bias and source expertise as elements in source credibility theory which reflect the same notions as trustworthiness and expertise elements developed by Hovland and Weiss (1951)

the element of attractiveness which includes dynamism and overall evaluation of a source. In general, the source credibility theory comprises of four elements including trustworthiness, expertise (McGinnies & Ward, 1980; O' Keefe, 1990), attractiveness (Ohanian, 1991) and likability (Goldsmith et al., 2000).

The source of credibility theory has been heavily studied across different disciplines such as in marketing (Eisend, 2004; Jensen, Averbeck, Zhang, & Wright, 2013; Hussein, Manna, & Cohen, 2014), advertising (Sternthal et al., 1978; Gotlieb & Sarel, 1991; Ohanian, 1991; Clow, James, & Stanley, 2008; Umeogu, 2012; Jin & Phua, 2014), management (Hur, Kim, & Woo, 2014; Rhee & Fiss, 2014) and psychology (Kao, 2013; Finch, Deephouse, & Varella, 2015). In these studies, the dimensions (i.e. expertise, trustworthiness, attractiveness, and likeability) of source credibility were used to understand the credibility of various sources. The theory has also been applied in accounting and auditing literature (see for example Bamber, 1983; Beaulieu, 1994; Goodwin & Trotman, 1996; Hirst, Koonce, & Miller, 1999; Beaulieu, 2001; DeZoort et al., 2003). For example, Bamber (1983) applied source credibility theory to investigate the effect of audit seniors' reliability on audit managers' judgements, in which the results documented that audit managers may not rely on information considered less than reliable source.

DeZoort et al. (2003) illustrated how source credibility theory affects audit committee members' evaluation of information provided by two sources of information (management and external auditor) regarding a potential audit adjustment. Using experimental approach, the results suggested that audit committee members are more likely to recommend an adjustment for annual statements and when the external auditors maintain a consistent argument regarding proposed adjustments. With consistent arguments provided by the external auditors during their interaction, the audit committee



members are likely to perceive that the external auditor's credibility is high, thus increasing the audit committee member's support for adjustment. The results of the study illustrate the importance of the credible sources in making judgements, in which it may drive individual's thoughts and actions.

The source credibility is often found to be interrelated with trust (Rose, Rose, & Dibben, 2010). Information shared or provided by one party are only considered by the other party if some level of trust is established between the parties (Bamber, 1983; Chaiken & Maheswaran, 1994). In particular, the trust between the parties depends on an assessment of the other party's credibility (Doney & Cannon, 1997) which reflects the confidence level in a relationship and finally influence the outcome (Morgan & Hunt, 1994). To assess the other party's credibility, one party must have information about the other party (Doney & Cannon, 1997; Delgado-Márquez et al., 2015). As an individual has specific knowledge of others, it helps to identify the expertise and trustworthiness of the other parties which influence his judgements and actions (Bigley & Pearce, 1998). The knowledge of the other parties which reflects the trust may also be developed through their interactions (McKnight, Cummings, & Chervany, 1998). In particular, social interactions were evidenced to support the accumulation of knowledge among individuals (Tregaskis, Edwards, Edwards, Ferner, & Marginson, 2010), in which it helps to establish trust in an individual on the ability of the other parties. Once the trust is established, they seek more interaction between them, thus furthering information sharing between the parties. In short, the existence of a certain level of knowledge (i.e. personal and past experience) of the other parties gain through the interaction (i.e. formal interaction, report, presentation, social interaction) potentially affect the trust between the parties and their potential outcome.

In the context of this study, the source credibility theory explains the elements of trustworthiness and expertise in the interaction between external auditor with audit committee and internal audit function, thus reflects the trust between the parties. It illustrates that the elements of theory may affect external auditor's evaluation of the information and recommendations provided by the audit committee and internal audit function in the interaction. The perceived credible information by these parties may contribute to the audit quality in which the external auditors can use the information and recommendations provided in conducting their audit.

Regarding the audit committee, the recommendations and suggestions provided by the audit committee members may be applied in the audit process only if the external auditor perceived the information provided could be trusted, and the members possess sufficient knowledge and expertise. With the current regulations on the audit committee monitoring roles and the qualifications requirements (i.e. ISA 260; Blue Ribbon Committee, 1999; MCCG, 2017), it is expected that the external auditor may perceive the insights communicated by the audit committee members as credible. However, the recent studies (Beasley et al., 2009; Dobija, 2015) which provide evidence of the passive roles of the audit committee members call for the study to explore the interaction between the parties in the lenses of source credibility theory. The passive role of the audit committee evidences the lack of interaction between both parties, thus the credibility of the audit committee is questionable (Cohen et al., 2002). Therefore, it is important to understand how the trust can affect the external auditors' evaluation of the information provided in the interaction and eventually influences the audit planning, risk assessments and evidence gathering in the audit process (Sutton, 1993; Knechel et al., 2013).

Similarly, the external auditors will rely on the information provided by the internal audit function if they perceived the source provided as credible. The external auditors will

adjust their reliance on the information provided in response to indicators of the credibility of the internal audit function (Goodwin & Trotman, 1996; Goodwin, 1999; Beaulieu, 2001). With the knowledge of the organisation gained from day-to-day operations, the internal audit functions are expected to provide credible sources of information to the external auditor in their audit. Even though the regulations and literature have documented the importance of the internal audit function (Gramling et al., 2004; Coram et al., 2008; Sarens et al., 2009; Bame-Aldred et al., 2013), the evidence of internal auditors' ineffectiveness in the literature (Al-Twajjry et al., 2003; Mihret & Yismaw, 2007; Mihret et al., 2010) has raised doubts about the credibility of the information provided by the internal audit function to the external auditor. Therefore, using source credibility theory, this study addresses the trustworthiness of the information and expertise of the internal audit function to understand how the trust is established in the interaction between the parties and consequently affect the performance of the external auditors in the audit process.

The current and previous subsections have illustrated the importance of the power and source credibility theory in understanding nature of interaction and their influence on the quality of audit process. The discussions on theories have presented a framework which is shown in Figure 3-1, for conceptualising the nature of the interactions and their influence on the audit quality. Based on the above discussions and Figure 3-1, the underlying theory in this study is agency theory. The power theory and source credibility theory extend the agency theory in explaining and providing better insights on how the three key parties performing their monitoring roles to reduce agency's costs. Power and source credibility theory are related in certain ways which illustrates that power coexists alongside with trust. Power is exercised through the interactions in which it influences the act and behaviour of the parties involved. The bases of power (i.e. legitimate, expert, coercive, referent, informational and will) in power theory (French & Raven, 1959;

Raven, 1965; Raven 1992; Kalbers and Fogarty, 1993; Erchul and Raven, 1997) are important in explaining the acts of the parties (i.e. asking challenging questions, provide suggestions, information sharing based on each parties expertise) particularly audit committee, in the interactions (i.e. audit committee meetings, private meetings, informal meetings) between external auditor with audit committee and internal audit function.

The power held and exercised by the parties involved in the interaction will reflect the credibility of information shared (Chaiken & Maheswaran, 1994; Renn & Levine, 2001), thus influencing the behaviour or action of the information receiver. Trust exists when one party is confident of its exchange partner's reliability and credibility (Morgan & Hunt, 1994), thus affecting the information sharing during the interaction and finally the potential outcomes. Trust is established or developed through the experience and outcomes of the interactions taking place between the parties (Bigley & Pearce, 1998). In the interactions, the role of power and trust are central foundations in assessing the information provided by each party which may influence the outcomes. Therefore, both power and source credibility theory help to explain the role of power and trust in understanding the interactions between external auditor with audit committee and internal audit function and how the interaction affects the quality of the audit.

Some elements in the power theory (i.e. legitimate, expert and will) and source credibility theory (i.e. trustworthiness and expertise) are interrelated which is important in understanding the interaction between external auditor with audit committee and internal audit function. As discussed in Section 3.3.1, expert power is based on the knowledge, expertise and experience held by one party in a given area (i.e. accounting, financial and auditing). The same knowledge can also serve as a basis to determine the credibility of the sources. Being an expert and possessing special knowledge, each party will not only be able to exert power over the other parties, but it will also help to build

trust between them during the interaction as the information shared is perceived as credible.

However, this expert power would be incorporated with the will power to strengthen the trust between the parties. In certain situations, the expertise of the party alone is insufficient to establish the trust between the parties (Mintzberg, 1983; Kalbers & Fogarty, 1993). The party should demonstrate the willingness to exercise the expertise they have which may reflect the credibility of the information shared and valuable in the outcomes. It depends on the way power is exerted, trust in the powerful party can be strengthened or weakened (Choudhury, 2008; Castelfranchi & Falcone, 2010). In this light, a party will adjust their assessment on the credibility of the sources including their degree of trust in the other parties' expertise and their willingness to exercise the power.

Legitimate power is important in formed or established the trust between the parties in which a party with legitimate power are perceived as competent to provide assistance and support (Castelfranchi & Falcone, 2010). The information provided by a person with legitimate power is considered credible and may enhance information sharing between the parties. Hence, the legitimate power provides reasons to trust the person with the given authority (Gangl, Hofmann, & Kirchler, 2015) during the interactions.

This study recognised two critical strands underpin the findings presented in this thesis: (i) a consideration of the power held by the three key players, particularly audit committee during the interaction among them and (ii) the issue of source credibility which related with the power held by the key players, that influence the perceived credibility of the information sharing between the parties and accordingly affect the quality of the audit. The power of the key parties (i.e. external auditor, audit committee and internal audit function) exercised during the interaction is important to establish the trust relationship between the parties which can influence the exchange of information between both

parties, thereby reflects the quality of the audit. The power of all the parties and the credibility of the sources provided which are usually determined during initial interactions (i.e. formal and informal interactions) may influence how the information perceived as credible and affect the external auditors' working performance. More frequent interactions between the parties are important to determine the power and develop trust which encourages more information sharing particularly valuable information that applicable in the audit process.

In conclusion, theoretical perspectives based on power and source credibility theory have been outlined and is used to achieve the objective which examines the nature of interactions between external auditor with audit committee and internal audit function and the influence of the interactions on audit quality. These theories represent a small, but very important effort at contributing to the literature on corporate governance and audit quality. As discussed in Chapter 2, understanding the interactions between key governance players and influence of the interactions on the audit quality has been limited. Theories applied in this thesis are an attempt towards overcoming that shortcoming. The following section continues to explore the research design and includes a description data collection and data analysis, which complements theoretical perspectives of this study.

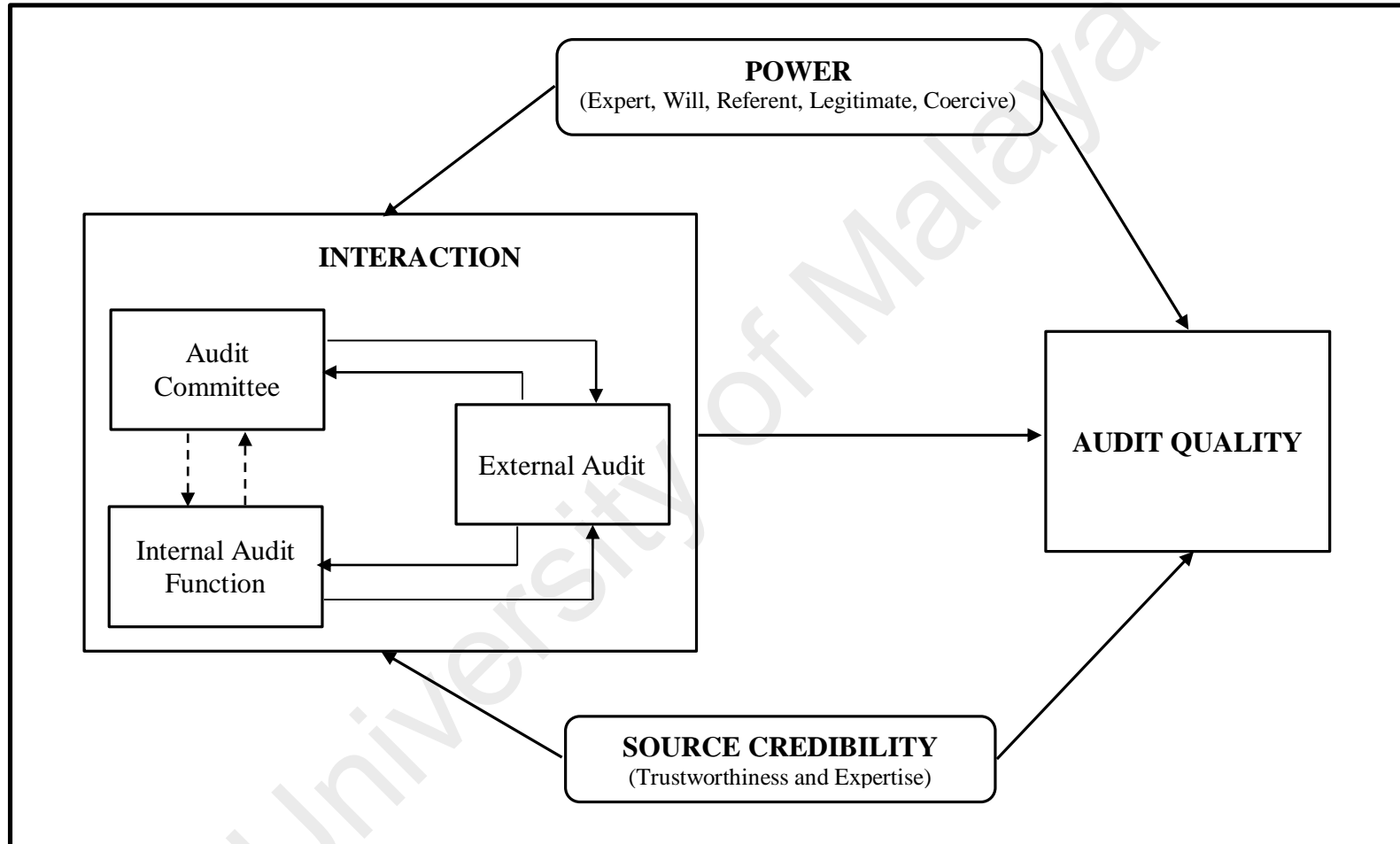


Figure 3-1: Theoretical Framework

### **3.4 Research Design**

The choice and appropriateness of a research method of the study is driven by the research questions and current knowledge of the phenomenon under study (Birnberg, Shields, & Young, 1990). The research questions in this study are designed to provide a better understanding of how the interactions between external audit with audit committee and internal audit function were conducted in practice and how these interactions may influence the way the external audit performs the audit. This study applied an interpretive approach which requires the use of the qualitative methods to provide insight into the topic under study. This approach gives a prospect to the researcher to explore the issue of the interactions between corporate governance mechanisms and audit quality in practice.

Most prior literature on the audit quality as well as the associations between audit committee, internal audit, external audit have utilised publicly available information or questionnaires which rarely reveal the practicality of the process of the audit quality and the interactions among key governance actors (Abbott et al., 2003; Goodwin-Stewart & Kent, 2006; Ho & Hutchinson, 2010; Mohamed, 2013). However, using merely questionnaire surveys and databases analysis cannot be sufficient to study the impact of the interactions between the corporate governance mechanisms on the audit quality. The ambiguous nature of these interactions may provide a better understanding of the application of qualitative research method. Therefore, a qualitative research method incorporating semi-structured interviews is chosen as a strategy as it provides significant potential for researching audit committee, internal audit and external audit interactions and its relation to external audit quality in practice (Cohen et al., 2010).

The qualitative approach is thought to be the most appropriate approach for the study as the topic needs to be explored in detail and cannot be captured through more structured approach. This was considered necessary because it offers the possibility of a more



holistic understanding of the nature, context, and processes of interactions between key governance mechanisms and its influence on the audit quality from the point of view of the interviewees. The qualitative designs are naturalistic as the research is conducted in real-world settings, and the researcher does not attempt to manipulate the phenomenon of interest (Patton, 2002). Further, qualitative research is more open-ended and flexible (ibid) compared to the quantitative research. Quantitative research is more structured in the sense that there will usually be clear guidelines and boundaries for the researcher to adhere to (Miles & Huberman, 1994). The quantitative approach has an advantage regarding generalisation of findings since it is possible to measure the reactions of a large number of people to a limited set of questions through this approach. In contrast, qualitative method sacrifices the generalizability as this method provides an in-depth understanding with detailed information about the smaller number of people and cases (Patton, 2002).

The qualitative research method applied in this study provides a better variety of findings collected within a complex behavioural context. The evidence of this study can complement extant research in this area (Turley & Zaman, 2004) which is largely driven by quantitative studies. There is very little literature that investigates the interactions, including the effects thereof, among the key governance mechanisms, particularly on the audit quality. Given the limited studies in this area, qualitative studies are more appropriate in gaining new insights into the interactions of the key governance players and its effects. It is important to see the broader context of the interactions between the key mechanisms as the interactions are important in improving the effectiveness of each key player and audit quality (IAASB, 2013). Therefore, the importance of the interactions and the specific ways the interactions are conducted in practice, and its effects thereof need to be studied qualitatively within its context.

### **3.5 Data Collection**

As discussed in the previous section, this study has adopted a qualitative research strategy as data collection method. Patton (2002) highlighted three types of qualitative data collection methods which include in-depth, open-ended interviews; direct observations; and written documents. The qualitative studies literature is dominated by interview method as it helps the researchers to understand how people think and feel (Esterberg, 2002). This is supported further by the Ritchie, Spencer, and O'Conner (2003) who emphasised interviews as key to qualitative data collection methods. Direct observations yield the data which consists of detailed descriptions of people's activities, behaviours, actions and the full range of interpersonal interactions and organisational processes that part of the observable human experience (Patton, 2002). Written documents data, on the other hand, includes studying excerpts, quotations, or entire passages from organisational, clinical, or programme records; memoranda and correspondence; official publications and reports; personal diaries; and open-ended written responses to questionnaires and surveys (ibid).

Interviews were utilised in this study as a data collection method to gather more information on the subject under study. The interview is a method to study a reality through direct contact with the people in the organisation (Merchant & Van der Stede, 2006). Yin (1989) claimed that the interviews are one of the most effective methods as the researcher can communicate directly with the participants or respondents. There are various advantages of using interviews as a data collection method in research. Through the interviews, the researchers can gain better insights and understanding of complex issues of a phenomenon which are difficult to achieve through archival methods (Beasley et al., 2009; Radcliffe, 2010) or potentially not well defined (Birnberg et al., 1990). Furthermore, it can elicit details and comprehensive information through the respondents' experiences (Cohen et al., 2002) and provide broader descriptions of the phenomenon

compared to other research methods (Birnberg et al., 1990). This method is also flexible whereby it allows the researchers to develop and clarify ideas which arises during the interview (Miles & Huberman, 1994), thus improving the reliability of the findings in the study (Maxwell, 1996).

### **3.5.1 Semi-Structured Interviews**

As discussed in the literature, different types of interviews are used to collect data. Maxwell (1996) and Creswell (2012) categorised interviews into three types including structured; semi-structured; and unstructured interviews. This study employs semi-structured interview as a means of data collection method instead of other interview types. The semi-structured interview is often used in exploratory research in the literature since this method provides the opportunities to the researchers to explore important insights that arises during the interview due to their inherent flexibility (Miles & Huberman, 1994; Gendron et al., 2004). This method also allows the researchers to ask additional questions and clarify specific issues which a questionnaire cannot accomplish. The main advantage of this method is it provides the researcher with the opportunity to probe answers if the researcher requires further information from the interviewees and not just those that existed when the original research design was conceived (Saunders & Lewis, 2003).

Semi-structured interviews are used to elicit the perceptions of key corporate governance actors in relation to the interactions among them, and how its influence the audit quality. Audit committee members, the head of the internal audit functions and audit partner/manager are chosen as the most appropriate subjects as they are considered to be in the best position to provide insights into the research questions outlined in Chapter 1 (Section 1.3, page 9). The interviews explored the interactions and audit quality within the listed companies' and non-listed companies with the formation of the audit committee board and established the internal audit function.

The primary aim of employing semi-structured interviews is to gain in-depth insights into the perceptions of the individual interviewees and to develop a greater understanding of the influence of the interactions to audit quality (Turley & Zaman, 2007; Beasley et al., 2009; Cohen et al., 2010), rather than to draw generalisations from the study. This method provides detailed insights on how the interaction between audit committee and internal audit with external audit and the extent to which such interactions affect external audit quality as this method allows the researcher to explore issues that are difficult to examine using the archival method. Furthermore, semi-structured interview approach allows the researcher to gain insights into the “black box” of the audit process and the interactions between audit committee, internal audit function and external auditors (Beasley et al., 2009).

### **3.5.2 Sample**

The key governance mechanisms that are part of the audit process (i.e. audit partner or senior manager, audit committee members and the head of the internal audit function) were chosen as the interviewees in this study. The main aim in the selection of the interviewees is to collect and gather the data from the persons who are in a position to offer useful insights on the subject under study. These groups of interviewees are in line with the internal governance stakeholders in the model of corporate governance by Cohen et al. (2004). Further, the interviewees at this level typically communicate and interact among them regarding the audit process. Therefore, it is expected that they have requisite task knowledge to be able to assess the interactions level among them and how those interactions can influence the audit quality. It is believed that the interviewees’ experience and knowledge would provide in-depth findings for the research questions.

The first group of interviewees were the audit partners or audit senior managers. For the audit partners, they are responsible for delivering audits that they consider to be of suitable quality. This group of interviewees have been spelled out in the prior literature (see for example Al-Ajmi, 2009; Bedard et al., 2010; Dehkordi & Makarem, 2011; Asthana & Boone, 2012; Eshleman & Guo, 2014) and regulations (IAASB, 2013) which hold the primary responsibility for improving audit quality. Furthermore, based on the standard and regulations, it is expected that the external auditor have the communications and interactions with the audit committee (ISA 260) and internal audit function (ISA 610) in performing their audit tasks. Thus, this group of interviewees is important in evaluating whether they are performing their roles or delivering and meeting the standards of quality audit as expected by the users.

The group of interviewees also include audit committees as the representatives of the board of directors. The audit committee members have the responsibility in monitoring and providing insights on the company's internal control and reviewing the effectiveness of external auditors in performing their tasks in audit (Blue Ribbon Committee, 1999; Sarbanes-Oxley Act, 2002; MCCG, 2017). The responsibilities of the audit committee can protect the stakeholders' interest by improving the audit quality. Therefore, the inclusion of the audit committee as part of the interviewees in the study is important to address the issues as to whether the audit committee are fulfilling their expected roles. The practices of the audit committees are important to improve our understanding and knowledge of how the audit committee play their roles in ensuring audit quality and overall effectiveness of the key players of corporate governance (Turley & Zaman, 2004; Gendron, 2009). This group of interviewees is part of the parties that involve the interactions and communications with the external auditors which is necessary for the external auditors to perform their roles and responsibilities.

The third group of interviewees was the head of the internal audit functions. Gaining the information on the interactions of the key governance actors in improving audit quality from the perspective of the head of the internal audit functions is essential as the interviewee plays a role in providing the information of the clients' organisations to the audit committee (Mat Zain & Subramaniam, 2007) and coordinate their audit plan with the external auditors (Blue Ribbon Committee, 1999; MCCG, 2017; ISA 610). Obtaining their insights as individuals involved in the process is also important to specify the factors that can influence their performance in improving their interactions with the external auditor, and accordingly the quality of the audit (Sutton, 1993).

Overall, audit committee and internal audit function contributes towards the achievement of audit quality in practice. Therefore, all of the groups of interviewees are considered as an important and credible source in answering how the interactions between the parties take place in practice and how it contributes to the external auditor's execution and performance of the audit process. Furthermore, a lot of the previous literature has compared the perceptions of the external auditors with other interviewees such as the client's management (i.e. the interviewees that attend the board meeting) and board of directors (see for example Turley & Zaman, 2007; Beasley et al., 2009). Hence, simultaneously comparing the perceptions and experiences of external audit partners or audit senior managers, audit committee members and the head of the internal audit function is a significant contribution to research on corporate governance and audit quality. Thus, semi-structured interviews were conducted with the audit committee members, the head of the internal audit functions and the audit partner/manager as they are considered to be in the best position to provide details insight on the subject.

The interviewees selected from Malaysian publicly listed firms (listed on the Bursa Malaysia), government-linked company (GLCs), large unlisted private firms; auditing

firms (including each of the Big Four and medium audit firm). The potential audit committee member and the head of the internal audit function interviewees were identified from the boards of the listed companies in Bursa Malaysia. After numerous and often unsuccessful attempts, five the head of the internal audit function agreed to be interviewed whereby most of them have vast experience in internal auditing.

The audit committee interviewees were then identified through “snowballing procedures” (Tremblay & Gendron, 2011), of which the interviewees of the head of the internal audit function suggested the audit committee members of the organisations that they were working. The interviewees of the audit committee also acquired through previous interviewees of the audit committee members whereby most have networked with other audit committee members for other companies. The potential interviewees of the audit committee were then contacted by email through their personal assistants which the letters were attached in the email (Appendix A).

Another five interviewees of the head of the internal audit function were also acquired through the “snowballing procedures” and the same processes were then followed. Getting access to the respondents in the field is recognised as one of the hardest parts of the qualitative study (Be´dard & Gendron, 2004). Recognising this problem, three of the external audit interviewees were acquired through the supervision team’s acquaintances and university-related contacts (Salleh & Steward, 2012a). Six interviewees were also attained through the “snowballing procedures” (Tremblay & Gendron, 2011) as the interviewees’ contacts were gained from the previous interviewees (external audit partner). The same process applied to the audit partners for the arrangement of the interview sessions whereby the email was sent to the potential interviewees. Out of all the potential interviewees approached through the snowball procedures, only six (including two audit committee members and four external audit partner) declined to be

interviewed. The audit committee members were overseas for extended periods of time and the audit partners were busy during data collection as it was a peak period for audit.

The number of individuals for each group of interviewees who participated in the study is shown in Table 3-2. Interviews were conducted with 28 interviewees, including ten external auditors (audit partners' and senior audit managers); eight audit committee members (including audit committee chairman) and ten of the head of the internal audit functions<sup>21</sup>. The following abbreviations are used to identify interviewees: EA = partners/ audit senior managers from auditing firms; AC = audit committee member/ chairman; HIAF = heads of the internal audit function.

**Table 3-2: Number and Details of Interviewees**

<b>Position in the Organisation</b>	<b>Total No. of Interviews</b>
Audit Partner/ Audit Senior Manager	10
Audit Committee members	8
Head of Internal Audit Function	10
<b>Total</b>	<b>28</b>

In a qualitative study, it is important for the researcher to establish the exact number of interviewees or interviews needed for the study (Taylor & Bogdan, 1997). However, it is very difficult to measure the exact number of interviews that should be conducted at the beginning of the study and usually it would be finalised towards the end of the research. Furthermore, there are no rules in determining the sample size in qualitative studies (Patton, 2002). Patton (2002) further argued that the sample size depends on the what the researcher wants to know, the purpose of the study, what will be useful or relevant and what will have credibility while taking into considerations time and

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<sup>21</sup> In the internal audit department, interviewees in different organisations hold different and various titles although positions were of equal status. The titles included 'Head of Internal Audit', 'Chief Internal Auditor' and 'Internal Audit Manager'.



resources available for the study. The objective of the qualitative study is to provide an in-depth understanding of the subject under study rather than a generalisation of the issues.

Francis et al. (2010) suggested that the sample size in qualitative inquiry should be determined by data saturation, which is generally achieved after ten interviews. The interviews with 28 interviewees were considered adequate with the assumption that theoretical saturation was reached at this point (Eisenhardt, 1989b). This means that the researcher has perceived that minimal new input or insights would be emerging from the new interviews later. In this study, the major themes emerged after twelve interviews and become apparent in the subsequent interviews.

### **3.6 Interview Procedure and Protocol**

In designing the interview study, the interviewees were first contacted for the interview. Organisations were chosen at random from the list of companies listed on the main board of the Bursa Malaysia, and their respective head of internal audit was then contacted. Telephone pre-notification was undertaken to solicit the participation of the subjects, and then consent letters were emailed to prospective interviewees. Subsequently, the researcher organised the interviews in consultation with the interviewees. The interview guide which contained semi-structured questionnaires were used in the interviews to establish a high degree of consistency (Patton, 2002). The interview process and the interview guide are discussed in the following subsections.

#### **3.6.1 Conduct of Interview**

The interviews were conducted over a period of 15 months between March 2014 and June 2015 with audit committee members and heads of the internal audit functions from few selected public listed, private and government-linked company in Malaysia. The

interviews were also conducted with audit partners and senior audit managers from Big Four and Non-Big Four audit firms in Malaysia.

The primary objective of conducting the interviews was to obtain the perceptions of the three groups of interviewees on their interactions and the extent to which the interactions can influence the process of audit quality. The length of the interviews ranged from 50 minutes to 75 minutes, with an approximate average of 67 minutes. This is consistent with some studies in this area including Gendron and Bedard (2006); Cohen et al. (2010) and Mat Zain and Subramaniam (2007). Most the interviews were conducted face-to-face except one interview which was conducted by telephone<sup>22</sup> due to time and distance limitations. The studies were conducted both face-to-face and telephone interviews in data collection include Gendron and Bedard (2006); Beasley et al. (2009) and Cohen, Hayes, Krishnamoorthy, Monroe, and Wright (2013).<sup>23</sup> The interviews were conducted mostly in the offices of the interviewees to maintain a natural setting and to gain first-hand knowledge of the situation (Singleton, Straits, Straits, & McAllister, 1988).

The interview questions focused on few themes including the nature of their interactions in practice such as formal and informal interactions; the audit issues discussed during the interactions; his/ her perception on what the impact the interactions have had on the quality of the audit process; and factors that can influence the interactions which can enhance the quality of the audit.

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<sup>22</sup> The nature of this interviewee's response was similar to other face- to- face interviews and appear unaffected even though the interview was conducted over the phone.

<sup>23</sup> For example, Cohen et al. (2013) conducted one of 22 interviews through telephone.

The questions were designed to make it possible for the interviewees to understand how they discharge their roles during the interactions which explain the importance of the power dimension such as legitimate, expert, will and others (French & Raven, 1959). It also relates to the trust established between the parties which was explained by the source credibility theory (Hovland & Weiss, 1951). For instance, the audit committee members were asked on how they develop interaction with external auditor. It will help to discover how the audit committee discharge their roles and exercise their power in monitoring the financial reporting and external audit functions (see Appendix B, part B). It will also help to discover how the role discharge will develop the trust between the parties during the interactions. In addition, the third part of the questions help to obtain views on how the power and trust established during the interaction may affect the quality of audit process. For example, all groups of interviewees were asked on how their skills and experiences may influence the interactions and qualities of audit process (see Appendix B, part C).

Before the interview, a review of the company's annual report (i.e. corporate information, directors' profile, statement of corporate governance, audit committee report, statement of risk management and internal control) was carried out to make oneself familiar with the questions and promote active discussions with the interviewees. Prior to commencing the interview, the interviewee was briefed about the confidentiality of the information collected and assured that the anonymity of his/her answers would be safeguarded.

Permissions to audio record the interview were requested before the interview started. The tape recorder allows the interviewer to capture more information compared to by relying solely on memory and to ensure that the important points were not missed out. However, in this study, the tape recorder was not used with two interviewees who

preferred not to have the interview recorded. Each interview was transcribed immediately after the interview. In order to limit response bias and to ensure the accuracy of the interview content, the interviewee was given the opportunity to verify the interview transcript (Gendron, 2002).

The researcher will probe the questions when the interviewer requested interviewees to elaborate on their response, or their response was unclear (Patton, 2002, p. 372). When asking probing questions, the researcher carefully avoided from highlighting her own opinion on the issues discussed to allow the respondents to provide responses from their experiences (Gendron, 2002; Anderson & Lillis, 2011) .

### **3.6.2 Interview Guide**

Semi-structured questions were developed to guide the interview which is flexible to probe further into issues that arise throughout the interviews. This standardised interview guide is important to provide a consistent approach in each interview (Beasley et al., 2009) and ensure completeness in covering the specified topics or themes (Lillis, 1999). The interview guide was developed based on the research objectives of the study, the roles of the external auditor, audit committee and internal audit function, as well as the interactions between these three key parties as discussed in the literature.

The guide (provided in Appendices A and B) focused on the audit committee, internal auditor and external auditor perceptions on critical aspects relating to the interactions and communications among them, the conduct of audit, and how the interactions and communications with the external auditor affecting the audit committee and internal audit function contribute to the audit quality. This interview guide also consists of questions that could be used to elicit deeper responses. It helps and reminds the researcher on what, when and how to ask and phrase the questions. The interview guide is essential as it gives a sense of what the researcher should cover in the interview (Taylor & Bogdan, 1998).

The first section of questions concentrated on the personal demographics of the interviewees. The second section aimed to obtain views on the nature of interactions between external auditor with audit committee and internal audit function in practice. This includes the perceptions on the relationship and coordination between these parties. The third section aimed to collect interviewees' opinions regarding the influence of the interactions on the quality of audit performed by the external auditor. This section aimed to capture the interviewees' opinion regarding the influence of the interactions on the audit quality. Consistent with Gendron et al. (2004), the interview questions were customised for each group of interviewees.<sup>24</sup> To collect the necessary data for this study, three sets of interview guide instruments were applied for each group of interviewees (Appendix B).

In line with the literature (Beasley et al., 2009; Cohen et al., 2010), the interview guides were reviewed by the academicians for the purpose of assessing the relevance, validity and reliability of the interview guides. The drafts of the interview guides were presented to the supervision team, other academicians in the fields of the audit or corporate governance, and four industry practitioners (i.e. experienced external auditors and internal auditors) to solicit their views. Based on the feedback on the interview guide, some of the questions were modified to improve the research instrument and approach (Gendron, 2002). Unclear and leading questions were rephrased to avoid repetition and complexity as well as to improve the clarity of the questions.

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<sup>24</sup> The interview guide is different for audit committee, external audit, and internal audit function interviewees. Only small different were made for each group of interviewees. The themes of the questions were not changed but the questions were restructured for interviewees various positions.

According to the common practices conducted in qualitative research, the interview questions were refined based on the responses given by the interviewees during the fieldwork (Yin, 2003). Therefore, the interview guides evolved and were revised as necessary when new themes arose or a theme was discovered revealing a need for more insights throughout the interviews (Cohen et al., 2002; Gendron & Bedard, 2006). Hermanson et al. (2012) suggested that the broad questions should be asked early in the interview to give the opportunity to the interviewees to probe deeply into the subject under study and express their views more freely. Responding to the suggestion, the first section asked interviewees to share their experiences (that is, the frequency of the interactions; type of interactions involved such as the presentation during the audit committee meetings; the example of audit issues discussed during the interactions). More focused questions were asked in the next section of the interview guide to invite the interviewee to describe and explain how the interactions that they have in practice influence the audit quality. The questions were designed to elicit the interviewees' experiences instead of their opinion (Cohen et al., 2010).

### **3.7 Validity and Reliability**

The prior sections discussed the method applied in the study, the sample, the process and instrument that the researcher followed in collecting the data. Within those sections, the issues of validity and reliability are addressed. Therefore, in this section, the validity and reliability concerns in qualitative research are further discussed. Guion (2002) suggested that validity in qualitative research relates to whether the findings of a study are true and certain. In this study, the validity concerns are addressed on whether the research findings are reflecting the real situation and available evidence that support the findings. On the other hand, reliability is addressed through the consistency of data collection procedures used in the study. The similar results and conclusion can be reached through the same procedures applied to all the interviews conducted by the researcher

(Yin, 2003). Hence, a clear research design adopted in this study as discussed in the prior section to enhance the reliability of the findings.

To ensure the instrument validity, the interview guide was designed to reflect the research questions and objectives of the study including the nature of the interactions between the parties, the interactions processes, involvement of the parties in the interactions, the roles play by each key parties during the interactions as well as its effects on the audit quality. The interview guide included three set of questions for each group of interviewees, of which divided into three sections. As suggested by Yin (2003), the interview questions were refined during the fieldwork based on the responses by the interviewees.

Meanwhile, the following methods were used by the researcher to enhance the validity and reliability of the interview. After the interviewees had agreed to participate in the interview, the appointments for the interviews were made at the convenience of the interviewees.

The interviewees were informed on the purpose of the interview and assured that the information they provided would be used in strict confidentiality and for the purpose of the study only. Explaining the purpose of the study can ensure that all the interviewees had clear and similar understandings of the study and thus, enhancing data reliability (Fowler, 2008). After briefly explaining the purpose and the confidentiality of the responses provided, a request was made to each interviewee to allow the interview to be recorded. Recording can help the interviewer be more attentive during the interview rather than focusing on note-taking, and thus help the interviewer to build a good rapport with the interviewee (Patton, 2002). It can also help the researcher to refer to the recording while transcribing the interview data and thus can reduce the possibility to missed out an important point and the chance of misinterpretation of data (Patton, 2002). Hence the

recording can improve the accuracy of the data and accordingly the validity of the research (Minichiello, Aroni, & Hays, 2008).

Brief notes of the main points were also taken during the interviews which can help the interviewer to develop questions to ask and act as a back-up to the recording (Patton, 2002). This is supported further by Irvine and Gaffikin (2006) who suggested that the notes would be helpful in the interpretation of transcripts during analysis. Most of the qualitative researchers chose to record the interview (Cohen et al., 2010; Gendron and Bedard (2006) and Trompeter and Wright (2010).

However, recording can affect the comfort of the interviewee and restrict the freeness of the interviewees to provide their responses or insights (Gendron, 2002). In the event the interviewees refused the interview to be recorded, the interviewer took notes and recorded a summary of missing parts immediately after the interview (Gendron, 2002). A draft of the interview transcript was presented to the interviewees upon requested to allow for comments, of which the interviewees may either add to or delete from the draft transcript to be comfortable with the responses they provided to the researcher (Gendron & Bedard, 2006; Tremblay & Gendron, 2011).<sup>25</sup> Accordingly, it can enhance the reliability, validity and overall credibility of the findings and conclusions of the study (Patton, 2002). A few studies did not record the interviews in their studies including Beasley et al. (2009) and Hermanson et al. (2012). In further enhancing the validity and reliability of the study, pre-testing was conducted to enhance the quality of the data collected. The interviews were pilot-tested with the first two interviewees to check the timing and assess the communication with the interviewees. Following these interviews,

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<sup>25</sup> Some of the interviewees requested for draft transcript. The drafts were sent to the interviewees within one week of the interview. Interviewees were asked to indicate any changes to the transcript he/she wished to make.



some changes were made to the interview guide (i.e. rephrase the questions, change the wording of the questions to make it simpler and easier to understand) and additional questions were incorporated in the next interviews.

Based on the discussions above, clear consideration was given to address the issues of validity and reliability. In this study, the validity and reliability issues had been considered at every stage of research design and process to ensure that the possibility of delivering valid and reliable conclusions can be enhanced. Furthermore, the method conducted in the present study also was consistent with few qualitative research conducted in Malaysia such as Salleh and Stewart (2012) and Mat Zain and Subramaniam (2007). The data analysis process discussed in the next section can further enhance the validity and reliability of the findings in the study.

### **3.8 Data Analysis**

Once the data collection and data transcriptions for each interview were completed, then the data would proceed to the data analysis stage. Miles, Huberman and Saldana (2014) documented that interweaving data collection and analysis from the start help the researchers to cycle back and forth between thinking about the existing data and generating strategies for collecting new data. Data analysis of qualitative research creates a challenge in interpreting the data (Creswell, 2012) as the data from the interviews produce massive amounts of data (Sarens et al., 2009). There is no right way or standardised method in analysing the data (Saunders & Lewis, 2003; Yin, 2003; Creswell, 2012). Patton (2002) further documented that there are no absolute rules to the data analysis, and the researcher should represent and communicate fairly what the data reveal according to the purpose of the study. However, there are still guidelines and the procedural suggestion that the qualitative researchers can follow in analysing the data (Patton, 2002). One of the most common guidelines to assist qualitative analysis is

developed by Miles and Huberman (1994). The authors suggested that there are three concurrent activities involve in data analysis including data reduction, data display and conclusion drawing and verification. Data reduction refers to the process that simplifies and sharpens the data which follows continuously along the process of data analysis. Meanwhile, data display is a process of displaying information to reach the conclusions. Finally, conclusion drawing involves making sense from the information gathered, while conclusion verification is important in assessing the validity of the information produced from the conclusion drawing.

This study applied a few steps in analysing the data which directed by the research questions. In the first step, data are organised and prepared for the analysis, of which the data were organised section-by-section based on the interview instrument. As such, responses from each interviewee were grouped by sections from the interview instrument. Following this step, it is enabled to highlight the important points from massive amounts of data and helps to focus on all responses based on the section to identify specific ideas emerged from the interviews. The next step involved reading all the data with the aim to be familiar with the data collected. In this step, the researcher listened to the voice recorder and read transcripts to gain a better understanding of the responses from the interviewees. This step also helps to identify the main issues that emerged and to gain insights in providing explanations for the findings (Creswell, 2012). The final step is coding the data. This is an inductive process of narrowing data whereby themes are identified, and the massive amounts data are reduced (Creswell, 2012). In this step, all interview transcripts were coded as suggested by the Miles and Huberman (1994) and converted into tables.

The computer assisted package, NVivo is used in this study to support data analysis process. The software helps in coding and categorising a large amount of narrative

information collected from the semi-structured interviews, which allows flexible and efficient coding of the data under themes determined by the researcher. The software also facilitates storage, coding, retrieval, comparing and linking of data (Patton, 2002). Even though the software is useful in organising the data, the researcher applies a development strategy to formulate the analysis (Myers, 1997). In the following subsection, the coding process is discussed in details.

### **3.8.1 Coding**

Miles and Huberman (1994) defined codes as the units of analysis applied to the data. It helps to classify and organise the interview data (Beasley et al., 2009) developed based on the questions in the interview guide. Coding is important to avoid misrepresentation of data and to ensure clarity in understanding the interview data. However, coding is often considered as the most subjective step in the data analysis of qualitative research (Malina & Selto, 2001). It starts during the fieldwork which helps the researcher to develop the next interviews with other interviewees by highlighting key issues and emerging patterns to follow (Miles & Huberman, 1994; Patton, 2002). In the coding process, the words and sentences from the interview transcriptions were categorised into codes. At the early phase of coding, the codes were recognised from themes and patterns discovered in the interview transcriptions. Excel spread sheets were used at the earlier stage of the coding process as part of manual coding which helps to organise data and to identify the patterns of responses given by the interviewees.

In the early process of manual coding, the researcher first drew a bracket around words that seemed to describe one idea to reduce the massive amount of data. The words or phrases were labelled as a method of coding. In some cases, the sentences were also used for coding purposes which are meaningful for data analysis. The code words and phrases identified were then defined and their meanings described. For example, the audit partners

frequently mentioned that they had few meetings with audit committee members, and thus, audit committee meetings were labelled as code and defined based on the participants' interpretations and relevant literature review. All transcripts were coded in line with the codes that were discovered during the early phase of the coding process. Once all the interview transcription was coded, a list of recurring classifications of codes was prepared. At this phase, the tables were used to analyse frequently-used words and statements (Miles & Huberman, 1994). Similar codes have been removed to reduce the list of codes. Codes were then analysed to another level of abstraction whereby the codes were classified into themes (Gendron, 2002). Then, the summaries of each interviewee were structured based on the coded data and the key themes are identified throughout the process. The same process was applied to each group of interviewees to identify the key themes across the groups. The analysis of the findings was conducted to present a blend of themes and quotes from all groups of interviewees while taking into consideration theoretical perspectives (Hermanson et al., 2012).

Once the manual coding process was completed, the interview transcripts were uploaded into the computer software, NVivo. This software is useful in qualitative research as it helps to reduce the researcher's reporting bias and add validity to the research (Abernethy, Horne, Lillis, Malina, & Selto, 2005). The software can also ensure that all data is coded, easier to make a comparison between the levels of analysis, and provides an audit trail of analysis (Miles & Huberman, 1994). However, as mentioned in a previous section, the software cannot be used to generate the results and findings of the analysis automatically. The main outcome of the analysis shows how the interactions between the parties took place in practice as well as the effects of the power and source credibility on the interactions and audit quality. The detailed findings from the interviews of the interviewees are presented in the next chapter.

### **3.9 Summary and Conclusion**

This chapter has outlined the detailed research methodology employed in the study to examine the perceptions of the interviewees (i.e. audit partner or senior manager, audit committee members and the head of the internal audit function) on their interactions and how the interactions can influence the audit quality. The chapter has attempted to justify how and why the research was conducted in a particular way. Among others, it discussed why a qualitative approach was adopted. The qualitative approach has been applied which concerns on the interactions of the interviewees in practice. This approach provides new and better insight on the issues of interactions in corporate governance and audit quality. The sample, data collection process and data analysis also discussed, of which the issues of reliability and validity were a focus in this chapter. The results of the analysis are presented in the next chapter.

## **CHAPTER 4: FINDINGS AND DISCUSSIONS**

### **4.1 Introduction**

This chapter sets out the results of a detailed analysis of the interviews that were conducted with audit partner or audit senior manager, audit committee members or chairman and the head of the internal audit function to elicit their views concerning how the interactions between them transpire in practice. The chapter also presents the findings on the interviewees' perceptions of the influence of the interactions on the quality of the audit. To get a clear picture on how power and trust play an important role in the interactions between these parties and its consequent effect on audit quality, research questions one and two are discussed in the same section. The methodology employed, the structure of the interviews and the data analysis approach to answering the research questions were described earlier in Chapter 3.

This chapter is structured as follows. Section 4.2 presents the profile of interviewees involved in the interviews. Section 4.3 describes the interactions between the external auditor and audit committee that took place in practice. Section 4.4 provides discussions on the interaction between external auditor with audit committee and its effect on audit quality, which highlighting the important role of power and trust. Section 4.5 presents a brief overview of the interactions between the external auditor and internal audit function in practice. Section 4.6 discusses the interaction between external auditor with internal audit function and its effect on audit quality. Finally, Section 4.7 provides a summary discussion of the findings and the conclusions of the chapter.

### **4.2 Profile of interviewees**

This section provides details on the characteristics of the respondents interviewed. Tables 4-1 to 4-3 provide demographic details of participants including their working experience. These tables show the participants in the sample represent a broad range of

participant experience. Since the task experience can influence the perceptions of the participants, the demographic data regarding participants' experience in the field were obtained. Participants were also asked to provide information regarding their qualifications and professional qualifications if any.

While most of the audit partners and audit senior managers are from medium or non-Big Four audit firms, most of them have working experience in the Big Four audit firm for more than five years. From eight audit committee members, four are audit committee chairman and one represented a large unlisted financial organisation which is also a government-owned bank. Five participants of the audit committee members are involved with public listed companies (PLC), and three are involved with non-listed companies. While three of the audit committee participants acted as audit committee members (executive or non-executive) in one company only, another five had concurrent directorships in other listed and non-listed company boards. Most of the head of the internal audit functions have long association and experience in internal auditing and related fields, while the audit partners and senior audit managers have broad experiences in auditing.

Despite the differences in the demographic data of the participants, it is believed that the insights provided by the participants can add value to the study and thus their perceptions on the subject of the study are considered in the analysis. It is also believed that this provided the study with a reasonable diversity of experience and background of the participants (Soobaroyen & Mahadeo, 2012). Furthermore, the nature of the research questions was designed to examine the interactions between these three groups of participants and how the interactions affect the external auditor's execution and performance of the audit process, not to determine such effects within specific companies. This is consistent with prior literature which has differences in the demographic data of

the participants in the studies. For example, Cohen et al. (2002) have one non-Big Five firms to their sample of 36 Big Five audit firms. Similarly, Tremblay and Gendron (2011) included at least one audit committee participant who recently retired from service in their sample.

	EA1	EA2	EA3	EA4	EA5	EA6	EA7	EA8	EA9	EA10
<b>Position</b>	AP*	AP*	SM**	AP*	AP*	AP*	AP*	AP*	AP*	AP*
<b>Types of Audit Firm</b>	Non-Big Four	Big Four	Non-Big Four	Big Four	Big Four	Non-Big Four	Non-Big Four	Non-Big Four	Non-Big Four	Big Four
<b>Demographic details</b>										
<b>Gender</b>	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male
<b>Age group</b>	40-45	40-45	35-40	45-50	40-45	40-45	35-40	40-45	35-40	40-45
<b>Prof quali***</b>	ACCA	ACCA	ACCA	MIC PA	None	ACCA	ACCA	None	None	ACCA
<b>Working experience</b>										
<b>- As an external auditor</b>	> 20 years	> 15 years	> 10 years	> 20 years	> 20 years	> 20 years	> 10 years	> 10 years	> 10 years	> 15 years
<b>- In the firm</b>	< 10 years	< 5 years	> 10 years	> 20 years	> 20 years	> 5 years	> 5 years	> 5 years	> 5 years	> 10 years

**Table 4-1: Demographic Details of External Auditor**

\* AP- Audit Partner

\*\* SM- Senior Manager

\*\*\* Professional Qualifications



	AC1	AC2	AC3	AC4	AC5	AC6	AC7	AC8
<b>Co Listing</b>	PLC	PLC	PLC&GLC	GLC	PLC	PLC&GLC	GLC	GLC
<b>Demographic details</b>								
<b>Gender</b>	Male	Male	Female	Male	Male	Female	Female	Female
<b>Age group</b>	55-60	55-60	55-60	50-55	55-60	40-45	40-45	40-45
<b>Accounting background</b>	No	Yes	Yes	Yes	Yes	No	No	No
<b>Professional qualifications</b>	IR	CPA, CA	CA	CA	CA	None	None	None
<b>Working experience</b>	> 30 years	> 30 years	> 30 years	> 25 years	> 30 years	> 20 years	> 10 years	> 15 years
<b>Period serving the current co as AC</b>	> 1 year	> 1 year	> 3 years	> 3 years	> 4 years	> 4 years	> 2 years	> 3 years
<b>Period serving other co as AC</b>	> 5 years	> 5 years	> 2 years	> 3 years	> 5 years	N/A	N/A	N/A
<b>Directorship in other co</b>	2 co.	6 co.	1 co.	2 co.	1 co.	None	None	None

**Table 4-2: Demographic Details of Audit Committee Members**

**Table 4-3: Demographic Details of Heads of Internal Audit Function**

	HIAF 1	HIAF 2	HIAF 3	HIAF 4	HIAF 5	HIAF 6	HIAF 7	HIAF 8	HIAF 9	HIAF 10
<b>Co Listing</b>	PLC	PLC	PLC & GLC	Private Co	GLC	PLC	PLC	PLC&GLC	GLC	PLC
<b>Demographic details</b>										
<b>Gender</b>	M*	M*	M*	M*	F**	M*	M*	M*	M*	M*
<b>Age group</b>	45-50	40-45	45-50	40-45	40-45	40-45	35-40	35-40	45-50	45-50
<b>Prof qual***</b>	CIA	CRMA, CIA, ICSA	N/A	CIA, CCSA, CMIIA	N/A	CPA, CIA	N/A	CIA	CIA, CISA	CIA
<b>Working experience</b>										
<b>- As an internal auditor</b>	> 10 years	> 15 years	> 5 years	> 5 years	> 3 years	> 15 years	> 5 years	> 5 years	> 9 years	> 10 years
<b>- In the firm</b>	< 1 year	< 1 year	> 5 years	> 5 years	> 15 years	< 1 year	> 10 years	> 10 years	> 14 years	< 1 year

\* M- Male

\*\* F- Female

\*\*\* Professional Qualifications

### **4.3 Interaction between External Auditor with Audit Committee in Practice**

The audit committees have vast roles as stipulated in the regulations including overseeing the financial reporting, internal control, business risks as well as monitoring the external auditors. In performing their roles, the audit committees are required to interact with the external auditors who help to enhance the financial reporting and audit quality (DeZoort et al., 2002; MCCG, 2007; 2012; 2017). Similarly, the interactions between audit committees with external auditors will benefit the external auditors in which the information shared through the interactions may influence the conduct of the audit (ISA 260; IAASB, 2013; Knechel et al., 2013).

Thematic analysis of the responses demonstrates that both groups of interviewees (audit partners or senior manager, and audit committee members) predominantly frame their nature of interaction around two types of interaction. When discussing the nature of the interaction between the parties, the interviewees expressed the view that relates their interaction to the formal and informal types of interactions. Consistent with Turley and Zaman (2007) and Zaman and Sarens (2013), the formal interaction is considered formal activities involving interactions between the parties which are centred on the regular meetings and specified formal responsibilities. For example, when discussing the formal interactions between the parties, several audit committee members and audit partners mentioned that the audit committee meetings which were conducted every year as the formal interaction between them. In Malaysia, the MCG (2000; 2007; 2012; 2017) has highlighted that the audit committee should interact to the external auditor with regards to the audit plan, the scope of the audit and the audit report as well as reviewing the financial statements. In addition, the MCG (2007; 2012; 2017) emphasised the private meetings between the audit committee with the external auditors without the presence of management.

On the other hand, the interviewees consider the informal interaction as an interaction which occurred outside those recognised in the formal structure. Consistent with Turley and Zaman (2007), this interaction may be informal in nature and be exercised on a regular or occasional basis. For instance, the interviewees viewed the interaction conducted outside the AC meetings and private meetings (i.e. conversation through phone call, email, special meetings, etc.) as informal interaction.

The nature of the interaction between all interviewees (external auditor and audit committee) is summarised in Table 4-4. The responses from the interviewees reflect the governance practices which stipulated in the regulations and illustrated how it would affect the external auditor's performance of the audit process. In the interviews, the audit partners and audit committee members illustrated that they had formal interaction through audit committee meetings, external auditor's presentation and report, and private meetings, which are related closely to the current regulators' requirement (MCCG, 2007; 2012; 2017; ISA 260) on interactions between external auditor and audit committee. Some of the interviewees also highlighted that they had informal interaction through phone or email, special or *ad hoc* meetings and social meetings on an occasional basis.

Consistent with the current requirement of MCCG (2000; 2007; 2012; 2017) and Bursa Malaysia Listing Requirements (BMLR), it was apparent during the interviews that almost all of the audit partners and audit committee members have formal interactions between them in satisfying the requirements of the standards during the course of the audit. The analysis suggests that most of the audit committees perform their duties in monitoring the audit function which reflected through the interactions happened between the audit committee and external auditor. Consistent with Gendron and Bedard (2006) and Salleh and Steward (2012b), the audit committees reviewed the external auditors' work through their meetings.

In the interviews, all the audit partners and audit committee members were in agreement that they have interaction through audit committee meetings that were held at least twice a year. In most cases, the meetings were attended by the audit committee members, audit partner or audit senior manager and the management representatives (Chief Executive Officer, Chief Financial Officer, etc.). This channel of interaction appears to be in line with the recommendations of the ISA 260 which requires that the external auditor communicate with the audit committee on the audit scope and timing of the audit. The following statements made by an audit partner and audit committee member illustrate this view:

“We meet with the AC quite regularly, and it depends on the dynamism of the audit committee. Usually, for the public listed companies, we meet **at least twice a year**. I mean, not all the external audit staff of the clients but me alone or senior manager will join” (EA2)

“Usually we met with audit partner during AC meetings. I think about **twice a year**. They did not attend all the AC meetings” (AC8)

Most audit partners and audit committee members viewed audit committee meetings as essential to discuss audit matters, in which both parties (i.e. external auditor and audit committee) can influence the discussion through information sharing between the parties. It was apparent that the audit plan and all audit findings are tabled in the audit committee meetings during the audit which also satisfy the requirements of the standards (ISA 260, BMLR, 2008). This is illustrated by the following assertions:

“So, basically there are two phases of communication, first one prior to engagement which is before we start the audit. In this phase, we discuss our **audit plan** including **audit scope, timeline, materiality, key risk areas, what matters discussed in the previous meeting and follow up, enquiring concerning fraud, and related party transaction**. Moreover, for the second phase, on the **completion of audit** where we will see the AC and **talk to them based on the issues raised during the audit**. **Both meetings are important because from there we can discuss...**” (EA2)

“For most of the companies, they come for one is for the **audit planning** for the year, and then, at the end of the year to discuss **final audit findings**. At the beginning of the year, the auditor will come to us with the audit plan. So, they will take us through what are the portfolio that they will go through over one whole year. From there, we can understand what their plans are for the year. So, based on that we will approve or make amendment or things that we want them to conduct audit further”. (AC4)

The above quotes are evidence that key audit matters such as audit plan (including audit objectives and audit criteria), areas to be audited during the financial year, potential risk area that needs to be covered and the audit approach that will be used in the audit were discussed during the first audit committee meetings. Once the audit has been concluded, the audit partners present their findings in the next AC meetings. This would include the discussions on the key issues discovered during the audit. The discussions enable the audit committee members to understand the approach that will be applied by the external auditors for their audit during the year and the issues rose during the audit.

The report was also given to the audit committee at the beginning of the financial year which provides information on the material issues discussed since the previous audit. It helps the audit committees to be aware on the potential issues that may arise throughout the year. It also influences the discussions during the audit committee meetings in which the members can raise any concerns on the issues discussed in the report which caught their attention. At the end of the audit, the final audit report is provided to the audit committee which predominantly highlight the key audit findings. The report is important to make certain that the auditors have conducted the audit according to the scope that has been agreed upon at the early phase of the audit. It can also ensure that the auditors have conducted sufficient audit work on the key risk areas, which may impact the audit quality. The following are responses illustrating the importance of external audit report as a channel of information exchange between the parties:

“We **go through the audit report on a quarterly basis** and from there we can get an overview that things are right and...we deal with the audit point raised. However, when the audit is not very satisfactory, or we have concern over a certain issue, we will ask them”. (AC4)

In addition to the scheduled audit committee meetings, at least once during the year, the audit committee is required to meet privately with external auditors in the absence of management (MCCG, 2007; 2012; 2017). When discussing the private meetings, most of the audit partners and audit committee members express that they usually have private

meetings during the year thereby complying with the MCCG (2007; 2012; 2017) recommendation. In most cases, the audit committee members and audit partners noted that they had private meetings at least twice a year. The private meeting discourse was usually conducted at the end of a scheduled audit committee meeting whereby the management and other parties were asked to give an opportunity for audit committee and the external auditor to have their private meetings. Nonetheless, one audit committee member in a public listed company is much less concerned about the private meeting with external auditor and perceived that such meeting should be conducted only if there are material issues raised during the year:

“We usually have a private session with AC about **twice a year**, and usually the sessions were conducted after the AC meetings. The AC chairman will ask the management and other parties in the meeting to leave the room” (EA7)

“It depends. If they have anything, they will just call us and might as well we have a meeting. However, if no issues were raised, why should we have a private meeting, right? So far, everything goes smoothly and I don’t think that we have to have private sessions with the external auditors. **We only met with them during the AC meetings and no private session afterwards** as everything is clear during the AC meeting and there were no big issues...” (AC5)

The analysis of the interviews is also evidences that some of the audit partners developed an informal channel of interaction with audit committee which often conducted whenever necessary. During the interviews, some of the interviewees illustrate that they had informal interaction through phone or email, special or *ad hoc* meetings and social interactions. The evidence suggests that the external auditor would report any material issue that was raised during the audit to audit committee chairman through the phone and eventually the audit committee will usually call for an *ad hoc* meeting to discuss the issues raised. In the normal circumstances, the external auditor will later communicate with the internal audit function for the arrangement of the meeting. This is evident in the following quotation:

“Not to say regular, but the **communication line is open for us to get direct access to the audit committee**. If we found something that we believe that it has to be brought to the attention of the audit committee, we just talk to internal auditors stating that ‘we found this thing, we need to understand it further and can we talk to your audit

committee chairman and can you arrange the meeting for us.’ So, then we have the meeting”. (EA5)

Even though informal interaction is found to be important in prior studies (Turley & Zaman, 2007; Sarens et al., 2013; Zaman & Sarens, 2013), the analysis of interviews data suggests that informal interaction is limited between both parties. In the following quotes, it is evident that the informal interactions were limited, and in certain cases, the informal interactions occurred only between the external auditors with audit committee chairman. The audit committee member expressed his confidence in the ability of external auditors, thereby informal interaction between the parties is unnecessary. It offers an explanation that lack of informal interaction between the parties is partly because the audit committee members believe on the ability of external auditors to perform a quality audit.

“So far with the auditors that dealing with us, I find they are knowledgeable. They are doing their work accordingly. So, I feel that there is **no necessity for me to have any other informal discussion** with them. Anyway, **time is an issue...**” (AC2)

“So far, I don’t experience any *ad hoc* meetings with the external auditors. Because there was **not so much issue to discuss**. But, if you asked me about audit committee chairman, as far as I’m concern, the external auditor did call or discussed on any issue with the audit committee chairman. I think last time there were **few times the external auditor called and discussed on several issues with audit committee chairman**”. (AC7)

A similar picture is evident which illustrated by most of the audit partners as shown in the following quotations:

“Well as an AC member, they usually **don’t have time for informal interaction**. So far, **I don’t experience much on informal interactions with audit committee**. There are few audit committee members that I had a special meeting, but it was based on the issue raised. Overall, the **special meeting is rare...**” (EA8)

“We don’t usually have informal meeting with the AC. Based on my experience, when I interact with audit committees, it would always be formal. So, basically **informal interactions like communication through phone or whatsoever is rare**. Because **they are usually very busy...**” (EA6)

The quotes above illustrate that majority of the audit partners and audit committee members perceived the informal interaction between both parties lacks due to time limitation. One possible explanation is that there is a small pool of experienced audit committee members in Malaysia (Mat Zain & Subramaniam, 2007). Thus most audit

committee members may be busy serving on several committees leading to limited informal interaction channels between audit committee and the external auditor. Furthermore, the interviewees addressed the difficulties to synchronise the busy schedule of audit committee members. Thus most of the controversial audit matters were dealt with during the audit committee meetings. For example, an audit committee member claimed that some audit committee members hold few directorships in various companies, and thus undeniably the time would be an issue for them to hold frequent informal interactions with the external auditor.

**“...it’s question of time and number of directorship that board members hold. You are limited by that. If you hold few directorships with big companies, and you also have a responsibility towards your current position, I mean which not related to the audit committee. Like me, I am Chief Operational Officer in this company. So, time is an issue to hold informal interaction with the external auditor. But, still this kind of interaction is important. You see, the mind is a funny thing. When you sit in a formal meeting between people in the room, you tend to focus on what’s in front you. In a situation like this, things can just omit. But, in informal meeting, the jewels of the information can come during this kind of a situation. So, it’s important.” (AC1)**

Despite concerns about limited informal interaction between both parties, the audit committee members believed that this interaction is important to achieve a high audit quality. For example, in a quote above, an audit committee member perceived that all parties could express things openly about various issues and share information during the informal interaction, like special or *ad hoc* meeting, thereby the best solution can be taken on any issue. Furthermore, the member perceived that this kind of interaction could bring them more ideas, opinions and thoughts as they felt comfortable to discuss matters of interest or concern. A number of interviewees also noted that they had social interactions in several occasions such as workshop organised by audit firm or festive events celebration. Even so, they do not discuss about their job during these occasions.



**Table 4-4: Summary of Responses on the Interactions between External Auditor and Audit Committee**

	Number of EAs <sup>a</sup>	Number of AC members
<b>Panel A:</b>		
<b>RQ1: How do the interactions between external auditor with audit committee take place in the companies?</b>		
<b>Types of interaction</b>		
- Formal	10	8
- Informal	10	4
<b>Channel of interaction</b>		
- AC meetings	10	8
- EA report and presentation	10	8
- Private meeting	10	6
- Informal <sup>b</sup>	10	3
- Social Meeting	7	4
<b>Person involved</b>		
- AC members	10	8
- EA partner & senior manager	10	8
<b>Common issues discuss</b>		
- Audit plan/scope	10	8
- Audit issues/ findings	10	8
- Financial reporting standards	10	8
- Risk and control issues	10	8
- Fraud issues	10	6
- Dispute with management	10	7

<sup>a</sup> The summary on the on the audit partners' responses based on the perceptions of audit partners on their overall experiences in interaction with audit committees

<sup>b</sup> Informal interaction (i.e. phone or email and special meetings) between both parties was rare and lacking in practice

#### **4.4 The Interaction between External Auditor with Audit Committee and its Effect on Audit Quality: The Importance of Power and Trust**

This section attempts to provide a detailed analysis of the interviewees' views on the interaction between external auditor with audit committee and how it would affect audit quality. The analysis illustrates that AC meetings, EA presentation, private meeting, *ad hoc* or special meeting discussing audit issues, major audit findings, risk and control issues and others are considered crucial channels of interactions which allow for information exchange between the parties and thereby increase the audit quality. Analysis indicates that the interaction efforts between these two key parties appear to be crucial in most phases of audit process (i.e. audit planning, risk assessments, evidence gathering) which help to improve the audit quality (i.e. improve financial reporting quality).

The following discussions will illustrate further the important role of power and trust in the interaction between the external auditor and audit committee which eventually affect the conduct of the audit.

##### **4.4.1 The Importance of Power**

As suggested by prior studies (Gendron et al., 2004; Gendron & Bedard, 2006; Cohen et al., 2010), the audit partners revealed that most of the audit committees review and are vigilant in asking challenging questions on any issue with which they have concern from the external audit report and external audit presentations in the audit committee meetings. The following quotations illustrating that the audit committees have active participation during the interaction in which questions were asked and any concerns were raised to the external auditor:

“They want to know, they want to understand, they want to make sure that they have carried out their work and **make inquiries to external auditors**, make inquiries to internal auditors, make inquiries to the management. I think there is a lot of improvement in that. We can see a **lot of questions were asked** in the audit committee meeting. They scrutinise a lot of things” (EA5)

“They **ask necessary questions** and sometimes the audit committee will **still ask the issues that already happened**. For example, the AC meeting is on March, but the issue happened on January, so during the meeting on March, the AC will still ask and discuss about the issue if necessary...” (EA6)

Here, the audit committee’s act of asking challenging questions during the audit committee meetings illustrates that the audit committee members want to ensure a sufficient level of audit quality by ensuring appropriate audit approach and good audit plan applied in the audit process. This finding is in line with Gendron et al. (2004) who suggested that the audit committee members are asking challenging questions to reach comfort on the ability of external auditors.

Further analysis shows that the audit committee uses their authority and expertise to influence the audit plan for the year by making enquiries to the external auditors. On a couple of occasions, the audit committee asked external auditors to provide further details on the issues which have occurred previously that potentially affect the conduct of the audit. There have been many instances where the interviewees illustrate that the audit committee has asked the external auditor ‘Why don’t you look into this part’? The audit committee has asked the external auditors to probe further in certain areas, particularly in high-risk areas.

The following quotes provide insights into how audit committee members play their roles in risks monitoring, which accordingly influence the risk assessments during the conduct of the audit.

“The AC provides information on risk appetite whereby some of the AC members who are risk averse. Even though that area is not red flag area, they ask for the explanation from the management and they sometimes **ask us to extend our audit scope in that area**. Their monitoring is very high, and thus, it will lower the risk”. (EA6)

“... usually the active AC, they will mention to us, ‘based on the IA findings, this process has certain issues...maybe you need to investigate further’. They advise us to extend the focus area. They also address their concerns and asked us to verify the matters. So, basically they will **make us aware on the potential area that need further audit**” (EA7)

This sentiment is further supported by audit committees’ statements:

“...based on our experience, **if we have any other areas that we think that they should do, we will inform them...** then, they will come back to us after they have done the audit to report the findings ... and then the other one, based on last year audit findings or profiling, we will inform them whether we want them to repeat the audit on certain areas or whatever ... Or probably, the internal auditor come to us for discussion, and based on their assumptions or parameters, they found that this is a high risk area. Okay, then the external auditors, will do the audit on the said area every year. And for the medium risk, they will do one in two years, probably. So, basically **we will suggest to the external auditor...**” (AC2)

The responses show that the audit committees provide useful feedback and direction to the external auditor during their interactions. The suggestions on potential risk areas by the audit committee members provide information and partly guide the external auditor in the audit process, in which it is likely to influence audit planning (Sutton & Lampe, 1991; Sutton, 1993; Cohen et al., 2002; Richard, 2006; Cohen et al., 2010) and risk assessments (Knechel et al., 2013). The members are more sceptical and seem to be fairly confident in their ability to monitor financial risk in which they require the external auditors to expand the audit approach on certain potential risk areas. This is supported by an audit partner as shown below:

“...so, doing that interactions, **they have the opportunity to assess where we are** and normally what happened based on my experience, because they have a lot of interactions with their internal auditors, they will start questioning ‘why you don’t look into this part that we thought’. Because they also have different thought in terms of that. So, **when we get the feedback like that on certain things, we will incorporate in our audit. More focus would be given on high risk area**” (EA10)

The interviewees also illustrate that audit committee were professional and act as mediator (Salleh & Steward, 2012b, 2012a) while handling the disputes between the external auditor and management. The audit committees illustrate that the disputes between the external auditor and management were usually discussed and resolved in the audit committee meeting or special meetings. Consistent with Turley and Zaman (2007), the audit committee members and audit partners perceived that the special meeting is considered as an important channel of interaction to raise and discuss any issue informally with the audit committee members. The audit committee members used the authority they have to resolve the disputes. They ask a series of questions to both sides and the best

solution be opted. In a situation where the audit committee is satisfied with the external auditors, the management should agree with the external auditors' suggestions and vice versa. The audit committee will ensure that the management is taking action and report the progress to them in the following audit committee meeting. In this context, it highlights that the audit committees possess the power to impose an outcome and decide on any issues raised which can help the external auditors to enhance the audit process, in which possible action are taken timely to resolve any issue raised. The audit partners and audit committee member further shed lights on this matter:

“...for the external accounts, sometimes the issues that was raised by our auditor, the management has not rectified. So, at that point of time, we will hear both. We will listen also to the management. I mean sometimes the external auditor can raise the issues but then it may not be practical. So, **we listen to both and then make a decision...**” (AC6)

“...let's say there is an issue...the issue can be on accounting, the issue can be just on auditing, or the issue can be something else. For example, the management refused to make **impairment**. For example, the company has a subsidiary which is very problematic, and we say we need to do the impairment. So, surely management won't do so and then, we will bring the issue to the AC. This is because the impairment value will impact the real story of the company's financial statements”. (EA4)

The ways which the audit committee resolves disputes between the external auditor and management is illustrated in the above quotes. The example above relates to the disputes over impairment issue, in which the management refused to record the impairment as suggested by the external auditor. Since both parties did not reach an agreement, the issue was brought to the audit committee's attention. The issues were then discussed during the special meetings to ensure that the financial statements are conforming to the financial standards and guidelines. Even though sometimes the audit committees have their own suggestions with regards to that matter, they will listen to the explanations given by both parties and the best solution reach on that issues.

Based on the above findings, it is appropriate to illustrate the power theory perspective (French & Raven, 1959; Raven, 1965; Raven 1992; Erchul and Raven, 1997) which emphasises the legitimate position power of the audit committee members that allowed

them to provide insights on audit process to the external auditor. The act of legitimate position power of the audit committee is indicated by the manner in which challenging questions were asked and the audit committee provided suggestions. More attention was given to the work of an external auditor since the audit committee hold legitimate position power and can request the external auditors to direct attention to particular areas of perceived high-risk areas which potentially affect the audit opinion. In addition, the act of the audit committees in resolving disputes between the external auditor and management further illustrate the legitimate position power hold by the audit committees. The audit committees were found to exercise the legitimate position power that they have in resolving the issues that brought to their attention. In line with Salleh and Stewart (2012), the findings also show that the audit committees have required expertise to mediate the disputes between the external auditor and management.

Apart from legitimate position power, it also illustrates that the audit committee members hold positive expert power in which audit committee members possess experience, knowledge and expertise to impose questions and suggesting any area that need further attention in the audit. For example, if the audit committee discovered certain issues which raised their concerns, they would say “Look, I’m not too happy about this, can you look into that? I want you to investigate this” to the external auditor. Through the audit committee members’ questions and recommendations on the coverage of audit planning and findings, specific audit reflecting major high risks area is suggested and considered by the external auditors. The external auditors perceived that the suggestions on the potential area will influence their risk assessments and lower the risk of material misstatement. The audit committees, therefore, perceived to acknowledge the existence of the legitimate and expert power and engage with the authority and expertise that they have.

Frequently during the interviews, most of the audit partners relate the audit committees' expertise, knowledge and experience with the audit committee members ability to provide greater diversity of opinion, ask challenging questions and provide suggestions on the audit approach or findings to the external auditor (Beasley et al., 2009; Cohen et al., 2010). The audit committee members' knowledge and experience is essential which enable them to suggest potential risk areas to the external auditor during their interactions. Consistent with prior studies which highlight the importance of the audit committees' competency (Cohen et al., 2002; Abbott et al., 2004; Salleh & Steward, 2012a; Cohen et al., 2014), the audit committee members appear to believe that having knowledge and the ability to understand the potential risks makes them able to carry out their roles better in overseeing risks which eventually influences the audit process. Apart from the audit committees' background and qualification (DeZoort et al., 2002; Salleh & Steward, 2012a), some of the audit partners perceived that the audit committee members' directorship in other companies could help them to ask challenging questions and offer suggestions on the potential risk area.

The effect of holding directorship with few companies is seen as increasing the positive expert power of the audit committee members. It helps the audit committee members to keep abreast or aware of the current issues that relates to audit. Using the experience as audit committee members in various companies, the audit committee can share the experience with the external auditors by providing suggestions and recommendations which potentially affect the audit plan. This is consistent with Cohen et al. (2014) who found that audit committee members with industry expertise can improve audit committees' effectiveness in term of their monitoring roles on the financial reporting process. It is, therefore, the ability to provide recommendations and asking challenging questions would depend on audit committees' positive expert power which often develops through their experience. In the following quote, the audit partner appears

to believe that the audit committee with several other directorships asks challenging questions and provide suggestions to the external auditor. The audit partner specifically provides an example that the audit committee members asked the audit partner on the effect of Goods and Services Tax (GST) on the financial statements. Such suggestion help the external auditor to be aware on certain requirements that they need to comply:

“...Because when they serve other companies as audit committee member, **they will share the information in this company**. When he was the committee member to the company which is a large company especially, what he learnt from the other side can be applied here... So, he started raising questions. For example, ‘have you started the Goods and Services Tax?’ Sometimes, we don’t realise on certain issue and then we take that into consideration... and sometimes, no need for us to explain further why we need to do certain things because he understand it already how and why it should be done. They would use the experience interchangeably”. (EA5)

This sentiment is further supported by the audit committee members who believed that the experience as audit committee members in various companies help them to perform better in the interaction, as evidence in the quotation below:

“It helps. First, the **knowledge**. Second, the **experiences** that I have with other organisation. Based on my experience in another organisation, I find that the audit committee should be like this. For example, I happened to be an AC member for the company of which the external auditor was Big Four... and in the same time I was also a member for company with Non-Big Four auditor. From there I can compare. Then I say, ‘the other organisation I’ve been in, the external auditors are really good and I’ve discussed on this issue. Why is it that you all have not raised with us on this issue?’” (AC2)

The quotes above show that the audit committee members emphasise the benefits that follow having the knowledge and being in few organisations as an audit committee member. In particular, it enhances information flows between the committee in different companies which help the audit committee members become aware of current issues and new requirements that need to be fulfilled by the company. This knowledge spill over potentially enhances oversights of the audit committee on the audit function.

For instance, the audit committee members gain the information based on the new requirements through the practices in one company, and eventually they will share that knowledge with the external auditor responsible for other companies. In certain circumstances, the audit committee members will question the external auditors as to why



they did not raise certain issues that possibly affect the accounting practices of the company. This will raise the concern of the external auditors on that issues and consider it in their conduct of audit. The act of external auditors indicated that they are confident in the ability of the audit committees and incorporated the comments by the audit committee members in the conduct of their audit. In short, it generates feelings of confidence in external auditors that the audit committee possess required knowledge and experience to perform their monitoring roles in audit function.

They also recognised that information they acquired from the internal auditors (Gendron et al., 2004; Sarens, De Beelde, & Everaert, 2009) enable them to provide suggestions to the external auditor particularly on the risky area that need further investigation. The regular meetings between the audit committee and internal audit function makes sure that the audit committee remained informed and knowledgeable about relevant issues, and therefore, the audit committee enable to convey the information to the external auditor. The internal auditors would report directly any issues raised to the audit committee (Mat Zain & Subramaniam, 2007), and in any situation where the issue relates to the financial matters, it is likely that the audit committee will discuss the matter with the external auditor. Direct reporting lines enable the audit committee members to keep updated with current issues which are happening in the organisation and interestingly, it also allows the internal auditors to voice out their concerns to the audit committee. From another angle, it also shows that the audit committee holds informational power in which they gathered certain information from the internal audit function in performing their monitoring roles. Such information gathered from the internal audit function are important for the external auditor in conduct their audit.

Apart from audit committee members, the external auditors also found possess expertise, knowledge and experience (Bedard & Wright, 1994; Low, 2004; Robyn, 2007;

Cohen et al., 2010) which apparently important in discussing the audit matters during the interactions. While the audit committee members give opinions and provide suggestions to the external auditor, the audit committee usually expects the external auditor to provide the information on the current financial reporting standards. Some of the audit committee members stated that in the meetings there is a considerable discussion with the audit partners in relation to financial reporting issues, such as the application of new accounting standards and their impact on the financial statements. In fact, some of the audit committee members see the external auditors as their 'partner' who helps them in their monitoring roles. For example, the members refer to the external auditor as their second opinion if any concerns or issues raised. In particular, the audit committee considers the external auditor to be an expert in the financial reporting standards and auditing issues which can help them to understand further and keep abreast with the new requirements in the financial reporting standards. This is in line with Gendron and Bedard (2006) who found that the external auditors were expected to keep the audit committee members informed with emergent accounting standards.

In other words, the audit committee also attempts to gain information from the external auditor to enhance their effectiveness in performing their prescribed monitoring roles. As a result of the information sharing through the interactions with the external auditor with respect to the new financial reporting standards and regulations, it should be expected that the audit committee members will be able to ask relevant and the right questions to the external auditor throughout the meetings. As a consequence, the transfer of knowledge on the risks and related information on financial statements of a company will not be one-sided. This practice of interactions fulfils the requirements in the ISA 260 which require the exchange of information between those charged with governance (including audit committee) and external auditor which accordingly can help both parties to perform their roles effectively. Such interactions also help the external auditor to ensure that the

financial statements have complied with the applicable accounting and auditing standards, and all possible issues relate to the standards which might have an impact on the reported financial results of the company were highlighted. In this light, compliance obligations with the accounting and auditing standards are one of the important features in the address of audit quality among the audit partners and audit committee members. The following quotations illustrate the information sharing between both parties on financial reporting standards matter:

“... normally we ask the external auditor in term of **compliance with the accounting standards**. Because there are so many accounting standards and it changed very fast. I cannot cope with the changes and I always find difficulties in coping with the change. The new standard keeps on coming all the time. And like ‘Takaful’ companies, we always subject to Bank Negara guidelines, circular, instructions. So, to keep up with all these is too much for the board. So, we rely on the external auditor and tell them “you refer or not with central bank’s instructions or whatever and also with the accounting standards” (AC4)

“...we always take the external auditor as our second opinion. Yes, it’s our responsibility in monitoring the financial statements and usually we will challenge the management in terms of the standard that we know, but, the financial standard keep on evolving at the certain treatment. So to me, personally, we take the **external auditor as second opinion**. And we deal with the management letter provided by the external auditor thoroughly. Or, I can also say they are our **partner in monitoring the financial statement**” (AC3)

However, in the event that the audit committee members do not have confidence in the ability of external auditor to conduct high-quality audit, they will suggest for the appointment of another external auditor. One audit committee member stressed that they would usually appoint another audit firm for the audit in cases where the current external auditors do not perform due to insufficient knowledge and experience. The quote below shows that audit committee member stressed on the issue of the competency of the external auditor in which the external auditor seems incompetent while discussing the issue related to the applicable financial standards with the audit committee. The competency of the external auditor is judged based on the responses provided on the questions raised by the audit committee members. The external auditor was unable to answer the questions imposed by the audit committee members. In this context, the incompetence of the external auditor in dealing with the issues may be explained by their

lack of detailed knowledge. The audit committee members also illustrate that they have authority to dismiss the external auditor if they are not satisfied with the external auditor's performance. This notion illustrates impersonal coercive base of power theory (French & Raven, 1959; Raven, 1965; Raven 1992; Erchul and Raven, 1997) whereby the audit committees have the power to dismiss the external audit who perceived as incompetence in performing the audit tasks. The quotation below by AC2 illustrates the statement:

“But I will say that, without naming a company, **if you find that the auditors are not forthcoming, we will inform that we are not happy**. There was one where we are not happy. The way they discuss and present the issues, I mean we find that they are not well versed. They seem to be uncertain with some issues, for example provision. We rely on the external auditor on certain things like financial reporting standards and what so ever. If they are not very certain, how can we rely on them and we might think are they really conducting good audit”? (AC2)

The above quote also shows that the audit committee perceived that the external auditors do not have positive expert power in delivering high quality audit. The uncertain behaviour of external auditors during the meetings would raise some doubt in the audit committee members on the competency of the external auditor. In line with prior studies (DeZoort et al., 2003; Gendron et al., 2004), the finding illustrates that consistency in answering the questions by the audit committee members indicated the credibility of the external auditor, thereby reflects the confidence in audit committees on the external auditors. Here, quality of audit is articulated by way of how external auditors' experience and knowledge play a part in the conducting the audit that could affect the audit opinion or judgement.

At this point, the findings show that most of the audit committee played their monitoring roles during the interactions by exercised their legitimate, coercive, informational and expert power which is important for the conduct of audit by external auditor. Frequently during the interviews, both groups of interviewees agreed that the requirements on the audit committees' monitoring roles encourage the members to carry out their roles effectively, which in turn, affect their interaction with the external auditors.

The increasing requirements with respect to the monitoring role of the audit committees have strengthened their legitimate power and found to be an adequate mechanism for increasing their motivation to participate in their interactions with the external auditors actively. In particular, the regulation requirements on the roles of the audit committee members offer potential explanations for their openness and their act in asking challenging questions and suggesting recommendations during the interaction. As mentioned earlier, the audit committees encourage comprehensive and prompt interaction by asking challenging questions and provide recommendations particularly on the relevant risks area which may affect the audit approach. The main concern of the audit committee is on ensuring that high audit quality is conducted which reduce the risk of material misstatements. Therefore, audit committee members tend to raise questions to the external auditors if they become aware of any potential risks. These acts indicated that the audit committee members tried to satisfy themselves (Gendron et al., 2004) that the best audit approach is applied and right audit opinion is formed.

Consistent with prior studies (Cohen et al., 2004; Cohen et al., 2010), a number of the partners indicated that the audit committee was now seen as being more rigorous and committed in the interaction than had previously been the case. The following quotation illustrates the penalty in breach any regulation enforcement has been a factor that motivates the audit committee members to involve actively in the interaction. The audit committee illustrates how the fraud scandals occurred in one of Airlines Company has caused the audit committee charged by the regulators as a result of not being able to detect the fraud issues. The main concern of the audit committees is to ensure the key information is channelled to the external auditors for their audit, and the audit committee are well informed on the important issues raised by the external auditor:

“I’m very concern about my role and obligations. Well, you know, **the regulations on board including audit committee have been tightened these days**. I remember there was a fraud in this one airlines company that provide cargo service and then I heard that the audit committee was fined. As an independent director, I’m very nervous.

Because you sign the financial statement, you are not sure actually. You can roughly say that is okay, but you can never be sure. So, I would usually interact more with the external auditor you know to force my survival because if something goes wrong, the first people that would be blame would be independent directors. In this case, we usually have more discussion with them to ensure the best audit approach applied and any issues raised are properly discussed and taken care of. So, at least the risk of financial statement misstatement can be minimised while the best audit approach adopted by the auditor...” (AC4)

The following quote by audit partners relates the regulation and active behaviour of the audit committee members during the interaction between the parties:

“**These kind of regulations and cases have lighten up audit committee to be more sceptical and put a lot of more time to understand any issues and most all of the audit committees are more active now in performing their roles.** ...they are professional and they ask if there is anything that they are concern with”. (EA2)

“Right now you go into the meetings, there are a lot of questions will be asked by the audit committee. They want to know, they want to understand, they want to make sure that they have carried out their work and make inquiries to external auditors... They wanted to know even things that we thought would be immaterial to us but they want to look into it. So, **based on those development in the regulations, the interactions that we have with audit committee actually more interactive.** And it’s not like last time only one person talk and all that...” (EA5)

The evidence on the importance of the regulations on the audit committees’ active behaviour in the interactions with external auditor is indicated by the responses above. The audit partners revealed how meeting the regulations has created an additional challenge to the audit committee, which highlight the struggle of the audit committee to perform their roles and responsibilities effectively. The penalty imposed by the audit committee who failed to detect fraud in the company has caused the audit committee to be more sceptical while interacting with the external auditor. Holding huge monitoring responsibilities towards the company’s account, the audit committee would communicate the information or knowledge they have to the external auditor to ensure that the best audit quality is delivered. Similarly, audit committees would like to be informed on any issues particularly on material issues that possibly affect the conduct of the audit. In this perspective, the underlying rationale is that the audit committee members want the external auditors keep them out of trouble by mitigate potential material risks misstatements that might lead to problem in the future. The finding is consistent with

prior studies (see for example Beasley et al., 2009; Cohen et al., 2010; Dobija, 2015) that found that the regulation has the force and encourage the audit committees to perform their roles effectively.

Interestingly, some of the audit committee members are passive. Although most of the audit committee members were appointed based on their appropriate background required by the regulations (i.e. qualification and expertise), the analysis shows evidence that there were members not actively participate in the interaction which perceived the members' unwillingness to exercise their legitimate power. It appears that audit partners perceived some of the audit committee members were a lack of financial knowledge and information of the organisation which impact their interaction with the external auditor. Some of the partners further opined that there was the little contribution of the audit committee members during the meetings particularly with respect to the conduct of the audit. In support of prior studies (see for example Cohen et al., 2002; Beasley et al., 2009), evidence from the interview comments suggests that some of the audit committee members may not have the expertise and knowledge to discharge their expected roles effectively. In consequence, they would not actively be involved in the interactions during the audit committee meetings. As expressed by the audit partners:

**“...But, some audit committees just don't care, doesn't bother, just come, have a coffee, have a meal and then go home.” (EA3)**

**“One more thing, which an issue nowadays, most of the audit committee members especially from GLC, they already retired. So, the retired person normally will not catch up with current issue. So, when we present especially on FRS, they tend to keep silent, or they just ask any questions, including those who have accounting background. So, regulators need to have some guide on this. Well, that's Malaysia's style nowadays. Those who are retired person at the age 60s to 70s being an audit committee member. And the members usually attended the meeting, but not necessarily they understand or exercise the knowledge. So, it really affect your interaction. The **awareness and understanding of the current issues is very important for the interactions. If not, there wouldn't have active communication with us**” (EA7)**

The audit partners are not alone in perceiving that some of the audit committee members lacked knowledge and information to exercise their duties as audit committee

members. A number of the audit committee members supported this finding by indicating that there are individual audit committee members on their board who lack internal knowledge on the company. These individual committee members tend to keep silent and had no comments or asked questions on any issues raised by the external auditor. For instance, the audit partners would say, 'that's our audit plan for next year. Do you have any question or suggestions?' and the audit committee would reply that there were no questions. In certain situations, the audit committee members ask irrelevant questions during the meetings, in which the audit partners illustrated that the members asked the questions about the basic items in the financial statements included in the external auditors' reports. The audit partners perceived the audit member's eagerness to ask questions as to avoid being seen as passive members. The questions addressed by some of the audit committee members were not sufficiently penetrating to pinpoint the potential issues in a way that challenged the external auditors to any great extent, thereby do not influence the conduct of their audit.

In this perspective, the limited interaction of the individual audit committee members with external auditors may be explained by their lack of detailed knowledge (Gendron et al., 2004; Gendron & Bedard, 2006). Limited detailed knowledge is shown by the lack of the audit committees' skills in questioning the external auditors which are considered as the prime quality in an effective audit committee (Spira, 1999). Asking the relevant and challenging questions requires the members to have knowledge and experience. Audit partners believed that audit committee members required industry background and to be updated with the current issues to being able to pose the right questions. It illustrates the need for audit committee members to update themselves with the current issues or knowledge as highlighted in the quotation above. The audit committee with a willingness to exercise their authority would equip themselves with the required knowledge, for example by attending the seminars or workshops and have frequent interactions with



internal audit function, to improve their understanding particularly on the organisations financial reporting and audit function. It also identified the importance of the audit committee members' expert power in which the lack of knowledge in audit committee members would weaken the trust of external auditors on audit committee members' abilities. This would affect the quality of the audit in which the external auditor has limited information that may be important in conducting the audit (i.e. audit plan, risk assessment).

Furthermore, the audit committee members' responded that some of the members do have the knowledge and experience, but they do not conduct vigilant monitoring roles as required by the regulations.

“Well, based on my experience being an audit committee member in several boards, I can say there are few members who are **not aware of their roles and tend to be passive during the meetings**. They are all selected based on the qualifications they have, so I think not having the expertise would not be a cause for them not to perform. Some of the member do not even read or go through the report provided to us before the AC meeting. Being an audit committee member really requires you to read a lot. Before you go for the meeting, you need to read the report which is usually given before the meeting. So, if you do not read the report, how can you give suggestions and raised any concerns or ask any questions to the external auditor? For me, **we are not only responsible to the shareholders but we are also responsible to our Lord**. As a Muslim, we should be responsible in our task. That's our **'amanah'(trust)**. If everyone has that thing in mind, I'm sure we would do the best we can to ensure good audit”.

(AC3)

The above quote assumes that in certain cases, the audit committee members have the required knowledge to perform their roles as audit committee members. Nonetheless, due to the lack of effort on the preparation for the audit committee meetings, they tend to be passive and do not contribute during the meetings. The interviewee added that she could be actively involved in the interactions with the external auditor and perform her responsibilities as audit committee member due to religious and professional considerations. Recognising the responsibility towards the Creator and the shareholders, the interviewee perceived that it is a must for her to perform her duty effectively. The

member further noted that she devotes significant time by reviewing the relevant documents including financial statements and reports before meetings.

This finding highlights the importance of the audit committee members' willingness to exercise their power as an audit committee member (Mintzberg, 1983; Kalbers & Fogarty, 1993). The findings provide evidence that the expertise alone is helpless without the willingness of the audit committee members to exercise their power in performing their monitoring roles in which some audit committee members play passive roles during the interaction with the external auditors. For an exchange of information in the interaction to exist, it is necessary that audit committee members perceive their power and willing to exercise the power. In particular, the knowledge and expertise are important for the members to know what questions to ask; and the willingness to exert their power is essential for the members to verbalise the question. This is illustrated further in the following quotes:

**"... It depends on the individual intention.** It depends on that one point, who do you have as audit committee members? How interested are they, it goes back to the individual directors? **It is our intention. So, the 'nawaitu' (intention) is important as well as concerned.** So, it translates into us having a good interaction with the internal auditor, management, and external auditors. If there are any problems going on, okay, we want to know. We want to ensure good audit is conducted. In doing so, we should have an inquisitive mind, and keep digging and asking the questions to the external auditor until we are completely convinced and satisfied with the answer". (AC1)

**"All parties should know their roles and responsibilities.** Having that, it will improve their seriousness in doing their job. So again, it should be complement with the experience and knowledge to enable them to be more serious in performing the responsibilities. **If you have enough experience, knowledge, but you don't have a courage or intention to do your job, you will end up not serious in doing your task"** (EA9)

The quotes acknowledge an awareness of how audit committee members' intentions and willingness reflect the interactions between both parties. The sense of responsibility of an audit committee member reflects his/her inner sense or intention to perform their roles effectively and accordingly, support the willingness to exercise the power. The real intention of the individual to perform effectively will boost their willingness to act or

perform during the interaction. The quotes highlight the influence of the willingness of the audit committee members to exercise the power is depend on whether the audit committee is credible for its responsibilities (Turley & Zaman, 2007). The sense of responsibility built a strong inner consciousness that directs individual towards implementation of his responsibilities. Eventually, the audit committee members would be actively involved in the interaction by asking challenging questions and provide recommendations from their knowledge, skills and experience. The following subsection discusses the impact that follows from the power that exercised and not exercised by the audit committee.

#### **4.4.2 The Importance of Trust**

As previously discussed, the analysis shows evidence that the audit committee locate needed resources in terms of asking challenging questions and providing suggestions of the potential area that need further investigation to the external auditors in the audit committee meetings. As such, the act and knowledge of the audit committee members generate feelings of confidence for the audit partners and build trust on the ability of the audit committee members in monitoring the audit function. Accordingly, it will possibly affects the external auditors' performance and conduct during the audit, in which external auditors being more critical and sceptical during risks assessments by taking into consideration suggestions by the audit committee members. As shown in the quote below:

“We took considerations all relevant suggestions from the audit committee. Let say, the audit committee raised concern over certain area. So, when we perform the audit procedures or testing, we will do more in that area. For example, we do not stop at invoice issuance and we look at till the collection. So to what level the audit procedures are carried out. We also challenge the management on the issue raised by the audit committee.” (EA5)

The input provided by the audit committee allows the external auditors to challenge the management further and report any material misstatements. In this light, audit partners and audit committee members perceived audit quality is connected to the ability of the

external auditors to recognise high risks areas which enable them to pose significant challenge to the management about various accounting issues related to the company. This finding also highlights that the ability of the audit committee members suggesting the potential area to the external auditor are important to recognise their experience, knowledge and expertise which reflects the trusts in external auditors on audit committee members, and finally, effect the conduct of the audit. Conversely, the passive act by the audit committee members diminished the trust and confidence of external auditors in the audit committee members' ability to influence the audit process. Illustrating source credibility theory (Hovland & Weiss, 1951), the audit committee member highlighted that the external auditors would not put trust on the audit committee as they perceived audit committee members do not possess sufficient knowledge or expertise.

The existence of trust also illustrates in the situations where there is a disagreement between the external auditors with audit committee. During the interviews, some of the audit partners and audit committee members mentioned that in certain circumstances, they had an arguments or conflict over certain issues during the meetings. In these situations, both parties are willing to discuss and compromise on the issues. The difference in opinion between the audit committee and external auditor sometimes raised over-classification of financial items. The conflict also occurred when the external auditor did not agree certain recommendations suggested by the audit committee members.

In most situations, the conflicts occurred between the external auditors and audit committee members with a non-accounting background. Even though the audit committee members with non-accounting background may not be well-versed with the requirements of financial reporting standards, they usually seek to apply the practical knowledge and expertise that they have in their fields in formulating the questions and recommendations. The audit partners also noted that in certain cases, audit committee

members with non-accounting backgrounds were the most probing and helpful in instigating a more thorough investigation of the certain area in which the external auditors were not familiar with. These members were usually brought different perspectives during the interactions, leading to better audit performance by the external auditors. They are perceived as being able to grasp certain issues particularly on non-accounting issues which related to audit, which may be expected to generate an appropriate level of comfort on certain concerned raised. The external auditors can expand their knowledge and apply the information in the conduct of their audit.

“If there are any issues, it would be **impairments. Impairments tend to be subjective.** The level of impairment and how much you want to impair the value of that particular entity, okay, is subject to debate. It may be incurring losses, so, from what it is as far as book is concerned, and with the losses, you want to impair the value to the balance sheet, and that’s where you can argue, whether it is prudent or not. And then there’s another issue, about us making provisions more than the auditors think we should, and that’s a very strange thing. But, we are a **professional, we discuss the issues and look for the best solutions...**” (AC1)

The quote above is an example of disagreement between the parties during the interactions. In particular, the disagreement arose from non-accounting background member. The audit committee member casts doubt on the impairment amount raised by the external auditor in their report. The member views that the amount of impairment of particular entity suggested by the external auditor was quite significant in which it will cause reported losses to the income of the company. Based on his experience in engineering, the member added that the amount should even lesser than the amount recorded. In such a situation, more discussions were conducted, and both parties tried to reach consensus on the right amount that reflects the impairment value of the entity. Typically, the audit committee member asked the external auditor ‘Why are you providing more than what I think you should?’ And the external auditor related the amount of the impairment with the applicable accounting standards and explained the reason to the audit committee members. The discussions continued until both parties reach an agreement on the issue discussed.

Consistent with Gendron and Bedard (2006) who documented that the different points of view between the parties create opportunities to challenge decisions, the interviewees acknowledged the difference and agreed that it is necessary and act as stimuli that promote more active interactions. It would allow for more discussion of significant issues which may have a high impact on the audit quality. The audit committee members and audit partners also agreed that both parties act professionally and not take things personally in the event that there were differences in the views or opinions during the interactions. This is illustrated in the following quotation:

“Most of them have good background and qualified enough as audit committee members, so they are **professional**, we have **two-way communications** and it is not unusual the audit committee do not agree with us... **we will discuss and this is important because we need the right information so that we can form the right audit opinion**” (EA2)

From the first quote above, it can be deduced that the audit partners believe in the ability of the audit committee members. Similarly, the previous quote above shows that the audit committee member has trust on the expertise of the external auditors. Thus the best solution is discussed and adopted in resolving the impairment issue. In most situations, both parties opted for the best solutions and relied on each individual's expertise. In this context, it is consistent with Kang and Stewart (2007) which highlights the importance of trust in the interaction between both parties. Trust exists in the interaction as each party (i.e. audit committee members and external auditor) understands and relies on the other's expertise during the interaction. Even though there were differences in opinion between both parties, they acknowledge the expertise that each party have, and in turn, they tend to appreciate each other's opinion and further discussions on the subject matter were made. Finally, it will reflect the quality of the audit, in which the best audit approach is adopted, high quality of the audit process is delivered, and hence right audit opinion is formed.

The important element of trust is also seen during the private meeting between both parties. The private meeting is commonly viewed by the audit committees and audit partners as an essential feature of the interactions between both parties which enable transparency of exchanges and critique, particularly from the external auditor perspectives. Both groups of interviewees perceived that the private meetings also facilitates the confidential exchanges between both parties as it places the external auditor in a more powerful position, to be frank and share their honest views on certain issues especially those that relates to the management (Gendron et al., 2004; Gendron & Bedard, 2006). In this respect, audit committees questioned the external auditors about any difficult issues raised during the course of the audit and whether they discovered any difficulties to access the information required for their audit. The lack of private meetings between both parties as noted by the audit committee member (as mentioned in Section 4.3) raises significant concerns over the audit process as the meeting is an important platform to resolve any issue which is management related or sensitive audit issues.

During the private meetings, key issues such as on operational audit, industry issues and others are discussed which enhance the knowledge of the audit committee as illustrate in the quotation below. Furthermore, both groups of interviewees also demonstrate that they often discussed any inaction by management or the issues that were neglected by the management even after the external auditors brought the issues to their attention. In this respect, the audit committee would ask the external auditor on the cooperation given by the management during the audit, and eventually, the external auditor would express their concerns and responses on such issues during the meetings. This is evidenced in the following quotes:

“...In the private meetings, we discuss the key concerns for example, what areas to concentrate on which enrich the audit committee knowledge; operational audit as well as overall industry issues. And during the private meetings, we discuss about the **internal audit issues** as well... the **management related issues that we cannot say in front of the management**. I think it does help in the private sessions, usually they are **more open** because it is a closed door between them and us...” (EA9)

“...If the audit committee members have some concerns then they will let us know, ‘I don’t want to discuss in front of management but I want you to look at this. These are the area that we are concern and so you have to look through to these things’. And then they will ask ‘what about the interactions with the management? Are they giving attention to your request’? So **if we didn’t get cooperation from management or other parties** and things like that, we will **highlight those to the audit committee** during that private session. For example, in one case we need to obtain more reliable audit evidence from external party by sending out the confirmation letter. But the management suddenly did not allow us to submit the confirmation letter. We explained to them why we want to submit the letter but they still refused, then we brought the issue to the audit committee”. (EA5)

“We will have another item whereby the management will have to leave the room for us to have a private discussion with the auditors. And then we will ask them, I mean, **‘is there any issues that you would like to inform us which you feel reluctant to say in front of the management’?** And then, **‘do you get your cooperation’?** And all those things” (AC2)

Consistent with Gendron and Bedard (2006), the above quotes highlight that the private meeting between both parties play important roles in building openness and trustworthiness, in which the meeting helps the external auditor to raise and discuss sensitive matters with the audit committee members. For example, the audit partners viewed that they are more open and willing to express things especially on sensitive matters (i.e. the issue with the management) during the private meetings. Through the private meetings, the external auditor will feel comfortable to voice their opinion, and thus possible action can be taken in time and more issues can be resolved. The external auditors also put their trust on the audit committee’s ability to resolve the issues rose during the private meeting such as cooperation with the management. As shown in the second quote above, the audit partner shared his experience whereby the management refused to allow the external audit team to submit the confirmation letter to the external party. The audit partner was then bringing the issue to the audit committee’s attention.

Given the nature of private meetings between the external auditors and audit committee, it is not surprising that the private discussions do normally help the external auditors in gathering the audit evidence which is important to achieve audit quality. As a result of the private meeting, the audit committee will direct the management to provide the documents needed by the external auditor in a situation where the management



refused to fulfil the external auditors' requests for specific audit evidence. The act by the audit committee will ensure that management is taking action and provide the external auditors with the required documents. Occasionally, the audit committee will follow up in the following audit committee meeting.

“...for example, **if management refused to provide the documents that we need for the audit, the audit committee will direct the management to do so.** Most audit committees are very helpful and usually they concerned on the matters or issues that we raised up. “(EA1)

“So, that will also help to improve the audit quality. It keeps the management on their toes... and it makes our life easier. So, **that help with the quality in terms of... you know management take audit seriously, they are more responsive, when we asked for documents etc.** So, that's the thing” (EA5)

A significant finding from the interviews are the role of social interaction, between the external auditor and audit committee, in fostering trust between the parties and eventually affect the interaction and audit quality. It is also part of the informal channel of interaction between the parties in which this interaction often referred by the interviewees as the communication that not task related. Even though no discussions on job-related issues during this interaction, both audit committee members and audit partners perceived that this interaction has an indirect effect on the information sharing between the parties and quality of the audit. It is clear that the other channels of interaction (particularly AC meetings, EA presentation, private meeting and special meetings) have been facilitated by the existence of social interaction between the parties. It is noteworthy that this is not a practice recommended in codes of recommended best practice, such as MCCG by Securities Commission or BMLR by Bursa Malaysia.

The fact that this interaction may not discuss the issues related to their conduct of the audit, what is significant is that it can create informal contact between the external auditor and audit committee. In particular, the audit partners note that the social interaction helps to create rapport and establish trust between the parties, and therefore, contribute to improving the interaction between the parties particularly informal interaction. The

existence of social interaction in practice clearly impacts on the overall interactions between the parties which appear to be associated with the frequent informal interactions conducted between them. Not only does communication of external auditors and audit committee members in the social interaction influence the frequency of the other channel of informal interactions, but it also influences the discussion in the meeting and eventually affects the audit quality.

Both formal and informal interactions are facilitated by the fact that both external auditor and audit committee meet each other during any occasions and thus have an opportunity to communicate informally. To diminish the barriers in the formal and informal interaction which related to their task in audit, the interviewees suggested that the parties should foster social interaction to increase trust, understanding and knowledge creation between the parties. Through the social interactions, it helps both parties to know more about each other's background and experience, thus, allows the external auditor to form a network with the audit committee. The interviewees stated that they have social interaction during several occasions such as events conducted by the organisation (festival celebrations etc.) or the workshop organised by the audit firm which involved the audit committee members and internal audit function in the industry. The audit partners consider that being a Big Four audit firm is a strength that provides better chances to have social interaction with the audit committee as the firm would frequently organise the workshop that involved the audit committees. Since Malaysia has a small pool of experienced audit committee members (Mat Zain & Subramaniam, 2007), the chances to meet with the members during these occasions are high.

“Our audit firm usually organise series of courses or discussion of monthly basis (workshop) with regard to the new financial standards, requirements and regulations (i.e. new FRS etc.) which usually attended by the audit committee members and sometimes internal auditors. During these courses, we have chances to interact with them. Well, **it may not be job related** but we have chit chat over anything and sometimes, we meet with the audit committee and internal audit function during other occasions such as open house, ‘Jamuan Hari Raya’, by the clients. It is always good to **create rapport** and it is normal. Then, **it is easier to deal and discuss later on our**

**audit task.** In Malaysia, we have a small community of the audit committees whereby some of the audit committee holds few directorships. So, we usually meet the same audit committee members. “(EA2)

“...we do have social meetings with them for example during company function like company annual dinner. We **don't discuss any work related issue during the function** and usually we **talk more on personal matters**. But, I can say **this kind of meetings influence our interaction later on because during the social meetings, we can know the AC members better, their background, I mean their field of expertise etc....**So, yes, this interaction can make the audit committee easy to pick up the phone or to call the audit committee chairman for example, as they feel comfortable with us...” (EA6)

The quote above assumes that the trust must be established to foster strong relationship between the parties. In this light, the social interaction supports the accumulation knowledge between the parties (Tregaskls et al., 2010) and create a good vibe between the external auditor and audit committee which is necessary and important for the informal interaction between them that eventually facilitate the external auditor in the conduct of their audit. This is consistent with Bigley and Pearce (1998) who viewed that the individual's personal knowledge of the other person drive his thoughts and actions towards that person in their relationship, in which it affect trust between them. This is also consistent with Richard (2006) who suggests that trust develops and is based on a shared experience. The external auditor and audit committee members get to know each other through the social interaction and accordingly they start to trust each other. The information shared during their interaction will perceived credible by each party as they know the background and expertise of each other, and correspondingly, will assist the external auditor in the audit process.

The audit partners further enhance the importance of the social interaction in which it would make them easier to have informal interaction and interact during the formal interaction with audit committee once the trust has been established. The outcome of the social interaction will normally make it easier for the audit committee to respond to the issues raised by the external auditors through the informal interactions arranged between the parties. Such interaction that can provide the external auditor with valuable

information such as better understanding to risk and internal control system which lead to better audit quality. The external auditors then can be somewhat assured that they deliver quality audit by performing the right audit opinion from the responses provided by the audit committee.

It is evident that both formal (audit committee meeting, external auditors' presentations and reports, and private meetings) and informal interactions (phone or email, *ad hoc* or special meeting, social interaction) between external auditors with audit committee members are connected to a range of potential individual authority, attributes and willingness which have an impact on the conduct of the audit such as on audit planning, risk assessments, evidence gathering and timeliness of the audit. The authority, attributes and willingness illustrate the power of the individuals (i.e. audit committee members) which affect the credibility of the information provided to the external auditor. These interactions are also connected to social interaction in developing trust between the parties and eventually allow for more interactions between the parties. In conclusion, both power and trust are crucial in the interaction between the parties to affect the quality of the audit.

#### **4.4.3 Interactions and Audit Quality**

As noted in the literature review chapter, the audit committee effectiveness has positive relationship with outcome measures of audit quality (i.e. restatements, litigation, financial reporting quality and effectiveness of external auditor's report). Based on the insights from the interviews, the interactions between audit committee with external auditor have indirect affect to the audit quality, in terms of financial reporting quality. In the literature, financial reporting quality has been linked to the auditor's ability to improve credibility of earnings (Kim et al., 2003), the accuracy of the audit opinion (Feroz et al.,

1991), and the accuracy of the information reported by the auditor (Davidson and Neu, 1993).

As discussed in the above subsections, the audit committee asking challenging questions and providing suggestions to the external auditor. Given the active participation by the audit committee in probing questions and provides suggestions on the potential risk area, it is not surprising that discussions normally lead to changes in the external auditors' work, particularly their audit plan and risks assessments. Often, the interviewees noted that assessing risk is highly related to various audit planning and conducting all audits which are important to achieve high audit quality. It would ensure that the external auditors challenge the management on the right key issues and make certain that they form their judgement on the right key areas.

“...so normally **we would suggest to the external auditors areas that we have any concern**. For example, **revenue recognition**, we want to make sure that they look at that because the revenue recognition is very tricky business. I mean, particularly if you are on contract type of business where you need to recognise your revenue... because sometimes, you do the work before you got the contract, and you do the job first before you sign the contract. The contract come later and then how it should be recorded? How you recognise this revenue, it's very tricky, especially the contract with government because situation sometimes is not normal and at the same time, we must be in comply with the accounting principles, accounting standard and so on... (AC4)

As illustrated in the above quote, the audit committees' suggestions often tend to be concerned with particular items, for example, the level of audit coverage given to revenue recognition considering its risks of material misstatement. As illustrated in the above quote, in revenue recognition, it was found to be difficult to recognise the right amount of revenue to be reported in the financial statement. The audit committee members specifically give an example on the issue of revenue recognition involving contract type business with government institution whereby the job often conducted even before the contract is finalised. It gives a problem to the company to recognise the revenue in which it would like to declare the revenue based on the job done while at the same time it needs to comply with related accounting principles and standards. The audit committee member

raised his concern on the issue to the external auditor to ensure that proper audit procedure can be carried out to minimise the risk of earnings misstatement so as to increase the audit quality. It will increase the accuracy of the information reported by the auditor and produce more accurate audit opinion.

As illustrated in the below quote, the audit plan is thus modified by the external auditor with the input from the audit committee and then reported to the audit committee for authorisation. Additional audit effort and audit work (Walo, 1995; Guess et al., 2000; Beaulieu, 2001) would be conducted in that area to minimise earnings manipulation risk (Bedard & Johnstone, 2004). The suggestions provided by the audit committee members enable the external auditors to conduct better risk assessments and increase the external auditors' ability to detect material misstatements, thereby form the right judgement.

**“Audit quality usually relates on how well we assess the risk.** We need to identify the right risks to know the area that we need to focus on... so, when we go to the audit, we will do the planning first to identify what happened in risk assessment, focus area and all those things. We **need to firm up the risk assessment** because it will affect the audit plan and testing. And yes, **from the interactions with the AC we can get the idea on high risk area.** Once we know the risk area, we know what to focus on, we can design the testing to address, and we know how we are going to challenge the management.” (EA4)

In a similar manner, the act of the audit committee in resolving disputes between the external auditors with management also can enhance the financial reporting quality. As shown in the following quote:

**“The audit committee will get the response or the feedback on the management, they will hear from the auditors.** And based on my experience, **a lot of it towards the auditors.** [...] for example, we say that we need to do the impairment for any asset, and we should use the discounted cash flow which is based on the new standard. Let's say in this case it is 12%. So, when we use the discounted cash flow, the client say they use WACC (weighted average cost), 8%... but as auditors, we take it through our valuation especially things like that...then, we would say to them 'it shouldn't be 8%, and it should be 12%.' It is this kind of difference. And if the management do not agree with that, we should address this issue to the audit committee. Then the audit committee will decide based on both sides' explanations” (EA5)

The above example illustrates the dispute between external auditors with management over an accounting method choice. In this case, the external auditor proposed to the management that the impairment value should be calculated based on discounted cash

flow instead of weighted average cost. The difference in the proposed amounts by both parties was quite significant. Since it involved material value and the management refused to accept the suggestion by the external auditor on that particular matter, the issue was taken to the audit committee. The issue is then solved whereby the best option is selected according to the financial reporting standard.

The issue of impairment discussed above illustrates two points. First, it highlights that the external auditors put their trusts on the ability of the audit committees to resolve the issues. The audit committee has required expertise to mediate the disputes between both parties (Salleh & Steward, 2012a, 2012b). Second, it can ensure that the accuracy of the financial information is provided and increase the propensity of the auditors to issue an accurate audit opinion. The interactions lead to greater monitoring by the members, thus, lowering the control risk for the auditor. Furthermore, the presence of high quality information sharing between both parties may sharpen the focus of the external auditor and enhance overall audit process.

It is, however, depending on how well both parties play their roles and use their expertise properly to influence the interaction and the quality of the audit. As previously discussed, the power and trust established between the parties through the interactions is important to enhance the audit quality. Both parties must exhibit the commitment in the interaction to ensure that it has impacts on the performance of the audit process accordingly financial reporting quality. As discussed in the previous subsection, the interviews also provide insights where the audit committee play passive roles during the interactions. They did not perform their monitoring responsibilities as required by the standard. As such, the interactions between the parties would not contribute to the financial reporting quality and it may reduce the propensity of the auditors to issue an accurate audit opinion.

“When they are do not really perform or they don’t really see... **they won’t actually have an impact.** So, that’s why more and more professional qualified person to sit on the AC and the board is very important. Because they can push the management if the auditors brings up the issue. And the implication of it the audit committee will push the management. They would probably help to improve the financial information better. And the governance better.” **(EA3)**

As shown in the above quote, the audit partner responses that the passive audit committee will not bring much impact on the audit function. It is clearly that this practice is not recommended by the standards and regulations. Consequently, it may create uncomfortable feeling about the risk assessment and internal control of the company which requires the external auditor to look for more audit evidence to challenge the management that may lengthen the audit process.

#### **4.5 Interaction between External Auditor with Internal Audit Function in Practice**

Besides the interaction with the audit committee, the interaction with internal audit function is also deemed necessary for the external auditor to enhance the quality of the audit. A real interaction between the external auditor and internal audit function in practice is perceived to be important by most of the interviewees and in line with guidelines and standards (ISA 315, 610) which promote the interaction between both parties. For example, ISA 610 which emphasised on the use of the work of the internal audit function by the external auditor encouraged the discussions and communications between these parties throughout the audit period.

Consistent with the analysis of the interactions between the external auditors with audit committees, it is observed that the audit partners and heads of the internal audit function also framed their nature of interaction around two types of interaction-formal and informal interactions. Most of the interviewees illustrate that they have discussed the audit issues and findings through the formal channel of interaction including IA report and private meetings between both parties. Both groups of interviewees were in agreement that the IA report is a key channel of formal interaction, in which the IA report



including their working papers used by the external auditor as one of the sources of information in their audit. Furthermore, a number of the interviewees highlight that they often interact during the audit through the informal channel of interactions such as phone or email, informal meetings and social meetings. The nature of the interaction between the interviewees (external auditor and internal audit function) are summarised below in Table 4-5.

It is notable that the IA report was sent to the external auditor every year which provides the external auditor with the necessary information for the audit, especially on risks and control. All the audit partners indicate that they assess the reports and recommendations issued by the internal audit function. As mentioned by the following audit partner and the head of the internal audit function:

“But, for our audit, when we conduct the audit, **we will review the work of internal auditor through IA report**. We usually request the IA report from them”. (EA7)

“When the auditor comes in to audit, they will come to see me and **asked for the report**. The external auditor usually reviews the report and basically the reports are complete, which **presenting the process internally**” (HIAF1)

In addition to the IA report, the responses show that audit partners and the head of the internal audit function meets privately without the other parties being present to discuss their audit plan, risk assessments and other audit related issues. This channel of interaction was commonly practised by the financial institutions, which is known for its stringent regulations and the tight regulatory environment. One of the heads of the internal audit function from the financial organisations stated that the private meetings were conducted as to comply with the regulations.

“All financial institutions are subject to the same ruling. So one of the **unwritten requirements, even in our audit charter also it spelt out the need for two parties, to discuss**. So whenever before they commence the audit, they will come and see me first and we will have private meeting...” (HIAF9)

Interestingly, despite the importance of the private meeting to the quality of the audit, some of the audit partners and heads of the internal audit function mentioned

that the private meeting between both parties is limited in practice. The following quote provides evidence on the limited private meeting between the parties:

“I can say that we don’t have much private meeting with the internal audit. As far as I remember, **we don’t have regular private meeting. It’s very limited.** Only few clients that we have frequent private meeting with them, which mostly from financial industry”. (EA8)

The finding highlighted that the private meeting is not common in practice. However, in general, both interviewees were in agreement that the private meeting is important to influence the audit quality in which the best audit plan can be adopted, and material issues can be discussed further during the meeting.

Analysis of interview data revealed that a small number of audit partners and the head of the internal audit function have informal interaction between the parties in which it often took place during the conduct of the audit. Even though both interviewees were in agreement that the informal interaction between both parties is important, most of the audit partners and the head of the internal audit function recognised that there was a less informal interaction between them in practice. Most of the interviewees opined that the informal meeting between external auditors with internal auditor was limited, and some of the interviewees mentioned that their interaction is limited to the IA report only. The next quote provides a picture of limited interaction between both parties:

“**We don’t usually used to have informal interaction with them.** We don’t really rely on them but we just want to know their existence and what they have for the purposes of determining the nature, extent and timing of our work. Because if they have a strong internal audit function, that will implies that internal control environment is conducive and therefore we can consider to adopt control relies strategy. But however, if the internal auditor is not really working, just one person and all that, sometimes, we don’t ever bother”. (EA3)

“Yes, we admit that **interaction between external and internal auditor may be somewhat lacking,** but we do share information when we need to do so. We **provide them with our internal audit reports for their review** just to make sure that nothing is left out or any big issues are not left out of their audit”. (HIAF3)

The first quote illustrates that the external auditors would not have informal interaction and relies on the internal auditors if they perceived the internal auditors are incompetent

in performing their job. Conversely, a different picture was drawn when analysing the comments from the head of the internal audit function. Some of the heads of the internal audit function appear to believe that they have done a good job on their audit and presented the audit findings properly in the IA report. Thus no further discussions are needed. The head of the internal audit function perceived that the IA report alone is sufficient to provide information on the organisations' operations and compliance on the internal control systems which important for the external auditors in their conduct of audit. The following quotation further illustrates the views concerning this issue:

“Interactions may seem to be a bit lacking, but work is still being done without problem. For now, this may be because we do not see the need to meet periodically or to have scheduled monthly meeting etc. It has never been practised here before and this may also be the cause. I think it is **not necessary for them to see us since there were no issue**. They already have our report and they may gain information that they need from the report even though we not sure which part of the report that actually help them in doing their job. So far, we did not have any claim or comment from the external audit about the report”. (HIAF10)

From the above quotes, it appears that audit partners and the head of the internal audit function have different views on the lack of informal interaction between both parties.

**Table 4-5: Summary of Responses on the Interactions between External Auditor and Internal Audit Function**

	Number of EAs <sup>a</sup>	Number of HIAFs
<b>Panel A:</b>		
<b>RQ1: How do the interactions between external auditors with internal audit function take place in the companies?</b>		
<b>Types of interaction</b>		
- Formal	10	10
- Informal	10	6
<b>Channel of interaction</b>		
- IA report	10	10
- Private meetings	10	6
- Informal <sup>b</sup>	10	6
- Social Meetings	7	5
<b>Person involved</b>		
- EA partner & senior manager	10	10
- HIAF	10	10
- EA team	10	6
- IA team	10	6
<b>Common issues discussed</b>		
- Audit plan/scope	10	10
- Audit issues/ findings	10	10
- Risk and control issues	10	6
- Fraud issues	10	4

<sup>a</sup> The summary on the on the audit partners' responses based on the perceptions of audit partners on their overall experiences in interaction with internal audit function

<sup>b</sup> Informal interaction (i.e. phone or email and special meetings) between both parties was rare and lacking in practice

#### **4.6 The Interaction between External Auditor with Internal Audit Function and Its Effect on Audit Quality: The Importance of Power and Trust**

The first question underlying the nature of the interactions between the internal audit function and the external audit was directed to the audit partners and heads of the internal audit function to establish the influence of the interaction on the audit quality. Based on the interviews, most of the audit partners and heads of the internal audit function perceived the importance of the interaction to improve the audit quality. In general, it is in line with much of the extant literature on interaction between these two parties, (i.e. Goodwin-Stewart, 2004; Arena & Azzone, 2009; Mihret, 2010) as discussed in Chapter 2 (2.3.3), which revealed the importance of the cooperation and interaction that can bring mutual benefits for both parties, and accordingly enhance the quality of the audit (Mihret & Admassu, 2011; ISA610).

Again, the benefits of interactions between the parties on the audit quality will depend on the power and trust established during the interaction. The analysis shows that most interviewees emphasise the need for the involvement of the audit committee members and internal audit function and exercise their power during the interaction to achieve a better audit process. Interestingly, the analysis of the interviews, however, as will be evident in later sections, lack of information exchange and interactions between the parties in certain instances caused by a lack of power exert and trust established between the parties, does not enhance the audit process. The discussion below details the important roles of power and trust in the interaction between the external auditor and internal audit function which influence the audit quality based on the perspectives of external audit partner or audit senior manager and heads of the internal audit function.

#### 4.6.1 The Importance of Power

Frequently during the interviews, the audit partners and the head of the internal audit functions indicate the importance of their interactions in which it can be a platform for information exchange between the two parties. For example, both parties have private meetings without the other parties being present to discuss their audit plan, audit findings, compliance, fraud and others issues which are important for both parties in performing their responsibilities. Consistent with prior studies (Turley & Zaman, 2007; Zaman & Sarens, 2013), the first quote below illustrates that the private meeting is an important channel of interaction for both parties to exchange their honest views and opinions. In normal practice, both parties attended the audit committee meetings but do not have a direct discussion between both parties.

“...we has **several meetings to share**. Because sometimes, in your position there is off record, cannot report. Not because we don't want to declare. We declare at the certain level and it would be resolved. But for them, they should know...” (HIAF2)

In particular, the head of the internal audit functions tended to express that the interaction on the audit plan or audit scope is important to ensure that there is no duplications of work. Most of the heads of the internal audit function under study indicated that such interaction should exist between the parties to ensure the redundancy of work is at minimum. The discussions may lead to adjustments to both parties' audit plans based upon the recommendations and agreement reached, thereby reducing any unnecessary duplication of work for both parties. It illustrates that both parties rely on each other credibility and competence in ensuring the adequate audit coverage were performed. This is illustrated by the following assertions:

“For example, we will show the annual audit plan for 2014 at the end of the year 2013. During the meeting, **we usually mention proposed coverage for the audit and then the external audit will put comments on the audit plan**”. (HIAF4)

“[...] firstly, in term of audit plan and scope of work. We **try to eliminate the redundancy of duplications of work**. That's the first thing we discuss. They look into our audit plan, overall audit plan. Because they are normally engaged for five-year period. So they can plan for their audit for following years. Let say, we plan to

conduct audit on equity business, but we limit our scope of review to only review the dealing and the equity operation and all, but other areas like share margin-financing and what not, we defer it. So when we do the deferment on certain areas, and when external audit come, they will look into areas that excluded from our work scope". **(HIAF6)**

In the quotes above, the head of the internal audit function emphasised that the audit plans of both parties were linked and coordinated in the meeting, to some extent, it can avoid redundancy in the conduct of the audit and accordingly, proper audit plan applied by both parties. In the meetings, both parties will present their audit plan in which a consensus is normally reached between the parties on their audit coverage (Felix et al., 1998; Sarens & De Beelde, 2006). The internal audit functions may gain feedback from the external auditors (Mihret et al., 2010) and vice versa. From this interaction (i.e. private meeting), the external auditors can have an information of the area that they need to focus on for their audit during the year.

Reference is made to the internal auditor's audit plan to identify the focus area in their audit and also may indicate the audit plan for the following year as a consequence of the external auditor's views on the internal auditor's audit coverage. In particular, the internal auditors would not cover the areas that have been covered by the external auditors. Similarly, the external auditors would usually place greater attention on the certain areas that not are covered by the internal auditors. Such interactions allow both parties to assist each other in performing their roles (Al-Twaijry et al., 2004; Coram et al., 2008) and deepen their relationships (Pickett, 2004). The interviewees under study further indicate that the close relationship between both parties can enhance the effectiveness of the internal audit function within the companies (Gramling et al., 2004; Mat Zain et al., 2006) and increase its opportunity to suggest potential issues that affect the external auditors' audit plan (Felix et al., 1998). This eventually influences the quality of the audit as the best audit plan adopted during the audit.

The responses also discovered that the internal audit function will interact with external auditors with regards to audit findings, compliance issues, fraud issues and other audit issues. The following quotes provides a picture concerning this view:

“So, **before they commence the audit**, they will come and see me first. We will discuss any issue raised such as **fraud issue, internal control, whether the system of the company meet with the requirement or not etc.**” (HIAF8)

“We also got to work in term of **audit issues**, which may trigger external audits to actually review a bit further. Because sometimes there could be some audit issues that we internally have validity, but there could be some integration to the financial as a whole. For example, internally, we don't define materiality. I mean, if in term of governance, we will review all areas, whereas financial audit, external auditors, when they come here, they will look into the financial statement, they will only focus those transactions, above certain materiality. That is the issue. So that if that continues, they may overlook on certain areas” (HIAF9)

“...normally we discuss with the internal audit function about the **timetable audit (i.e. final, interim), any issues arise** and etc. From there, we can get some insights on certain issues that we need to focus on...” (EA1)

As noted, any audit issue is discussed during the meetings in which the head of the internal audit function gives his/her insights on certain matters from their conduct of internal audit. It helps the external auditors to know the root causes of the issues that they discovered. Although the external auditor's primary concern is on the financial statements, the non-financial matters or issues provided or discussed by the internal audit function have an influence on the financial statement and does affect their conduct of the audit.

As illustrated in the second quote, both groups of interviewees believe that the internal auditors may potentially discover complex issues that external auditors would not normally observe during their work as internal auditors generally have more knowledge and better understandings on business operations (Gramling, 1999; Coram et al., 2008; Arena & Azzone, 2009). For example, without defining the materiality level, the internal auditors would inspect all the areas in their audit and potentially discover certain audit issues during the audit. In such circumstances, the head of the internal audit function may



take the initiative to discuss the issue with the external auditors during their meetings, thereby affect the external judgement on the determining the high risks area. This eventually provides insights to the external auditors on the conduct of their audit.

A perceived influence of the interaction between external auditors and internal audit function on the quality of the audit is also illustrated by the IA report sent to the external auditors every year which provides the external auditor with the necessary information for the audit, especially on risks and control. Analysis of the responses illustrate that the IA report generally discusses the multiple aspects of the audit that have been conducted by the internal audit function throughout the year, including the processes involved, the areas reviewed by internal auditors, the findings that have been highlighted in the audit, the level of reporting and other matters of significance that may impact negatively on the organisation. The level audit carried out and findings discovered by the internal audit functions will influence the contents of the IA report. . All the audit partners indicate that they assess the reports and recommendations issued by the internal audit function. As mentioned by the following audit partner and the head of the internal audit function:

“But, for our audit, when we conduct the audit, **we will review the work of internal auditor through IA report**. We usually request the IA report from them”. (EA7)

“When the auditor comes in to audit, they will come to see me and **asked for the report**. The external auditor usually reviews the report and basically the reports are complete, which **presenting the process internally**” (HIAF1)

As suggested by prior studies (Coram et al., 2008; Sarens et al., 2009; Desai et al., 2010), the internal audit function acquire knowledge of the processes, risks and controls in the organisation as their work touches every corner of the organisation. In fact, by monitoring the internal control systems of the company, the interviewees perceived that the internal audit function could provide feedback on the effectiveness of the controls through the IA report and help the external auditors in their risks assessment. The finding highlights that that external auditor sometimes use the IA report to accomplish their audit.

The IA report provides the external auditor with an indication of the area that has been focused on by the internal audit function and the deficiencies raised by the audit. Even, a small number of the audit partners stated that the report highlights issues which not indicated by the management. According to an audit partner, as illustrate in second quote below, the external auditors might reduce the scope of their audit on an information technology (IT) section if they satisfied that the internal audit function has sufficiently covered the scope of the work. This eventually allows the external auditors to carry out a more detailed examination. Even though this does not reduce the responsibility of external auditors, it does help to minimise the time used in their conduct of audit.

“We will **refer to and relate with their audit scope**. For example, cash count, we will look at their report. From the report, we can know whether we will improve, extend or do it differently. So, sometimes we **rely on the information they provided in the report**”. (EA6)

“As an auditor, normally, we want to **focus on the issue**. We will look at the overall IA report, and that’s why IA report is very important. If the report is very good, for example, in terms of IT, if everything is good after we went through the report, then we would not pay much attention on that area. Even sometimes, they highlight the issue which the management not aware of. So, whatever big issues they highlighted in there, we will follow up with their Head of Internal Audit later on to clarify whether the issues can give big impact or not to the financial statement”. (EA7)

Similar evidence is mentioned by the head of the internal audit function as shown in the following quote:

“...They look on our statement of internal control and risk management from our report, and they go through our audit plan, **audit report, and working papers**. They rely on us in terms of policies and procedures, sales and marketing review, human resource, security, safety health policies, insurance, and most importantly risk management framework. They rely on us for reviewing the risk management framework and structure within the organisation. These are all part of it, non-financial controls where we play a very big role. External audit is very finance focused, so that’s how their reliance factor comes in here”. (HIAF6)

The report is also used as an indicative of performance of the internal audit function, in which it demonstrates the level of audit activities conducted by the internal audit function. In general, the report is used by the external auditor to develop expectations in their conduct of the audit. Most of the audit partners expressed that this kind of information is valuable to the external auditor to carry out their tasks, particularly while

assessing the risks and evidence gathering. Evidence is in the following statements by the audit partners the importance of the IA report in understanding the processes and risks area. Referring to an example of Construction Company, the audit partner revealed that the issues discovered in the IA report might help the external auditors to assess the area with high risks:

“In terms of risk, the **internal audit will prepare overall risk assessment** and then we will look at the control feature at various levels including governance level and we identify the weaknesses. We always prioritize which area that we should focus on and we will always prioritize the financial statement”. (EA7)

“...This is to **enable us to determine the risk area**, which area has more risks. For example, Construction Company, if on the site they have subcontract, we will ask them, ‘is there any issue with subcontract, is there any issue other than those’. So, we can know. The interaction is more on assessing the report, assessing their plan and has the interaction with them so that what they know about the companies can help us to determine the significant risk is in which area...” (EA5)

The quotes below further demonstrate the importance of IA report in understanding the process and assessing the risks. The risk register discussed in the IA report provides an information to the external auditor, and more attention will be given to high risks area compared to low and moderate risks area in their audit. Through the interaction, both parties can get a clear picture on the risks involved in the organisation that they should focus on. It also will give an indication to the external auditors on the areas that may contain material misstatements and accordingly reduce the detection risks.

“In this company practice, the internal audit involved with the risk management and every subsidiary has their risk register. **In the risk register, it discusses the risks opportunity.** The risks have been categorised in few categories such as catastrophic risk, moderate risk, low risk etc. So, basically most of the subsidiaries have the catastrophic risk area. I think the external auditors definitely will take the control in this area and they may know which area that they should focus on. So, they will pay more attention in this area when they are doing the audit” (HIAF8)

“...under risk-based auditing, you have to identify areas which is high risk, and then you have to prioritize it...So, in our report, we will highlight what are the risks, their control, and how the control would be the recommendations, to adjust the control, the inconsistencies. That’s how we work. External auditor will look into risk-based as well. So in our discussion, first we discussed all the risk areas. But, of course, there could potentially it may have some differences. Maybe to my definition it is high risk area, external audit say, ‘no, this is not...it could be just moderate risk’, for instance. They have their own justification for that, we also have our own basis for that, and then we discuss. And from the report, **external auditor will use that report to actually evaluate the effectiveness of the controls established in that business unit to**

**mitigate that risk.** That's how we interact with external auditor on risk management".  
(HIAF9)

Furthermore, the audit partners and the head of the internal audit function view that the IA report and working papers provided to the external auditor can be a basis of reference to the external auditor. Even though the substance of the IA report cannot be primary evidence for their audit, the audit partners illustrate that the substance of the report can be a source of reference in the evidence gathering process which help to indicate the external auditors have gathered appropriate and sufficient evidence. As an example illustrated by the audit partner in the quote below, the experience and knowledge of the internal auditors is perceived as valuable to help the external auditors to discover the issue that relates to certain regulations that the external auditors did not aware of. This has important implications on the evidence gathering process by the external auditors in which it indicates that more evidence should be gathered in the said area before the external auditors conclude their opinion. In the same time, the external auditor can ensure that they have form their opinion based on the applicable accounting standards and they have conform to other related standards as illustrated in the first quote bellows. The audit partner believed that audit quality is not only about meeting the various requirements of the accounting standards and guidelines but also about meeting the other applicable standards for the company. As indicated by the audit partners:

"In terms of evidence gathering **we can use their report and the info they provide as a basis of information, but not as primary audit evidence.** [...]This is because the company itself have their own regulations and are not restricted to the Companies Act only. For example, this listed company is under or subsidiary to Ministry of Finance (MOF). When we look at the evidence from the Companies Act perspectives, everything is okay, but actually there are other guidelines that we are not aware of. So, based on the MOF's guidelines, they should follow certain things and we as external auditor not aware of that matter. So, there was an issue and the internal audit function discovered the issue as they understand the companies better than we do" (EA4)

"Internal audit is helpful **when we have a dispute with the management.** For example, the management says the provision for this is 20%, but when we check it should be 19%. When things like this happened, we refer the internal audit report. If the report says it is 19%, we then show it to the management and asked them to change. The

internal audit basically have conducted audit regarding the business process operations. That is why we can rely on them, as a **basis of our arguments and source of information**". (EA1)

The quote above shows that the external auditor relied on the internal audit function in which they refer to the findings in the IA report in determine the appropriateness and sufficiency of their audit evidence. The external auditors also develop their expectations from the information provided by the internal auditors, compare them to the financial figures, and then seek explanations from the management on the differences. It enables the external auditor to challenge the management by using the information provided by the internal audit function as a basis to support their argument. The quality of the challenge of the external auditors to the management is important so as to ensure that the financial statements are credible.

The quote below illustrates another example of how the internal auditors assist the external auditor in gathering audit evidence. Frequently during the interviews, the audit partners and the head of the internal audit function relates their interaction with the materiality issue. Due to the time constraints, the external auditor gathers the audit evidence on the sampling basis, in which the samples are decided based on the materiality level. In contrast, the internal audit function conducted the audit and covered all the areas without determining the level of materiality. In this light, the information or key findings of the internal audit can help the external auditor to ensure that they do not overlook important evidence. It can assure the external auditor that sufficient work and evidence has been gathered to support an audit opinion. Furthermore, in the case of where the fraud issues discovered, both parties work together to solve the issues.

"Internally, we don't define materiality. We will review all based on important areas, whereas external auditors, they will look into the financial statement, they will only focus those transactions which above certain materiality. But, from our standpoint, every single cent is considered material for us. So anything below that, would not be looked at by them. That is the issue. If that continues, they may overlook on certain areas. But we look into that as well. So, in short, **we are assisting for their audit evidence, they can base on us**". (HIAF5)

In the event that issues are discovered by any party (internal audit function or external auditor), the party who discovered the issue would contact the other party and further discussions will be held accordingly. This will enable the external auditor to assess whether appropriate attention and action are taken to avoid future issues and to ensure the audit process is conducted properly. The following quote implies that the internal audit functions are proactive and had several informal interactions with the external auditors throughout the financial year.

“So, I just **share the information with them and when they highlighted something during the audit**, I will share what I understand about the company. I will give you an example. What happened was based on internal audit report; we noted that there is some discrepancy on the financial. We make a conclusion saying that we unable to verify which one are accurate [...] and the number is substantial run to millions. So, balloted to audit committee and before that we pre-empt the external auditor. And we proposed that a special audit to be done ... so, they come and see us. We share our comments. When they're done, they come back to see us and share their findings. We give some inputs. So that's important for quality audit.”  
(HIAF2)

Again, the evidence of the external auditor and internal auditors' competency is indicated in the quote above in which the internal auditors raised some concern involving large amount based on their audit findings. The issue was then brought to the audit committee and external auditor's attention and accordingly special meeting were conducted to solve the issue. Both parties (external auditor and internal auditors) communicate to each other to find the best solution.

The responses discuss above evidence that the related effect of the interaction between these two parties on the quality of the audit is conditioned by positive expert and will power of the internal audit function. Although a related schedule of meetings or informal meetings provide room for both parties to the information exchange, the manner in which both parties act during the meeting plays a critical role in determining their power and the effect of the interaction to the quality of the audit. It illustrates the willingness of the head

of the internal audit function to share their knowledge and expertise to the external auditor which channelled through the meetings between these parties and IA report have influenced the external auditors' audit plan, risk assessments and evidence gathering. Having practical experiences in day-to-day operations of the organisation (Gramling, 1999; Arena & Azzone, 2009; Alzeban & Sawan, 2015), internal audit function alluded its positive expert power by communicates the knowledge and information they have to the external auditor which can contribute to the conduct of the audit process.

The findings also highlight that some of the internal audit functions have sufficient knowledge on the organisation (Coram et al., 2008; Desai et al., 2010) which reflected through the discussions and IA report provided to the external auditor. The knowledge channel through the IA report seems to be a critical factor which impacts the positive expert power of the internal audit function in driving the interaction between the parties and the influence on the quality of the audit. The IA report which provides reasonable assurance regarding the adequacy and effectiveness of the organisation's internal control illustrate the competency of the internal auditors in performing their oversight roles. As such, the internal auditors hold positive expert power, in which with the knowledge on the business operations and procedures, it become a source of power to the internal audit function that can help to increase the audit efficiencies (Abbott et al., 2012). For example, the information provided in the risk register revealed the level of competency of the internal auditor on the risk management and illustrated their positive expert power, thereby reflecting the source credibility. The external auditor, therefore, relies on the information which they perceived as credible and applied in their risk assessments. By relying on the information in the IA report, external auditors can save their time and cost as they do not repeat the same work which have been conducted by the internal auditors.

#### 4.6.2 The Importance of Trust

In the interviews, most of the audit partners drew attention to the importance of the IA report quality. The influence of IA report on the audit process signified through external auditors' assessment of the content of the auditors' reports. For example, in explaining the substance of the IA report, the following audit partner and the head of the internal audit function illustrates the importance of the contents of the report for the external auditors in determining the credibility of the sources and their reliance on the IA report:

“At first, I would review the report and look through the information provided in the report. From there, I can see their yearly activities, I mean their scope area and also the issues that they raised. **From the information provided itself we can know whether the report is good or not. If it is good, then we usually have further discussions to get clarifications on certain issues raised in the report that related to our audit. But if it doesn't, then we do not rely and there is no reason to hold any other discussion with them.** So, that's why we request for IA report”. (EA7)

“The format for the report is the same every year, but the contents of the report would be different from year to year, depends on the issues raised during the year. For example, we raised the issue for last year and then the management did not take any action, then we go to the management and do the follow up. If they are still not take any action, and then we reported this issue in our report under recurring issues part. **I like to believe that this kind of information is important for the external auditor**”. (HIAF8)

Furthermore, supporting documents provided together with the IA report enhance the confidence of the external auditor to rely on the report which illustrate in the following quotes. The external auditors would request additional information such as access to working papers to collect corroborating evidence, if they perceived that the IA report could be relied on. The audit partners mentioned that the access to the internal auditors' working papers is made available to the external auditors in most organisations.

“...the report covers several sections. For example, the expenses like marketing expense. We will look at the supporting document and test is it reasonable for the expense to occur. Let say, for mileage claim for marketing expenses, if the amount claimed for short distance trip is high and it is unreasonable, we look back at the supporting document and if something wrong then we will question the management. Usually, the external audit will rely on this kind of information which will help to improve their audit work. So, **with the supporting documents that we have in our audit, it will make them comfortable with the information.** They would also then ask our working papers. **Because they want to be comfort that the numbers in the accounts are accurate.** As reason but reasonably accurate. So, that's where we are. They acquire internal auditor's opinion”. (HIAF4)



“If the **documentation is not sufficient**, then we can know their level. We can know whether the internal auditors are really doing their job or not”. (EA6)

Consistent with Clark et al. (1981), the above quotes shows that the quality of the report is important to influence the quality of the audit . This is because the content of the report would provide the information to the external auditor in their conduct of the audit. As it illustrates in the first quotation above, the information reported in the IA report can help the external auditors to challenge more the management on certain audit issues. With sufficient information provided in the report, the external auditors became comfortable with their conduct of audit by assessing the extent to which the management addressed the deficiencies highlighted in the IA reports. It would help the external auditor to feel assured that they have provided accurate information on the integrity of financial statement. Thus, there is no doubt that the IA report is necessary for the external auditors in the conduct of their audit (Lampe & Sutton, 1994).

However, if the report does not provide adequate information on internal auditors' audit activities, then it will be ineffective in the interaction and eventually does not affect the quality of the audit. In particular, if the information provided in the IA report is inadequate, the external auditor could as well receive inadequate information which might be vital in the conduct of their audit. The above quotes also highlight that the IA report can be a significant benchmark on the competency of the internal audit function which accordingly affects the confidence and trust on internal audit function. The audit findings, the issues raised, and recommendations provided in the IA report may provide a signal to external auditor whether or not the internal audit function can be relied on. Again, this is in line with Lampe and Sutton (1994) who identified that the report has the greatest effect and significant determinant of internal audit performance and quality.

Source credibility (Hovland and Weiss, 1951) is hence realized within this interaction. Trust is established between the parties in which the external auditor acknowledged the

information provided by the head of the internal audit function and does applied the information in the conduct of their audit. From this angle, the competence of the internal audit function in performing their roles generates confidence and trust in the external auditor on the internal audit findings and information suggested by the head of the internal audit function.

Interestingly, during the interviews, the audit partners expressed deep concern that the IA report from several internal audit functions do not provide information that they need for the audit, and thus, they cannot rely on the report. They are not convinced enough with the IA report provided to them and perceived that some of the internal audit functions are not aware of its role especially in risk management. For example, as illustrated in first quote below, an audit partner describes that his team cannot rely on the IA report of one of their clients as it lacked substance and supporting evidence. One of the audit partners argued that his team has experience that the internal audit function refused to provide the IA report to them. Due to the low quality of the IA report, the external auditor cannot rely on the report and accordingly it does not have an influence on the quality of the audit.

“It depends on who prepared the IA report. We sometimes had an **IA report which does not provide supporting information on the issue**. In the worst case scenario, they **did not address the issue in the IA report**. They just provided the report without highlighting the audit issues and supporting documents, that wasn’t going to do it. How we can get the confidence on the information provided? So, for me, at the end of the day there is the situation that your judgement would be there but you don’t really want to rely on the internal audit. And then you have to test on your own.” (EA3)

“...it depends on the company. Not all internal audit function cooperate with us. Even, I had experiences where **the internal audit function didn’t provide us with the IA report**. Supposedly they should give us the report, but if they refused, that was their right. Well, I just think maybe they don’t have the information, I mean, they did not do their job” (EA7)

The responses show that some of the audit partners are sceptical about the performance of the internal audit function. It can be deduced that in the event that the external auditor perceived IA report quality to be low, the external auditor will not rely on the information provided in the report, and hence, no further interaction between the parties. The refusal

of external auditors to interact further with the internal audit function during the audit is in fact indicated their concern or worry on the information provided and the ability of the internal audit function. The lack of IA report quality may influence perceived credibility of internal auditors that may cause external auditors to perceive them as not credible and trustworthy. As such, the external auditors did not foresee the need for a further channel of informal interactions with the internal auditors. In short, the external auditors have some doubts about the ability of the internal audit function reflecting the trust and information exchange between the parties.

In such situations, the external auditors need to do more work testing as the internal auditors did not provide such reliable information for them. This has important implications for the expert power of internal auditors in providing insights on the internal control and risk management of the company. The low quality of the IA report is indicated that the internal auditors do not hold positive expert power, thereby reflects the source credibility. Given the lack of competency and information in the IA report, it is not surprising that the external auditors would not have further interaction with internal audit function. It is noteworthy that this is not a practice recommended by the standards (i.e. ISA 315; 610).

The findings are consistent with Richard (2006) who documented the importance of trust in the relationship between the auditee and auditor, in which it can influence the exchange of information between the parties. In particular, the lack of trust between the parties has contributed to the lack of interaction between the external auditor and internal auditor. External auditors are willing to generate productive interactions with internal audit function only if they trust the internal auditors. The findings are also in line with Granovetter (1985) who find that the formation of trust will lead to the repeated interactions which eventually enhance the information sharing between the parties.

Again, these findings illustrate the source credibility theory as the external auditors put little trust in the internal audit function if they perceived the internal auditor's lack of competence or expertise. Accordingly, the external auditor would not rely on the information provided in the IA report by the internal audit function. The findings also illustrate that some of the internal audit function does not realise its potential value as an important party to disseminate the information on the organisation to the external auditor which eventually add value to the audit process.

The discussions above highlight that the competency of the internal audit function is important to established the trust between external auditor and internal audit function. Apart from that, interpersonal quality is also a key. Frequently during the interviews, the interviewees highlight the importance of interpersonal quality to support the informal meeting between both parties, in which it has found to have a greater impact on the role behaviours of individual during the interaction. In fact, some of the interviewees viewed the individual interpersonal quality is more important attributes than the knowledge and skills they have. The interviewees relate the interpersonal quality with certain attributes or characteristics such as honesty, respect and humbleness. These attributes or characters of the individual can help to establish the rapport and trust between them in which the external auditors may perceive the internal auditors as trustworthy, and accordingly, create the environment which promotes transparency during the interaction. If the external auditors perceived that the internal auditors are not honest or lack attitudes, they potentially limit their informal interaction with internal auditors. In such a situation, the external auditors may lose the bigger picture of the organisation's operations, and thus, possibly the audit conclusions will be impaired.

The interviewees further illustrate that it is important to discuss matters in a frank manner which may promote regular informal interaction between the parties. The audit

partners, in the following quotes, express the importance of the interpersonal quality of each party which, in turn, allowed for more interactions and information exchange between the parties:

“All parties should be **frank when delivering their roles**. For example, the internal auditor should immediately and directly communicate all his suspicions of any major issues that they discovered in their audit. Such a direct form of communication to us is very important, because when we do the audit, we don't want surprises. If every parties be **frank, and communicate the information timely**, then no problem would arise during the interaction... and the quality of the audit can be improved as well...” (EA2)

“**Public relation** and your **personal attitude** are very important. If you have regular communication and **respect each other**, then there is tendency that the internal auditors will communicate the things that they refuse, something that difficult for them to convey. When you show the respect to each other, they will feel comfortable, and they will share the information during meetings. These are some of the characteristics that are lacking in governance practices, I guess”. (EA5)

“To deal with the human behaviour is the most difficult part. The internal auditors or audit committee members usually comes from various backgrounds. As for internal auditors, it can be trained to make them understand about the internal audit. So, qualifications or your background doesn't matter. The most important thing is you should have **right attitude on how to respect people especially when you interact or communicate**. We should use the right approach to communicate. Even when we want to ask any documents from them also we need to use the right approach. Only then, your interaction with them later on would be done smoothly”. (EA8)

The above quotes are consistent with the head of the internal audit function's view concerning this issue:

“...and another one is **humbleness**. Being an internal auditor if you are not humble, you are dead. It is also important for the external auditor as well. It is more comfortable to communicate with this kind of person. I don't really like to have a conversation with somebody that couldn't show empathy and just go 'I've got a list of questions that I want to ask you'. And to share the information with humble person would be easier and we don't feel reluctant to share”. (HIAF2)

The finding indicates that the interpersonal quality has an impact on the interaction that is regarded important to enhance the performance of audit process and accordingly, quality of the audit. Based on source credibility theory (Hovland & Weiss, 1951), the external auditors limit their informal interaction when internal auditor's credibility is diminished. For example, as illustrated in the above quotes, both parties consider the respect and humbleness in the individuals involved in the informal interaction are important which allow both parties to be comfortable with each other's to discuss any

issues and exchange information. The head of the internal audit function claimed that they would feel refuse to share the information if they perceived that the external auditors are a lack of humbleness and respect towards them.

Interestingly, the audit partners have noted the unpleasant experience of interact with the internal audit function. A number of the audit partners revealed their experience interact with the internal auditors who were a lack of honesty, which affect their informal interaction and quality of the audit. As such, the audit partners believed that the interactions between the parties do not have a significant impact on audit quality. For example, while discussing their audit findings in a vague or inappropriate manner, the internal auditors do not disclose all the information they have which would likely reduce the likelihood that the external auditors would identify potential issues raised.

An evidence of the critical nature of the honest relationship between external auditor and internal audit function is indicated by the issues surrounding provision of doubtful debt as illustrated in the quote below. The audit partner was surprised with the undisclosed information by the internal auditors which discovered later by the external auditors during their audit. It is then affected the interactions between the parties. The audit partner expressed deep concern on the dishonest behaviour of internal auditor which eventually affect the timeliness of the report. The act of the internal auditors has caused the external auditor lost their trust on the internal auditor and reflected their reliance decision on the internal auditor. The external auditors commonly devoted more audit work and time, and finally, they cannot meet their audit timeline. The external auditor needs to spend considerable time and effort to ensure that they have formed the right opinion. In general, audit process can be impaired if there were no proper and honest interaction between internal audit function and it can affect the timeliness of the audit report. Both parties recognise the possible effect of the dishonest behaviour or act by the internal audit

function, in which it would discourage the very cooperation and interactions between the parties. An audit partner explains:

“When we do the audit, **we don’t want the surprises**. For example, I had an experience where our audit team members do the audit in the area that is confusing, provision of doubtful debt. The internal auditors said everything was good and they did not give forthcoming. They hide something and did not highlight the issue. In a situation where we discovered the issue, we ask the internal auditors and they admit the issue. Usually the external audit doing audit on sampling basis. **When things like this happened, we broaden our scope and we spend more time and it affected the timeline and shareholders not satisfied**. It would be good if the internal auditors can identify, resolve the issues and communicate to us on timely basis. So, it will use a lot to address the issue and for us, the **speed of work is very important**”. (EA2)

The above quote further illustrates that ‘no surprise’ is central in delivering quality of the audit. Therefore, as the other independent party for the organisation, it is crucial for the internal audit function to address any concerns and quickly pick up on inaccuracies to the external auditor promptly. The information, particularly on significant risks, should be reported without delay to the external auditor. This is to ensure that the external auditor can meet the audit timeline to meet the shareholders’ satisfactions. It is therefore, informal interactions between external auditors and internal audit function is facilitated by the fact that both parties exercise right attitude or present good interpersonal values.

With the interpersonal quality within the individual involved in the interaction, any important issues can be discussed and take into consideration during the audit process. As suggested by Williamson et al. (1996), the audit partners illustrate the issues raised by the internal audit function through their interaction particularly through the IA report and informal meetings help the external auditor to respond promptly to the issues raised during the audit process. Hence, the external auditor can complete the audit within the established timeline.

“In audit, we have the timeline which basically established in the audit plan. So, **we need to ensure the audit is done and coincide with the timeline**. So, for me, this is where the interaction with both parties, internal auditors and audit committees is important, because the information and resources like support from audit committee to instruct the management, or maybe issues raised by the internal auditor is helpful for us to meet the deadline. **Because we need to meet the deadline, and it represents our name and the quality of the audit itself**” (EA8)

The above quote illustrates the importance of the external auditors to meet the deadline as it is considered as an integral feature of audit quality and affect the reputation of the audit firm. It also affects the client retention in which the external auditors need to conclude their audit in a timely manner to meet the expectations of the client and shareholders. In the case where the external auditor failed to meet the audit timeline, it might affect shareholders' confidence and trust concerning the quality of services that they offer. As such, the timeliness of the audit is one of key determinants in satisfying the client and shareholders, and eventually retains the client.

In general, the interactions (formal and informal) between both parties are important to enhance the audit process such as on evidence gathering, risk assessments and timeline of the audit. The information exchange during the interactions allows the external auditors to focus on the right high risks area and collect sufficient appropriate evidence, while meet the audit timeline. In conclusion, the interactions between these two parties depends on few factors, (i) the perceived competence and expertise of the internal auditors; (ii) the way IA reports are prepared; and (iii) the interpersonal quality of both parties (i.e. honesty, respect and humbleness). These factors are evidence of the power of the parties and trust established between the parties. The analysis shows that the trust established leads to more information exchange and frequent interactions between the parties, thereby in line with prior studies (Cross et al., 2001; Borgatti & Cross, 2003). It is noteworthy that without the power and trust between the parties, the interaction would not have an impact on the quality of audit.

#### **4.6.3 Interactions and Audit Quality**

Based on the discussions above, it is found that the interactions between external auditor have an impact on audit quality which is driven by the power exercised and trust established between the parties. Consistent with the impact of the interactions between



external auditor and audit committee, the interactions between external auditors with internal audit function also have an impact on financial reporting quality. Specifically, the interactions between these two parties may help to uncover fraudulent activities and ensure more accurate financial information and audit opinion reported.

Based on the responses, the interviewees often strongly associates sufficient audit coverage with the meaning of audit quality. In this light, the audit partners expressed the view that good audit plan is important for them to feel comfortable and confident that they are delivering high-quality audit in which they have covered all the area that they are supposed to. In other words, both parties felt that the external auditors have incorporated the best audit approach and strategy in their audit plan. Thus, right audit opinion is formed. As one of the audit partners notes:

“Talking about audit quality... I would say that perceived quality is when **you have covered all the audit scope that you are supposed to**. What you should do, then you should do. It is almost impossible for you to check everything because of time constraints and costs as well. So, **to guide you that you have covered all the area, then you need to have good audit plan...**that’s one of the measure...” (EA9)

The external auditor needs to obtain a continuous understanding about the client’s company throughout the audit. This is to ensure that the external auditor may be able to assess the business risks faced by the entity and how those risks may affect the risk of material misstatements. Without the interactions with internal audit function, the external auditors may lose sight of a bigger picture of the company, thus affect their risk assessments (Knechel et al., 2013) and accordingly it may affect the external auditors’ abilities to provide accurate information.

In obtaining information about the clients, the external auditor may enquire the internal audit function apart from management. As discussed in the previous subsections, interactions or inquiries directed to the internal audit function might help the external

auditor to identify business risks and understand the potential misstatement that may result. This is supported by the following quote:

“We will also pick up issues which are problematic and try to solve the issues. There will be some discussion, and they will need to justify. Though they have their own quality assurance, but quote unquote we say internally I’m being the quality assurance for their audit work as well. Because sometimes, you cannot see every single thing, in one big picture just by reading through some documents. You need to understand the cost effect of it, why things happen that way. If you just look at the effects, and then you conclude and draw a conclusion from that effect, without understanding of the why, what it causes, you may have a wrong conclusion”  
(HIAF8)

The quote illustrates that the interactions between external auditors with internal audit function may help the external auditor to obtain knowledge about the client’s entity and solve any issues raised. Based on knowledge of the entity and its environment, the auditor may determine the audit procedures that are necessary based on that risk assessment. At this point, in the risk assessment process, the auditor needs to consider how the identified risks could result in a material misstatement in the financial statements. Eventually, it will help the external auditor to provide accurate audit opinion.

In like manner, the audit partners interviewed in the study also associated the meaning of audit quality with obtaining appropriate and sufficient audit evidence to support audit opinion. This is in line with the importance of the interaction between the external auditor with internal audit function which can help the external auditor to assure that they have gathered or collected appropriate and sufficient audit evidence to support their audit opinion. As illustrated in the following quote:

“To attain the audit quality, **we should make sure that we collect sufficient appropriate audit evidence to support our opinion.** That’s probably what we should do. But however, there are really instances where even when if you follow everything you may have not been able to detect some of this because there are group of people out there who actually perpetrate fraud and all that you know... it is very difficult for you to do it but I think **audit quality definitely relates with obtaining sufficient appropriate audit evidence to support the opinion you see...** so, we got to make sure that all our working papers are properly supported with audit evidence. That’s how we actually do the works...” (EA3)

In addition, the interactions between the parties may help to uncover fraudulent activities occurred in the company. The following quote provides a specific example of fraud issues occurred during the year which regards to the manipulation of the stock account. The external auditors were then taking cautious action in which extra attention would be given in that area. The primary concern of both parties is to ensure that the best approach is adopted in their audit . It also ensures that all the possible risks were taken into account to ensure that the external auditors provide accurate information on the financial information and fairness of the financial statements.

“There was case of **misuse of fund** and we have private meeting to discuss the issue with the external audit. There was also case of **stock manipulation** last year where the person in charge manipulates the stock account, the amount they reported is not the same as the actual stock amount. We do the stock take for all the stock and we can notice and know how the person in charge manipulates the stock account. So, we reported this issue in the findings of the report and the external audit take not this issue and this will help them to do their job. In this case, we tell the external auditor” **(HIAF6)**

This is further supported by the following quote:

“We usually have a meeting **when there is any issue raised**. For example, recently, there was an issue on inventory. Towards the end of last year, around November to December, someone blew the whistle about the manipulation of the inventory record worth millions ringgit, more than RM1 million. The case was reported to the CFO and then to board, audit committee and finally to the internal audit and external audit. Then, we concurrently check the case. We, as internal audit focus mainly on the process, how it happened. Meanwhile, the external auditors check the exposure, they check whether the amount reported was correct or more than that. For example, if it reported RM1million was manipulated, is it really RM1million or more or maybe less... we will do the checking concurrently and during this time, the exchanges of the information were quite extensive. So, overall the extensive interactions occurred based on project basis...” **(HIAF4)**

Further evidence is indicated by the issues on manipulation of the inventory record. Both parties, external auditor and internal auditors, took several actions and the exchange their information to solve the issue. The internal auditors communicate, inform and discuss their findings as much as possible with the external auditors who have led to increased level of interaction between the parties. The act of information exchange between these parties illustrates that they perceived the information shared as credible

and trustworthy, thus enhance their confidence and trust on each other. Both examples above show that the interaction between the parties will influence the conduct of external auditors' audit process. Such discussions may provide information that will assist the auditor in uncovering fraud. Here, the high audit quality is expressed by way of how the external auditors deal with the accounting and auditing issues discovered during the audit that could affect the credibility of financial figures, which reflects the audit quality.

Nevertheless, in the event the internal audit function did not perform its roles appropriately, it will result in less interaction between the parties. As discussed in previous sections, the external auditor will perceive that the internal auditor is less competent and the information provided is less credible. Without such transactions, it is doubtful whether the external auditor discovered the issue and right audit could be formed if the internal auditors did not bring the issue to the attention of the external auditors and the information exchange did not occur between the parties.

#### **4.7 Summary and Conclusion**

The discussions above have provided empirical evidence on the nature of interaction between external auditor with audit committee and internal audit function in practice. It has provided some interesting insights on the actual practice of the parties in the interaction and the influence of the interaction on the quality of audit process. Power and source credibility, both seem, can be found in various situations during the interactions. As discussed in the Chapter 3 (Section 3.3), the interaction between these parties is shaped through individuals' power in exercising the roles and responsibilities and the trust established between them. Thus, all parties need to use the authority, expertise, knowledge, and experience they have during the interaction in order to establish trust between them which eventually influence the quality of audit process.

Primarily, this study suggests that the interactions between external auditor with audit committee and internal audit function can simultaneously impact the quality of audit process in terms of audit plan, risk assessments, evidence gathering and timeliness. Two types of interactions with different medium of interactions are identified to influence the quality of audit process. First, formal interaction is related to the interactions between the parties which are conducted on the regular basis and specified formal responsibilities. Second, informal interaction refers to the interaction that occurred on occasional basis which those recognised in the formal structure. The study also reveals that these three parties interact particularly through the formal interactions whereby the analysis have evidence limited informal interaction between these parties.

With respect to the interactions between external auditors with audit committee, the evidence on the perceptions of audit partners and audit committee members on their interactions have provide some interesting insights. The general pattern based on the responses indicates that the audit committees in most organisations have sufficient knowledge, expertise and experience to fulfil their responsibilities, by actively involve during the interactions with the external auditor. The evidence have illustrate that the external auditor have interact with audit committee largely through formal interactions in which they have interact through audit committee meetings where the external auditor presents their audit plan, audit findings and other key issues, external audit report and private meeting. The formal interactions were often described in the interviews where the external auditor and audit committee can expressed their views and concerns on the audit issues which eventually influence the quality of audit process. For example, the audit committee members asking challenging questions on certain issues and provide suggestions during audit committee meetings have influence on the audit approach and risk assessments. Similarly, the interviewees often describe that the audit partners expressed their views during the private meetings particularly on sensitive issues which

finally influence the evidence gathering in the conduct of audit. The private meeting was illustrates as an important channel for both parties as it helps to generate trust between the parties. During the interactions, the audit partners also communicate their knowledge on the current accounting standards to the audit committee members which eventually enhance the audit committee members' monitoring roles. With such interactions between these two parties, it finally affects the audit quality in terms of more accurate financial information and audit opinion.

The informal interaction between these parties found to be limited due to time limitation. This is inconsistent with prior studies (Turley & Zaman, 2007; Sarens et al., 2013; Zaman & Sarens, 2013) who view informal process can provide significant contribution on the audit committee activities and effectiveness. However, it is notable that the audit partners who frequently have social interaction with the audit committee members often manage to have informal interaction with audit committee. The audit partners and audit committee members believed that the social interaction helps to establish trust between the parties, and therefore, help to improve the interaction between the parties. The external auditors then can communicate the issues to the audit committees immediately and accordingly several action can be taken to solve the issues thereby reduce the risks of material misstatements in the financial statements.

Such interpretations are, however, influenced by the knowledge, experience and expertise of the audit committee members and the willingness to exert their power. The analysis has evidence that some audit committees play passive role during the interaction. Even though some of them were found qualified as an audit committee member, they did not involve actively during the interaction with external auditors, illustrating the unwillingness of the members to exercise their power. The passive acts of the members can reduce the level of trust in external auditors on the members' abilities and thus, reduce

the influence that they may have and or/ exercise on the audit function. However, consistent with prior studies (Beasley et al., 2009; Cohen et al., 2010; Dobija, 2015), the majority of the interviewees agreed that the recent changes in regulatory framework introduce pressure to the audit committees, thus force them to be more rigorous in performing their prescribed roles particularly in audit function.

Concerning the interaction between external auditors with internal audit function, some of the interviewees illustrate regular formal and informal interaction in certain organisation. Based on the insights provided by these interviewees, both types of interactions have effects on the quality of audit process. For example, the private meeting between the parties allow for more discussions on certain audit issues and risk management; and the informal interaction allow both parties to discuss the issues arise during the audit such as fraud and others. These interactions have effects on the quality of audit process in terms of risks assessment, evidence gathering and timeliness of the report and eventually enhance financial reporting quality and provide more accurate audit opinion. This is consistent with Abbott et al. (2012) who suggested that internal audit assistance may result in greater audit efficiencies.

Nonetheless, deep concern has been expressed by most of the audit partners where there is limited interaction particularly informal interaction between the parties in practice. Rather, both groups of interviewees indicated that their interaction largely driven by IA report. Both groups of interviewees however believed that in organisation with effective audit committee, the information or knowledge of internal audit function were communicated to the external auditor through the audit committee whereby the internal audit function has direct reporting to the audit committee. In such circumstances, the interaction between external auditor and internal audit function is indirectly influence the audit planning and risks assessments by the external auditor. Further reflections on this

issue reveal that the lack of trust in external auditors on the ability of the internal audit function were perceived to be one of the reasons of the limited interaction between the parties. In some circumstances, the audit partners find that the internal auditors were lacking of competence and thus, the information provided were perceived as incredible by the external auditors. This will influence the quality of audit process such as timeliness of the report.

In general, the overall impression that emerges from the interviews discussed in this chapter is related to the power hold by all the external auditor, audit committee and internal audit function; and trust established between the parties. The power theory (French & Raven, 1959; Raven, 1965; Raven 1992; Kalbers and Fogarty, 1993; Erchul and Raven, 1997) and source credibility theory (Hovland & Weiss, 1951) has provide a rich set of findings that has remarkably improved understanding of the interaction and their influence on the audit process. The major insights on the interaction between the external auditor with audit committee and internal audit function; and their influence on quality of audit process is summarised in the Figure 4-1 and 4-2 below.

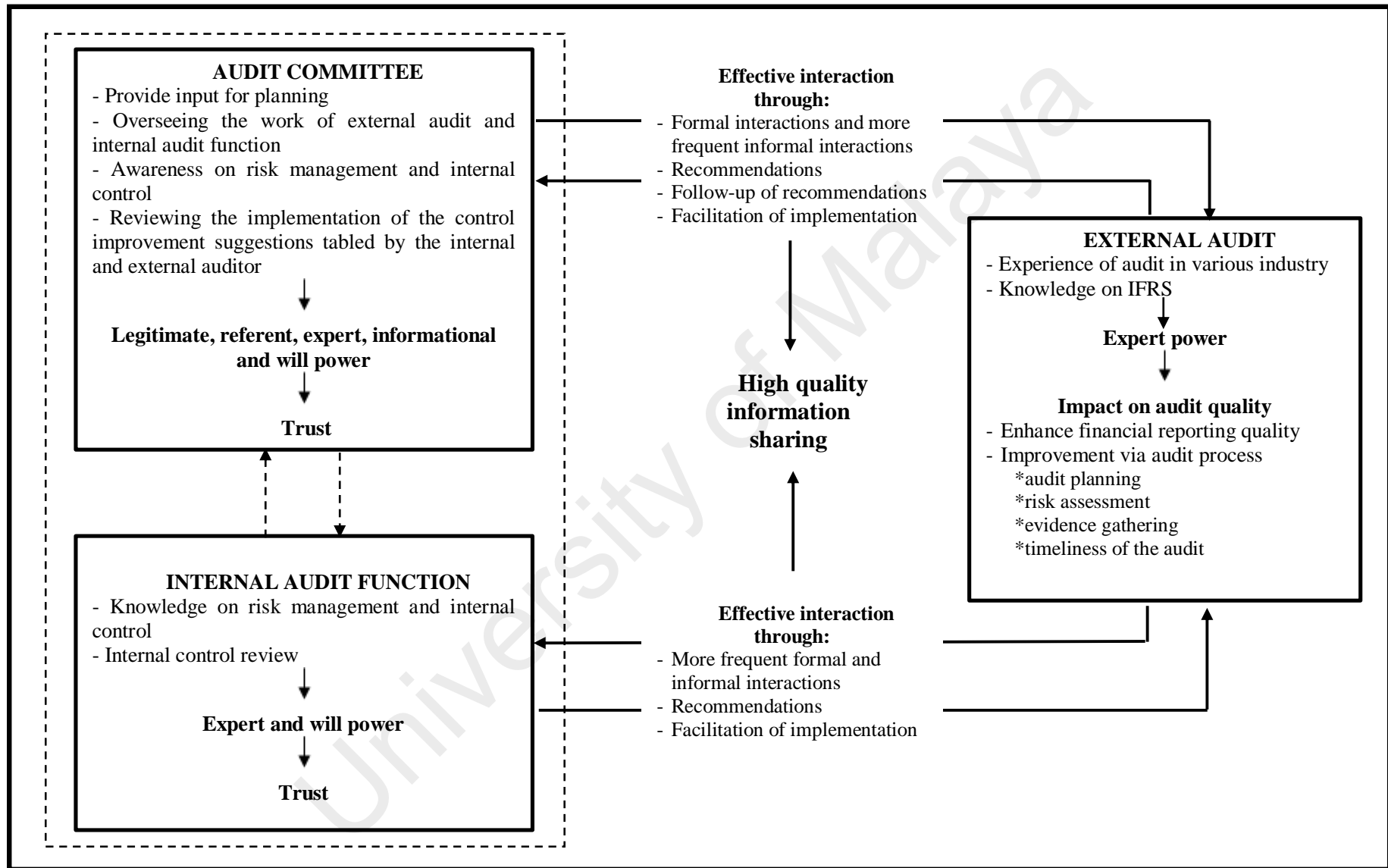
Based upon the insights from the interviews, Figure 4-1 shows the effects of the interactions between the three key parties on the audit quality where all the parties play their monitoring roles effectively. Audit committee that exercise its legitimate, coercive, informational, expert and will power will encourage more effective interactions with external auditor through their formal and informal interactions. Similarly, the internal audit function that exercises their positive expert power and will power will help to create more effective and frequent interactions with external auditor. The power exercise by both parties will establish the trust among them which leads to high quality information sharing as the external auditor perceived the suggestions and information provided by audit committee and internal audit function as credible. These interactions will affect the



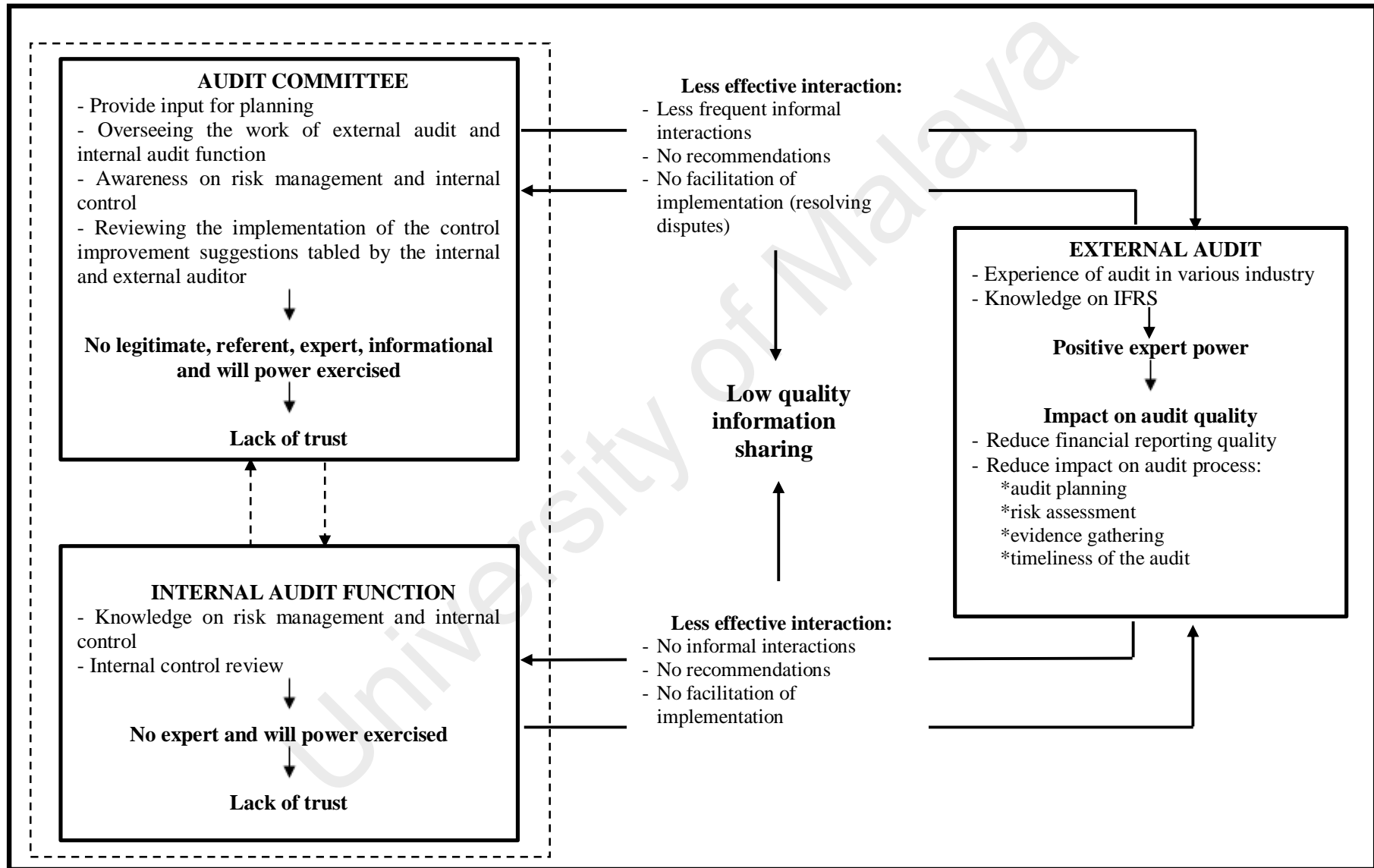
audit quality of audit process, whereby it can improve the audit planning, risk assessment, evidence gathering and timeliness of the audit. Eventually, it enhances the financial reporting quality.

The interviews also provide insights that certain audit committee and internal audit function do not exercise their power. Figure 4-2 illustrated the insights in a situation where these two parties did not perform their monitoring responsibilities. Accordingly, it will affect the trust between the parties and information shared by the audit committee and internal audit function will be perceived as incredible by the external auditor. Even though the external auditor has various experience, knowledge and skills in the industry, they also need information from the audit committee and internal audit function about the client's organisations to perform the audit. Without effective interactions among them, the external auditor may not be able to reduce the possibility of material misstatements which eventually affect the financial reporting quality.

**Figure 4-1: Major insights on the effective interactions between corporate governance players and their impact on audit quality**



**Figure 4-2: Major insights on the less effective interactions between corporate governance players and their impact on audit quality**



The overall impression that emerges from the interviews discussed in this chapter is related to the power hold by all the external auditor, audit committee and internal audit function; and trust established between the parties. The power theory (French & Raven, 1959; Raven, 1965; Raven 1992; Kalbers and Fogarty, 1993; Erchul and Raven, 1997) and source credibility theory (Hovland & Weiss, 1951) has provided a rich set of findings that has remarkably improved understanding of the interaction and their influence on the audit quality. It is notable that the conduct of the audit may only be enhanced when an external auditor is surrounded by audit committee members and internal audit function which permitting the sharing of information and matters of concern to be discussed. The analysis demonstrates that without the involvement by all parties during the interaction, the interaction would not have an influence on the audit quality. Therefore, the awareness of the parties particularly audit committee members and internal audit function in performing their roles and responsibilities is critical to enhancing the quality of the audit. The elements discussed in the power theory and elements of source credibility theory provide a logical connection of how the interactions can influence the audit quality.

## CHAPTER 5: CONCLUSION

### 5.1 Introduction

This chapter summarises the results and evidence, outlines possible contributions and implications arising from the study and provides suggestions for future research. In Chapter 4, the nature of the interaction between external auditor with audit committee and internal audit function in practice were explored to understand the influence of the interaction to the audit quality. The perceptions of audit partners, audit committee members and heads of the internal audit function concerning the subject of the study were explored.

This study extends prior studies on audit quality by broadening theoretical and empirical approaches to understanding the audit quality. Rather than looking at indirect signals or proxy of audit quality, the study has focused on the influence of the interactions between external auditor with audit committee and internal audit function on the audit quality. This thesis has sought to add to the understanding of how the interactions between these parties take place in practice and the potential influence of the interactions on the external auditors' approach to conducting the audit.

Prior studies assert that the interactions between the external auditor with audit committee (Bedard & Gendron, 2010; Cohen et al., 2010) and internal audit function (Felix et al., 1998; Engle, 1999; Al-Twaijry et al., 2004) are important in enhancing the audit quality. In conducting the audit, the external auditor needs sufficient information to ensure that they made sound judgements for the audit processes (Brown-Liburd et al., 2015), and thus, the information from other independent parties (i.e. audit committee and internal audit function) are necessary for the better audit performance (IAASB, 2013). A review of literature found that most of the prior studies in this area has adopted an archival approach in investigating the relationship between the parties and audit quality (Abbott

et al., 2003; Goodwin-Stewart & Kent, 2006; Suwaidan & Qasim, 2010), which focuses on variables to examine possible associations or cause and effect of the proxies for the relationship of the parties and audit quality. Despite the substantial contribution of the research to the body of knowledge on the relationships or associations between the parties and audit quality, it provides limited information about how the interaction between the parties in practice influences the quality of the audit. Since the aim of the thesis is to understand the interaction between the parties and the audit quality, a theoretical and methodological framework which enables a more meaningful way of exploring the interaction between the parties and the influence of the interactions on the audit quality is needed. Therefore, a qualitative approach has been considered suitable to provide insights on how the interaction happened in practice and its potential influence on the audit quality. Power and source credibility theories were chosen as a theoretical perspective, and semi-structured interviews were employed to address the research questions of the thesis.

This chapter has six sections. Section 5.2 provides a review of the significant findings in the study. The contributions and implications of the study are highlighted in Sections 5.3 and 5.4 respectively. Section 5.5 outlines the limitations and suggestions for future research and finally Section 5.6 presents the conclusion of the chapter.

## **5.2 Review of Significant Findings**

It is advocated that interaction between the external auditor with audit committee and internal audit function is an important element in promoting audit quality (Cohen et al., 2010; IAASB, 2013). As discussed earlier in Chapter 2, both formal and informal interactions between these parties enable the parties to share their opinion and information on significant matters such as financial reporting risks and weaknesses in internal financial controls (Engle, 1999; Gendron et al., 2004; Mat Zain et al., 2006) thereby

improving the external auditors' performance of audit process. This section offers some reflections on key findings from the study based on the research objectives. The detailed discussions on the findings from the interviews conducted are found in Chapter 4.

The researcher has listed two specific objectives of the study which are to:

- 1) Understand the interactions between external auditor with audit committee and internal audit function in practice.
- 2) Understand the impacts of the interactions between external auditor with audit committee and internal audit function in practice on the audit quality.

The findings indicate that power and trust between the parties play significant roles to ensure the interactions have an influence on the quality of the audit. The notion of power, initially introduced by French and Raven (1959) and further developed by (Raven, 1965; Raven 1992; Kalbers and Fogarty, 1993; Erchul and Raven, 1997), combined with the source credibility theory (Hovland & Weiss, 1951), provides a relevant framework for understanding the interaction between the parties and their influence on the quality of the audit.

This study suggests that the audit committee hold legitimate, expert, coercive and will power which allowed them to provide insights on key audit issues or matters to the external auditor, thus illustrating power theory (French & Raven, 1959; Raven, 1965; Raven 1992; Kalbers and Fogarty, 1993; Erchul and Raven, 1997). Most of the audit committee members possess experience, knowledge and expertise to ask challenging questions and suggesting high risks area that needs to be considered in their conduct of the audit. The audit committees' active participation during the interaction (i.e. asking challenging questions and provide suggestions to the external auditor) implies that they want to ensure a sufficient level of audit quality by way of ensuring appropriate audit plan

applied and sufficient risk assessment conducted by the external auditor. This would help the external auditors to form the right audit opinion. The audit committee members also found resolved disputes between the external auditor and management. Furthermore, the audit committee also have used their rights to dismiss the current auditor and appointed another auditor in the event that the external auditor was found not executing high-quality audit.

An additional conclusion from the study is that the power of the audit committee is only significant in the interaction if the members have a will to exercise the authority and expert they have. It is worth noting that the analysis evidence some of audit committee members act passively during the interaction even though they were appointed based on appropriate background as required by the regulations. The finding offers unique insights into the potential connection between feelings of responsibility and willingness of the audit committee members to exercise their power, and the active participation in the interaction with the external auditor. The real intention of the audit committee members to perform effectively can assist them to exercise their authority and power. It can also encourage both active formal and informal interaction to strengthen the audit approach and recommendations through open information and sharing of views. With the sense of responsibility and their willingness to act (Mintzberg, 1983; Kalbers and Fogarty, 1993), it encourages the audit committee members to candidly discuss and challenge the external auditor on the issues that may be sensitive but which are essential for improving the quality of the audit in terms of financial reporting quality and audit opinion.

The findings also suggest that the power of the audit committee (i.e. legitimate, coercive, informational, referent, expert and will) which demonstrated during the interaction have generated confidence and trust in external auditor on audit committees' ability to assist the external auditor in their conduct of the audit. Similarly, the vast



experience, knowledge and expertise of external auditor, particularly on the financial standards, have built trust in the audit committees on the ability of external auditor to conduct high quality audit.

The finding further reveals that the social interaction helps to establish trust and allow for more informal interaction between both parties. Illustrating source credibility theory (Hovland & Weiss, 1951), the social interaction between the parties assists both parties to know each other better (i.e. background and their expertise) and allow for more informal interaction which was found to be limited in practice. The informal interaction is important which ensures that the external auditors are able to address their concerns in a timely manner and accordingly, the issue can be handled appropriately. Having personal knowledge of the other parties helps to establish trust between the parties as the information shared were perceived as credible and valuable for the audit. The finding is consistent with the extant literature that the individual's personal knowledge of the other person can affect the trust between them (Bigley & Pearce, 1998; Tregaskls et al., 2010), in which it is developed based on a shared experience (Richard, 2006).

In terms of interaction between external auditors with internal audit function, the findings also suggest the importance of expert power of the internal audit function during the interactions to influence the conduct of the audit. The findings illustrate that in certain companies, the internal audit function exercises their expert power by sharing the knowledge and information with the external auditor through the IA report, private interaction and informal meetings. During their interactions, the audit plans of both parties were linked and coordinated to avoid redundancy in the conduct of the audit by both parties. With the best audit plan adopted, it helps the external auditors to feel assured that they have covered the required scope of the audit and thus, more accurate audit opinion issued.

The findings further suggest that the positive expert power (Raven, 1965; Raven 1992; Erchul and Raven, 1997) of the internal audit function which evidenced during the interactions through the information sharing between the parties, eventually built trust on the ability of the internal audit function in external auditor. Consistent with Richard (2006), the trust can influence the exchange of information and leads to the frequent interactions between the parties. The findings also suggest that the initial perception is often determined by the establishment of trust between the parties. Whether the information provided by the internal audit function is useful or not depends on the external auditors' initial perception of the internal audit function's quality. This study illustrates that the IA report provided by the internal audit function may determine whether the internal auditors are competent or not, thus affect the frequency of the interaction may evolve and information exchange between the parties. In particular, the influence of the IA report on the audit quality signified through external auditors' assessment of the content of the auditors' reports.

Furthermore, the interpersonal quality (i.e. honesty, respect and humbleness) of the parties also play a major role in building the trust and shaping the interaction which eventually enhances the quality of the audit. Illustrating source credibility theory (Hovland & Weiss, 1951), the interpersonal quality was found to be important in promoting regular communication and the ability to discuss matters in a frank manner. In general, it is identified that trust is a critical prerequisite before the external auditors rely on the information provided to them. The trust is communicated through more interactions between parties, the acceptance of another's suggestion and the reliance on the information provided. The input received through the interaction eventually affects the conduct of the audit and enhance the financial reporting quality.

One general conclusion from the finding is the importance of power and trust in the interactions between external auditors with audit committee members and internal audit function to influence the audit quality. These interactions are connected to a range of potential individual authority, attributes, perceived source credibility and trust established between the parties which have an impact on the conduct of the audit such as on audit planning, risk assessments, evidence gathering and timeliness of the audit. The improvement in the audit process will help the external auditor to ensure financial reporting quality and more accurate audit opinion is provided. The external auditor, audit committee members and internal audit function must exhibit the commitment in the interaction to ensure that it can affect the audit process. It depends on how well the parties play their roles and exert their expertise properly to determine the impact of the interaction on the quality of the audit. Therefore, the power of these three key players and the perceived credibility of the sources are important in determining whether the information shared during the interaction may be applicable in conducting the audit.

### **5.3 Contributions of the study**

By employing a qualitative research design, the study attempts to contribute to the understanding and knowledge on the interactions between key governance players (i.e. external auditor, audit committee and internal audit function) which directly involved in audit function and their impact on the audit quality. Various authors implicate the importance of the relationship between these parties and audit quality (see for example Abbott et al., 2003; Yatim et al., 2006; Al-Ajmi, 2009; Mansouri et al., 2009; Suwaidan & Qasim, 2010; Dehkordi & Makarem, 2011). The above studies are exclusively based on the large samples and utilising publicly available information; very limited research<sup>26</sup>

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<sup>26</sup> Among the studies that focus on the key audit governance players and audit quality are conducted by Cohen et al. (2002) and Cohen et al. (2010). Other studies (i.e. Gendron et al., 2004; Gendron & Bedard, 2006; Turley & Zaman, 2007; Beasley et al., 2009)

was carried out to explore the “back stage” of interaction between the parties and their influence on the quality of the audit. This study adopts qualitative approach by conducting semi-structured interviews with the people who are in a position to offer better insights on the subject under study (i.e. audit partners or senior manager, audit committee members and the head of the internal audit function). The findings reported in this thesis therefore complements existing research through opening up the potential behaviours of the actors during the interactions which have influence on the conduct of the audit accordingly.

While the agency theory is an underlying theory which explains the monitoring roles of the three key parties (i.e. external auditor, audit committee and internal audit function), the study adapts power theory (French & Raven, 1959; Raven, 1965; Raven 1992; Kalbers and Fogarty, 1993; Erchul and Raven, 1997) and source credibility theory (Hovland & Weiss, 1951) in enhance understanding how audit committee members and internal audit function use their power and expertise to perform their duties through the interaction with external auditor; and how the external auditor develop trust through the information provided by audit committee and internal audit function which finally connected with the quality of the audit. The combination of these theories are relatively unrepresented in existing research in this field, but provides insight into the interactions of these key players that impact the conduct of audit performance. This perhaps has added a new dimension to the research in this field.

The current study has shown the positive expert (French & Raven, 1959; Raven, 1965; Raven 1992; Erchul and Raven, 1997) and will power (Mintzberg, 1983; Kalbers and

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focused on audit committee effectiveness which partly include the discussion between audit committee with other parties such as external auditor and internal audit function.

Fogarty, 1993) as the most important elements in the power theory in the interactions between these parties. The willingness of the audit committee members to exercise their power was found as a key to ensure that the audit committee members participate in the interaction. Illustrating power theory (French & Raven, 1959; Raven, 1965; Raven 1992; Kalbers and Fogarty, 1993; Erchul and Raven, 1997), the audit committee members' knowledge, expertise and experience combine with their willingness to exercise their authority enabling them to participate in the interaction which eventually effects the audit process and audit quality.

In addition to insights into the importance of power in the interactions, this study advances the existing knowledge about the influence of social interactions and interpersonal quality to the interactions and audit process. The use of source credibility theory allows greater insights into the importance of social interactions and good interpersonal quality of the parties impacting the trust between the parties. Thus, this research highlights the importance of studying the interactions of these parties and its relation to audit quality in practice and can be better understood by analysing it in relation to different theories and those involved in the interactions.

#### **5.4 Implications of the Study**

The study has implications for the stakeholders (i.e. companies) and policy-makers or regulators. There are also implications to the companies such as for corporate boards in appointing audit committee members, and internal auditors in developing strategies to enhance the interaction between the external auditor with audit committee and internal audit function and finally the audit quality.

Based on the insights from the interviews, knowledge, expertise and experience combined with the willingness of external auditor, audit committee and internal audit function to exercise the power proved to be important in enhancing the audit quality.

However, the findings also evidence that the audit committee and internal audit function did not exercise their power. Thus, organisation or company may consider qualification and experience of a person before appointing them as audit committee members. Therefore, options should be given to those with prior experience in the industry, in particular having experience in the other audit committee. The lessons learned from directorship in other companies helps the members to perform their duties and be aware their roles and best practices as audit committee members. Hence, the active interaction could be gained towards the objective of the audit quality. As stated by Roberts et al. (2005), the expertise and willingness of the members is the key to the effectiveness of the board in performing their roles. Similarly, in the appointment of internal auditors, the board should consider the internal auditor with required skills, expertise and knowledge in developing the trust in external auditor on the ability of internal auditors during the interaction. Where the interpersonal quality is of prime importance to enhance the interactions, options should also be given to those with good interpersonal quality (i.e. honest, humbleness, etc.) in appointing the internal auditors. Therefore, having qualified internal auditors with appropriate skills, expertise and interpersonal quality will improve the interaction and help to strengthen the quality of the audit..

In addition, the findings evidence that some of the audit committees and internal audit function did not perform their roles effectively. The legislators or policy-makers, such as the Securities Commission, may provide a possible measurement which can enhance the practice of the key governance players (i.e. external auditor, audit committee and internal audit function). For example, the legislators may provide incentives and encouragement to the key players to keep updating themselves in current knowledge and issue which will help them to perform their roles. This will assist the audit committee members to participate in the interaction actively and finally enhancing the quality of the audit. The legislators also may introduce public reporting by audit committee to ensure more

disclosures on the audit committee activities particularly on their monitoring roles in the audit process and their interaction with the external auditor. It also helps the legislator and other stakeholders to assess the contribution of the audit committee in the quality of the audit.

Furthermore, the findings illustrate that there is a lack of interaction between external auditors with the internal audit function since the external auditors put little trust in the internal audit function. Thus, it challenges the effectiveness of corporate governance framework as internal audit function is an important mechanism in governance (Sarens et al., 2009; Bame-Aldred et al., 2013). This may imply that the internal auditors require a greater understanding of their roles and need to acquire appropriate skills and expertise to make them function more effectively. It is, therefore, the regulators should put more attention or highlights specific requirements on the internal audit function such as qualifications of the internal auditors in ensuring the better performance of this function. Subsequently, the internal auditor should comprise of individuals who perform their roles and participate actively in the interaction. This could increase external auditors' trust on the internal auditor and improve the quality of the audit.

### **5.5 Limitations and Suggestions for Future Research**

This study suffers from a few shortcomings. Firstly, it is worth pointing out that this study did not provide straightforward evidence on the reasons of lack of will power of the audit committee members in performing their roles. Though the findings of this study may suggest the importance of awareness of the audit committee members to ensure the members perform their monitoring roles on audit function, more research is needed to explore further the underlying reasons of passive acts among the audit committee members., thereby taking perceptions by various participants (i.e. management, external auditor, internal audit functions) into account; such research could be ground breaking.

Secondly, the coverage of the groups included was constrained by practical issues concerning access to individuals and the time available and future research could attempt to expand the number of individual participants, possibly through wider survey methods. The findings of this study could be used as constructs in the future study in examining the interaction and its potential influence to audit quality. Another possible suggestion for future research could be considering the use of the experimental approach to examine the influence of the interaction between the three parties on the audit qualities. It would enable the participants to assess audit quality objectively. Further, a larger number of respondents promise more robust findings that can be generalised to the wider population.

Thirdly, the findings of this study only offer indirect evidence of actual practice. The main data from the three groups of participants were gathered through interviews rather than direct investigation of the interactions between the parties and their influence on the audit quality. Even though the interview method is appropriate to achieve the objectives of this study, observations of actual interaction between these parties in practice would also be relevant. However, it should be recognised that such method would have few challenges regarding being allowed to attend the meetings or review the minutes of the meetings and other relevant documents as the issues discussed generally subject to confidential issues of the companies. Hence, future case study research is needed to provide more in-depth analysis to explore the interactions and their influence to the quality of the audit through direct observations on the process.

## **5.6 Conclusion**

In summary, this thesis explored the interaction between external audit with audit committee and internal audit function and its effect on the audit quality, through interviews with experienced audit partners and senior managers, audit committee members and chairs, and heads of the internal audit function. It establishes that the present



understanding of the interaction between these parties in practice is limited. This thesis simultaneously considers the perceptions of the three independent key parties on their interactions and the contributions to the audit quality. Based on a combination of power theory and source credibility theory, it was found that the interactions (formal and informal) between these parties is shaped through individuals' power in exercising the roles and responsibilities and the trust established between them. The interaction is connected to a range of potential individual authority, attributes (i.e. expertise, knowledge and experience; interpersonal quality), regulation and social interaction between the parties which have an impact on the conduct of the audit and eventually financial reporting quality and audit opinion. The findings of the study complement and extend the existing literature in this area. The conclusions reveal the practical utility of the findings and pave the way for further research.

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## LIST OF PUBLICATIONS AND PAPERS PRESENTED

Conferences where Papers from this Thesis were presented

1. Corporate Governance Research: A Review of Qualitative Literature. Paper presented at the International Conference on Technology and Business Management, March 2014.
2. Mat Yasin, Fatimah; Muhamad, Rusnah; Sulaiman, Noor Adwa (2016). Effectiveness of Corporate Governance Mechanisms: A Review of the Literature. *Asian Journal of Accounting Perspectives*, 9 (1), 30-54.

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