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# High Quality Audit Committee - Internal Auditor Relationship - How to Establish One?

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## Abstract

*Corporate governance codes and internal auditing standards released around the globe emphasized the importance of high quality audit committee-internal auditor relationship. Accumulating academic research output (eg. Cohen, Krishnamoorthy and Wright, 2007; Van-Peursem, 2005) further reinforce the benefits of such relationship towards the firm's, particularly in ensuring firm's financial reporting quality, utilizing materials grounded in auditing and organizational psychological literature, this paper attempts to (i) conceptually define the quality of audit committee-internal auditor relationships and (ii) suggests practical approaches in ensuring high quality relationship could be established in public listed companies.*

**Keywords: Audit committee-internal auditor relationship, Audit committee, Internal auditor, Leader-member exchange theory, Superior-subordinate relationship, Workplace relationship, Financial reporting quality.**

## Introduction

The imperative of a high quality relationship between the internal auditor (IA) and the audit committee (AC) has been emphasized in corporate governance codes and internal auditing standards released around the globe. Accumulating academic research outputs (e.g. Cohen, Krishnamoorthy and Wright, 2004; Mat-Zain & Subramaniam, 2007; Van-Peursem, 2005) further reinforce the benefits of such high quality relationship towards the firm's, particularly in ensuring firm's financial reporting quality (FRQ). Utilizing materials grounded in auditing and organizational psychology literature, this short article attempts to (i) conceptually define quality AC-IA relationship and (ii) suggests practical approaches in ensuring high quality relationship could be established in every Malaysian public listed company.

The remainder of this article is structured as follows: (i) Actors in the AC-IA relationship, (ii) The nature of AC-IA relationship, (iii) Relationship quality, (iv) Factors that would encourage high quality AC-IA relationship and (v) Summary and conclusion.

## Who are the actors?

### a. Audit committee

Understanding AC's roles and functions necessitates us to analyze its organizational position and responsibilities, which all governance standards are providing. AC is technically a sub-committee to firm's board which comprises at least three directors majority of whom are independent directors and at least of them is financially knowledgeable director. At its minimum, AC is responsible towards the whole spectrum of firm's financial reporting activities including but not limited to monitoring firm's financial reporting processes, continuously reviewing firm's internal controls, ensuring compliance to externally imposed accounting and reporting rules, appointing external auditors, as well as planning, reviewing and endorsing internal audit activities.

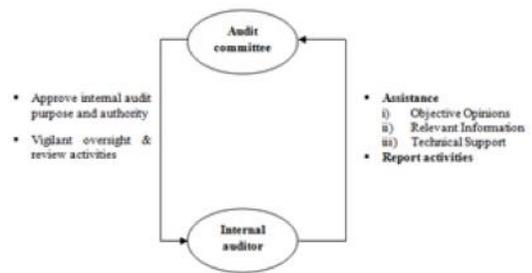
### b. Internal auditor

The latest published document by the International Standards for The Professional Practice of Internal Auditing by the Institute of Internal Auditors (IIA) refers IA as an individual, who conducts assurance and consulting activities for his/her organization, whose tasks include evaluating and enhancing the effectiveness of risk management, control, and governance practices.

## The Kind of Relationship?

The IIA clearly characterizes AC-IA relationship as "interdependent" and "mutually accessible". The IIA further illustrate this reciprocal relationship by suggesting that while the IA provides assistance to the AC including objective opinions, information, support and education, the AC reciprocally provides validation and vigilant oversight to the IA on matters relating to internal control and other specific financial accounting and reporting related assessments and investigations (e.g. misstatement, fraud, etc.) (Cohen et al., 2004; Gramling et al., 2004). Accordingly, the IA which occupies the lower organizational level relative to the AC has to report the results of their audit activities to the AC. The reciprocal relationship as reflected by their operations can be illustrated as follows:

Figure 1 The AC-IA relationship



## What constitute high quality AC-IA relationship?

Organizational psychology literature offers an applicable theoretical explanation using the Leader-Member Exchange theory (LMX theory) in explaining and facilitating an objective assessment of a quality AC-IA relationship. The LMX suggests that high quality relationship is effectively characterizes by a high degree of mutual trust, respect and obligation between the two parties. In this state of relationship, both AC and IA respect the capabilities of each other, trust each other and presume that there is an obligation to relate to each other. The theory further informs that in a high quality relationship, the AC as a leader will protect and help the IA whom in turn, will provide services transcending beyond workplace's minimum requirements. Inversely, lack of trust, respect and obligation reflects a low quality relationship, causing both parties to carry out tasks as required in their 'job contract' only (Graen & Uhl-Bien, 1995; Osman & Nahar, 2015).

## How to develop a high quality AC-IA relationship?

The extant of academic studies on LMX relationship imply that the following measures could ensure high quality AC-IA relationship:

- i. Active and fair interaction: Inculcating good AC-IA relationship necessitating both parties to actively work and interact closely through open and closed meetings. The workplace environment also has to be reciprocally fair in terms of exchanges of support given by the AC and services provided by the IA.
- ii. The characteristics of parties involve in the relationship: As it does a norm for parties preferring to work with an equally competent or better counterparts, a high quality relationship

could only develop when AC possesses the desired characteristic of an effective entity which includes independent, knowledgeable and active. IA on the other hand needs to maintain competency supported with sufficient organizational capacity.

- iii. Psychology concepts: Prior psychology studies suggest that psychology concepts such as superior and subordinate's liking, expectation and values act as important contributors to the development of high quality relationship. These need to be appropriately identified and subsequently matched in developing a high quality relationship.

### Summary

It can be summarized that the ACs as sub-committees to firm's board of directors are tasked to provide vigilant oversight over the wide array of financial reporting and auditing activities while IAs are professionals hired by a firm to provide internal assurance and consulting services. Between the two, AC is seen to hold the 'superior' role while the AC's as a 'subordinate'. Both the AC and IA are interdependent where they have to mutually work together in order to be effective as an oversight role in overseeing the activities of the management. Thus, a high quality AC-IA relationship is needed where both parties highly respect, trust and committed to each other.

Taking LMX Theory as the theoretical framework, high quality AC-IA relationship means that the AC respects the knowledge and experience of the IA in performing their audit task. The AC also shows their trust to IA in performing their responsibility and the 'loyalty' of the IA to AC. Apart from that, the AC also shows their commitment by supporting the work and independence of the IA professionally. On the other hand, the IA would respect the experience and wisdom of the AC and the trust given by the AC to the IA by performing to the highest standard and ethics. The IA would be able to deliver quality and timely output to the AC. Thus, the IA that experience the high quality AC-IA relationship is one who is competent in their work and aware themselves with the development around the company.

### Insights and Findings from Auditing Literature

Previous studies in the auditing literature shed light on the benefit of having high quality AC-IA relationship. Sarens, De Beelde and Evereart (2009), for instance found that AC experienced greater 'comfort' in the area of control environment and internal control when they have high quality relationship with IA. IA who traditionally play internal assurance role and involved in improving internal control is viewed by the AC as can provide good assistance because they have appropriate skill and experience in internal control and the IA are familiar with internal aspects in company where they provide services. A Malaysian study by Mat Zain and Subramaniam (2007) found that high quality AC-IA relationship is not very common in this country specifically they found evidences that it is difficult for Malaysian IA to trust AC in their company. However, the positive finding is this study found that Malaysian's IA viewed independence AC as having 'power/authority' in their company and this kind of AC would be able to question management activities and decision is such action is needed. With respect to factors that could contribute to high quality AC-IA relationship, a latest study by Zaman and Sarens (2013) discovered that such condition is positively associated with AC independence, the committee's chairman's knowledge and experience, and internal audit quality.

The contributing factors have been analyzed earlier in the auditing literature. As early as 1990s, Cooper (1993) postulated that a better relationship between AC and IA can be developed through exposing the real role and usefulness of internal audit. In this regard the IA need to project to AC the benefit and function of IA and also the differences between the services provided by the external auditor and internal auditor. The IA must sell to the AC the comfort which only he (IA) can provide. Also Rezaee and Lander (1993) suggested that three fundamental factors in establishing fruitful relationship between IA and AC. The factors are competence, corporate culture and positive thinking. Internal auditor need to have or show the level of competence that meets the expectation of AC. The Internal auditor also needs to understand the corporate culture of the organization. According to Rezaee and Lender internal audit, by

its very nature, can be a very political function within an organization and the ability of the internal audit manager in handling the company politics without compromising independence and objectivity will command the respect of the AC. The third factor is the ability of the internal auditor to think positive and strategically in responding to the strategic objectives of the company. It can be seen that findings and insights from the auditing literature are not contrasting the idea provided by the LMX Theory.

### Concluding Remarks

According to LMX Theory, three main factors that could enhance AC-IA relationship quality are (i) active and fair give-and-take interaction; (ii) the presence of competent AC members and IAs; and (iii) psychology traits such as compatibility, liking and positive values. In conclusion, the quality of AC-IA relationship is pertinent to all firms, particularly public listed company as it provides significant influence on firm's FRQ. The framework for establishing this relationship has been provided neatly by regulators and standard setters in the form of local and international promulgations. While establishing an AC-IA relationship is considered as a straight forward task, the critical point is to maintain a high quality relationship and thereby reaping its due benefits!

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