

1. INTRODUCTION

The recent regulatory reforms following high profile corporate collapses in Australia (HIH and One.Tel) and the wider international arena (e.g. Enron, WorldCom, Parmalat) have focussed on improving the quality of corporate governance. The reforms have had significant implications for the roles and responsibilities of all parties in the corporate governance mosaic consisting of the board of directors (including the Audit Committee (AC)), senior management, the external auditor (EA), and the Internal Audit Function (IAF). They have also placed more importance on the relationships and interactions between these parties.

While the relationship between the AC and the IAF is increasingly being seen as a critical one in the pursuit of improved corporate governance (Zain & Subramaniam, 2007; Osman *et al.*, 2008; Cohen *et al.*, 2004), prior studies have mainly employed surveys to investigate the relationship (Zain *et al.*, 2006; Carcello *et al.*, 2005; Paape *et al.*, 2003; Goodwin, 2003; Goodwin & Yeo, 2001; Raghunandan *et al.*, 2001; Scarbrough *et al.*, 1998), thus undertaking only a limited investigation without providing in-depth insight into the interactions between these mechanisms. There have consequently been direct calls to examine the nature of the relationship and interactions between the AC and the IAF (Gendron & Rossignol, 2008; Cohen *et al.*, 2004; Gramling *et al.*, 2004; Tapestry Networks, 2004), in varying national contexts (Zain & Subramaniam, 2007; Raghunandan *et al.*, 2001; Scarbrough *et al.*, 1998). For example, certain variables in the relationship are not quantifiable and may be elucidated only through the use of a qualitative approach such as that of semi-structured interviews (Zain & Subramaniam, 2007). Further, studies examining pertinent issues such as the performance evaluation of both the AC and IAF, and whether and how the other party participates or contributes to such practices are also noticeably lacking (Cohen *et al.*, 2008).

Extant studies have also been largely undertaken prior to the regulatory reforms which have had implications for the roles of both the AC and the IAF. Given these changes and their emphasis on improving the relationship between actors in the corporate governance mosaic, Gramling *et al.* (2004, p. 195) suggest that “there is a need for increased understanding about how the IAF interacts with the audit committee... to achieve quality corporate governance”.

The relationship between the AC and the IAF, the organisational status and scope of the IAF, as well as the nature of the IAF’s communications with the AC is also important for EA purposes under the current Australian Auditing Standards (ASAs) when placing reliance on the work of the IAF (ASA 610). Similarly, when evaluating the overall control environment of the client entity during planning, the EA needs to examine the individual characteristics and effectiveness of both the AC and the IAF, and the relationship between both parties (ASA 315; Zain *et al.*, 2006; Cohen *et al.*, 2004, 2002). In the U.S., Auditing Standards (AS) require the EA to consider the extent of the adequacy of the internal audit activity and whether the IAF reports directly to the AC, as well as the extent of the AC’s involvement and interaction with the IAF (PCAOB, AS 2, p. 24)

In light of the regulatory reforms (e.g. Australian Securities Exchange (ASX) Corporate Governance Council (CGC) Guidelines 2003 and 2007, and ASX Listing

Rules in Australia in 2003, Sarbanes-Oxley Act (SOX) in the U.S. in 2002, the Combined Code on Corporate Governance in the U.K. in 2003)¹, this study employs a qualitative approach to investigating the relationship between the AC and the IAF, through the use of semi-structured interviews with AC chairs (ACCs) and Chief Audit Executives (CAEs). The aim of this study is to extend our understanding of the relationship between the AC and the IAF by providing an in-depth insight into the nature of the interactions between these two parties in the contemporary Australian context and the prevailing financial market volatility and credit crisis (PwC, 2008). The study examines a number of issues including general interactions (e.g. reporting lines, hiring/firing decisions), key characteristics, expectations and mutual involvement in performance evaluation practices.

The remainder of this paper is organised as follows. Section 2 undertakes a literature review, while Section 3 develops the research questions. Section 4 outlines the research method. Section 5 presents the results and analysis from the study, while Section 6 provides conclusions to the study by discussing its contributions, limitations and suggestions for future research.

2. LITERATURE REVIEW

2.1 The relationship between the Audit Committee and the Internal Audit Function

Prior studies investigating various relationships within the corporate governance mosaic have been largely focussed on the relationship between the IAF and the EA. In particular, the extent of reliance the EA places upon the function has been extensively studied (Gramling *et al.*, 2004). The relationship between the AC and the EA has also been considered although further research is needed in this area (Cohen *et al.*, 2008, 2004). Academic research examining the nature of the relationship and interactions between the AC and IAF has been limited in depth as it has typically employed surveys of CAEs to investigate how specific characteristics (particularly independence and expertise) of the AC, individually or in various combination, affect its relationship with the IAF (Cohen *et al.*, 2004).

The overall results of the studies to date suggest that ACs composed of only independent members with at least one member who is a financial expert are more likely to have more frequent and longer meetings with the IAF, to provide private access to the CAE, as well as to review the IAF program and results (Zain *et al.*, 2006; Goodwin, 2003; Goodwin & Yeo, 2001; Raghunandan *et al.*, 2001; Scarbrough *et al.*, 1998). These studies have called for further research to provide a deeper insight into the interactions between the AC and the IAF, such as the nature and depth of the meetings between both parties (Goodwin, 2003; Goodwin & Yeo, 2001), across different countries (Zain & Subramaniam, 2007, Raghunandan *et al.*, 2001; Scarbrough *et al.*, 1998). Goodwin (2003) also suggests that future research should aim towards providing

¹ Other relevant reforms in Australia include the enactment of CLERP 9 in June 2004, that had implications for items within the ambit of the AC, such as legislative protection for whistleblowers, the release of the Public Sector Audit Committees practice guide by the Australian National Audit Office in February 2005, and the release of APRA Prudential Standards which included requirements for board ACs for APRA regulated institutions in May 2006.

a better understanding of how the AC and the IAF can complement each other in the pursuit of stronger corporate governance.

DeZoort *et al.* (2000) find that CAEs' evaluation of their contributions to the financial statement audits are positively related to the independence and expertise of the AC, and propose that the development of structured communications programs between the IAF and the AC could facilitate the achievement of quality corporate governance. The results of an experimental questionnaire survey study involving Certified Internal Auditors (CIAs) in Australia (De Zwaan *et al.*, 2008) indicate that a strong relationship between the AC and the IAF may mitigate the loss of independence and objectivity of the IAF as a result of its participation in enterprise risk management. However, the authors report in the same study that CIAs do not perceive the AC to be functionally effective in its ability to detect breakdown in procedures, even when the AC was in compliance with all the relevant best practice recommendations.

In summary, the results of the predominantly quantitative approach undertaken by prior studies and their reliance on publicly available information, such as the number of AC meetings in a year, provide limited in-depth evidence as to the nature of the relationship and interactions between the AC and the IAF in practice, particularly in the Australian context.

Reporting lines

The reporting and communication channels of the IAF have recently received increased attention by regulators, practitioners and academic researchers. Best practice guidelines (e.g. AICD *et al.*, 2008) suggest that the AC, rather than management, should be responsible for oversight of the IAF within an organisation. Such duties would include responsibility for the hiring/firing decision of the CAE, as well as reviewing the budget, program and results of the IAF. For example, the ASX CGC Guidelines Principle 7 suggests that companies should consider dual reporting lines for the IAF to both management and the AC. However, the feasibility of the dual reporting lines have been questioned, with studies suggesting that the IAF should report to the AC rather than management in order to improve its effectiveness in performing its corporate governance role (Zain & Subramaniam, 2007; Zain *et al.*, 2006; CPA, 2005; Gramling *et al.*, 2004; Paape *et al.*, 2003).

2.2 The roles of the Audit Committee and the Internal Audit Function

In order to appreciate the mutual reliance and essential interactions between the AC and the IAF, it is useful to consider the roles of each of these corporate governance mechanisms. This in turn provides a point of reference against which the notions of effective performance of the individual functions and a strong relationship can be established and discussed. It has also been suggested that clarifying the roles and responsibilities between the IAF and the ACs will assist their intercommunication (AICD *et al.*, 2008).

The Audit Committee

The ASX CGC Guidelines (2007) refer to the AC as a corporate governance mechanism responsible for ensuring the integrity of an organisation's financial reporting, as well as for overseeing the independence of the EA. While the primary role of the AC is to oversee the financial reporting process and hence contribute to improved

financial reporting quality, the duties of the AC have been suggested to fall into three categories, namely, accounting and financial reporting matters (including internal controls), auditing, and corporate governance (such as facilitating communications between the EA and management) (Wolnizer, 1995).

Prior qualitative studies have recognised the complexity in defining audit committee effectiveness (ACE), and instead employed the notion of perceived effectiveness of the AC from the perspective of those interviewed, including management, internal auditors and AC members (e.g. Gendron *et al.*, 2004). In general, these studies suggest that a major factor in determining ACE relates to the ability of the AC members to communicate effectively and to ask questions (Zain & Subramaniam, 2007; Gendron *et al.*, 2004; Cohen *et al.*, 2002). Employing a qualitative approach has also facilitated the examination of process factors, such as significant matters of discussions in AC meetings, which are indisputably important in determining ACE (Gendron *et al.*, 2004).

The Internal Audit Function

Although there are presently no mandatory requirement for companies to have an IAF in Australia², specific references in the ASX CGC Guidelines are made in regards to the IAF and its role. The ASX CGC Guidelines suggest that an IAF will generally carry out the analysis and independent appraisal of the adequacy and effectiveness of the company's risk management and internal control system. The IAF also assists the AC with its monitoring and oversight duties as the Australian Institute of Company Directors (AICD) *et al.* (2008) provide that the IAF acts as an agent for the AC and provides independent and objective assurance to the AC on internal corporate governance, risk management, internal control and compliance. It is noteworthy that in November 2003, the SEC approved the updated New York Stock Exchange (NYSE) listing standards. Consequently, under Rule 303A.07(d) in the Listed Company Manual (effective October 2004), "listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control".

Prior research in the area of internal audit activity has been mainly facilitated through surveys of CAEs. The results indicate that IAFs are primarily engaged in internal and operational audits, financial audits and testing of internal controls. Other areas in which the IAF participates include consulting or support jobs for management, as well as health, safety and environmental audits and quality audits. Significantly, risk management is becoming a more prominent activity that the IAF is participating in (Paape *et al.*, 2003). It is suggested that the role of the IAF has undergone significant expansion and increased attention (Carcello *et al.*, 2005; Spira, 2003), and that "*the nature of internal audit activity today typically includes risk assessment, control assurance, and compliance work, all of which map directly into corporate governance*" (Gramling *et al.*, 2004, p. 196). Although the recent regulatory reforms in Australia have not directly addressed the role of the IAF, reforms addressing issues such as the independence requirements of the EA and the duties and greater compliance requirements of the AC (e.g. ASX Listing Rules, ASX CGC Guidelines) have inevitably

² The Commentary to Recommendation 7.2 states that a company should consider having an internal audit function, but that an alternative mechanism may be used to achieve the same outcome depending on the company's size and complexity and the types of risk involved.

resulted in the expanded role of the IAF (Nagy & Cenker, 2007; Arena & Azzone, 2007; Carcello *et al.*, 2005; CPA, 2005; Hermanson, 2002).

2.3 Performance evaluation practices

The Audit Committee

Despite the extensive amount of research that has examined ACE, performance evaluation practices of the AC have been virtually unexplored in the academic literature. The professional literature (e.g. KPMG, 2006, 2008; Deloitte, 2008) highlights the current practice of self-evaluation and provides guidance in this area through various pro-forma questionnaire surveys for AC members to rate themselves. KPMG (2008) reports that the annual self-assessment process undertaken by ACs has proven unproductive, and that there is work to be done in the area of AC performance evaluation. Cohen *et al.* (2008) suggest that there is potential for the EA to contribute to the performance evaluation of the AC, in view of the auditor's responsibility in considering the ACE as part of their control environment assessments during the audit process. To the authors' best knowledge, there are no studies to date that have explored the current practices relating to AC performance evaluations, and whether the IAF contributes to AC evaluations, particularly in light of the recommended dual reporting lines for the IAF.

The Internal Audit Function

Although Arena and Azzone (2007, p. 110) note that “*if companies are investing increasing efforts in developing internal auditing mechanisms, the investigation of their actual contributions can provide relevant insights on this issue*”, there has been limited research as to the performance evaluation of the IAF and the CAE. Research to date has focussed on the quality of the IAF work from the EA's perspective, in terms of the nature and extent of the reliance placed on the work (DeZoort *et al.*, 2001). Characteristics such as the independence, objectivity and proficiency have been used as indicators of quality of the IAF (e.g. Messier & Schneider, 1988). The results of these studies (Zain *et al.*, 2006; Krishnamoorthy, 2002) suggest that the extent of reliance the EA places on the work of the IAF is positively related to these factors.

There is thus a need to consider a wider set of quality measures and a consideration of IAF performance from the perspectives of the other actors in the corporate governance mosaic (Coram *et al.*, 2008). Further, in evaluating the IAF, it is important to bear in mind the influential role the AC has in determining the quality of the IAF, given its resource allocation and oversight responsibilities pertaining to the IAF (Gramling *et al.*, 2004; Cohen *et al.*, 2004). A number of recent studies (Coram *et al.*, 2008; Arena & Azzone, 2007; Carcello *et al.*, 2005) have also directly called for further research into examining how IAF effectiveness is defined and assessed.

3. RESEARCH QUESTIONS

3.1 The relationship between the Audit Committee and the Internal Audit Function

Apart from its responsibilities of ensuring the independence of the EAs and the integrity of the financial reporting processes within the company, the commentary to Recommendation 4.3 in the ASX CGC Guidelines also provides that it is part of the

AC's ambit to assess the performance and objectivity of the IAF, as well as to make recommendations for the appointment and dismissal of the CAE. ISPPIA Practice Advisory 2060-2(3) provides three key areas of activities that are critical to an effective relationship between the AC and the IAF, primarily through the CAE. These are:

- *Assisting the AC to ensure its charter, activities, and processes are appropriate to fulfil its responsibilities;*
- *Ensuring that the charter, role and activities of the IAF are clearly understood and responsive to the needs of the AC and the board;*
- *Maintaining open and effective communications with the AC and chairperson.*

This study thus investigates ACC perceptions of their IAFs and the relationship between both mechanisms.

Hiring and firing responsibility

Existing best practice guides and professional standards suggest that the AC should make recommendations to the board on the appointment, remuneration and dismissal of the CAE (AICD *et al.*, 2008; ISPPIA, 2009). It is also interesting to note that the revision of the ASX CGC Guidelines in 2007 have seen the requirement for the AC's responsibility in making recommendations for the appointment (and dismissal) of the CAE shift from Principle 7 to Principle 4, effectively making it part of the mandatory requirements under ASX Listing Rule 12.7. However, there is no evidence as to the impact of this in practice, if any, as there are currently no Australian studies that have investigated these practices and how they impact on relationship and interactions between both parties.

Reporting lines

In order to maintain the independence, objectivity and organisational stature of the IAF, the ASX CGC Guidelines and the professional literature have advocated dual reporting lines for the IAF (AICD *et al.*, 2008). Under such a structure, the IAF would report functionally to the AC, while reporting administratively (day-to-day operations such as the administration of the organisation's internal policies and procedures) to management. The AC would thus be responsible for reviewing and approving the IAF's mission, charter, resources and budget.

While the professional standards promulgate the dual reporting lines structure, the standards recognise that "*other relationships may be effective if there are clear distinctions between the functional and administrative reporting lines and appropriate activities are in each line to ensure that the independence and scope of activities are maintained*" (ISPPIA Practice Advisory 1110-2(3)). Consequently this study examines the nature of reporting lines currently employed between the IAF and the AC, and the implications they have for the relationship between both parties.

Collectively, the above outlined issues pertaining to the relationship and interactions between the AC and the IAF are addressed through the following research questions:

RQ1: What is the nature of the relationship and interactions between the Audit Committee and the Internal Audit Function in the current Australian context?

RQ2: Has the relationship between the Audit Committee and the Internal Audit Function changed over recent years, and what are the key driving factors?

RQ3: What support do the Audit Committee and the Internal Audit Function offer each other and what are their expectations in this regard?

3.2 Characteristics perceived essential for a strong relationship

The Audit Committee

Studies on ACE suggest that the composition and characteristics of the AC and its members are critical to its success. Past studies have largely focussed on the diligence, independence and expertise of ACs and their members. The notion of AC diligence has often been proxied in prior studies by the number of times the AC meets during the year, presumably because this information is readily available in the public domain. However, in view of the increased scope of the AC and the IAF responsibilities and the concomitant need for greater interactions between both parties, this study examines the perceptions of what is the appropriate frequency of meetings between the IAF and the AC (recommended to be at least quarterly by AICD *et al.*, 2008) as well as how the AC ensures it performs its oversight role of the IAF.

Extant research has examined a myriad of operationalisations of AC member expertise, ranging from the financial literacy and expertise, to auditing, board and industry experience, thus making it difficult to discern from an external archival study how each of these different kinds of expertise contribute to ACE and an effective relationship with the IAF. In regards to independence, the ASX CGC Guidelines only require the AC to consist of a majority of independent directors, although it is becoming recognised as best practice to have only independent directors on the AC (ASX, 2007). The professional guidance suggests that it is important for the AC members both to be independent and to be *perceived* as independent. Specific to the AC's relationship with the IAF, it has been suggested that the independence of the AC promotes the independence and objectivity of the IAF and thus enhances its effectiveness (Abbott *et al.*, 2004; Raghunandan *et al.*, 2001; Scarbrough *et al.*, 1998).

Hence, this study extends prior research by examining perceptions relating to the above characteristics in maintaining a strong relationship between the AC and the IAF through the following research question:

RQ4a: What are the perceived key Audit Committee characteristics which contribute to a strong relationship with and its ability to support the Internal Audit Function?

The Internal Audit Function

Research to date on the characteristics of the IAF has been largely descriptive in nature, and has considered variables such as the organisational structure, human resources of the IAF, as well as its adherence to professional standards or frameworks. Ernst & Young (2007, p. 2) indicates that human resources are a critical area for the IAF, as reported by one of the key findings of the survey as follows:

People are still the foremost challenge for Internal Audit functions around the globe: recruiting, retooling, developing, and retaining the

right skills... Industry, IT, fraud, and business and operational risk are the specialized skills most difficult to recruit and retain.

This study thus examines the perceptions of ACCs and CAEs in what they consider to be the key characteristics of the IAF in achieving an effective function and a strong relationship with the AC by posing the following research question:

RQ4b: What are the perceived key Internal Audit Function characteristics which contribute to its effectiveness and its ability to support the Audit Committee?

3.3 Performance Evaluation of the Audit Committee and the Internal Audit Function

The Audit Committee

The revised ASX CGC Guidelines (2007) introduced Recommendation 2.5 that requires companies to disclose the process for evaluating the performance of the board, its committees and individual directors for reporting period commencing on or after 1 January 2008³. The only study to date (KPMG, 2006) indicates that a significant proportion of organisations have no formal performance measurement for their ACs or its members, and that those in place are often ineffective. The potential for the CAE to make important contributions in the periodic review of AC activities and in suggesting enhancements has been noted by the internal audit profession (ISPPA Practice Advisory 2060-2(4)). This study aims to elucidate the nature of current performance evaluations of the AC, and in particular, the extent to which the IAF and/or CAE is involved in this process through the following research question:

RQ5a: What are the Audit Committee performance evaluation practices in the current Australian context, and to what extent is the Internal Audit Function involved in this process?

The Internal Audit Function

There are several aspects relating to the performance evaluation of the IAF within ISPPA. Attribute Standard 1300 requires the CAE to develop and maintain a quality assurance and improvement program that covers all aspects of the IAF's activity through internal and external assessments and monitoring, while Practice Advisory 2060-2(5) suggests that the AC should be made aware of the external quality assessment review (minimum five yearly by independent reviewers), which aims to provide assurance to the AC and management that the IAF activities conform to the ISPPA. Lastly, Practice Advisory 1110-2(7) suggests that "*at least once a year, the AC should review the performance of the CAE*". In light of the interactions between the AC and the IAF and the suggested mutual participation in the performance evaluation process, this study investigates the current performance evaluation practices of the IAF, and the level of AC involvement in this process through the following research question:

³ The Guide to reporting on Principle 2 (p. 20) states that the corporate governance statement in the annual report should include "*whether a performance evaluation for the board, its committees and directors has taken place in the reporting period and whether it was in accordance with the process disclosed*"

RQ5b: What are the Internal Audit Function performance evaluation practices in the current Australian context, and to what extent is the Audit Committee involved in this process?

4. RESEARCH METHOD

Semi-structured personal interviews with 6 Audit Committee Chairs (ACCs) and 6 Chief Audit Executives (CAEs)⁴ were used to collect evidence for this study, of which 5 pairs were from the same organisation. This is considered appropriate for the exploratory nature of the study, as well as in light of the prevalence of quantitative, particularly survey research that has been carried out in the area of ACs and IAFs. Prior qualitative research focussed on the CAE also highlights the need to consider the perceptions of ACCs in order to provide a more holistic understanding (Zain & Subramaniam, 2007).

ACCs and CAEs have an overall understanding of the impact of the regulatory reforms and are in the best positions to provide insights into the nature of the relationships and interactions between the AC and the IAF. The primary aim of employing the particular research method is to facilitate an in-depth insight into the perceptions of the individual interviewees rather than to make generalisations from the current study.

4.1 The participants

A majority of the participants for the study were recruited with the assistance of the IIA-Australia⁵. An effort was made to include organisations across a range of industries as prior research indicates the need to consider the industry context in examining governance mechanisms (Beasley *et al.*, 2000). The only other criterion applied in the recruitment of matched pairs of ACCs and CAEs from the same organisation was that organisations had to be from the ASX 300 companies⁶ in the financial year immediately preceding the study. Table 1 provides a profile of the participants and their organisations. Each participant and their corresponding organisation have been identified by a code in order to ensure anonymity in view of the confidential nature and sensitivity of the information collected.

As shown in Table 1, seven respondent organisations participated in this study. Six of the organisations are in the top 150 ASX listed organisations, while one organisation is a public sector entity (ORG6). Given the size and nature of ORG6, as well as the mandatory requirement to have an AC in public sector entities⁷, it is considered that the organisation operates within a similar context to that of the top ASX 150 listed companies, and was hence included in the sample. Taking into consideration the number of boards each ACC sits on in the capacity of a director, the sample of target organisations increases to 15. The average experience of ACCs as a director in the

⁴ Note that the term Chief Audit Executive refers to the individual in charge of the internal audit function within an organisation and may be referred to by other terms as the Chief Internal Auditor, Head of Internal Audit, Chief Audit Officer or Director of Audit. ISPPA defines CAE as: “The top position within the organization responsible for internal audit activities. Normally, this would be the internal audit director... The term also includes such titles as general auditor, chief internal auditor, and inspector general.”

⁵ 2 ACCs were recruited with the assistance of a Big-4 partner.

⁶ It is mandatory for the top 300 listed companies on the ASX to comply with Principle 4 of the ASX CGC Guidelines under ASX Listing Rules 1.1 and 12.7

⁷ Section 46 of the Financial Management and Accountability Act 1997 provides that “a Chief Executive must establish and maintain an Audit Committee within the entity, with the functions and responsibilities required by the Finance Minister’s Orders”.

Table 1: Participant information

<i>ACC & AC demographics</i>	ACC1	ACC2	ACC3	ACC4	ACC5	ACC6	
Financial expertise	Undisclosed	FCA, FAICD	FCPA	FCPA, MAICD	None	FCA, FCIS, MACS	
Independent AC members	4 (80%)	4 (100%)	2 (40%)	3 (100%)		3 (100%)	
AC meetings in a year	4	4	4	5	5	7	
<i>CAE & IAF demographics</i>	CAE1	CAE2	CAE3	CAE4	CAE5	CAE6	
Professional qualification	FCA, CIA, BBus	CISA, BComm	CPA, BBus & IT	BBus, MBA	CA	BComm	
Professional experience	Big-4 Senior Manager	Big-4 IT auditor	Financial controller	Big-4, Senior IA manager	Big 4 partner, IAF specialist provider	Acct & finance manager	
IAF staff (incl. CAE)	6 (in-house)	5 (in-house)	1 (co-sourced)	3 (co-sourced)	Outsourced	4 (co-sourced)	
<i>Organisation profiles</i>	ORG1	ORG2	ORG3	ORG4	ORG5	ORG6*	ORG7*
GICS Industry Group⁸	Media	Diversified Financials	Media	Materials	Diversified Financials	Real estate	Food Beverage & Tobacco
Total assets	\$8b	\$6.8b	\$2.8b	\$4.4b	\$26b	\$14.7b	\$4.6b
Number of employees	9,000	550	200	9,000	50	1,200	16,000

⁸ GICS (Global Industry Classification Standard) is the new ASX industry classification scheme of the ASX from 1 July 2002. It consists of 10 Sectors aggregated from 24 Industry Groups, 67 Industries, and 147 Sub-Industries. Refer to <http://www.asx.com.au/research/indices/gics.htm> for further details.

* ACC6/CAE6 are not matched pairs as it was not possible to conduct interviews with the corresponding ACC/CAE. The participant/organisation relations are as follow: ACC6:ORG6; CAE6:ORG7

target organisation is 9.5 years (range 2 to 13 years). For the IAFs, the length of in-house presence for those functions which are fully in-house or co-sourced averages 4 years. Respondent CAEs have an average of 10 years of experience in internal auditing.

4.2 Data

Data was collected through the use of semi-structured interviews that were guided by target issues developed through the literature review, discussion with academic colleagues, as well as senior representatives of IIA-Australia. The target issues were designed to be as open-ended as possible so as to allow participants to articulate their responses without explicit boundaries and without imposing preconceived categorisations that may inhibit their responses (Fontana & Frey, 2005). A non-directional style of questioning was also employed in order to mitigate any potential interviewer bias. Participants were asked if they had any further relevant areas of interest they would like to pursue further after all issues were covered. A full list of the target issues used to guide the interviews is provided in Appendix A.

The interviews were conducted between August 2008 and January 2009. All interviews were attended by both researchers, and were conducted in approximately one hour. All interviews were recorded with a digital recorder with the consent of each interviewee.

A protocol was developed in recording and analysing the data from the interviews. All interviews were attended by both researchers who simultaneously took notes, and subsequently collaborated in combining their individual written responses. The combined responses were then categorised according to target issues upon discussion and agreement on the interpretation of each response. Each researcher would then re-confirm the consistency and accuracy of these combined responses by revisiting their interview transcripts. The digital audio recordings were used to elucidate any issues that remained unclear or inconsistent with each researcher's transcription. This process was undertaken to mitigate the primary disadvantage of in-depth interviews, that is, the inherent complexity in analysing free responses (O'Dwyer, 2004).

In order to provide validity to the data collected, the combined interview summaries were then emailed to each interviewee to review and approve. This was to allow each interviewee to validate the interpretation of their responses, as well as to provide them with the opportunity to refine, clarify or add any relevant details they considered necessary. This ensured that there were no significant omissions or misinterpretations by the researchers. The final interview responses were then summarised individually, within and across ACC and CAE categories. This allowed for the identification of themes and formed the process by which the collected data was analysed.

5. RESULTS

Research Question 1 (RQ1) addressed issues relating to the nature of the relationship and interactions between the AC and the IAF in current practice. In investigating *RQ1*, data was collected pertaining to the general nature of the relationship and interactions, including practices relating to reporting lines and the hiring/firing decision of the CAE.

Overall the relationship between the AC and the IAF is viewed as crucial on both sides. The most pertinent aspect of the relationship raised during the interviews relates to the annual IAF work plan. Specifically, the AC (or ACC) approves the IAF work plan and reviews IAF. Communications between both parties, however, are usually contained between the AC or ACC and the CAE. CAEs meet with their ACC prior to each AC meeting to brief them on the progress and results of the work plan since their last meeting, as well as to update them or raise any other relevant concerns. Both ACCs and CAEs note that this is performed in order to “*prevent any surprises*” from arising during the actual proceedings of the AC meetings. AC meetings are thus well planned and executed events with specific items on the agenda, including the CAE formally presenting the IAF report, and the AC “*chasing management on follow-up actions*” identified by the IAF if necessary. CAEs attend all AC meetings in their entirety except for when there are discussions of unusual matters (e.g. change of CFO: CAE1), and private discussions with the EA (CAE3).

CAEs are comfortable with the present frequency of contact with their ACs, particularly given the availability of access to the ACC on an informal basis. For example, ACC3 and CAE3 maintain monthly informal meetings together with the CFO. All CAEs also note that they have free access to the ACC by email and as necessary. Accordingly, they perceive the nature of the relationship and interactions to be appropriate and adequate for the present purposes of performing their role. As CAE1 notes, “*it is not a frequent relationship with the AC, but there is a nonetheless a deep connection*”. More importantly, CAEs perceive the support provided by the AC to be critical to the success of the IAF as discussed under RQ3. The findings in this regard should also be considered in the context of prior research in this area. Diligence has often been proxied by the number of annual AC meetings, and has been positively related with ACE (e.g. Abbott *et al.*, 2004; Abbott & Parker, 2000). However, the results from the present study indicate that ACs perform their duties (including oversight over the IAF) outside of formal AC meetings as well. Informal meetings and communications between the ACC and the CAE take place at a much higher frequency than formal meetings and are also instrumental to contributing to perceptions of ACE and in facilitating a strong relationship with the IAF, and particularly the CAE.

Hiring and firing responsibility

With the exception of ORG5 which has a completely outsourced IAF, the responsibility for the hiring and firing of the CAE resides with the management group across all respondent organisations. However, the AC and/or ACC in all organisations have an influential role to play in these decisions, given that they have to concur with the final decision. CAE3 provides that he would “*refuse to accept anything except if it’s from the ACC*”. ACC2 suggests that having such an arrangement would make the Managing Director “*think very carefully and have very good reasons for even thinking about firing the CAE*” and that it is “*protection that is not given to many employees*”, which effectively protects the independence of the IAF. Responsibility for the hiring and firing decisions rest exclusively with the AC in ORG5.

The results of the study provide context to the findings of prior studies such as Paape *et al.* (2003) which reports considerable diversity in the hire/fire responsibility and KPMG’s (2006) survey which reports only a third of AC members have responsibility for the hire and fire decisions relating to the CAE. The results of this study do not contradict prior studies, but instead indicate that while ACs are not

responsible *per se*, they have significant influence over the decision, and are in compliance with the ASX CGC Guidelines which provide that it is the AC's responsibility in making recommendations relating to the decision that is critical. Both ACCs and CAEs indicate that such an arrangement is necessary in order to ensure the objectivity and independence of the IAF. The results thus provide justification for the recent revision of the ASX CGC Guidelines (August 2007) in moving the recommendation relating to the decisions from Principle 7 to Principle 4, effectively making it mandatory.

Reporting lines

With the exception of CAE2, IAFs across respondent organisations report directly to the AC/ACC with administrative reporting to senior executives including the CFO and the Chief Risk Officer within the organisation. CAE2 reports directly to both the CEO and ACC for all functional matters. CAE1 provides that as a result of the introduction of the ASX CGC Guidelines (2003), the reporting line for the IAF to the AC (as opposed to the CFO) has become much clearer. He also adds that "*the CFO would be tempted to use the IAF as a free resource to save costs*" (particularly given the regulatory requirements for the CFO to sign off on the financial statements) if the IAF was to report directly to the CFO. CAE reporting lines are thus critical to ensuring the appropriate flow of information and access to key executives and management, which are the foundations of risk assessment and reporting of results of audit activities. The results are consistent with the ISPPA which provides that the CAE should have the opportunity to meet privately with AC without the presence of management, and that the CAE's reporting lines should be appropriate so as to facilitate the ability of the IAF to meet the heightened expectations in its corporate governance and risk management duties (ISPPA Practice Advisory 1110-2(6)).

In relation to prior studies, the results from the present study are contrary to that from Paape *et al.* (2003) which reports that less than half of IAFs in the European Union report directly to the AC, but confirms findings of Leung *et al.* (2004) where a majority of CAEs in Australia report directly to either the AC alone, or to both the CEO and the AC. The results also provide support for the finding of a qualitative study by Zain and Subramaniam's (2007) that highlights the importance of establishing explicit reporting lines for the CAE.

Research Question 2 (RQ2) investigated the issue of how the relationship between the AC and the IAF has changed over recent years and the driving factors for the change. Both ACCs and CAEs note that there is now closer relationship between both parties. ACCs indicate a greater mutual understanding of the roles that the other party plays. CAEs support this sentiment and they perceive that their ACs have now become more comfortable and confident in the IAF. CAE2 provides evidence for this claim by offering that the AC now reviews the IAF report a lot quicker than they used to in the past. According to ACCs, the driving factor for the closer relationship between the AC and the IAF relates to the increased attention to risk issues and the awareness that the IAF is often in the best position to support the AC in relation to its risk management duties. This sentiment is shared with the CAEs who also add that the appropriate competencies of the IAF and the in-house nature of the IAF have contributed to this change.

Although ACCs and CAEs consider regulatory reform to be a significant factor to changes in the AC and IAF roles and the consequent need for a closer relationship between the two mechanisms, they also expressed a view that corporate governance practices may be overregulated. For example, ACC6 points out that he has a *“healthy disrespect for check-list type legislation. You need a sense of what is right, business intuition, independence, good behaviour and common sense, but how do you define these and how do you legislate for common sense and good judgment?”*. Similarly, CAE3 suggests that corporate governance is an impost on organisations and is increasingly becoming more so with issues such as carbon emissions trading schemes. ACs will thus become more concerned with ensuring compliance to additional regulation while IAFs will have to provide assurance in these areas. He presents his view that there has to be a balance between conformance (to risk management practices) and performance i.e. ensuring smooth operations of the business.

Research Question 3 (RQ3) addressed the actual and expected support provided by the IAF to the AC, and vice-versa. CAEs consider the AC critical to the protection of the independence and objectivity of the IAF, such as by ensuring the job security of the CAE. CAE2 provides that the support of the AC to the IAF is necessary, without which *“in all reality [we] would not be able to perform the function properly”*. ACCs on the other hand place substantial reliance on the IAF to perform its duties and to derive assurance. As ACC6 explains *“The IAF is very important to the AC. The AC by itself cannot do much given that it meets infrequently, 6 times a year for 2-3 hours, working out to 18 hours annually. The AC needs some leverage which is provided by the IAF.”*

In describing the support that the AC receives, ACCs suggest that the IAF provides an independent review of the internal controls and risk processes within the organisation and provide comfort to the AC in these areas. CAEs confirm this. ACCs indicate that they are satisfied with the above practice. CAEs perceive the provision of independent and objective opinions as a necessary support for the AC, and similarly feel that the present level of support provided to the AC is appropriate. CAE1 expressed a concern that this relationship may be brought too far and that he has seen cases *“where the IAF ends up looking more like a secretary to the AC rather than serving a functional role to the AC”*. However, it should be noted that none of the respondent organisations or CAEs fall into this category.

The results provide a context with which to consider KPMG’s (2006) survey which reports that 26% of the Australian AC member respondents are less than absolutely sure that their IAF would raise any controversial issues, 27% of the respondents are either not receiving or unsure if they are receiving updated information regarding the organisation’s risk profile, and less than half (42%) were ‘very satisfied’ that the IAF plan is linked to the agreed risk profile for the company. The findings from this study are that the IAF is not responsible for risk identification or risk profiling, which all respondents indicated to be management’s responsibility. Rather, the IAF’s role is to support the AC by providing an independent review of the risk processes and ensuring that risk mitigating controls are in place.

In terms of the support provided by the AC to the IAF, the common response from ACCs and CAEs was that the AC elevates and protects the status and visibility of the IAF within the organisation by providing the appropriate platform for the IAF to present findings at AC meetings. This sends the signal that the IAF is an important

function within the organisation and its work is not meant to be taken lightly. Further, the AC empowers the IAF and is used “*as a hammer to chase management on outstanding issues if necessary*” (CAE2). CAEs consider that the AC reviewing and approving the IAF work plan, scope and budget, provides support to the IAF, as CAE2 suggests that “*it gives credence to the IAF reports*”. ACs also ensure that the IAF is adequately resourced, including approving the use of external resources as necessary, which ACC3 notes “*sends the signal that the IAF is well supported*”.

Apart from providing a forum for the IAF to be heard, ACCs also indicate that they consider the AC’s support of the CAE necessary, particularly in potentially controversial situations. This sentiment is echoed by CAEs, such as CAE1 who notes that CAEs always need to know that the ACC and AC are one hundred percent supportive as “*it is a very rocky road in a situation when they do not, it is a very uncomfortable and potentially untenable place to be*”. CAE4 suggests that the best ACC provides “*questioning support*” by mentoring the IAF and speaking to the CEO on its behalf. CAEs also believe that it is necessary for the AC to continue to raise the profile of the IAF within the organisation, such as by “*ensuring that the CAE is present in operations meetings*” (CAE3).

Another issue raised by the CAEs relates to the support from the AC, and particularly the ACC, as they perceive their role to be a very autonomous one which can also be very isolated. CAE1 notes that he does not know “*if all AC members realise the importance of their support, but that the loyalty and relationship between the ACC and the CAE are vitally important*”. He suggests that it is the knowledge that the ACC is relying on him that motivates him and provides a great sense of responsibility and accountability, and provides the sense that he is “*looking out for him [ACC] personally*”. ACCs typically note that the support provided to the CAE is inherent in the provision of job security by maintaining significant influence in the hiring and firing decisions as discussed above in RQ1. Lastly, it is noteworthy that CAE2 mentions that he would appreciate “*AC members imparting more of their knowledge and experience, particularly since they sit on the boards of other companies and interact with other CAEs and IAF*”. He suggests that this would allow the CAE to benchmark the performance of the IAF.

In summary, the results indicate that the relationship between the AC and the IAF (and ACC and CAE) is viewed as critical to the success of both these corporate governance mechanisms. The results provide depth to the findings of previous studies, through an insight into AC characteristics that CAEs perceive to be essential to ensuring a strong relationship between the AC and IAF, and an insight into the nature of the communications (formal and informal) between the AC and IAF.

Research Question 4a (RQ4a) examined the perceptions of key AC characteristics which contribute to a strong, functional relationship with and its ability to support the IAF. Overall, respondents raised issues relating to independence, expertise and experience, as well as other personal attributes of AC members as essential characteristics in contributing to a strong relationship and the ability to support the IAF.

With the exception of CAE4 who believes that independence is absolutely vital and even more important than expertise and experience, CAEs believe that while

independence is important in facilitating a diversity of opinion on the AC, expertise and experience are critical. However, individually there is a range of positions on the level of independence needed on the AC. For example, CAE3 maintains that the AC members in his organisation have been on board for a substantial period now but *“they still speak their mind”*, and they are not *“pushed around by anyone”*, and that *“as long as everyone’s aim is to increase shareholders’ wealth, I don’t see a problem”*, while CAE2 emphasises that independence is more important to the AC than to the board and that he would *“struggle reporting to an AC with executive directors on the committee as he would effectively be auditing them as part of his job”*.

Respondents also suggest that they consider a diversity of expertise and experience on the AC as crucial. Technical financial expertise is considered the most important type of expertise across both respondent groups. Given that the AC is perceived to have a significant role to play in ensuring the integrity of the organisation’s financial reporting, CAE1 notes that *“it is important for the AC to have grounding in financial expertise in order to engage with the IAF, although the function considers more than just financial matters”*. The desirability of a legal expert is also raised by CAE1 who suggests that a *“legal background is important to facilitate understanding context, the need to go through right procedures and due process, and asking the right questions”*. According to CAE1, having AC members with legal backgrounds also works well for the IAF as *“being appropriately anxious about responsibilities of being on an AC is a great asset as they make IAF work hard for them”*.

Experience on other boards and ACs is also perceived to be valuable. ACC5 suggests that AC members who are engaged on other boards and ACs bring insights and a broader view from these other organisations, which *“gives the opportunity for cross fertilising and leveraging of ideas and approaches”*. CAE6 and CAE4 support this view as experience on other boards gives ACs exposure to a range of topical issues which can then be applied to their organisation, and provides a benchmark for the performance of their IAFs against those of other organisations (CAE2).

Other characteristics considered to be important in facilitating a strong relationship with the IAF and supporting the function relate to the diversity of the AC members in terms of expertise and backgrounds, personalities, an effective ACC, and personal attributes such as integrity, an inquiring mind and a challenging nature. Related to the desirability of having AC members with diverse expertise and experience is the need for a strong ACC to manage the dynamics within the committee. As CAE1 provides, *“an experienced and active ACC is important to manage the dynamics and to ensure there is a consensus and harmony within the AC”*. CAE1 reinforces this need by recounting his experience with non-executive directors who were previously CEOs who are *“not used to being a single voice as a member of a committee”*. ACC6 notes the need for a *“moral compass to guide you through”*, and that the ACC should not dominate, but should encourage views. Several ACC and CAE respondents also suggest that an effective ACC is necessary to manage conflicts between the IAF and the EA when they arise.

CAEs note that the personalities within the AC and particularly of the ACC are instrumental in determining the effectiveness of the relationship. CAE2 explains that *“a lot of it comes down to personalities within the AC and what the ACC would like to see or do”*. In terms of personal attributes, the key ones are an inquiring mind and a

challenging nature to hold people to account as ACC6 states “*it is not a mutual appreciation society*”. Respondents expect AC members to ask (right) questions and be willing to express their opinions as ACC6 provides, “*every member needs to have a view... [and] have the strength of character that if you disagree with something you are able to express it and do something about it*”. Integrity was also repeatedly brought up by interviewees as an essential characteristic of AC members. ACC5 in particular considers that integrity and accountability “*are the baseline necessities, as skills and expertise can be brought into the organisation or built on, but it is a lot harder to import these values*”

Lastly, issues with AC member turnover and AC succession planning were brought up in a number of interviews. CAE1 considers that stability in membership is a key characteristic of the AC, as an “*inordinate amount of time spent explaining what the IAF does within organisation and how it adds value*” as a result of having a particularly high turnover of AC members in his organisation. In alluding to the importance of planning AC member succession, CAE2 notes that although the composition of the AC in his organisation is presently “*quite good*”, once the ACC leaves, there will not be the same level of experience and detailed accounting standards knowledge. However, he adds that “*this needs to be balanced with the requirement to have very good risk and control knowledge on the AC as well*”.

In summary, the results in the area of AC characteristics provide support for findings from prior research and an in-depth insight into issues considered to be in need of further research, such as how expertise and experience contribute to the effective communications, review and oversight of the IAF and in ensuring ACE (Zain & Subramaniam, 2007; McDaniel *et al.*, 2002). The results provides context to the KPMG’s (2006) survey that finds that 91% of the Australian AC member respondents to its survey believe that it is important for at least one AC member to have financial expertise,. The results also provide a context to the operationalisation of financial literacy and financial expertise in practice which according to Abbott *et al.* (2004) is virtually impossible to determine from publicly available information. The results also support Kang *et al.* (2008) findings that qualitative AC member characteristics such as industry experience are crucial in ensuring improved financial reporting quality. The findings are consistent with McDaniel *et al.* (2002) experimental results which indicate that financial experts and financial literates focus on different activities and business issues. The relevant data is provided in Table 2.

Table 2: Expertise of Audit Committee Chairs

Respondent	ACC1	ACC2	ACC3	ACC5	ACC6
Level of financial expertise	Financial literate	Financial expert	Financial expert	Financial literate	Financial expert
Specific current issues of concern	Look at business in terms of financial opportunities and efficacy of various procedures	Conducting cross-checks of financial accounts and certain monthly ratios	Disclosures required (e.g. AASB7 <i>Financial Instruments</i>)	Business improvement initiatives (e.g. improving efficiency and lowering costs)	Financial risks relating to derivative products

Research Question 4b (RQ4b) examined the key IAF characteristics perceived to contribute to an effective IAF and to its ability to support the AC. Apart from the

characteristics relating to structure of the function (i.e. in-house vs. outsource vs. co-source), characteristics relating to the human resources of the IAF were brought up by both ACCs and CAEs. As CAE4 summarises, both respondent groups note that “*there is now good talent in the audit and risk space*”. ACC6 recognises the need for a good team of internal auditors within the function with the appropriate technical competencies such as technical finance and audit, operational (business), technological, and occasionally legal. He also adds that it is important to have a team (i.e. a number of IAF staff) of like-minded individuals “*who can use one another as a sounding board for issues and concerns*” as he is aware that “*being in the IAF is a challenging role and can be isolating*”.

Similarly, CAEs report the importance of the necessary skills including accounting and IT backgrounds. Further, they emphasise that the relationships of the IAF, particularly with AC and senior management, in terms of support and appropriate reporting lines are necessary for the success of the IAF. CAE4 also emphasises the importance of the independence and objectivity of the IAF in ensuring its effectiveness.

Respondents also drew attention to the CAE in their discussions of the characteristics of the IAF. ACCs note that there are now heightened expectations of the CAE and the quality of the person in the role. They emphasise that it is important to have a good CAE who is able to work with other stakeholders in the organisation and who is not afraid to raise his opinion even in controversial situations. As ACC3 provides, it is necessary for a “*good CAE who is able to command the confidence and respect of the people out in the field so as to be able to gain access and cooperation*”. Attention was also drawn to the fact that the role of the CAE can be an isolated one and that the support of the AC is necessary in this regard. As some of the respondent CAEs have been in their position for a number of years, issues were raised about whether there was a need to have a limited tenure and a rotation of the CAE, as well as more certainty in the career path of a CAE. These issues were not pursued at length for the purposes of the present study, but could prove an interesting area for future research.

In summary, the results of the study highlight the emphasis placed on having the right people with the appropriate skills (particularly accounting and IT) in the IAF as well as for the role of the CAE. This provides evidence for the findings from Ernst & Young (2007, p. 2) that “*people are still the foremost challenge*” for IAFs. Further, the results confirm the findings of prior studies that report that the perceptions of IAF effectiveness are related to the level of expertise within the function (Zain *et al.*, 2006) and the status and position of the IAF (Leung *et al.*, 2004) Lastly, it is worth mentioning that the issue of the career path of the CAE came up in several of the interviews and may be an area in which future research can consider.

Research Question 5a (RQ5a) investigated the AC performance evaluation practices in the current Australian context, and the extent to which the IAF is involved in this process. ACCs presented a variety of performance evaluation practices ranging from none to a process undertaken every few years either internally or externally, to a formal evaluation process undertaken annually.

Overall, CAEs are uncertain or in the dark about the performance evaluations practices of the board or the AC. They indicate that performance evaluation is directors’ private business and are not privy to how AC performance or effectiveness is

operationalised or measured. As CAE1 states, the performance evaluation of the AC is “*a complete black box, a complete mystery*”.

Accordingly, CAEs had virtually no participation in the process. When asked about the potential to contribute in this area, CAE1 suggests that ACCs would consider an upwards evaluation of the AC by the CAE “*abhorrent and inappropriate*”. However, CAE2 in fact performs such an evaluation of the AC, as suggested by ISPPIA Practice Advisory 2060-2(4). This upward evaluation is conducted by providing ratings and corresponding feedback on the AC’s performance in relation to the its charter and best practice guidelines (e.g. ASX CGC Guidelines, AICD Best Practice Guide and Big-4 Guidelines).

In summary, there is diversity and a level of inconsistency in the performance evaluation of the AC in practice. Only one of the respondent organisations has publicly available disclosures about the performance evaluation practices of the board. In light of the increasing attention paid to the performance evaluation practices of the board, such as the addition of Recommendation 2.5 in the revised ASX CGC Guidelines in 2007, which will require boards to disclose their performance evaluation practices for reporting periods commencing 1 January 2008, further development and attention is warranted in this area. Furthermore, in light of the symbiotic relationship between the AC and the IAF, their effectiveness and performance are inevitably interrelated (ISPPIA Practice Advisory 2060-2(2)). Future research may thus examine the potential of the IAF and EA to contribute to the performance evaluation of the AC (Cohen *et al.*, 2008).

Research Question 5b (RQ5b) examined the performance evaluation practices of the IAF and the nature of the AC’s involvement in this process. While it varies across organisation whether the process is conducted by HR or management, the AC or ACC typically has input in the process, and is generally responsible for determining the CAE’s salary and bonus. CAEs self-report the performance of the IAF in relation to internally and externally developed guidelines, particularly from the ISPPIA.

The most commonly employed measures of effectiveness relate to the efficiency of the IAF with regard to the annual IAF work plan, in terms of the completion of planned audits and timely completion of the work plan, as well as measures of acceptance and adoption of IAF recommendations. It is noteworthy that value-tracking in terms of cost savings or value creation as a IAF performance metric is only raised by CAE1, although ACC1 and ACC5 indicate that it is likely to become an important criteria. ACC2 also recounts that one of the key considerations particularly in the initial years of establishing an in-house IAF was a cost-benefit analysis of the value-added by the IAF. Table 3 presents the performance metrics for the IAF employed in ORG1 and ORG3 which had the most comprehensive IAF performance evaluation matrices.

Table 3: Performance operationalisation and measurement of the Internal Audit Function

ORG1	ORG3
5 Attributes (4 top line, 1 underlying): <ul style="list-style-type: none"> ➤ assurance (covering key areas within the year) ➤ shareholder value (value preservation and creation through identifying efficiency opportunities) ➤ strengthening control environment ➤ stronger management team ➤ efficiency of IAF (budget and scope) 	5 KPIs: <ul style="list-style-type: none"> ➤ timely completion of IAF plan ➤ identify and address risk in proactive manner ➤ manager acceptance of IAF recommendations ➤ increase effectiveness of ICs ➤ increase profile of IAF

In summary, there are a range of practices relating to the performance evaluation of the IAF, and a level of diversity in the operationalisation of performance metrics of the function. The results of the study provide support for Ernst & Young (2007) survey that reports that one of the top metrics used in the measurement of IAF effectiveness is the completion of audits in comparison to IAF plan, and that a majority of IAFs do not perform any value tracking. In light of the increased involvement of the IAF in operational issues, the issue of value-tracking as a mechanism to measure the IAF's support of the key business initiatives and to demonstrate the value and relevance of the IAF is a potential area for future research. The degree to which the IAF's independence and objectivity is impaired from its involvement in these activities may also be investigated.

The complexity in performing performance evaluations of the IAF was well explained by CAE6 (external service provider) who has extensive experience with several organisations implementing such processes. He suggests that performance evaluation needs to be *“aligned with objectives... [and] balanced, but it is difficult to judge quality and qualitative information as opposed to quantitative information. For example, whether the IAF delivered on budget does not tell you anything”*.

Table 3 also illustrates the emphasis of quantitative measures as opposed to qualitative measures used in evaluating the performance of the IAF. As the findings from this study indicate, these metrics are not necessarily reflective of the performance or effectiveness of the function, which necessarily include the strength of the relationship with the AC, and the nature and quality of the support provided to the AC.

5.1 Additional Analyses

In order to provide a holistic understanding of corporate governance practices, respondents were asked to comment on the role of the EA and whether the EA impacted or changed the roles of the AC or IAF in any way. While there were varying levels of mutual reliance between the IAF and the EA, respondents indicated on the whole that there was a good relationship between the EA and the IAF, and the EA and the AC. EAs typically had free access to the IAF's reports and working papers, and vice-versa. Both parties also consulted each other as necessary and coordinated their work in order to avoid duplication (*“not replicating the wheel in undertaking the exact same project”*) and to promote cost efficiency in some instances (ACC5), and/or to ensure smooth business operations and minimal disruptions in others (CAE1, CAE6). While ACCs

placed reliance on the work of the EA, they tend to rely more on the IAF for assurance and comfort as the IAF is 'internal'. Tensions in the relationship with the EA often arise in relation to issues with the audit fees as “*auditors these days never believe that their fee is sufficient*” (ACC3). ACC6 also adds that tensions occasionally arise in the planning process as the “*EA or IAF want to do their own thing and push themselves apart or push issues to each other*”. In summary, while overall there appears to be a cordial relationship with the EA and IAF, “*it could be better*” (CAE6), and there is “*value to be had in improving the dialogue between the EA and IAF*” (ACC6).

6. CONCLUSION

This study has provided insights into the current nature of various aspects of the relationship and interactions between the AC and the IAF, two key corporate governance mechanisms. The data collected and reported in this study aims to inform policymakers (e.g. ASIC, ASX) and professional bodies (IIA, AICD) in their deliberations of regulations, standards and guidance pertaining to the AC (e.g. AC member selection) and the IAF, as well as the relationship between both parties (e.g. AC-IAF communication and reporting). The study is useful for practitioners (AC members and CAEs) when benchmarking their roles and relationships to the reported results. This also allows them to reflect upon their present performance, and to take steps to improve their relationship in working towards the common goal of quality corporate governance.

In summary, the results suggest that there is now a greater appreciation for the importance of mutual reliance and a strong relationship between the AC and the IAF consequent of the expansion and refocus each party has experienced in their respective roles. The quality of individuals in key roles within each function, as well as personal attributes and values of members are also perceived to be critical for the effectiveness of each mechanism, and in ensuring a strong functional relationship between both. Lastly, the findings present a level of diversity in the participation in and practice of performance evaluation of both the AC and the IAF.

The results of the present study must be considered in light of a number of limitations. The first limitation is inherent to the use of a qualitative approach of collecting data, in that the findings are limited in terms of their generalisability. The data collected represents the perceptions of the individual respondents and are not necessarily representative or generalisable to the wider population of ACCs and CAEs. However, given that the aim of the study is to provide a greater understanding and to provide depth to the predominantly quantitative survey research in the area of ACs and IAFs, the use of semi-structured interviews was considered the most appropriate for the present study. The generalisability of the study is also limited in view of the potential sample selection bias. Respondents were recruited on a voluntary basis, which may skew the results in favour of organisations in which the ACS and/or IAFs represent (or are perceived to represent) better practice than the wider population.

This study investigated the perceptions of ACCs and CAEs in the context of mandatory regulatory AC requirements relating to the composition and responsibilities as set out in the ASX CGC Guidelines (with the exception of ORG6). Future research may consider investigating similar issues in other regulatory contexts and national settings. For example, studies may focus on different types of industries such as financial institutions in which there are a different set of regulations and requirements.

Future research may also examine the perceptions of other actors in the corporate governance mosaic including senior management such as the CFO and CEO, as well as the EAs.

APPENDIX A: List of Target Issues for Semi-structured Interviews

Research Project Title: The relationship between the Audit Committee and the Internal Auditor: what works, what doesn't?

The following issues are indicative of the areas that will be explored during the interviews with individual participants:

Audit Committee Chairs

- The roles of the Audit Committee (AC) and Internal Audit Function (IAF) within the organisation
- Key characteristics of the AC and the IAF in contributing to their effectiveness
- The nature of the relationship and interactions with the IAF (e.g. frequency and duration of formal/informal meetings, matters of significant debate, nature of reporting lines, composition of AC, characteristics of AC members, and decisions relating to: hiring/firing, remuneration, scope & budget)
- Support expected and received from the IAF
- Support expected to be provided and actually provided to the IAF
- Performance evaluation practices relating to the AC and IAF
- AC performance and effectiveness operationalisation and measurement
- IAF performance and effectiveness operationalisation and measurement
- Changing nature of the roles of the AC and the IAF, their relationship, and the driving factors

Chief Audit Executives

- The roles of the Audit Committee (AC) and Internal Audit Function (IAF) within the organisation
- Key characteristics of the AC and the IAF in contributing to their effectiveness
- The nature of the relationship and interactions with the AC (e.g. frequency and duration of formal/informal meetings, matters of significant debate, nature of reporting lines, composition of AC, characteristics of AC members and decisions relating to: hiring/firing, remuneration, scope & budget)
- Support expected and received from the AC
- Support expected to be provided and actually provided to the AC
- Performance evaluation practices relating to the AC and IAF
- IAF performance and effectiveness operationalisation and measurement
- AC performance and effectiveness operationalisation and measurement
- Changing nature of the roles of the AC and the IAF, their relationship, and the driving factors

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