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### Audit Committee Perceptions about Internal Audit: Survey Evidence from Indonesian Audit Committee Members

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#### ABSTRACT

The audit committee and the internal audit are two important pillars of corporate governance that monitor the financial reporting process. In this study, I investigate how audit committee members perceive the role and effectiveness of their company's internal audit function. I survey audit committee members working for Indonesian companies to learn about their dealings with the internal audit function. I obtain information about the frequency of meetings that audit committees hold with internal audit. I gather insights about the magnitude to which audit committees influence the mechanisms of internal audit. The audit committee respondents also shared their ratings about the independence, competency, and efficiency of internal audit. Finally, I document how audit committee members assess their reliance on and overall satisfaction with their internal audit function.

#### 1. INTRODUCTION

The audit committee and internal audit are two cornerstones of corporate governance that is needed for effective and reliable financial reporting (Raghuandan et. al. 2001; Sarens et. al. 2009; Abbott et. al. 2010; Barua et. al. 2010). In this study, I survey 40 audit committee members working for Indonesian companies and gather insights about their interactions with internal auditing. The results of the survey offers a unique look into how audit committee members perceive the role and importance of their internal audit departments. I investigate the frequency of meetings that audit committees hold with internal audit. I examine the extent to which audit committees influence the inner workings of internal audit. The audit committee respondents also provided their ratings on the independence, competency, and efficiency of internal audit. Finally, I ask the audit committee members to rate their reliance on and overall satisfaction with their internal audit function.

Audit committees first attracted attention in the late 1930's when the United States Securities and Exchange Commission (SEC) and New York Stock Exchange encouraged their establishment after the McKesson and Robbins scandal of 1938, which was one of the major financial scandals of the 20th century (Birkett 1986). A 1970 survey by Mautz and Neuman showed that 32 percent of the corporations responding had audit committees, while a repeat of the survey in 1976 showed that 87 percent had audit committees (Mautz and Neuman, 1977). Also, when The New York Stock Exchange (NYSE) decided to require that all listed corporations have audit committees as of June 30, 1978, audit committees were made to be an integral part of the corporate organization (Birkett 1986).

As part of its monitoring duties, the audit committee is in charge of overseeing their company's financial reporting process and disclosure practices (Abbott et. al. 2004). In 1999, the audit committee received special attention when a committee in USA composed of individuals from the The New York Stock Exchange (NYSE), the National Association of Securities Dealers (Nasdaq), public companies, and CPA firms issued the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (Raghuandan et. al. 2001; Abbott et. al. 2003; Buchalter and Yokomoto 2003). The report recognized that the audit committee has an important role in ensuring high-quality financial reporting (Buchalter and Yokomoto 2003).

Recently, KPMG (2014) issued several important insights about the priorities and future challenges facing audit committees. KPMG (2014) finds that 75 percent of the 1,500 audit committee members responding to their 2015 Global Audit Committee Survey said the amount of time required to carry out their audit committee responsibilities has increased moderately (51%) or significantly (24%) over the past two years. And 40% said it's becoming increasingly difficult to oversee all the major risks on its agenda given the committee's agenda time and expertise.

According to the Institute of Internal Auditors (IIA), which is the international professional association for internal auditors, internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.<sup>1</sup>

While internal auditing can certainly add value to various business processes within the company, it is commonly expected that internal auditors play an important role in monitoring the financial reporting process, including internal controls over financial reporting (Messier et. al. 2011; Christ et. al. 2015). For example, section 2120 of the International Standards for the Professional Practice of Internal Auditing states that the internal audit activity must evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the reliability and integrity of financial. Furthermore, section 2130 of the standards asserts that the internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organization's governance, operations, and information systems regarding the reliability and integrity of financial information.

With regards to financial reporting fraud, internal auditors are often asked to be alert to the signs and possibilities of fraud within an organization (Ege 2014; Abbott et. al. 2015). While external auditors focus

<sup>1</sup> For more details, see <https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Definition-of-Internal-Auditing.aspx>.

on misstatements in the financial statements that are material, internal auditors are often in a better position to detect the symptoms or signs of fraud because internal auditors usually have a continual presence in the organization that provides them with a better understanding of the organization and its control systems (Ege 2014; Christ et. al. 2015). While management and the board of directors (i.e., audit committee) are ultimately responsible for fraud prevention and detection, internal auditors can play a crucial role by determining whether the organization has adequate internal controls and fosters an adequate control environment (Lin et. al. 2011). Therefore, an effective internal audit activity can be helpful in addressing fraud risk.

Researchers have great interest in examining the interactions between the audit committee and internal auditing. As pointed out by Raghunandan et. al. (2001), the Blue Ribbon Committee Report includes recommendations highlights the role of internal auditors in assisting audit committees in the corporate governance process. The work by Raghunandan et. al. (2001) is based on responses from chief internal auditors of public companies and find that audit committees comprised solely of independent directors and with at least one member having an accounting or finance background are more likely to (1) have longer meetings with the chief internal auditor; (2) provide private access to the chief internal auditor; and (3) review internal audit proposals and results of internal auditing.

Barua et. al. (2010) investigate the association between audit committee characteristics and the investment in internal auditing (internal audit budget). Their findings suggest that the internal audit budget is negatively related to the presence of an auditing expert on the committee and the average tenure of audit committee members. Hence, when the audit committee has more auditing expertise and more firm-specific knowledge, it may not invest as much in internal auditing. Stated differently, audit committees that lack expertise and knowledge about the firm would put more investments into internal audit in order to fill the void. Barua et. al. (2010) also find that the internal audit budget is positively related to the number of audit committee meetings. They explain that a diligent audit committee would be more supportive of internal auditing thus leading to a higher internal audit budget. Alternatively, their finding can suggest that audit committees that meet more frequently, to manage the risk of financial misreporting, also demand a higher internal audit budget.

Sarens et. al. (2009) suggest that internal audit can be a comfort provider to the audit committee. They base their study on four Belgian case studies and offer interesting insights. They find that audit committees seek comfort from internal audit on issues regarding the control environment and internal controls. Internal auditors are able to provide such support for the audit committee because internal audit is perceived to have familiarity about various aspects of the organization and possess unique knowledge about risk management and internal controls.

Abbott et. al. (2010) investigate the association between the audit committee's oversight of the internal audit function and the nature of internal audit activities. The authors hypothesize that higher levels of audit committee oversight of the internal audit function (compared with management's level of oversight over internal audit) is associated with a higher percentage of internal audit resources devoted to internal-controls-based activities. They find that audit committees have more desire for internal audit to focus on maintaining effective internal controls.

## Survey Approach

In this study, I examine how audit committees perceive the efficacy of their internal audit. In order to identify audit committee members as survey subjects, I scanned through the annual reports of publicly traded companies in Indonesia. These annual reports contain the identity and information about individuals belonging to the audit committee. In sum, I identified a total of 200 individual audit committee members. With the help of research assistants, I sent the survey materials (via mail) to all of these individuals. Out of the 200 targeted subjects, 40 audit committee members completed and returned the materials (which represents a 20 % response rate).

## Demographic Information

In this section, we provide demographic information about our audit committee members that responded to our survey instrument. A total of 9 of the 40 (22.5%) audit committee respondents work for companies that have revenues less than one trillion Rupiah. 18 of the respondents (45%) belong to audit committees of companies that have between one to five trillion Rupiah in revenues. The remaining 13 respondents (32.5%) are members of audit committees of companies that generate more than five trillion Rupiah in revenues.

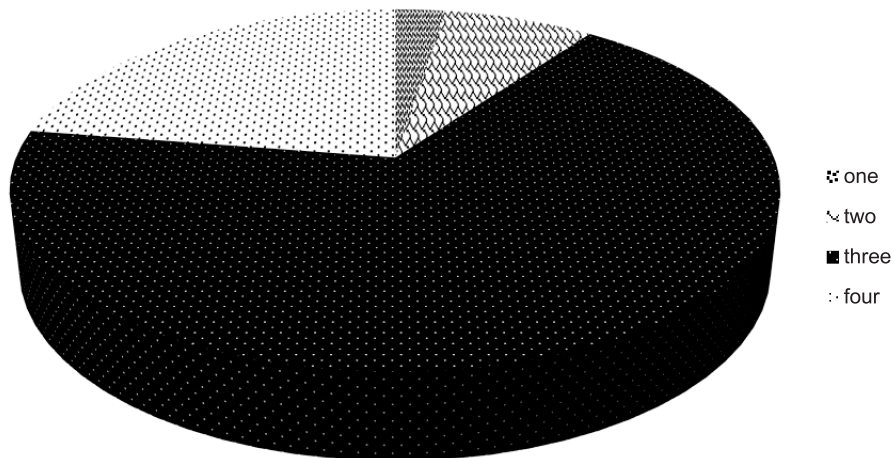


Figure 1: Size of Audit Committee

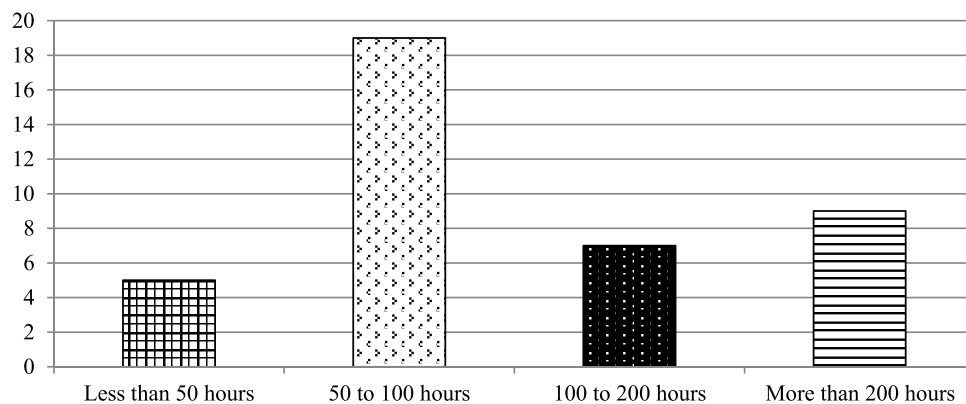
Out of the 40 respondents, seven (17.5%) individuals are chairmen of their audit committees. As shown in Figure 1, the respondents are members of audit committees that range from one to four individuals. Approximately 68% of the audit committees have three members, while 23% of the audit committees have four members. The remaining 9% of audit committees have either one or two members.

Table 1 shows the number of years of experience the respondents have being an audit committee member of their current company. The mean (median) number of years the respondents have being an audit committee member is 4.65 (4) years. There are 8 respondents that only have 2 years of experience being an audit committee member of their company and five respondents have more than six years of experience.

Figure 2 shows the number of hours in a year that the respondents devote in carrying out their audit committee work and responsibilities. A total of 19 of the respondents (47.5%) state that they devote 50 to 100 hours annually. Only five respondents (12.5%) say they dedicate less than 50 hours annually. There are seven respondents (17.5%) that spend 100 to 200 hours annually and remaining nine respondents (22.5%) allocate more than 200 hours annually to do audit committee work.

**Table 1**  
**Years of Experience being Audit Committee Member of Current Company**

<i>Number of Years</i>	<i>Frequency</i>	<i>Percent</i>
2 years	8	20
3 years	4	10
4 years	12	30
5 years	8	20
6 years	3	7.5
7 years	2	5
8 years	1	2.5
15 years	2	5
Total	40	100
Mean is 4.65 years		
Median is 4 years		



**Figure 2: Hours (Annually) Devoted to Audit Committee Work**

Figure 3 shows the number of annual audit committee meetings the respondents have in their companies. Out of the 40 respondents, 16 (40%) individuals report that their audit committee meets seven to ten times per year. A total of 12 (30%) respondents report that their audit committee meets four to six times per year. Furthermore, nine (22.5%) respondents inform that their audit committee meets more than ten times per year. The remaining 3 respondents report that their audit committee only meets one to three times per year. In terms of the average length of regularly scheduled audit committee meetings, 35% of the respondents report that their audit committee meeting typically last one to two hours. 47.5% of the respondents state that their meetings last for two to three hours and the remaining 17.5% of respondents affirm that their audit committee meetings usually take more than 3 hours.

### Survey Results

We asked the audit committee respondents about who they believe the internal audit provides the “most” value to. As shown in Figure 4, an overwhelming majority (34 out of 40) believe that internal audit provides the most value to company’s management team. Eight of the 40 respondents suggest that internal audit provides the most value to the board of commissioners and only three of the 40 respondents perceive

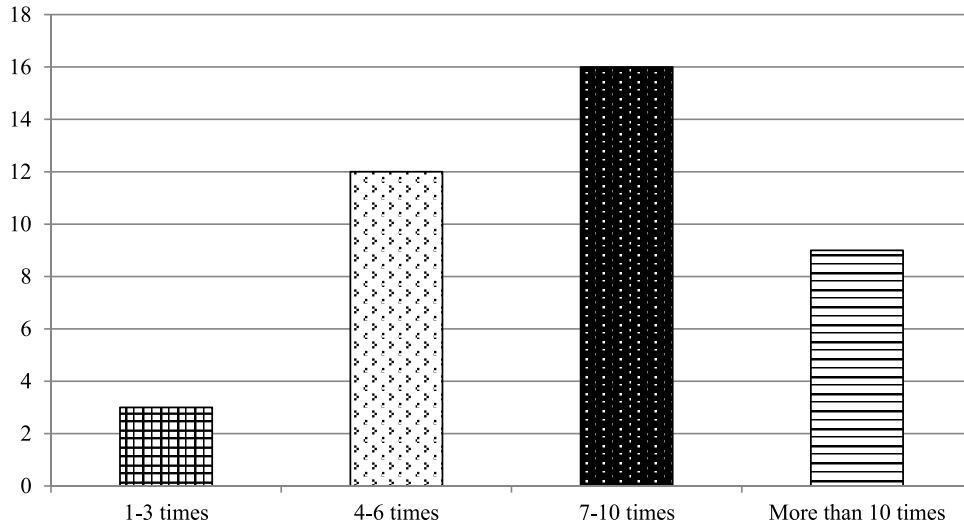


Figure 3: Audit Committee Meetings per Year

that internal audit provides the most value to the audit committee. In this case, some respondents picked multiple answers and hence the total answers exceed 40.

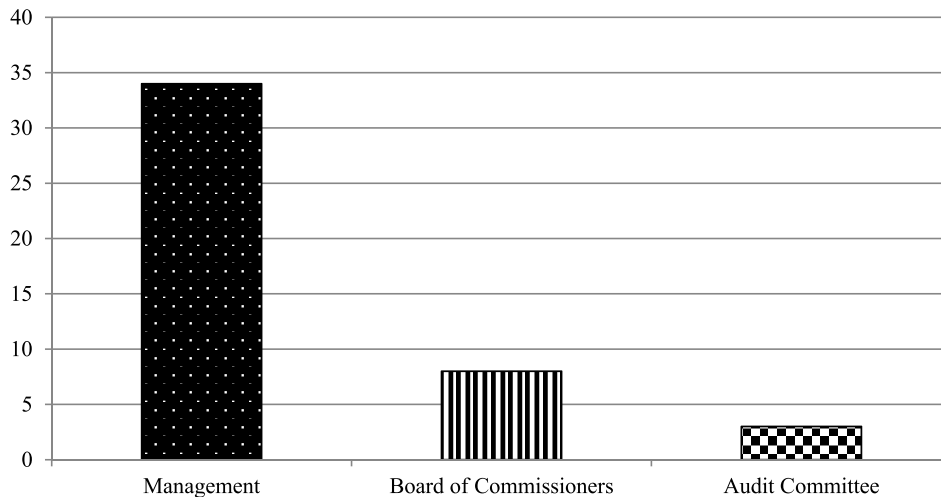
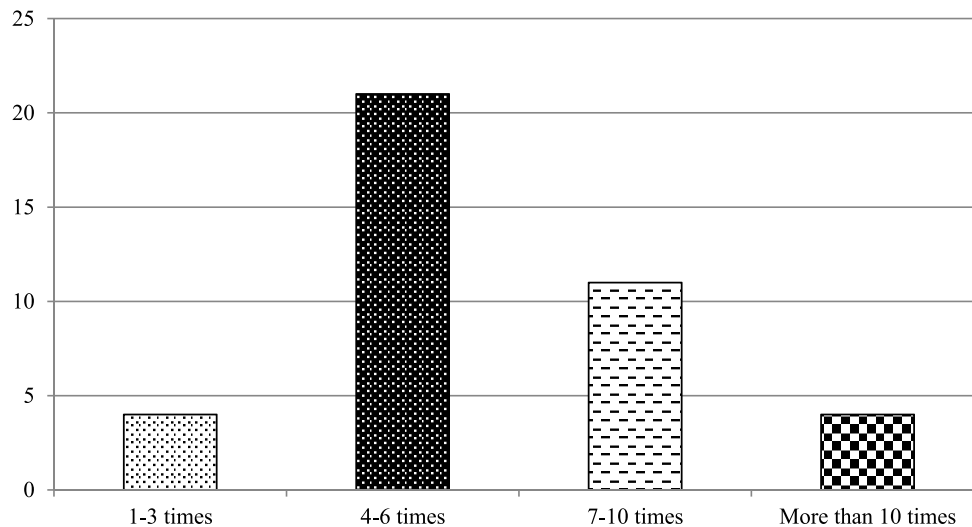


Figure 4: Who does Internal Audit provide Most Value to?

We asked the audit committee members about the frequency of meetings between the audit committee and internal audit. As shown in Figure 5, the majority of respondents - 21 out of 40 (52.5%) - report that their audit committee meets with internal audit between four to six times during the year. 11 (27.5%) of the respondents state that their audit committee meets with internal audit between seven to ten times during the year. Only 10% (10%) of the respondents suggest that they meet with internal audit between one to three times (more than ten times) during the year. We also asked the respondents about whether the meeting frequency between the audit committee and internal audit is adequate. The vast majority of respondents – 29 out of 40 (72.5%) - suggests that the meeting frequency between their audit committee and internal audit is currently enough. Only 17.5% (10%) of the respondents believe that the meeting frequency between their audit committee and internal audit is currently not enough (more than enough).





**Figure 5: Meeting Frequency with Internal Audit**

In the next set of questions, we asked audit committee respondents about how much influence they perceive to have over their company’s internal audit. On a scale of one (very low) to seven (very high), we asked the respondents to answer the following questions:

- AQ1. How much influence does the audit committee have in the selection and hiring of the chief audit executive (i.e., CAE or head of the internal audit department)?
- AQ2. How much influence does the audit committee have in the selection and hiring of internal audit staff (other than the head of internal audit)?
- AQ3. How much input do you provide to internal audit when they begin to generate their audit plan?

Figure 6 provides the distribution of answers to AQ1. As shown in the figure, the majority of respondents gave an answer of three or four. The mean response is 4.2. Only 9 of the 40 respondents (22.5%) gave an answer of six or seven (very high). This suggests that, on average, audit committees have a “medium” influence over the selection and hiring of the CAE. Figure 7 provides the distribution of answers to AQ2. As shown in the figure, the majority of respondents gave an answer of two or three. The mean response is 3.28. Only 4 of the 40 respondents (10%) gave an answer of six or seven (very high). This suggests that, on average, audit committees have a “fairly low” influence over the selection and hiring of the internal audit staff.

Figure 8 provides the distribution of answers to AQ3. As shown in the figure, the response of six (6) received the most votes (10 out of 40 – 25%). The mean response is 4.35. There are 12 of the 40 respondents (30%) that gave an answer of six or seven (very high). Interestingly, no respondent gave an answer of 1 (very low) to this question. Overall, audit committees, on average, have a “medium” input over the audit plan generated by internal audit.

Next, we asked the respondents whether they believe their audit committee should be given *more* influence and control over the internal audit department than is current given. As shown in Figure 9, a majority of respondents (57.5%) answered “No” while 42.5% of respondents believe the audit committee should be given more authority over the internal audit function.

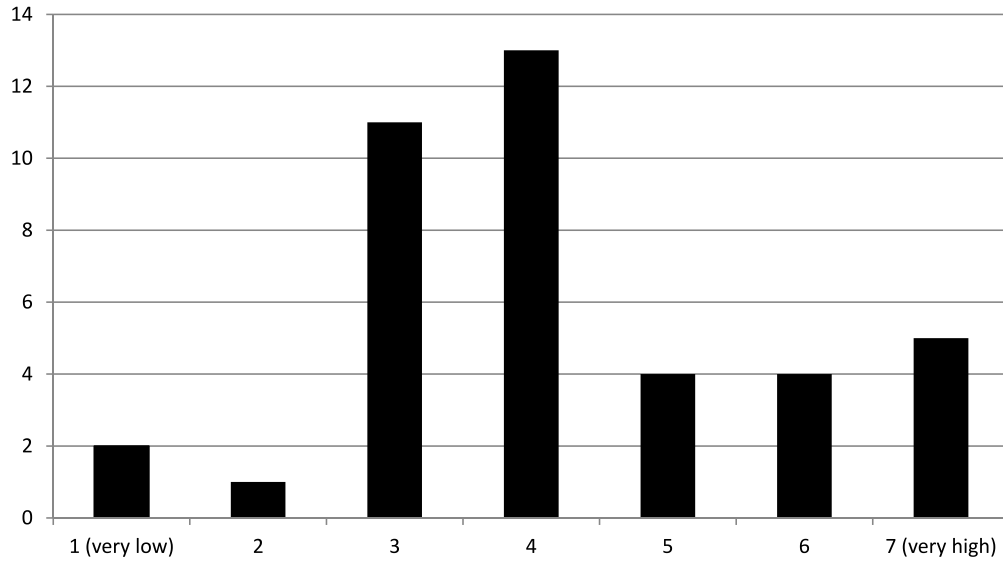


Figure 6: Audit Committee Influence over Hiring CAE

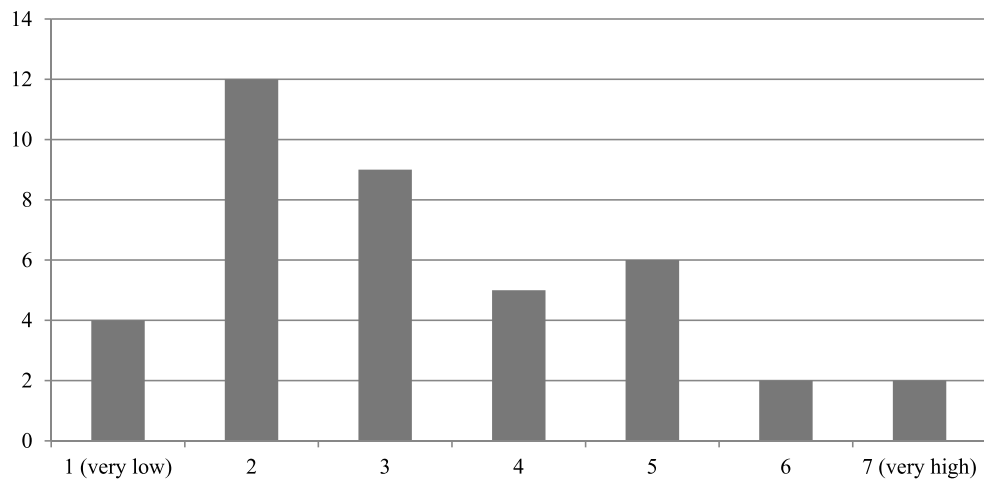


Figure 7: Audit Committee Influence over Hiring IA staff

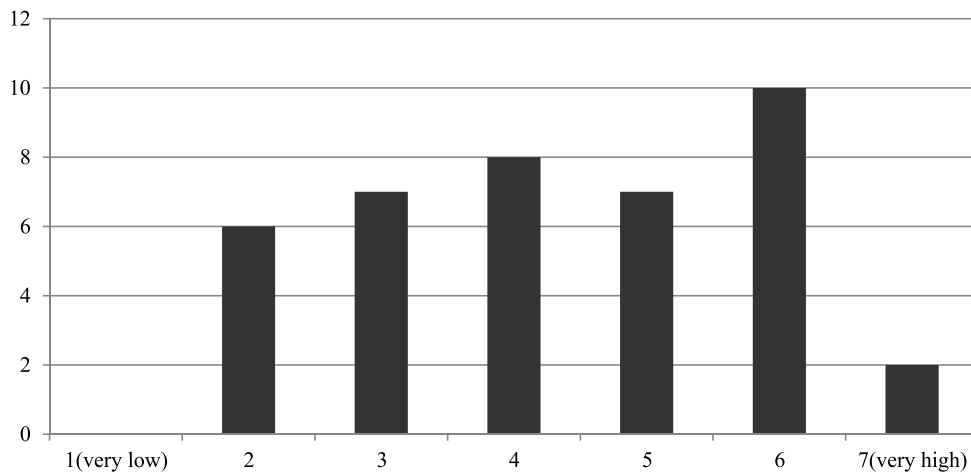
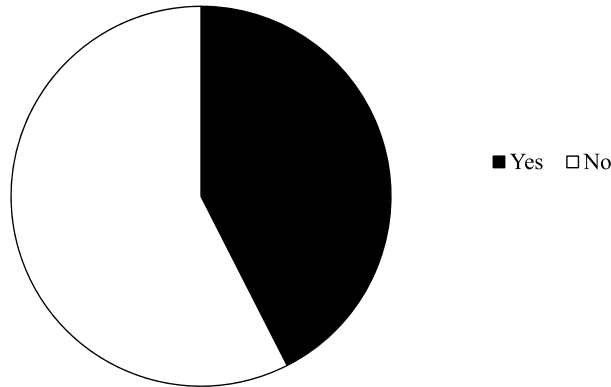


Figure 8: Audit Committee Input over Internal Audit Work Plan



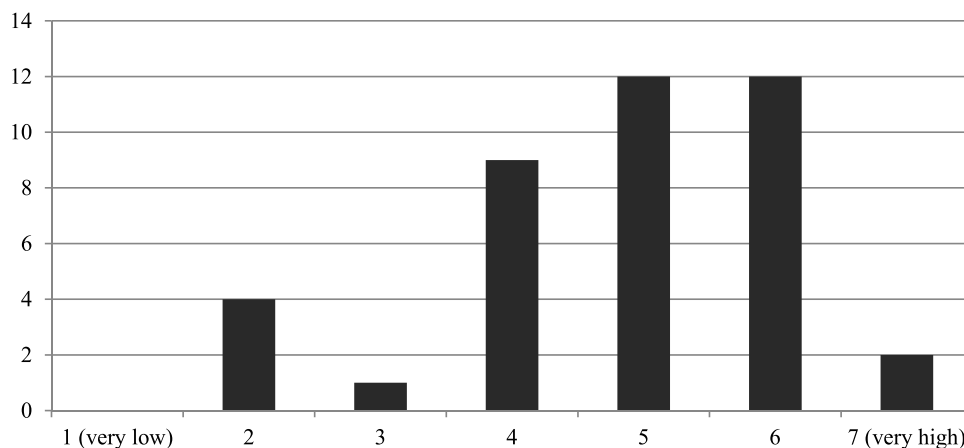


**Figure 9: Should Audit Committee Have More Influence over Internal Audit?**

The audit committee respondents provided some insight about whether they believe their internal audit has sufficient and appropriate resources. On a scale of one (very low) to seven (very high), we asked the respondents to answer the question:

- AQ4. How confident are you that the internal audit function has sufficient and appropriate resources (i.e., staff and monetary resources) to effectively conduct its duties?

Figure 10 provides the distribution of answers for AQ4. As shown in Figure 10, the majority of respondents (26 out of 40 or 65%) gave an answer of five or above. The mean response is 4.825. No respondents gave an answer of one (very low) and only 12.5% of respondents gave an answer of two or three. In sum, the respondents, on average, have “fairly high” confidence that the internal audit has sufficient and appropriate resources to effectively conduct its duties.



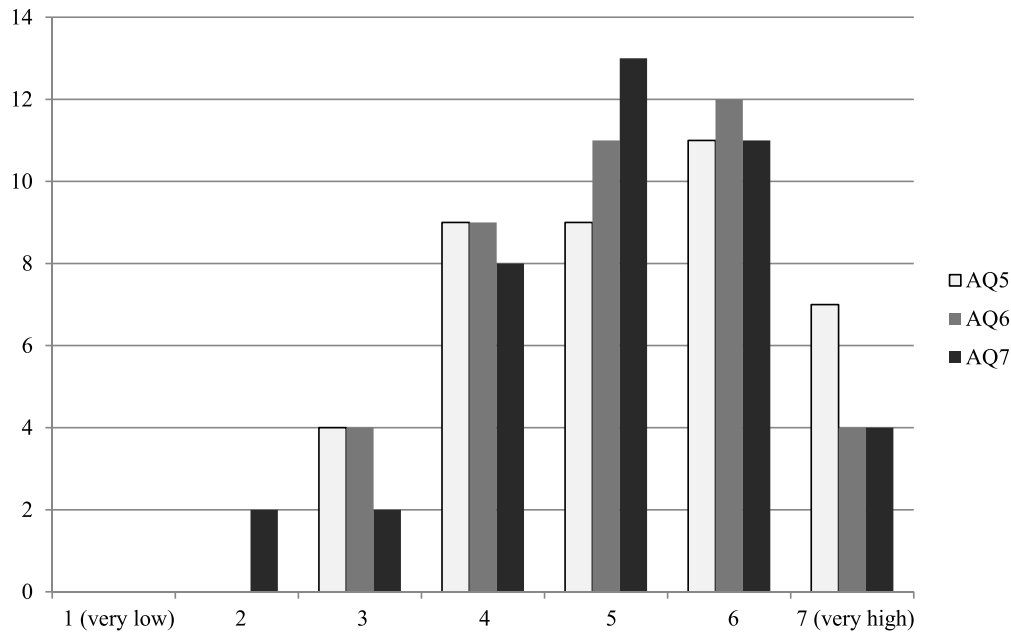
**Figure 10: Internal Audit Resources**

In the next set of survey questions, we asked the respondents to rate the effectiveness and efficiency of their internal audit department. These responses give us an insight about how the audit committee perceives the function of their internal audit. On a scale of one (very low) to seven (very high), we asked the respondents to answer these questions:

- AQ5. How would you rate the independence/objectivity of the internal audit function at your company?

- AQ6. How would you rate the competence (knowledge and skill) of the internal audit function at your company?
- AQ7. How would you rate the efficiency of the internal audit function at your company? – e.g., can produce reports on a timely basis?

Figure 11 provides the distribution of answers to the three questions above (AQ5, AQ6, and AQ7). The mean response for questions AQ5, AQ6, and AQ7 is 5.2, 5.075, and 5.025, respectively. Note that none of the respondents answered 1 (very low) for any of the three questions. Overall, the audit committee members, on average, rate their internal audit’s independence, competency, and efficiency to be “fairly high”.



**Figure 11: Audit Committee Perception of IA Effectiveness and Efficiency**

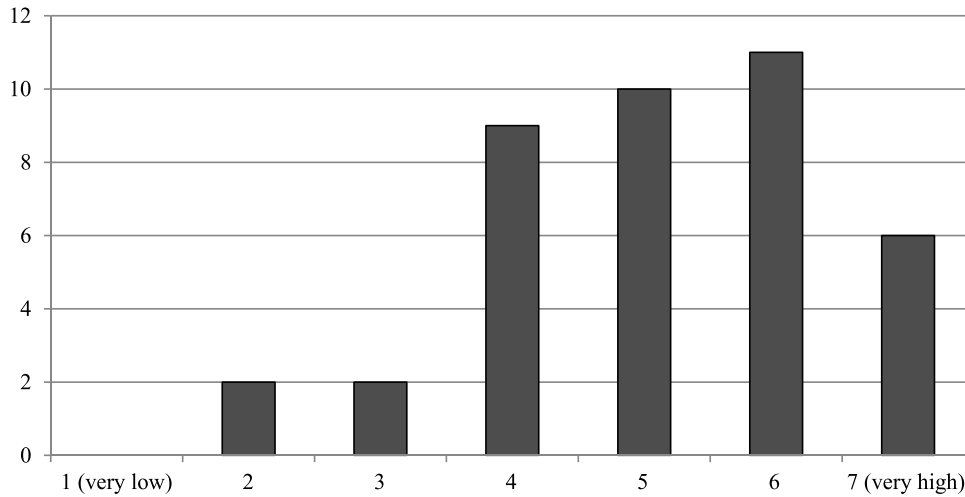
As previously discussed, the audit committee often relies on the work and findings of internal audit in order to carry out its committee responsibilities. We questioned the respondents about how much reliance they put on their internal audit’s outcomes. On a scale of 1 (very low) to 7 (very high), we asked the respondents to answer the following question:

- AQ8. How much reliance do you put on the overall work/findings of the internal audit function?

Figure 12 provides the distribution of answers to question AQ8. The mean response is 5.1. The vast majority of respondents (27 out of 40 or 67.5%) answered at least a five on this question. None of the respondents answered a one (very low), and only 10% of the respondents answered either a two or a three. In sum, I find that the audit committee respondents place “fairly high” reliance on their internal audit’s work and findings.

We asked the respondents about reliance regarding 4 particular issues: financial reporting, operations and business processes, risk management, and compliance with rules. On a scale of 1 (very low) to 7 (very high), we asked the respondents to answer the following four questions:

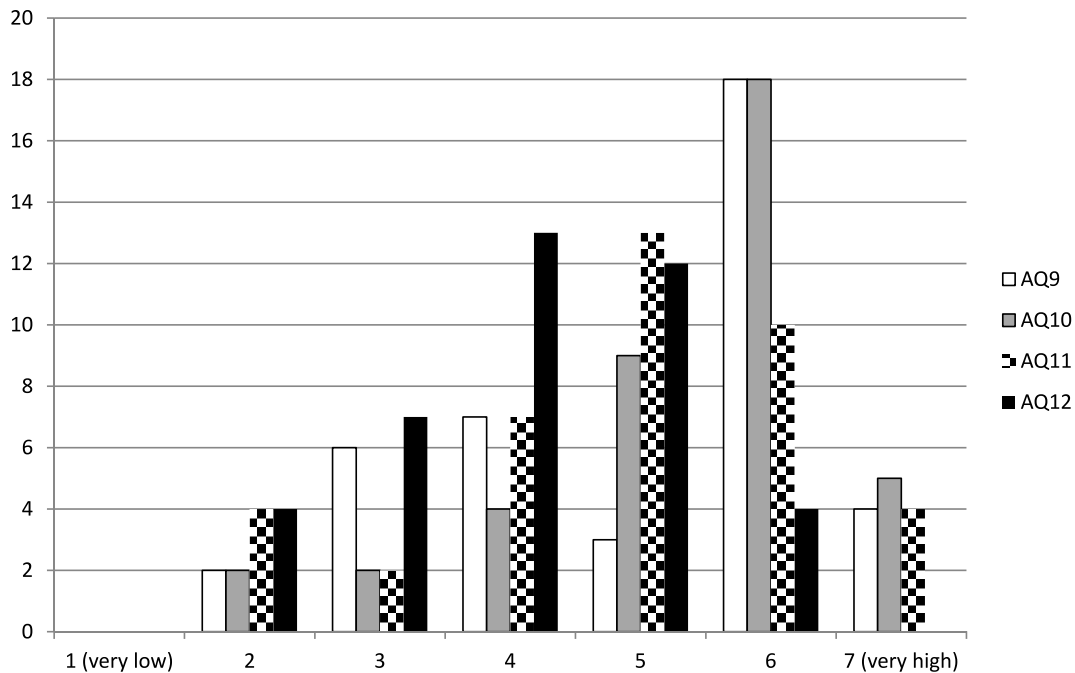
- How much reliance do you put on the work/findings of the internal audit function – pertaining to the following issues?



**Figure 12: Audit Committee Reliance on Internal Audit**

- AQ9. Financial reporting and disclosure
- AQ10. Operations & business processes
- AQ11. Risk management
- AQ12. Compliance with rules and regulations

Figure 13 provides the distribution of answers to question AQ9 – AQ12. The mean response for question AQ9, AQ10, AQ11, and AQ12 is 5.03, 5.35, 4.88, and 5.13, respectively. None of the respondents answered a one (very low) on any of the questions AQ9 – AQ11. On all of these four issues, the audit committee respondents place “fairly high” reliance on the internal audit’s work and findings. I note that the mean response is highest for operations and business processes and lowest for risk management.



**Figure 13: Audit Committee Reliance on Internal Audit: Four Areas**

We also asked the audit committee respondents to rate their overall satisfaction level with the work quality of the internal audit function in their companies. On the seven point scale, we asked the following question:

- AQ13. How would you rate your overall satisfaction level with the work quality of the internal audit function at your company?

Figure 14 shows the distribution of responses for question AQ13. The majority of respondents (75%) answered with at least a five rating. The mean response is 5.2. No respondent gave an answer of one (very low) and only 10% of respondent answered below a four. Hence, audit committees, on average, have “fairly high” overall satisfaction with their internal audit function.

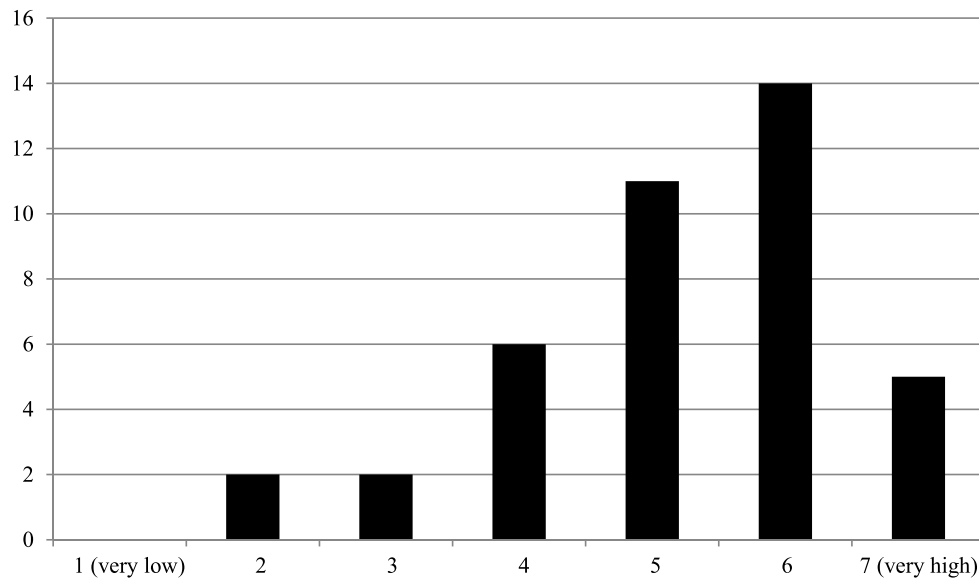
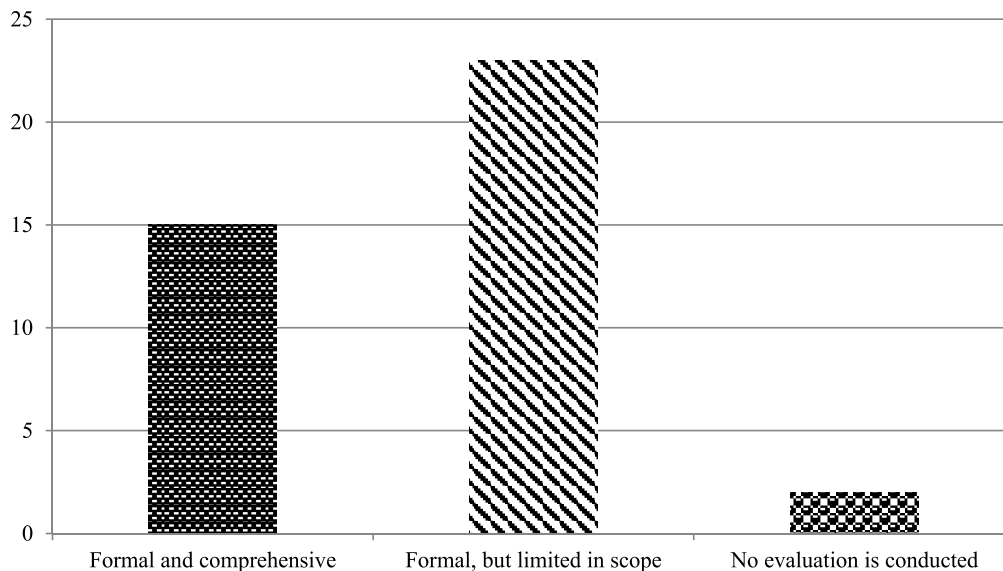


Figure 14: Overall Satisfaction of Audit Committee about Internal Audit

Finally, we asked the respondents about how their audit committee evaluates the internal audit function. We asked “How would you describe the audit committee’s annual evaluation process of the internal audit department?” and gave them three choices: (1) Formal and comprehensive, (2) Formal but limited in scope, or (3) No evaluation is conducted. Figure 15 shows their response. First, almost all respondents (95%) report that there is some sort of a formal evaluation of internal audit by the audit committee. Only two of the 40 respondents state that is no evaluation by the audit committee. The variation centers on the scope of the evaluation. 37.5% of the respondents report that the audit committee holds a formal evaluation of internal audit and such evaluation is comprehensive. 57.5% of the respondents affirm that the formal evaluation held by the audit committee is limited in scope.

## 2. CONCLUSION

The audit committee and internal audit are two important components of corporate governance that is required for effective and reliable financial reporting (Raghuandan et. al. 2001; Sarens et. al. 2009; Abbott et. al. 2010; Barua et. al. 2010). I survey audit committee members to inquire about their interactions with and perceptions about internal audit. Specifically, I survey a total 40 audit committee members working for Indonesian publicly traded companies.



**Figure 15: Audit Committee Evaluation of Internal Audit**

Through the survey, I was able to gather insights about audit committees' interactions with internal auditing. The results of the survey offer a unique look into how audit committee members perceive the role and importance of their internal audit departments. The study provides information about the frequency of meetings that audit committees hold with internal audit, the extent to which audit committees influence the inner workings of internal audit, audit committee's perspective about the independence, competency, and efficiency of internal audit, and audit committee's reliance on and overall satisfaction with their internal audit function.

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