When Does the Internal Audit Function Enhance Audit Committee Effectiveness?

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Executive Summary

With this paper, I hope to help answer the following high-level question: What can we do to improve the quality of information that is provided by management of firms to markets? Because of the agency costs that come with asymmetry of information and incentives when owners and decision makers are separated from management, there is a clear need for some monitoring of management as they prepare and disseminate financial statements and related disclosures. Independent auditors, internal audit functions (IAFs), and audit committees (ACs) all exist in part to fill this role. ACs in particular are endowed by Congress and shareholders with ultimate oversight of the audit, internal controls, and financial reporting.

Thus, it is important to understand whether ACs fill the monitoring role effectively. While some practitioners and researchers say that it is clear that ACs have an impact, others argue differently. For example, in recent work, Kim and Klein (2017) examine the impact of the regulations that first required minimum AC size and independence. They find no evidence that these regulations were valued by investors or that they had any impact on reporting quality. In a follow-on article, Klein (2018) concludes that such "structural" AC characteristics may not have much impact individually, but may instead represent base conditions to satisfy in order to enable committee *processes* that can positively impact monitoring effectiveness (e.g., Larcker and Tayan 2011; DeFond and Zhang 2014).

I identify AC utilization of resources as an important and understudied AC *process* with potential implication for monitoring quality. AC members are by regulation independent from management and by nature limited in the time and attention they can devote to monitoring activities. Therefore, if they are to provide informed oversight, they must rely on a source of inside information about the controls and processes that inform the financial statements. Among potential such resources, the IAF stands out as the most important because of its mix of inside expertise and objectivity (e.g., PwC 2016; KPMG 2017).

My main objective is to provide evidence on whether ACs that have access to and utilize an IAF provide higher quality monitoring. In my first approach, I exploit the 2004 New York Stock Exchange (NYSE) internal audit mandate as a shock to the availability of an IAF to the AC as a resource. By searching AC charters (which describe AC activities and are a required disclosure of all public companies) for references to interactions with the IAF, I identify whether ACs have access to an IAF and the extent to which the AC utilizes the IAF. Relative to companies that had IAFs all along, "compliers" (those that *did not* utilize an IAF prior to the NYSE rule but implemented a new IAF that interfaces with the AC in response to the rule) exhibit a significant decline in the probability of materially misstating financial reports. Importantly, this improvement in financial reporting reliability is concentrated in the companies with ACs that not only have access to a new IAF, but also utilize the IAF significantly.

My second approach is to provide descriptive data regarding the specific kinds of interactions that occur between ACs and IAFs and to examine whether certain interactions matter more for monitoring quality. For 1,000 randomly selected AC charters, I read and assign each IAF reference to a type of interaction. Using this rich, detailed data, I show that the value of the IAF as a resource to the AC increases when (1) the AC meets privately with the IAF to discuss the activities of the IAF and relevant internal audit findings and ensures open communication between them, (2) the AC promotes the independence of the IAF, and (3) AC members are stretched thin with multiple board positions.

Finally, I examine whether there is a financial benefit to utilizing the IAF by examining the cost of bank loans. I choose this setting because banks represent the most important source of capital for companies and have significant ability and incentives to monitor borrowers' governance processes. I find that loan spreads are 31 basis points lower for companies with ACs that have access to an IAF, and that loan spreads decrease as AC utilization of the IAF increases.

In summary, I interpret the findings in this paper as evidence that mandating IAF adoption and utilizing the IAF as a resource to the AC improves the reliability of financial reporting and lowers debt contracting costs. These findings should be of interest to regulators considering IAF mandates but with incomplete information as to the implications for financial reporting, to board members working to enhance AC effectiveness, and to managers struggling to gauge whether the benefits of implementing an IAF outweigh the costs.

References

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