

# Disclosure of independence-enhancing attributes within the audit committee/ internal audit activity relationship

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## ABSTRACT

Independence is a cornerstone of the internal audit profession, hence its prominence in the definition of internal auditing. The quality of the audit committee/internal audit activity relationship is important for the enhancement of the independence of the internal audit activity. Using content analysis, this article examines attributes within the audit committee/internal audit activity relationship. Information disclosed in the annual reports of the Top 40 companies listed on the Johannesburg Stock Exchange on the internal audit activity was used during the content analysis. The findings revealed that most companies did not disclose the selected attributes extensively in their annual reports. Since there are no legislative requirements on the extent to which such disclosures should appear in the annual reports of companies in respect of the internal audit activity, the results of this study can be used by the internal audit standard setters to advance their work in this area.

## Key words

Annual report disclosure; internal audit activity; Top 40 JSE listed companies; audit committee; internal auditor independence

## 1 INTRODUCTION

Von Eck (2013:Online), the chief executive officer (CEO) of the Institute of Internal Auditors South Africa (IIA SA), posted an article on the IIA SA's blog page entitled "Have we created a generation of bullies?" In the article, she indicates that she has listened to numerous internal auditors recounting incidents of intimidation and victimization by senior individuals within their organizations. She even went as far as to reveal that in certain instances intimidation and victimization were of such a magnitude that the lives and/or posts of internal auditors were specifically threatened (Von Eck 2013Online). Internal auditors are in a unique position that allows them insight into their organizations, including their most sensitive matters (Soh & Martinov-Bennie 2011:605). Thus, the occurrence of wrongdoing, such as fraud and corruption, within an organization, could first be detected and reported by internal auditors (Ahmad 2011:25; Barac & Coetzee 2012:33). This situation (being the discoverer of a significant act of wrongdoing) could be a contributing factor to internal auditors being intimidated and victimized, and which, if allowed to continue, could threaten their independence and compromise their authority and effectiveness.

The independence of the internal audit activity (IAA) is sufficiently important to be a specific component of

the definition of internal audit. Independence is defined as "the freedom from conditions that threaten the ability of the IAA to carry out internal audit responsibilities in an unbiased manner" (IIA 2012). When an IAA is not independent, its authority may be weakened and thus rendering it vulnerable to challenges by management, and its contribution may be disregarded (Mahzan, Zulkifli & Umor 2012:71). Together with the IIA's professional standards (Standards) (IIA 2012) and the *King Code of Governance for South Africa* (King III Report) (IoD, 2009), the literature recognizes various attributes of the function that confirm that when present, the authority of the IAA is established and its independence is strengthened. These attributes include: the IAA's reporting lines; the need for an approved internal audit charter; the need for the formal approval of the internal audit plan, and audit committee (AC) approval of the hiring or dismissal of the chief audit executive (CAE) (Christopher, Sarens & Leung 2009:204; Mahzan *et al* 2012:69-71). The IAA should report functionally to the AC (Soh & Martinov-Bennie 2011:615) and the AC is required to approve the IAA's charter (Sarens & De Beelde 2006:225; IIA, 2012). These reporting lines and attributes serve as indicators of the quality of the relationship between the AC and the IAA. Stewart and Subramaniam (2010:333) posit that "A quality relationship between the IAA and the AC also works towards providing the IAA with the appropriate

environment and support system for carrying out its own governance related activities". Thus, the AC plays a vital role in enhancing the independence of the IAA (Goodwin & Yeo 2001:107; Christopher *et al* 2009: 215; Marx & Voogt 2010:20).

An AC is a sub-committee of the board of directors (IoD 2009). A well-composed AC is an important corporate governance structure, which is also tasked with overseeing the IAA (Goodwin 2003:263; IoD 2009:63; Schneider 2010:19). The IAA is influential as it can enhance the effectiveness of the AC by updating the AC on developments in legislation, and educating the AC members on their (changing) roles and responsibilities, amongst other issues (Moorthy, Seetharaman & Saravanan 2010:91; Lin, Pizzini, Vargus & Bardhan 2011:290; Mahzan *et al* 2012:72). A quality relationship between the AC and the IAA is thus critical to enhancing the independence of the IAA (Christopher *et al* 2009:15). Previous research has illustrated the importance of this AC/IAA relationship describing it in various ways. This is confirmed by the publication of comments such as: the AC/IAA relationship is one of mutual dependence and symbiosis; the IAA is the "eyes and ears" or "legs and arms" of the AC; the IAA is the watchdog of the AC; the IAA is the comfort provider to the AC; and the AC is viewed as a key safeguard mechanism for the IAA (Marx & Voogt 2010:18; Stewart & Subramaniam 2010:333; Lenz & Sarens 2012:538; Azza 2012:iii).

A broad body of knowledge exists on how the AC should support the IAA and thus enhance its independence. Numerous research studies have identified and highlighted attributes that contribute to developing a quality relationship between the AC and the IAA, thereby enhancing the independence of the IAA. Such attributes include the following: the AC approves the IAA's resources, internal audit plan, internal audit charter, and staffing complement; the AC supports the IAA having private meetings with the CAE; the AC also follows up on matters reported to it by the IAA; and it arbitrates on matters of disagreement arising between the IAA, management and external auditors (Goodwin & Yeo 2001:110; Alleyne, Howard & Greenidge 2006:569; Ferreira 2007:9; Van der Nest, Thornhill & De Jager 2008:552; Stewart & Subramaniam 2010:334; IIA 2012; Mahzan *et al* 2012:77).

The CAE drives the internal audit quality and is a link between the IAA, the AC and management (Coetzee, Fourie, Plant & Barac 2013:56). The success of the IAA is thus dependent on the good standing of the CAE, which is in turn founded on the CAE being in possession of a postgraduate academic qualification, professional certification, and a minimum of ten years of internal auditing experience (Coetzee *et al* 2013:57). Furthermore, the CAE should have management and leadership skills, communication skills, independence and objectivity, and an ability to partner with management and the AC (Mahzan *et al* 2012:93; Coetzee *et al* 2013:56), in the interests of the organisation. If the CAE commands these personal attributes, such an individual is less likely to be coerced into performing actions that might compromise the independence of the IAA.

Nevertheless, to strengthen the IAA's independence, the AC should play a role in the appointment and dismissal of a CAE; review the performance of the CAE and advise the remunerations committee regarding the remuneration of the CAE. If these actions are undertaken by the AC, the IAA's staff is less likely to feel that their job security is dependent on management's good opinions of their jobs, and their independence should be enhanced (Goodwin & Yeo 2001:110; Goodwin 2003:271; Christopher *et al* 2009:204; IoD 2009:63; Marx & Voogt 2010: 22; IIA 2012:4).

From the above it is clear that various attributes within the AC/IAA relationship have the potential to influence the independence of the IAA. The disclosure of the presence and status of these attributes in the annual report would, therefore, enable users of the financial statements to evaluate the degree of independence enjoyed by the IAA. Since the IAA is regarded as a governance mechanism and type of internal control, if it is perceived to be independent, investors may then perceive the organization's control environment to be sound, and that the organisation is safe (sufficiently low risk) for investment (Moorthy *et al* 2010:91-96; UNCTAD 2010:20). It is against this backdrop that this study analyses the disclosure of the IAA's independence-enhancing attributes in the AC/IAA relationships of the Top 40 JSE-listed companies (as presented in their annual reports), to determine the degree to which the information that influences the independence of the IAA is formally disclosed. A number of studies have been conducted on the independence of the IAA; however, these studies have been conducted with the objective of understanding the relationship between the AC and the IAA (Goodwin & Yeo 2001:107; Goodwin 2003:263; Christopher *et al* 2009:200). Although these studies highlight the role of the AC in enhancing the independence of the IAA, they do not investigate whether these specific attributes within the AC/IAA relationship that would enhance the independence of the IAA, are publicly disclosed. The study reported on in this article aims to close this gap.

The remainder of the article conforms to the following structure: the following section presents the problem statement, and the objective, scope, limitations and significance of the study. Thereafter, a review of published literature is reported on, the methodology and design of the research is described, and the findings of the study are presented. In the final section, the conclusions reached are presented, and recommendations are made.

## 2 PROBLEM STATEMENT

There are no legislative requirements to guide the AC on what disclosures should be made regarding the presence or absence of independence-enhancing attributes within the AC/IAA relationship, which probably explains why this matter has received so little attention from researchers. This could be seen as a shortcoming in business-specific legislation, since the IAA is now regarded as an important corporate governance mechanism (Holt 2012:881). Holt (2012:881) explains that although there are

mandatory corporate disclosure requirements about the AC, management and external auditors, there are no mandatory disclosures about the IAA. Therefore, he suggests that companies voluntarily disclose the composition, responsibilities and activities of their IAAs to enhance the credibility of their other disclosures and financial results (Holt 2012:881).

Marx and Voogt (2010:24) conducted a study to determine the extent to which the ACs' reports on their oversight of the IAA addressed key independence-related issues. They investigated the ACs' involvement in the appointment or dismissal of the CAE; the sign-off of the internal audit plan; responses to findings arising from the internal audit; co-operation between the internal and external audit functions, and the degree to which internal audit had access to the chairperson of the AC and the board. The findings of their study revealed that even though the AC has an increasing number of functions and responsibilities to fulfil in respect of the IAA, its disclosures in the annual report remain limited in number and depth (Marx & Voogt 2010). In a more recent study, Chambers and Odar (2015:41) noted that although the IAA has a direct reporting relationship with the board and the AC, the low number of related disclosures reported remains a concern. This could be due to the sensitive nature of some of the issues discovered, the disclosure of which could reflect badly on those charged with governance. Furthermore, as noted by Chamber and Odar (2015:45), the IAA is not empowered to make unilateral public disclosures if the board has not sanctioned the release of such information. In order to address this issue, the IAA is formulating a mandatory guidance note regarding when such unauthorized public disclosure by internal audit would be appropriate (Chambers & Odar 2015:46). Against this background, a study of the disclosures relating to the independence of the IAA is not only timeous but also relevant.

### 3 OBJECTIVES, SCOPE, LIMITATIONS AND SIGNIFICANCE OF THE STUDY

The objective of this study is to analyze those independence-enhancing attributes of the IAA within the AC/IAA relationship that have been disclosed in the annual reports of the Top 40 JSE-listed companies published between 2012 and 2013. Information on ACs and IAAs disclosed in these annual reports was analyzed and interpreted to shed light on the AC/IAA relationship as described in the literature review. However, a limitation of the study is that the analysis of the disclosures of attributes that enhance the independence of the IAA within the AC/IAA relationship was limited to scrutiny of those published in the annual reports of the Top 40 JSE-listed companies. Although restricting the research to the review of the annual reports may be seen as a limitation, the annual report is an important company document and a key channel for communication with stakeholders: it provides the reader with her first impression of the company's compliance with corporate governance requirements, as well as its wider sense of accountability (UNCTAD 2006:29; Barac & Moloi 2010:20).

The thematic analysis approach, as part of the content analysis research method used to evaluate the annual reports, has inherent limitations. It risks conveying an incomplete picture of the company's business as it focuses on words and numbers, and may, by ignoring the graphics and pictures that are not always fully described in supporting paragraphs, give an incomplete view of the message the company is attempting to communicate (Barac & Moloi 2010:20). Furthermore, content analysis does not have an intrinsic theoretical base, and thus inferences may be drawn too liberally, and relationships and impacts implied in a study may be disregarded, thereby drawing inaccurate inferences (Bryman, Bell, Hirschsohn, Dos Santos, Du Toit, Masenge, Van Aardt & Wagner 2014:299-305; CSU [n.d]:27; Mouton 2001:166). Another risk integral to content analysis is its ability to re-code data the same way over an extended period of time, without considering how information and practices change over that period, which opens the research to accusations of inaccurate information and conclusions (CSU 2004:27).

These above-mentioned limitations are applicable to this study, since the documents analyzed are the annual reports of the Top 40 JSE-listed companies for FY2012/3. However, the limitations are countered through conscious adoption of a syncretic view of the contents of the various sections of each annual report (usually structured as an overview, corporate governance review and the financial statement sections). This was intended help to establish links between various styles of presentation of information (annual reports are usually the products of a team of authors) and to enhance the accuracy of the conclusions. In addition, the thematic analysis is set out in Table 1 to facilitate comparable follow-up studies (Bryman *et al* 2014:299-305). Despite these limitations, content analysis remains an acceptable method of coding annual reports as it can extract information that is not otherwise prominently quantified (Leedy & Ormond 2005:145).

Management of organizations and their AC members should recognize the benefits arising from applying the findings of the study because the disclosure of the IAA's independence-enhancing attributes within the AC/IAA relationship sends a strong signal to stakeholders that the AC has fulfilled its oversight duty. Stakeholders may then use the disclosed attributes as a yardstick to determine the degree of independence enjoyed by the IAA, and thus of the organization's corporate governance performance. Since investors enjoy peace of mind when investing in organizations with demonstrably sound corporate governance, the disclosure of the attributes should demonstrate the AC's commitment to transparency and to enhancing the IAA's independence. Furthermore, the users of the financial statements could benefit from an enhanced focus on internal audit disclosures, and the IIA could use the findings of the study as inputs to improve disclosure requirements with respect to the IAA.

## 4 LITERATURE REVIEW

### 4.1 Why organizations need an internal audit activity

Corporate scandals such as Enron and WorldCom brought significant public and regulatory attention to corporate governance (Goodwin & Yeo 2001:108; Savcuk 2007:275; Archambeault, De Zoort & Holt 2008:376). Furthermore, the demand for internal assurance on the effectiveness of corporate governance, internal controls and risk management increased (Goodwin & Yeo 2001:108; Savcuk 2007:275; Archambeault *et al* 2008:376). Since the IAA is uniquely positioned to provide such internal assurance, public expectations of the function's efforts grew rapidly. The heightened interest in IAAs resulted in the recognition that a proactive IAA was needed, which in turn powered the demand for improvements in internal audit quality. Simultaneously, the need for the visibility and relevance of the IAA to be improved, and for their skills to be put to effective use was recognized. This was a radical change from the then norm where the IAA's presence was for little more than "tick-box" compliance purposes (Marx & Voogt 2010:17; Moorthy *et al* 2010:90; Mutai 2011:7; Soh & Martinov-Bennie 2011:606; Lenz & Sarens 2012:534).

Over the subsequent 10 - 15 years, the role of internal auditing has evolved to the point that it is now a key corporate governance mechanism, providing independent assurance on the effectiveness of the company's governance processes, and includes prevention of wastage through fraud, corruption, unethical behaviour and "irregularities" (Mihret, James & Mula 2010:225; Stewart & Subramaniam 2010:4; Soh & Martinov-Bennie 2011:606). The need for internal auditing has been driven by guidance in the King III Report that recommends all companies should have effective IAAs. In the event that a company decides not to establish an IAA, full reasons justifying this decision should be disclosed in its integrated report, together with an explanation of how adequate assurance of an effective governance, risk management and internal control environment has been maintained (IoD 2009:93). The UK Corporate Governance Code, in contrast to the King III code, does not specifically require companies to establish and maintain an IAA; however, it does require that in cases where there is no IAA, ACs should annually consider whether there is perhaps a need for an IAA, and if so, make recommendations to the board (FRC 2012:19). In addition, the reasons for the (continuing) absence of such a function are required to be explained in the relevant sections of the annual report (FRC 2012:20).

The increase in business complexity presents the IAA with an opportunity to help the organization to achieve its business objectives (Savcuk 2007:275). Because the IAA is independent and objective, its review of the organization's state of economy, efficiency and effectiveness enables the AC to make informed decisions about the status of the organization's internal corporate governance, risk management, internal control and compliance functions and efforts

(Mihret *et al* 2010:225; Soh & Martinov-Bennie 2011:606). However, in that the AC requires an objective assurance, independent of management, and the IAA is in a position to offer such assurance (Chambers 2014:197), it is vital that this independence and objectivity is demonstrably protected and promoted. Furthermore, external auditors have also come to trust and use the IAA's knowledge of the business, and rely on its independence and experience (Suwaidan & Qasim 2010:509). In addition, the IAA is well-positioned to assist and advise the board and management. Thus, their input is sought on how to apply corporate governance principles, and how to execute business strategy. They are also asked to make recommendations to address weaknesses in internal controls, counter unethical behavior and to respond to regulatory changes. In addition, they are sometimes asked to make informed decisions in respect of acquisitions and mergers, and on how to protect the assets, reputation and sustainability of the organization (Moorthy *et al* 2010:91; Soh & Martinov-Bennie 2011:611; Lin *et al* 2011:287; Mahzan *et al* 2012:70-74; Chambers 2014:199).

### 4.2 Why should the internal audit activity be independent?

The above discussion highlights the need for an IAA. However, the value the IAA adds to the organization may be diluted or disregarded if it is not independent of management and other extraneous influences (Stewart & Subramaniam 2010:320). The concept of internal auditor independence is widely championed by academic research and endorsed by business practice (Sarens & De Beelde 2006:220; Stewart & Subramaniam 2010:327; Schneider 2010:19). It is in the core of the definition of internal auditing, being described as "an independent, objective assurance and consulting activity" (Stewart & Subramaniam 2010:330; Schneider 2010:19; Leung, Cooper & Perera 2011:794; IIA 2012). It is embedded in the International Standards for the Professional Practice of Internal Auditing (generally referred to as the Standards) which requires internal auditors to be independent both in fact and appearance (IIA 2012); in addition, they should be "seen" and be "heard" to be independent (Al-Ajmi & Saudagaran 2011:131). Other best practices, such as those contained in King III Report, recommend that companies have an effective IAA that is independent, objective and strategically positioned, so that it is able to contribute effectively to corporate governance (IoD 2009:97).

According to the source credibility theory, individuals place more reliance on information provided by an IAA, than they do on other sources because they perceive the IAA to be credible and reliable (Holt 2012:884). Thus, the AC, which does not have direct access to the same level of information as management (since it is not involved in the day-to-day operations of the organization), relies on the IAA to obtain and present it with the credible and reliable information it requires in order to make informed decisions, and to exercise oversight in the best interests of the organization (Marx & Voogt 2010:22; Mutai 2011:18; Soh & Martinov-Bennie 2011:615).

The credibility and reliability of the information obtained is directly linked to the degree of independence the IAA enjoys (Holt 2012:884). In addition, an independent IAA commands company-wide respect and can be perceived by the stakeholders as aiding senior executives fulfil their desire to achieve business objectives (Stewart & Subramaniam 2010:329; Holt 2012:884). Other stakeholders who benefit from the independence of the IAA are the external auditors. Ebaid (2011:114) states that to decide on whether or not to place reliance on the work of the IAA (whether or not to view IAA as reliable and credible), external auditors consider a number of variables, including the IAA's independence and objectivity.

The IAA plays a prominent role in the organization's internal control structures, and is seen as an internal control component itself (Mihret *et al* 2010:240; Yasin & Nelson 2012:188). Over and above the fact that the IAA is an internal control, it also examines and evaluates the adequacy and effectiveness of other controls and this is where its independence and objectivity become critical (Marx & Voogt 2010). An IAA that lacks independence and/or objectivity is likely to be influenced by management, which weakens its effectiveness as an internal control. This lack of independence can constitute a material weakness, compromising the entire system of internal control, thereby increasing the likelihood of misstatements in the annual and interim financial statements (Hermanson, Ivancevich & Ivancevich [n.d]:21; Lin *et al* 2011:293). The view held by certain executives and managers (that internal auditors are their employees, and that their reporting to the AC is little more than a formality to satisfy corporate governance requirements), places the IAA open to manipulative abuse by management, thereby weakening its independence (Van Peurse 2005:490; Sarens & De Beelde 2006:223; Christopher *et al* 2009:203; Schneider 2010:19).

### 4.3 Independence-enhancing attributes within the AC/IAA relationship and the importance of their disclosure

It is recommended that for good corporate governance to be effected, the IAA should report functionally to the AC and administratively to the chief executive officer (IoD 2009:96; Stewart & Subramaniam 2010:333). As previously discussed, the independence of the IAA is strengthened when it reports to a level in the organization that permits it to fulfill its responsibilities free from interference or influence (IIA 2012; Holt 2012:880). From an administrative reporting perspective, such a level is one held by an executive with sufficient authority to promote the independence of the IAA; from the functional reporting perspective, such a level is that of the AC (Stewart & Subramaniam 2010:331; IIA 2012). Holt (2012:883) highlights that functional reporting involves the governance-related activities of the IAA, such as charter approval, hiring or terminating the CAE and receiving periodic results of IAA's investigations. Administrative reporting involves the day-to-day activities of the IAA, including human resource administration, budgeting, and the administration of internal policies and procedures.

According to the IIA (2012), there are actions (attributes) that specifically establish functional reporting. These actions are: the approval of the IAA's charter by the AC and the board; approval of the risk-based internal audit plan by the AC and the board; and the CAE communicates the IAA's performance relative to its plan, and other matters, directly to the AC and the board. In addition, the AC and the board approve the remuneration of the CAE, the IAA's resources, and decisions regarding the appointment or removal of the CAE. Finally, the AC and the board make appropriate enquiries of management and the CAE to determine whether the audit's scope and the allocated resources are sufficient for the intended purposes. In view of the fact that functional reporting to the AC enhances the IAA's perceived independence (Stewart & Subramaniam 2010:331; IIA 2012), these actions/attributes can be regarded as enhancing the independence of the IAA, albeit still within the AC/IAA relationship. These aforementioned functional reporting actions/attributes are also included in the model audit charter the IIA has developed for the IAA (IIA 2013) and which is also used in legislated governance and professional regulations (FRC 2003:12; IoD 2009; IIA 2013).

A number of studies have analyzed the actions required to establish functional reporting lines for the IAA, and have related them to the strength of the AC/IAA relationship. Among these studies is that of Savcuk (2007:278), who analyzed the independence of an IAA in Greece by examining the AC/IAA relationship, looking for evidence of the AC's approval of the appointment or dismissal of the CAE, the AC's approval of the IAA's resources and audit plans, and for the IAA's reports and recommendations. In a study in South Africa, Barac, Plant and Motubatse (2009:982-986) also reported on these functional reporting-specific attributes/actions implicit in a quality AC/IAA relationship, and found them to be in place. A study conducted by Goodwin and Yeo (2001:110) presents corroborating findings. The Joint Inspection Unit (JIU) conducted a review of the efforts of the IAA in the United Nations system organizations, with a view to improving system-wide coherence among entities dealing with the IAA (JIU 2010:7). To enhance the effectiveness and efficiency of the IAA in the United Nations system organizations, the JIU identified attributes prerequisite for an independent IAA; these are closely aligned with the functional reporting-specific attributes discussed above and viewed as essential to enhancing the quality of the AC/IAA relationship.

Established, functional reporting lines seem to enhance the effectiveness of the AC/IAA relationship over time. This relationship is important since it should provide the IAA with an appropriate environment and support system from which to execute its governance activities (Stewart & Subramaniam 2010:333; Marx & Voogt 2010:18; Lenz & Sarens 2012:538). Since functional reporting establishes the working relationship between the AC and the IAA, it can be inferred that the previously discussed functional reporting-specific attributes enhance the AC/IAA relationship, thus strengthening the independence of the IAA (IoD 2009:93; Soh

& Martinov-Bennie 2011:615; IIA 2012). The functional reporting-specific attributes, regarded as independence-enhancing attributes, comprise the basis for the fieldwork in this study.

Since this study focuses on the AC/IAA relationship, a brief discussion of the AC is now essential. The AC is a subcommittee of the board of directors, tasked with overseeing the IAA (Schneider 2010:25; Soh & Martinov-Bennie 2011:615; Lary & Taylor 2012:336). Arising from the aftermath of the many corporate collapses in the early 2000s, regulatory authorities in many national jurisdictions made the establishment of ACs compulsory for companies (Schneider 2010:25; Soh & Martinov-Bennie 2011:615). However, these companies soon became aware that the mere existence of ACs would not necessarily reduce the frequency or extent of corporate collapses; a significant requirement was, therefore, introduced to legislation, regulations and guidelines, being that in order for ACs' operations to be effective the ACs should be independent of influence from boards of directors and management (Baxter 2010:57; Magrane & Malthus 2010:427; Kang, Kilgore & Wright 2011: 623). The AC's effectiveness is thus strengthened by enhancing its key characteristics; particularly its independence, expertise, size and its activity level (Baxter 2010:58). An effective AC thereby enhances the independence of the IAA, amongst other benefits (IoD 2009:69).

Certain legislative efforts such as *Sarbanes-Oxley Act* in the USA, and best practice such as King III Report in South Africa, require ACs to disclose (usually in the AFS) the status of the internal controls (IoD 2009; Haron, Ibrahim, Jeyaraman & Chye 2010:142; Ali 2014:133). Earlier it was noted that Mihret *et al* (2010:230) and Yasin and Nelson (2012:188) have viewed the IAA as an internal control. By virtue of an IAA now being recognized as an internal control, the AC has to disclose the status of the IAA. Holt (2012:881), as well as Soh and Martinov-Bennie (2011:607), believe that although there are as yet no mandated disclosures about the status of a company's IAA, this should not prevent the disclosure of such information. The AC's report seems to be a useful vehicle for such disclosures. They further maintain that since the effectiveness of the IAA (which includes the IAA's independence) enhances the credibility of the information reported, such a disclosure on the status of the IAA will be in the best interest of the company (Holt 2012:881; Soh & Martinov-Bennie 2011:607). Haron *et al* (2010:142) support this view, indicating that voluntary disclosures (i.e. disclosures over and above the minimum disclosures required by law or regulation), send a positive signal to stakeholders about management's commitment to internal controls, and their commitment to the protection of company assets and shareholders' investments.

Haron *et al* (2010:156 & 157) discuss items that could be disclosed voluntarily in respect of the IAA. They suggest that the IAA's direct reporting relationship to the AC, the approval of the IAA's charter by the AC, the AC's approval of the hiring or dismissal of the CAE, as well as CAE's remuneration should be

disclosed voluntarily. Such a call for the voluntary disclosure of independence-enhancing attributes within the AC/IAA relationship is an indication that their disclosure is important. Holt (2012:881) notes that investors do value disclosures on independence-enhancing attributes relating to AC/IAA relationship, since such disclosures enhance the investors' confidence on the effectiveness of the AC's oversight efforts. When investors are confident about the effectiveness of the AC's oversight of the IAA, they can comfortably form an opinion about the effectiveness of the organization's control environment, as well as the reputation of the IAA. This opinion could impact their investment decision-making processes (Moorthy *et al* 2010:91-96; UNCTAD 2010:20). Other important benefits following disclosure of independence-enhancing attributes within the AC/IAA relationship include: enhancing shareholder confidence in the organization's management, and the reliability and credibility of financial reporting; demonstrating the organization's compliance with laws and regulations and management's commitment to transparency and good corporate governance, and enhancing external stakeholders' confidence regarding the organization's oversight effectiveness (Archambeault *et al* 2008:376; Lary & Taylor 2012:336). Of great importance is the fact that such disclosure also helps external stakeholders to evaluate the independence of the IAA and thus to form an opinion about the role it plays in governance (Archambeault *et al* 2008:379-382).

## 5 METHODOLOGY AND RESEARCH DESIGN

The study uses the empirical method known as content analysis to examine the independence-enhancing attributes of the IAA within the AC/IAA relationship. A thematic analysis (a part of content analysis), was used, requiring the researcher to code text in terms of themes (Bryman *et al* 2014). Content analysis is a systematic, rigorous research approach used to analyze passages within documents obtained or generated in the course of research (Bryman *et al* 2014:299-305; CSU [n.d]:1). This method is also referred to as document analysis, which is defined by Bowen (2009:28) as a systematic procedure for reviewing or evaluating documents, both printed and electronic. Content analysis requires a detailed and systematic examination of the contents of a particular body of material in order to identify patterns and themes (Leedy & Ormrod 2005:142). Furthermore, its claim to research rigor rests in its ability to make replicable and valid inferences from texts (CSU [n.d]:2); U.S GAO 1989:8).

Although content analysis has been used to complement other research methods, it has also been utilized as a stand-alone method, particularly in specialized qualitative research studies (Bowen 2009:29). Bowen's endorsement of content analysis as a stand-alone method is supported by Stewart and Subramaniam (2010:333), who used the method in a study in which only the AC charters and reports of 150 US companies were examined, in preference to the more time-consuming alternative of conducting surveys and face-to-face interviews. Furthermore, Dumay and Cai (2015:131) assert that content

analysis is also appropriate where direct observational evidence is not available. The use of content analysis in the aforementioned studies supports and strengthens the authors' choice of content analysis as a stand-alone research method appropriate for this current study.

The study was conducted by identifying themes that enable the analysis of IAAs' independence-enhancing attributes within their AC/IAA relationships, using disclosures in the annual reports of the Top 40 JSE-listed companies. The JSE's Top 40 Index (based on market capitalization), as quoted by I-Net Bridge on September 2014, was used to identify the companies for this study (I-Net Bridge 2014:Online). The 2012/13 annual reports of the selected companies were downloaded from the companies' websites, and the sections containing the corporate governance reports (particularly the ACs' reports on their IAAs) were analyzed. Annual reports were used for the analysis because these reports are considered to be the primary mediums for communicating with the public. In addition, annual reports also contain other useful information, enable the companies to connect with their internal and external stakeholders, and be used collectively as a barometer of the attitudes of companies towards reporting (Guthrie, Petty, Yongvanich, & Recceri 2004:287; Dumay & Cai 2015:125). The 2012/13 financial year was chosen, as it was the most recent complete source of published data available to the authors (this study commenced during the 2014 financial year). In addition, since this study did not seek to establish trends in disclosures of independence-enhancing attributes of IAAs over a period of years, the focus on a single financial year was appropriate and sufficient. Bowen (2009:28) posits that even though researchers review prior literature with the intention of incorporating it in their current work, all the analyzed documents are not necessarily considered for the current study, as they may not have been found to be relevant. Thus, following Bowen's notion, the analysis of the prior years' annual reports was seen as unnecessary as it did not help the authors to achieve the objective of the study (essentially, to benchmark the state of the relationship as it existed at the end of the 2012/3 financial year).

The annual report is a publication comprising financial and non-financial reports. Included amongst the non-financial reports is the corporate governance report. Although the AC/IAA relationship-enhancing attributes are reported in the corporate governance section of the non-financial report, the annual report was analyzed in its entirety, seeking to corroborate the information, to give it wider context and to make sense of it.

A further justification for the use of content analysis for this study is that it is less time-consuming, and more efficient in comparison to other research methods. In addition, most documents are in the public domain; the method is less costly to conduct than interviews and surveys, and the documents are not affected by the research process. These documents can be repeatedly reviewed, and conclusions can be drawn based on the content

evidence, without having to access unwilling and inaccessible communicators. As an effective research method, it has been used for many decades to study performance and reporting, as it creates a picture of a given phenomenon, as opposed to describing reality objectively (Beattie & Thomson 2006:3; White & Marsh 2006:38; Bowen 2009:31; Kusuma 2013:9; Moolman, Cronje & Wingard 2001:5; Barac & Moloji 2010:19; Bhasin 2012:59).

Although content analysis is a widely acknowledged research method, it has inherent limitations. As used in this study, the following potential limitations are recognized. The information reported by the AC is prepared for general reporting purposes and not necessarily to satisfy (or even be aware of) the needs of academic research. Additionally, the information reported on the IAA's independence-enhancing attributes may be specific to a particular company's unique policies and business environment. Thus, the analysis, findings and conclusions may not be generalizable across the business universe. Information on the IAA's independence-enhancing attributes may be inaccurate, short on quantity/depth or excessively detailed, and there may be an element of subjectivity in both content and layout that could affect how the information is assimilated and coded by the researchers (Guthrie *et al* 2004:289; Bowen 2009:29; Goebel 2015:683; Dumay & Cai 2015:125).

*Thematic analysis as part of content analysis: implementation steps*

**Step 1:** Review the literature pertaining to the IAA's independence with respect to its relationship with ACs and identify and understand currently recognized attributes of the relationship that enhance the independence of the IAA.

**Step 2:** Identify data and select a sample. FY 2012/2013 annual governance reports of the Top 40 JSE-listed companies were accessed from the companies' websites. The data (the text of the governance reports within the annual reports) was extracted.

**Step 3:** Determine the content unit; select the unit of analysis from reports. The content unit is the portion/extent of written material that is to be examined for categories of words or statements. The unit can be a chapter, section, paragraph or a sentence in length, depending on the type of content being analyzed (Zhang & Wildemuth [n.d]:5; U.S GAO 1989:1; Cooper & Schindler 2001:430). Report sections with headings "audit committee" and "internal audit" were selected as content units.

**Step 4:** Identify themes or categories (outlined in Table 1): These form the heart of content analysis. They provide the structure for grouping recording units and are generated by grouping observations that are similar or related (Prasad [n.d]:11; Zhang & Wildemuth [n.d]:3-5; U.S GAO 1989:11).

**Step 5:** Develop the recording units (also outlined in Table 1): These are "specific segments of the context unit in the written material that is placed in a category", which can be a word, a group of words, a

sentence, a paragraph or an entire document (U.S GAO 1989:10). The recording units were developed from reviewing the annual report analysis, with particular focus on the ACs' reports on the IAAs.

**Step 6:** Develop and apply the codes for the themes or categories: Coding entails assigning an identifier (key word) to a theme or category and subsequently to a recording unit within that theme or category. This is equated to developing a dictionary and can be done using a computer or manually. For the purpose of this study, manual coding was used by using the keywords listed in Table 1.

**Step 7:** Analysis and interpretation of results: Coded data was analyzed, leading to the identification of patterns within the recording units of the sampled companies.

**Step 8:** Validity: Establish whether the results of this study were consistent with other studies (they were) (Barac & Moloi 2010; Holt 2012; Marx & Voogt 2010).

**Step 9:** Reliability: Determine whether the recording units identified during the analysis of the annual reports were supported by literature (they were).

**Table 1: Summary of categories, codes and recording units**

Themes or categories	Recording units	Key words
1. AC support for the IAA	1.1 Approval of the IAA budget	Budget
	1.2 Confirmation of the IAA resources	Resources, sources
	1.3 Approval of the IAA plan	Plan, planning
	1.4 CAE's access to the board	Board access
	1.5 CAE's access to the AC chairperson	AC access, chairperson
	1.6 Private meetings with the AC chairperson	Private meetings
2. Authority of the IAA	2.1 Approval of the IAA charter	IAA charter
	2.2 Administrative reporting to chief executive officer	Administrative, reporting
	2.3 Functional reporting to AC	Functional, reporting
3. Employment of the CAE	3.1 Appointment of the CAE supported by the AC	Appointment, CAE
	3.2 Dismissal of the CA supported by audit committee	Dismissal, CAE
	3.3 Performance evaluation of the IAA (relative to plans)	Performance evaluation
	3.4 Determination of CAE's remuneration	Remuneration, CAE

## 6 PRESENTATION OF FINDINGS

Figure 1 presents the results of the analysis of the attributes that enhance the IAA's independence within the AC/IAA relationship, as disclosed in the annual reports of the Top 40 JSE-listed companies. The results highlight the existence of an unsatisfactory position of their disclosure, which reveals areas for improvement. The contextualization of "fully disclosed", "partly disclosed" and "not disclosed" is explained in Appendix A.

The analyzed results revealed that of the 13 identified attributes, only one was reported on in the majority of the companies' annual reports. Twenty three (57.5%) of the companies sampled fully disclosed that the AC had approved the IAA's plan. Nineteen (47.5%) of the companies fully disclosed information on the IAA charter. Such disclosures arguably demonstrate that the primary focus of ACs is on the IAA's plan and charter. This observation is closely aligned to findings published by Marx and Voogt (2010), who found that 100% of ACs reviewed the IAA's plan and charter.

Another attribute that received some prominence is that of the CAE's access to the AC: 16 (40%) of the selected companies fully disclosed this information. However, none of them disclosed whether the CAE's remuneration had been approved by the AC. This finding is closely aligned with those in the study conducted by Ernst & Young in 2006, in which it was found that only 8% of ACs had approved the remuneration of CAEs (Marx & Voogte 2010).

Most of the Top 40 JSE-listed companies in this present study did not disclose the bulk of the attributes identified as capable of enhancing the IAA's

independence within the AC/IAA relationship. Attributes which are generally omitted include: the approval of IAA budget; confirmation of the IAA's resources; confirmation of the CAE's access to the board; confirmation of the CAE's access to the AC; confirmation of administrative reporting to the CEO; confirmation that the appointment of the CAE was supported by AC; dismissal of CAE supported by AC, and the evaluation of the IAA's performance relative to approved plans.

This research finding revealed that there is a relatively low level of disclosure on the presence or otherwise of independence-enhancing attributes within the AC/IAA relationship and this is consistent with that of Marx and Voogt (2010:24). They found that although the AC fulfills various functions and responsibilities in respect of the IAA, disclosures of these in the annual reports remain limited. The finding is also aligned to that of Holt (2012:879) who found that external stakeholders have no information about the composition, responsibilities or activities of the IAA. The most cost-effective way of communicating this information to external stakeholders should be in the companies' annual reports. Furthermore, this agrees with the finding by Barac and Moloi (2010:23) in their study entitled "An assessment of corporate governance reporting in the annual reports of South African listed companies", where they observed that there was at best only partial disclosure of information in respect of internal audit independence.

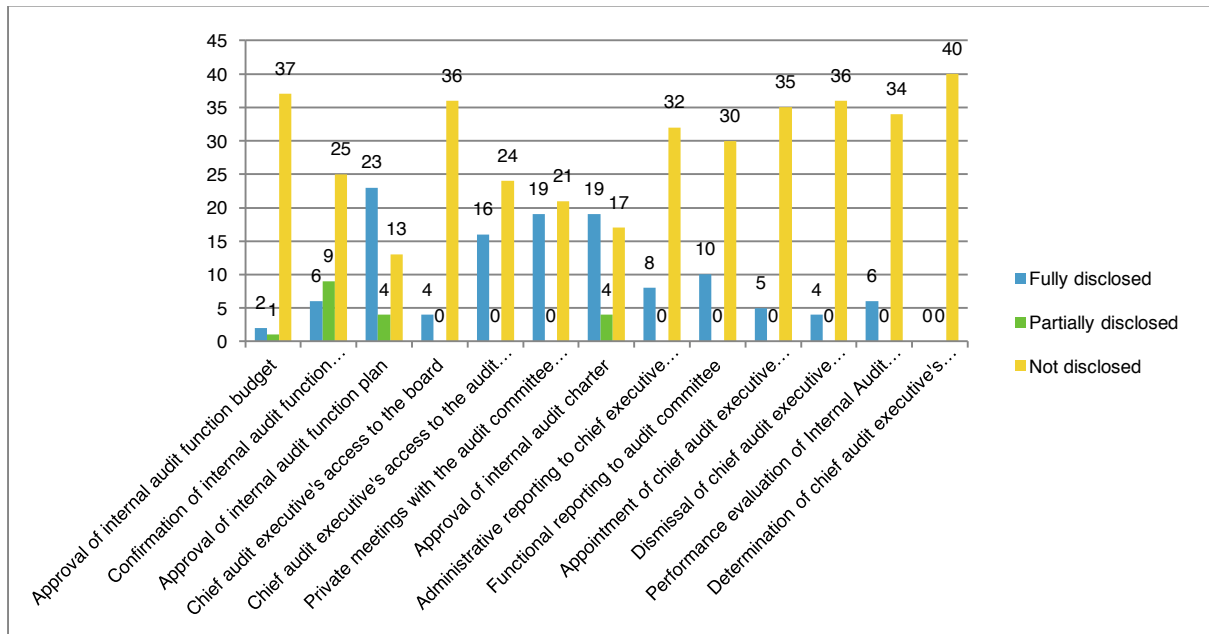
Overall, the findings of this study provide evidence of a minimalist approach to disclosure regarding the presence of independence-enhancing attributes within the AC/IAA relationship in South Africa's Top 40 JSE-listed companies. Furthermore, the findings



give an updated perspective on the state of the disclosure of these independence-enhancing attributes within the AC/IAA relationship in the Top 40 JSE listed companies, and this contributes to the body of literature on the subject. In addition, these findings have implications for the internal audit profession's standard setters, as they highlight,

among others, a probable need to compel the disclosure of the state of compliance with IAA independence-enhancing attributes, so as to address the impact of their non-disclosure. Furthermore, the findings question the need and importance to fully disclose these attributes and this could inform future regulation and direct future research.

**Figure 1: Analysis of the independence-enhancing attributes within AC/IAA relationship as disclosed in the annual reports of the Top 40 JSE listed companies**



**7 CONCLUSIONS AND RECOMMENDATIONS**

The existence of an IAA increases the likelihood that a company will detect and report fraud themselves: thus, its establishment is in the best interest of the company. The company derives value from an independent IAA as it is then able to resist pressure from management, and conducts audits in accordance with the professional standards of the internal audit profession. A good (well-defined and managed) AC/IAA relationship is important for the enhancement of the independence of the IAA. Previous research, in addition to regulations and guidelines, have identified and alluded to various attributes within the AC/IAA relationship that enhance the independence of the IAA.

The objective of this study was to use thematic analysis (as part of content analysis) to analyze the annual reports of the Top 40 JSE-listed companies to determine if there has been disclosure of such independence-enhancing attributes within the relationship between their ACs and IAAs. The results revealed that companies do not disclose these attributes extensively in their annual reports. This lack of extensive disclosure raises questions, as demonstrable independence is the cornerstone supporting the continuing existence of the internal audit profession; information revealing the ongoing independence of the IAA could, therefore, be of significant value to users of financial statements, as well as to internal auditors desiring to retain their relevance on the payroll.

A lack of disclosure of independence-enhancing attributes with respect to the IAA could create an impression that the AC lacks commitment to ensuring the organization's internal controls remain effective, and to establishing an optimal working relationship with the IAA. Report recommends that ACs should provide a "description of [their] working relationship" with the CAE (IoD, 2009:69). As an area for future research, the investigation as to whether users of financial statements need (or even consider) information on the independence of the IAA, and if so, to identify their preferred disclosures, would be instructive. As the amendment to King III Report is currently being debated, the achievement of clarity on what the "description of the working relationship" should entail, and of the supporting legislative requirements to guide disclosures regarding the independence of the IAA could be most useful.

Since the IAA's independence-enhancing attributes within the AC/IAA relationship considered in this study relate specifically to the establishment of the functional reporting of the IAA, the lack of extensive disclosure raises doubts about the existence of effective functional reporting *per se*, and thus of the very independence of the IAA] The lack of extensive disclosure on the status of the IAA's independence-enhancing attributes could create an impression that the AC does not see value in confirming the independence of the IAA, and it thus lacks commitment to internal controls. This might well influence stakeholders, both by inhibiting their ability to evaluate the effectiveness of the IAA, and to be

assured of their independence. This then obviously represents an area ripe for future research, particularly in light of recent studies that have questioned the value proposition of internal auditors (Lenz & Hahn 2015). A future study could, therefore, determine whether this could be addressed by the ACs disclosing the presence of independence-enhancing attributes within the IAA.

This article focused on analyzing the AC/IAA relationship as disclosed in the annual reports of the Top 40 JSE-listed companies to determine the

presence of attributes that enhance the independence of the IAA. Future research could expand this understanding by analyzing the annual reports of government institutions, and particularly state-owned entities to identify whether (and if so, the degree to which) these entities report on the attributes that enhance the independence of their IAAs. Another area that may be useful to explore is the determination of the extent of IAA independence when reporting through modes of communication other than companies' annual reports.

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**APPENDIX A: CONTEXTUALIZATION OF THE MEANING OF FULLY, PARTLY AND NOT DISCLOSED**

Recording unit	Fully disclosed	Partly disclosed	Not disclosed
1.1 Approval of IAA budget	The IAA is agreed upon by the AC	The IAA reviewed by the AC; no mention that it was agreed upon or approved	Not mentioned at all
1.2 Confirmation of the IAA resources	The AC reviewed and agreed on the sufficiency of IAA's resources	The AC reviewed the IAA's resources, but no confirmation of sufficiency	Not mentioned at all
1.3 Approval of the IAA plan	The IAA plan is reviewed and agreed upon by the AC	The IAA's plan is reviewed but not agreed upon	Not mentioned at all
1.4 CAE's access to the board	Reported that the CAE has access to the board	Not applicable	Not mentioned at all
1.5 CAE's access to the AC chairperson	Reported that CAE has access to the AC chairperson	Not applicable	Not mentioned at all
1.6 Private meetings with the AC chairperson	Reported that CAE has private meetings with AC chairperson or other member	Not applicable	Not mentioned at all
2.1 Approval of IAA charter	Reported that the IAA charter is reviewed and agreed upon by the AC	The IAA charter is reviewed but not agreed upon by the AC	Not mentioned at all
2.2 Administrative reporting to CAE	Reported that the IAA reports administratively to the chief executive officer	The level to which the IAA reports administratively is reported, however, it is not to the chief executive officer	Not mentioned at all
2.3 Functional reporting to AC	Reported that the IAA reports functionally to AC	The level at which the IAA reports functionally is reported, however, it is not to the AC	Not reported at all
3.1 Appointment of CAE supported by the AC	Reported that the AC is involved in the appointment of the CAE	Reported that CAE was appointed but no mention of the involvement of the AC	Not mentioned at all
3.2 Dismissal of CAE supported by AC	Reported that the AC endorses the dismissal of the CAE	Reported that the CAE was dismissed but no mention of the endorsement of the AC	Not reported at all
3.3 Performance evaluation of the CAE	Reported that the AC evaluates the performance of the CAE	Reported that the CAE's performance was evaluated but no mention that it was evaluated by the AC	Not reported at all
3.4 Determination of the CAE's remuneration	Reported that the remuneration of the CAE is determined in consultation with the AC	Reported on remuneration of the CAE, but no mention was made of involvement of the AC	Not reported at all



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