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WORKING PAPER

Interaction between internal auditors and the audit committee: An analysis of expectations and perceptions

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Abstract

This study, based on six case studies within a Belgian context, provides a qualitative assessment of the interaction between internal auditors (IA) and audit committees (AC), by analysing their expectations and perceptions. It became clear that both groups have high expectations vis-à-vis each other, although perceptions of IA-AC interactions are not universally positive. Our empirical data indicate that audit committee members want internal auditors to be an important information provider. Therefore they expect internal auditors to demonstrate and communicate, as much as possible, their contribution to the monitoring and functioning of the organisation, and to play both an active and proactive role in risk management. It became clear that, in most cases, due to a mismatch of interests, there is an under-emphasis on the internal audit oversight role of the audit committee, which is more perceived by the internal auditors than by audit committee members. In order to reduce this mismatch, both parties should broaden their interests in a converging way, in conjunction with clear communication about the mission and roles of internal audit.

Keywords: internal audit, audit committee, interaction, corporate governance, case studies.

Introduction

Corporate collapses of the past few years, in the U.S. as well as Europe, have focused global attention on the need for strong corporate governance. This has generated significant discussion about the role of both audit committees and internal auditors in strengthening corporate governance (e.g. McElveen, 2002). Moreover, *interactions* between internal auditors and the audit committee are considered to be an important element of sound corporate governance (e.g. Bishop et al., 2000).

In academic research, a large percentage of the empirical work related to audit committee (AC) oversight has focused on *audit committee effectiveness* (e.g. DeFond and Jiambalvo, 1991; McMullen, 1996; Beasley et al., 2000). However, according to DeZoort et al. (2002), more research is needed to understand audit committee *interactions* with internal auditors. Therefore, and similar to Spira (1998; 1999) and Gendron et al. (2004)'s field studies of audit committees practices, this study, based on six case studies within a Belgian context, aims to understand the two-way interaction between the audit committee and internal auditors. More specifically, this paper provides a *qualitative analysis* of the expectations and perceptions of audit committees and internal auditors, vis-à-vis each other, followed by possible reasons for the differences between expectations and perceptions about the interactions. As internal audit and audit committees are relatively 'new' phenomena within Belgian companies[1], we will formulate suggestions for improvements in this interaction.

Willekens et al. (2004), investigating audit committee formation and practices in Belgium for the first time, mainly focused on the formation, size and composition of audit committees. Moreover, they found that, in 79 percent of the companies that do have an audit committee, this audit committee meets with an internal auditor. Despite focusing on a specific Belgian context, their study provides no details on the interaction between the audit committee and the internal audit function. Therefore, the current Belgian study, based on six extended case studies, can be considered complementary to this earlier study.

For each case study, we conducted interviews with the Chief Audit Executive (or equivalent) and the chair of the audit committee (or an audit committee member). We also sought access to many relevant confidential documents to support the insights we gleaned from our interviews.

This paper is structured as follows. The next section presents a focused overview of the existing literature on the interaction between internal auditors and audit committees, in order to formulate four research questions. The third section outlines some methodological aspects. The fourth section presents insights from our interviews and document analysis. The last section summarises the conclusions drawn from this study and discusses their implications.

Literature review and development of research questions

This section will present necessary background information on the responsibilities and possible expectations of the audit committee in relation to internal auditors, in addition to major insights attained from previous research in this area.

Audit committee responsibilities

According to the *agency theory*, owners and agents have incentives to invest in various information systems and control devices to reduce agency costs associated with information asymmetry (Jensen and Meckling, 1976). In this context, management may use various means to indicate to others the quality of the information they are providing. Demands for monitoring may lead to external audits (see Chow, 1982; Anderson et al., 1993), the use of outside directors (see Fama, 1980; Anderson et al., 1993) and audit committees (see Bradbury, 1990; Menon and Williams, 1994). The use of audit committees can be considered an important part of the decision control system for internal monitoring by boards of directors (see Fama, 1980). In other words, the board of directors delegates some of its oversight responsibilities to the audit committee.

As this paper focuses on a Belgian context, we refer to the audit committee responsibilities mentioned by the European Commission (2004) completed with relevant paragraphs from the recently-issued Belgian Code on Corporate Governance[2] (2004).

In 2004, the European Commission published proposals for EU requirements on risk management and internal controls in the form of the proposed Directive on Statutory Audit[3], and through proposed amendments to the Fourth and Seventh Directives. Article 39 of the proposed Directive on Statutory Audit (2004) stipulates that the audit committee shall *monitor* the financial reporting process, the effectiveness of the company's internal controls, its internal audit where applicable, and its risk management systems. Moreover, the audit committee shall select and propose a statutory auditor or audit firm, oversee the statutory audit, and monitor the independence of the statutory auditor or audit firm. These general responsibilities appear in most national and international guidelines and best practices.

Principle Five of the recently-published Belgian Code on Corporate Governance (2004) stipulates that "the board should set up an audit committee to assist the board in fulfilling its *monitoring* responsibilities with respect to control in the broadest sense". Additionally, Appendix C of the Code gives more detailed guidelines concerning the audit committee's responsibilities in areas similar to those mentioned in Article 39 of the proposed Directive on Statutory Audit (2004). An overview of these responsibilities can be found in Appendix 1. In the section on empirical results, we will investigate whether specific recommendations from this new Code do have an influence on the expectations of audit committee members, vis-à-vis internal auditors.

Several studies have examined the effect of audit committee presence or absence on various measures of financial reporting quality. Evidence of a positive link between audit committee existence and the quality of financial reporting has been provided by analysis that indicates that earnings overstatements are less likely among companies having audit committees (DeFond and Jiambalvo, 1991), and that companies that manipulate their earnings are less likely to have an audit committee (Dechow et al., 1996). Evidence also has been documented that audit committees are associated with a reduced incidence of errors and irregularities in financial statements (McMullen, 1996). Furthermore, Gwilliam and Kilcommins (1998) found that the presence of audit committees creates a perception of enhanced auditor independence, and more reliable financial reporting among financial statements users.

Contrary to the numerous articles in the practitioner literature discussing the monitoring responsibilities of audit committees in risk management and internal control, the academic literature on the impact of audit committees in these areas is rather limited. DeZoort (1997) found that audit committee members of U.S.-listed companies perceive internal control evaluation as their most important area of oversight. Similarly, results from a more recent study by Gendron et al. (2004) lead to the conclusion that audit committee members have an interest in the extent to which internal control is effective, not least because internal control "underlies" the credibility of financial reports. To develop their own appreciation of the effectiveness of internal controls, audit committee members can review internal accounting procedures and controls with the company's financial and accounting staff. Moreover, they can rely on the work of internal auditors (Krishnan, 2005).

Interaction between the audit committee and the internal auditor(s)

In this section, we will provide an overview of some previous studies on the interaction between audit committees and internal audit so as to reveal insights into possible expectations audit committee members and internal auditors can have towards each other.

The relationship between the audit committee and the internal auditor is an important one, with a *reciprocal strengthening* of each other's function (Goodwin and Yeo, 2001). In other words, the audit committee can strengthen the internal audit function, and internal auditors can, in turn, be an important resource to the audit committee as it strives to fulfil its responsibilities (Turley and Zaman, 2004). Based upon their analysis of audit committee charters and reports, Carcello et al. (2002) discovered that, although internal audit can be a valuable resource for the audit committee, disclosures suggest a possible under-emphasis of internal audit.

Based on empirical research, Spira (1999) argues that one benefit of audit committee establishment is the raising of the status of the internal audit function. Internal auditors interviewed in her study particularly valued audit committee support and sought to be proactive in achieving it, sometimes by means of 'educating' audit committee members. An effective audit committee can strengthen the position of the internal auditor(s), by acting as an independent forum for internal auditors to raise matters affecting management (Goodwin and Yeo, 2001). Therefore, the IIA (2004) strongly insists that the Chief Audit Executive (CAE) should report functionally to the audit committee, which is critical to good corporate governance. The lines of communication and reporting should encourage internal auditors to speak freely, regularly and on a confidential basis with the audit committee. The CAE should be invited to audit committee meetings to present and discuss the audit planning, findings and observations. Moreover, Braiotta (1999) argues that private meetings between the audit committee and the CAE serve the purpose of enhancing and protecting the independence of internal auditors.

The Belgium Audit Committee Institute[4] (2005) gives an overview of the specific aspects of the internal audit oversight role of the audit committee. The audit committee should:

- develop and approve the internal audit mandate, goals and mission;
- review the (re)appointment, promotion or dismissal of the head of internal audit, and the determination of his/her qualifications, reporting hierarchy and compensation;
- monitor whether the internal audit function has adequate resources;
- follow up on the internal audit department's scope, the results of its operations and recommendations, and on management's responses thereto;
- regularly evaluate the internal audit department's objectivity and independence of judgement;
- monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system; and

- review and assess the annual internal audit work plan.

According to Bishop et al. (2000), internal audit is a valuable resource that can provide the information needed for audit committees to meet their governance mandate. Similarly, Raghunandan et al. (1998; 2001) argue that the information asymmetry between audit committees and management is more likely to be reduced when there is high-quality interaction between audit committees and internal audit. Regular meetings between the audit committee and internal audit make it more likely that the audit committee remains informed and knowledgeable about relevant accounting and auditing issues. Maximum benefit from this interaction can be expected, however, if members of the audit committee have the technical expertise to understand the work of the internal audit function, together with the independence to enhance the status of the internal audit (Goodwin, 2003).

Bishop et al. (2000) give an overview of more specific (theoretical) roles of internal auditors to support the audit committee:

- *general assistance* could include: facilitating the information flow to the audit committee or performing special projects or investigations, as requested by the audit committee;
- *financial reporting assistance* could include: supporting the audit committee in its evaluation of whether or not the company has satisfied its internal and external reporting objectives, supporting the audit committee in its assessment of the quality of financial reporting, providing information and insight regarding the strength of controls over the quarterly reports or assuring audit committee members that they are receiving reports with relevant and timely business performance measures;
- *risk and control assistance* could include: supporting the audit committee in its evaluation of whether the company has satisfied its control objectives, providing information that will help the audit committee monitor the company's control environment, and providing information that will help the audit committee monitor key financial and business risks facing the organisation.

Figure 1 summarises the potential interactions between internal auditors and the audit committee:

[INSERT FIGURE 1 HERE]

By formulating answers to the following research questions, this study attempts to validate this figure:

Research question 1:

What do audit committee members *expect* the role of internal auditors to be?

Research question 2:

How is the interaction between the audit committee and internal auditors *perceived* by audit committee members, as well as internal auditors?

Research question 3:

What are *reasons* for the *differences* between the expectations and perceptions about the interaction between the audit committee and internal auditors?

Research question 4:

How can the interaction between the audit committee and internal auditors be *improved*?

Methodology

Complementary to the existing research in this area, mainly based on *quantitative* data (e.g. DeZoort, 1997; Goodwin and Yeo, 2001; Carcello et al., 2002; Goodwin, 2003), this study uses a wide range of *qualitative* data in order to access more in-depth insight in the dynamic interaction between internal auditors and the audit committees. Turley and Zaman (2004) are convinced that qualitative research methods, incorporating case studies and interviews, provide significant potential for researching the interaction of audit committees with other parties, such as auditors.

The selection of the six companies (cases) for this study was partially theoretically driven and partially based upon experience with the internal audit profession in Belgium. Based on previous research, indicating that *the economies of scale* via the establishment of an internal audit function increase with firm size (e.g. Chow, 1982), we controlled for *firm size* and selected companies with at least 1 000 employees[5]. Furthermore, we included an equal number of manufacturing and service companies. Note that all six companies operate on an international scale (Europe, US, Asia and Middle East). Previous research on internal audit within a Belgian context (cf. Sarens and De Beelde, 2004; 2006) indicated two interesting parameters for which control should be considered: 1) the age of the internal audit function and 2) the number of internal auditors. By doing this, we were able to compose a more or less representative sample, reflecting the fact that internal auditing remains a relatively young profession in Belgium. Related to the first parameter, we included four companies with a mature internal audit function (having existed for more than five years) and two companies that recently created an internal audit function (having existed for less than five years). Related to the second parameter, we selected five companies with a small internal audit department (less than five internal auditors) and one company with a larger internal audit department (more than five internal auditors). Table 1 presents an overview of the six cases:

[INSERT TABLE 1 ABOUT HERE]

For each case, we conducted a semi-structured interview with the internal auditor (when there is only one person performing the function) or the Chief Audit Executive (when there is more than one internal auditor). We also asked him/her for the coordinates of the audit committee chair (or another audit committee member). Contrary to the internal auditors, it was not easy to reach these latter individuals to arrange an interview with them. Consequently, it took us several months to conduct all interviews (June – September 2005). The interviews lasted from 60 to 120 minutes. All interviews were tape-recorded and transcribed immediately after the interview took place. In order to support the interview data and enhance the reliability of our conclusions, we obtained copies of several archival materials, like the internal audit charter and internal audit planning, as well as even more confidential documents like internal audit reports, internal presentations, risk matrices, business control guides, audit committee reports, and so on. Only one company was reluctant to release these confidential documents. Table 2 provides an overview of all collected data:

[INSERT TABLE 2 ABOUT HERE]

The analysis of these qualitative data was based on the analytical protocol recommended by Miles and Huberman (1994). More specifically, all interview transcripts and documents were coded. Next, the most important observations were summarised for each company and sent back to the interviewees to obtain their confirmation about our interpretations. They were afforded the opportunity to react openly and add new elements if necessary. These adjusted insights were translated into standardised matrices that facilitated the discovery of patterns through cross-case analysis.

Empirical results

What do audit committee (AC) members expect the role of internal auditors (IA) to be?

In general, AC members have high expectations about the role of internal auditors in their organisation. AC members want internal auditors to demonstrate, as much as possible, their specific contributions to the monitoring and functioning (efficiency) of the organisation. More specifically, they expect internal auditors to work towards the achievement of specific results in a limited number of areas. The following paragraph from an AC meeting report clearly illustrates the fact that AC members do not feel comfortable when there are too many audits "in the pipeline": *"The current audit strategy of having multiple parallel audits is not ideal, not for the organisation nor the internal auditor. The audits last too long and due to the fragmented input have diminished quality and coherence"*.

AC members, in most cases non-executive directors, want internal auditors to become (more) like *"translators"* or *"communicators"* between the operational levels and the monitoring level (of which the AC is part) of the organisation, in order to compensate for their lack of information about *"what* *generally is going on in the organisation"*. This shortage often is considered to be a serious constraint in the fulfilment of their responsibilities. More specifically, in the course of their work, internal auditors are expected to signal and communicate clearly all recognised risks and problems, as well as shortcomings in the internal control system. In order to achieve this, internal auditors should be able to communicate with everyone in the organisation, which necessitates an open and friendly attitude. Moreover, they expect internal auditors to be facilitators for whistle blowing.

It is remarkable that all AC members interviewed in our case studies expect internal auditors to be important, active and proactive players in risk management. More specifically, they want internal auditors to focus on specific high risk areas (e.g. inventories, foreign subsidiaries, IT applications), as these also are their areas of interest, especially when these have a direct or indirect impact on financial results. One of the AC chairs regrets that *"if you ask something about risks… internal audit is doing very little"*. After a thorough assessment of these risks, internal auditors should review the adequacy and effectiveness of the related internal controls, as well as compliance with existing policies and procedures, followed by the formulation of focused suggestions for improvements and even assistance with the implementation of these suggestions. AC members do not consider this last aspect to be a potential threat for the independence of internal auditors. In other words, AC members expect internal auditors to be specialists in risk assessment, and to develop and exhibit sufficient expertise to play a valuable advising or even more proactive role in the management of these risks. By fulfilling this role, the internal auditors can improve their role as a necessary and valuable source of information on risks and internal controls. We reasonably can expect that this specific expectation and need for information arises from the influence of the new Belgian Code on Corporate Governance (2004), clearly recommending that *"at least once a year, the audit committee should review the internal control and risk management systems set up by executive management, with a view to ensuring that the main risks (including those relating to compliance with existing legislation and regulations) are properly identified, managed and disclosed"*.

Most AC members are more or less convinced of the *potential* added value of the internal auditor(s) in the evaluation and especially the improvement of internal controls: *"Our internal auditor should be more actively involved in the implementation of his suggestions, this should certainly add value"*. Apparently, AC members expect internal auditors to fulfil a more *consulting-oriented* role in risk management. This probably is due to the fact that specific improvements, thanks to the internal auditors' consulting-oriented efforts, are easier to observe and value than the provision of a rather "abstract" level of assurance. For those organisations lacking a more or less formalised risk management system, AC members are convinced of the valuable role of internal auditors in this formalisation process.

The interaction between the audit committee and internal auditors: facts and perceptions

The cases show that the strength or maturity of the AC, in general, determines the strength of the two-way interaction between the AC and the internal auditors. The more that the AC is perceived as important and influential (more mature) within the organisation, which often can be derived from the topics and related discussions described in the AC meeting reports and the duration of these meetings, the stronger their interaction with the internal auditor(s). One specific case shows the opposite of what is mentioned above. Despite having a large number of meetings and a sufficient number of members with financial expertise, the AC chair suggests that his committee is a rather theoretical and obligatory concept without much decisive influence: *"I have to confess that, in most cases, the audit committee is running after the facts"*. Instead of considering the internal auditor as a valuable and independent information provider, in this case the AC chair prefers to rely almost exclusively on the external auditor. Consequently, the reciprocal relationship between the AC and the internal auditor clearly is underdeveloped, which can be considered to be a missed opportunity for both parties.

In a majority of the cases, IA-related topics, like the approval of the audit planning and the follow-up of the results and recommendations, are not considered to be the most important AC responsibilities. An analysis of several AC meeting reports reveals that they often spend a very limited proportion of their time on these topics. This was confirmed by one of the interviewed internal auditors who expressed regret over this situation: *"If an AC meeting takes two hours, they talk about the financial results for more than one hour and 45 minutes, so they (can) only spend five to ten minutes on internal audit topics"*. Remarkably, most AC members are convinced that they show enough interest in IA topics, whereas most internal auditors complain about the limited interaction that they have with AC members. This is understandable, as they have high expectations vis-à-vis the AC. More specifically, they are not satisfied with the opportunity of participating in AC meetings, nor with the input they receive from AC members. Moreover, based on the very limited number of questions, they feel doubt about the follow-up their audit reports receive.

On the contrary, there is one particular case in which the AC chair perceives the internal auditors to be very important for the organisation. Consequently, the AC is actively interested in the work of the internal auditors and seeks support from them in the fulfilment of their responsibilities. *"I perceive internal audit as extremely important for our company and attach a lot of importance to the function. Naturally, they have a very large added value for our company. I think we can say that more than 50% of our time is devoted to internal audit. The interaction between the audit committee and internal audit is optimal"*. This high level of AC support improves the acceptance of the IA findings and recommendations, which contributes to the maturity of the function as a whole. This optimal interaction can be associated with the fact that this company was really a pioneer in setting up an internal audit department in Belgium (20 years ago). In the meantime, the number of internal auditors has grown significantly and both parties have had sufficient time to actively work on their relationship.

***Reasons* for the *differences* between the expectations and perceptions about the interaction between audit committees and internal auditors**

We can conclude that, except from the one case mentioned in the previous paragraph, all our cases show, to some extent, a mismatch of interests between the AC and the internal auditors. As a result, the reciprocal strengthening between both parties is far from optimal. Similar to what was mentioned before, this mismatch of interests and the resulting limited interaction is more perceived by the internal auditors than the AC members. This can be explained by the internal auditors being more dependent on AC support, whereas the AC has other (potential) sources of information, like external auditors, about, for example, the strength of internal controls.

Looking for reasons to explain this mismatch of interests, our interviewees as well as several AC meeting reports indicate that, despite the broader range of audit committee responsibilities suggested by the new Belgian Code on Corporate Governance (2004), most ACs still focus strongly on financial results and related reporting issues. Conversely, the internal auditors' work is more oriented towards the review and improvement of the risk management and internal control system. Although the monitoring of the risk management and internal control system clearly is mentioned in most corporate governance charters as an AC responsibility, these topics only are marginally treated by the AC. Previous studies have discussed this remarkable difference between the theoretical ("how it should be") and actual responsibilities of the AC (e.g. DeZoort, 1997; Carcello et al., 2002).

How can the interaction between the audit committee and internal auditors be *improved*? In other words, how can we obtain better alignment of interests?

Based upon one particular case study in which the interaction between the AC and the internal auditors is perceived as optimal (see above) and suggestions offered by the interviewed AC members and internal auditors, we can formulate specific suggestions to reduce the gaps between the expectations and perceptions about the interaction between AC members and the internal auditors.

First, as internal auditing remains a relatively young profession in Belgium, both parties will benefit from clear communication about the specific roles and mission of IA, for example, through dissemination of the internal audit charter or a formal presentation of the function. Well-considered marketing of the IA function contributes to the creation of realistic expectations about IA and a more realistic evaluation of IA performance. One AC meeting report clearly mentions this need: *"AC member X is wondering whether the internal audit function is clear within the company. AC member Y responds by stressing the importance of marketing the internal audit function"*. Moreover, the sometimes opposite perceptions about the interaction between the AC and the internal auditors (see above) necessitate a critical and formal evaluation of their relationship (e.g. by means of a satisfaction questionnaire), which will provide both parties with opportunities to express their needs and expectations.

Second, it becomes clear that *both* parties should broaden their areas of interest in a converging way, as illustrated in Figure 2:

[INSERT FIGURE 2 ABOUT HERE]

On the one hand, if internal control and risk management topics become more prominent on the AC agenda, the mismatch of interests will disappear and AC members will have greater incentives to actively involve the internal auditors in their search for information. It can be expected that the new Belgian Code on Corporate Governance (2004) will facilitate this shift in the near future. Some AC members already stress their intention to spend more time on these topics and, by doing this, become more closely aligned with the internal auditors. On the other hand, internal auditors should garner more attention for the impact of their findings and their suggestions pertaining to financial results and reporting (direct or indirect effects). By doing this, they will be more able to attract the attention of the AC members and receive the necessary support from them (cf. Figure 1). Additionally, improved communication on the results of their work through *concise* and *focused* audit reports certainly will benefit the reaction and follow-up by AC members. One AC member clearly stated: *"We expect short reports focusing on the priorities, which would be a nice communication instrument. The current audit reports are too extensive and complicated and thus not a useful working tool for us"*.

We are convinced that these suggestions will strengthen the reciprocal interaction between the AC and internal auditors, which will probably generate, especially in this specific Belgian context, greater maturity in both parties. Consequently, internal auditors will be more valued as a crucial information provider on risks, internal controls and financial issues. The AC, in turn, will provide the necessary support to internal auditors by suggesting topics to include in the planning and by following up the results of the audit work more closely.

Conclusions and Discussion

This study qualitatively investigated the interaction between internal auditors and AC members. The extended analysis leads to the following conclusions. Overall, it became clear that both parties have high expectations of each other, although the perceptions of the interactions are not universally positive. Figure 3 outlines the findings:

[INSERT FIGURE 3 ABOUT HERE]

AC members want internal auditors to be an important source of information, in order to compensate for their own lack of information about the organisation, something which is considered to be a serious 'handicap', especially for non-executive directors, in the fulfilment of their responsibilities. Therefore, they expect internal auditors, with whom they meet only a couple of times yearly, to demonstrate and communicate (through concise and focused audit reports) their contributions to the monitoring and functioning of the organisation. In addition, internal auditors are expected to play a (pro)active role in risk management, by focussing on high risk areas and spending enough time on the formulation of specific suggestions to improve internal controls, and by even assisting with the implementation of these suggestions.

Although risk management and internal control topics still are marginally treated by most of the ACs in this study, the *individual* AC members have specific expectations about the role of the internal auditors in these areas. This illustrates that most *individual* AC members know which topics they *should* discuss in AC meetings (see new Belgian Code on Corporate Governance, 2004), although the *overall* AC agenda is not yet adapted and remains strongly focused on financial topics. We can ponder whether more open communication between AC members about their *individual* expectations would improve the functioning of the AC and, consequently, AC interaction with internal auditors. We found indications that the strength or maturity of the AC, in general determines the strength of its interaction with internal auditor(s).

Similar to Carcello et al. (2002), in a majority of our cases, there seemed to be an under-emphasis on the IA oversight roles of the AC. Contrary to most AC members, internal auditors often complain about the limited interaction they have with the AC. More specifically, they are not satisfied with the opportunity to participate in AC meetings, with the input they receive from AC members and with the follow-up their findings and recommendations receive.

Looking for reasons to explain the differences between expectations and perceptions, we found a mismatch of interests between the AC and internal auditors, which temper the reciprocal strengthening between both parties. Contrary to DeZoort (1997) and Gendron et al. (2004), the ACs in this study still focus too strongly on financial results and reporting issues, and neglect aspects like risk management and internal controls. In order to reduce this mismatch, there should be clear communication about the mission and roles of IA, thereby enabling the creation of realistic expectations. To improve the reciprocal relationship, both parties should broaden their interests in a converging way. As recommended by the new Belgian Code on Corporate Governance (2004), internal control and risk management topics should become more prominent on the AC agenda, whereas internal auditors should receive more attention for the (direct and indirect) impact of their findings and suggestions on financial results.

The Belgian context of this study offers a unique setting, as both the AC and IA are relatively 'new' phenomena. At the same time, this also can be considered a limitation of this study. Therefore, it would be most interesting to conduct the same in-depth study of these interactions within other countries where the AC and the IA profession are more mature, in order to see whether this generates different conclusions. Moreover, some interviewees suggested that, due to increasing corporate governance demands, more intensive interaction and collaboration with external auditors is becoming increasingly important. We are convinced that a qualitative study of this relationship will lead to interesting and relevant insights for the corporate governance literature.

Endnotes

[1] Willekens et al. (2004), using survey data from 2001/2002, found that only 57% of a group of 70 Belgian companies listed on Euronext Brussel had voluntarily installed an audit committee. Analysing the 2004 annual report of 40 Belgian listed companies, Van der Elst (2005) found that 72% of them already had an audit committee.

[2] The Corporate Governance Committee was established in January 2004 and is chaired by Maurice Lippens. The aim of the Committee was to update existing recommendations on corporate governance by drafting a single reference code for listed Belgian companies. The final version of the Code was published in December 2004. Note that the Belgian Code is based on the 'comply or explain' principle.

[3] At the beginning of October 2005, the European Commission welcomed the European Parliament's approval at first reading of the proposed 8th Company Law Directive on statutory audit of annual accounts and consolidated accounts.

[4] The Audit Committee Institute in Belgium (sponsored by KPMG) is a knowledge resource for the support of audit committees and other board members. The objectives of the Audit Committee Institute are to promote awareness of the responsibilities of the audit committee, and to support the implementation of effective monitoring processes.

[5] In September 2005, there were 190 Belgian companies with more than 1 000 employees (Belfirst).

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APPENDIX 1: Principle five of the Belgian Code on Corporate Governance
Audit Committee Responsibilities

5.2./1. The board should set up an audit committee composed exclusively of non-executive directors. At least a majority of its members should be independent. The chairman of the board should not chair the audit committee. The board should satisfy itself that the committee has sufficient relevant expertise to fulfil its role effectively, notably in financial matters.
5.2./2. The board should determine the role of the audit committee. The audit committee should report regularly to the board on the exercise of its duties, identifying any matters in respect of which it considers that action or improvement is needed, and making recommendations as to the steps to be taken.
5.2./3. Parent companies should ensure that the audit review and the reporting on that review cover the group as a whole.

Financial reporting

5.2./4. The audit committee should monitor the integrity of the financial information provided by the company, in particular by reviewing the relevance and consistency of the accounting standards used by the company and its group. This includes the criteria for the consolidation of the accounts of companies in the group. This review involves assessing the correctness, completeness and consistency of financial information. The review should cover periodic information before it is made public. It should be based on an audit programme adopted by the committee.
5.2./5. Management should inform the audit committee of the methods used to account for significant and unusual transactions where the accounting treatment may be open to different approaches. In this respect, particular attention should be paid to both the existence of, and the justification for, any activity carried out by the company in offshore centres and/or through special purpose vehicles.
5.2./6. The committee should discuss significant financial reporting issues with both executive management and the external auditor.

Internal controls and risk management

5.2./7. At least once a year, the audit committee should review the internal control and risk management systems set up by executive management, with a view to ensuring that the main risks (including those relating to compliance with existing legislation and regulations) are properly identified, managed and disclosed.
5.2./8. The audit committee should review the statements included in the annual report on internal control and risk management.
5.2./9. The audit committee should review the specific arrangements made, by which staff of the company may, in confidence, raise concerns about possible improprieties in financial reporting or other matters. If deemed necessary, arrangements should be made for proportionate and independent investigation of such matters, for appropriate follow-up action and arrangements whereby staff can inform the chairman of the audit committee directly.

Internal audit process

5.2./10. An independent internal audit function should be established, with resources and skills adapted to the company's nature, size and complexity. If the company does not have an internal audit function, the need for one should be reviewed at least annually.
5.2./11. The audit committee should review the internal auditor's work programme, having regard to the complementary roles of the internal and external audit functions. It should receive internal audit reports or a periodic summary thereof.
5.2./12. The audit committee should review the effectiveness of the internal audit. In particular, it should make recommendations on the selection, appointment, reappointment and removal of the head of internal audit and on the budget allocated to internal audit, and should monitor the responsiveness of management to the committee's findings and recommendations.

External audit process

5.2./13. The audit committee should make recommendations to the board on the selection, appointment and reappointment of the external auditor and the terms of his or her engagement. In accordance with the Code on Companies, this proposal should be submitted to the shareholders for approval.
5.2./14. The audit committee should monitor the external auditor's independence, in particular in view of the provisions of the Code on Companies and the Royal Decree of 4 April 2003. The committee should obtain a report from the external auditor describing all relationships between the independent auditor and the company and its group.

5.2./15. The audit committee should also keep the nature and extent of non-audit services under review. The committee should set and apply a formal policy specifying the types of non-audit services a) excluded, b) permissible after review by the committee, and c) permissible without referral to the committee, taking into account the specific requirements under the Code on Companies.
5.2./16. The audit committee should be informed of the external auditor's work programme. The committee should obtain timely information about any issues arising from the audit.
5.2./17. The audit committee should review the effectiveness of the external audit process, and the responsiveness of management to the recommendations made in the external auditor's management letter.
5.2./18. The audit committee should investigate the issues giving rise to the resignation of the external auditor, and should make recommendations as to any required action.

Operation of the audit committee

5.2./19. The audit committee should meet at least three times a year. It should review annually its terms of reference
and its own effectiveness and recommend any necessary changes to the board.
5.2./20. At least twice a year, the audit committee should meet the external and internal auditors, to discuss matters
relating to its terms of reference and any issues arising from the audit process.
5.2./21. The audit committee should decide whether, and if so, when the CEO, the chief financial officer (or senior
employees responsible for finance, accounting, and treasury matters), the internal auditor and the external auditor should attend its meetings. The committee should be entitled to meet with any relevant person without any executive manager present.
5.2./22. In addition to maintaining an effective working relationship with management, the internal and external auditors should be guaranteed free access to the board. To this effect, the audit committee should act as the principal contact point for the internal and external auditors. The external auditor and the head of the internal audit should have direct and unrestricted access to the chairman of the audit committee and the chairman of the board.

Figure 1: The interaction between the audit committee and internal audit

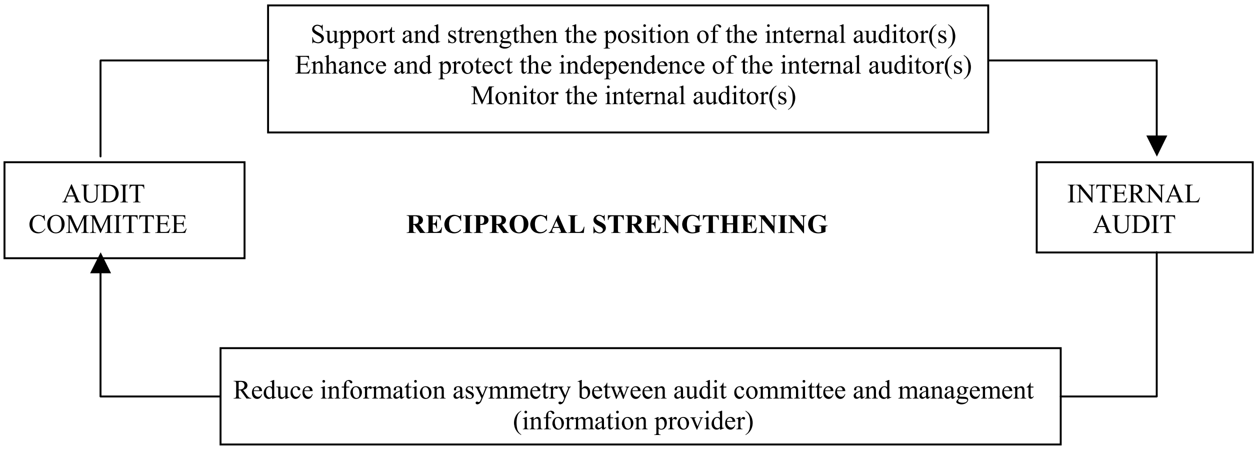

Figure 2: Mismatch of interests between audit committee and internal auditor(s)

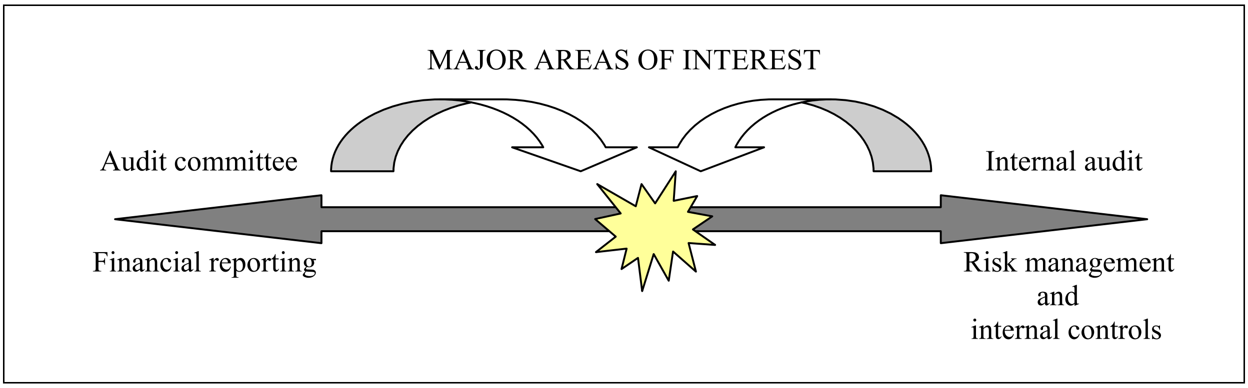

Table 1: Overview of the six case studies

	Case 1	Case 2	Case 3	Case 4	Case 5	Case 6
Number of employees (2004)	2 000 – 5 000	1 000 – 2 000	2 000 – 5 000	> 10 000	2 000 – 5 000	> 10 000
Turnover (2004)	> 1 billion Eur	< 500 million Eur	500 million – 1 billion Eur	> 1 billion Eur	500 million – 1 billion Eur	> 1 billion Eur
Sector	Services	Services	Manufacturing	Manufacturing	Services	Manufacturing
International dimension	14 locations within Europe	Active in 11 European countries	36 sites in Europe, Middle East, Asia and US	Active in 120 countries in Europe, US, Latin America and Asia	Active in 14 countries in Europe, Middle East and Asia	100 production units in 20 countries in Europe, US and Japan
Age IA function	1 year (start-up)	3 years (start-up)	15 years (mature)	20 years (mature)	15 years (mature)	7 years (mature)
Number of internal auditors	1 (small audit shop)	1 (small audit shop)	1 (small audit shop)	10 (large audit shop)	3 (small audit shop)	3 (small audit shop)
Number of AC members	4	3	3	6	3	3
Number of non-executive AC members	2	3	3	2	2	2
Number of independent AC members	2	2	2	1	0	1
Number of AC members with financial expertise	2	2	2	3	2	2
Number of AC meetings	3	4	5	3	5	5

Table 2: Overview of the qualitative data

	Case 1	Case 2	Case 3	Case 4	Case 5	Case 6
Interviews	o Member Audit Committee o Internal Auditor	o Chair Audit Committee o Internal Auditor	o Chair Audit Committee o Internal Auditor	o Chair Audit Committee o Internal Audit Manager	o Chair Audit Committee o Chief Internal Auditor	o Member Audit Committee o Chief Audit Executive
Documents	o Annual report 2004 o Internal audit charter o Internal audit planning o Internal audit report o Report audit committee meeting o Internal audit presentation to audit committee o Control matrices	o Annual report 2004 o Internal audit charter	o Annual report 2004 o Corporate Governance Charter o Corporate Governance Checklist o Corporate Governance Comply or explain overview o Report audit committee meeting o Management letter external auditor o Internal audit reports o Internal audit planning o Follow-up document	o Annual report 2004 o Code of Ethics o Business Control Guide o Internal audit planning o Internal audit presentation o Intranet pages on internal audit	o Annual report 2004 o Audit charter o Presentation audit methodology o Internal audit planning o Overview audits conducted o Internal audit report o Internal audit presentation to audit committee o Audit committee charter o Agenda audit committee meeting	o Annual report 2004 o Internal audit charter o Internal audit planning o Internal audit reports o Risk assessment questionnaire o Risk matrix o Control matrix o Business Control Guide o Minutes AC meeting

Figure 3: Overview of the empirical results