

ABSTRACT

This study provides empirical evidence on the relationship between audit committee effectiveness and professional objectivity of internal auditors in the Malaysian banking industry. There was no prior study done on this relationship. Although many studies had been done on the audit committee effectiveness in Malaysia and on the internal auditor's objectivity in overseas, no study is yet to be done on the relationship between an effective audit committee and the professional objectivity of internal auditors. Therefore, this study fills such gap.

Many official organizations and bodies internationally as well as in Malaysia have proposed an important role for audit committee and internal audits in the improvement of financial reporting, control and corporate governance. In this regard the internal auditors play an important role in assisting the governing bodies of their organizations for an effective discharge of their fiduciary duties and in promoting good corporate governance. More so, in banking institutions in view the significant role of banking system in an economy and the systemic negative impact of bank failures. Internal auditors can only be of value to all parties relying on their work if they perform their function objectively and professionally. Prior literatures had focused on how to improve audit committee effectiveness on the assumption that, among others, an effective audit committee would enhance the objectivity of internal auditors, hence the effectiveness of audit work.

This study, which is based on a sample of audit committee chairmen, chief internal auditors and their deputies of Malaysian banking institutions, examined the effectiveness of audit committees, the level of objectivity of the internal auditors and finally whether an effective audit committee would influence the objectivity of the internal auditors.

The results of the study show that banks have generally complied with the directives of the Central Bank on formation, function and duties of audit committees. Consistent with prior studies, all the four variables, namely the existence of an audit committee charter, the appropriate size and composition of an audit committee, the direct channel of communication between audit committee and the auditors, and the audit committee review of financial

statements contribute significantly to the effectiveness of an audit committee in the Malaysian banking system. Similarly, with regard to internal auditors' professional objectivity, the study confirms that all the four variables, namely, audit committee's approval of internal audit charter, the direct channel of communication between audit committee and internal auditors, vesting the responsibility with audit committee for hiring, firing and compensation of internal auditors and audit committee's review of internal audit work and programmes contribute significantly to the enhancement of the internal auditors' objectivity.

In terms of the impact of audit committee effectiveness on the objectivity of internal auditor, the study, however, revealed that the existence of audit committee charter has the most significant impact in the enhancement of internal auditors' objectivity, particularly in domestic banks. The domestic banks viewed that the existence of audit committee charter, that gives the power to the audit committee to discharge their duties, is important element for the approval of internal audit charter, appointment or removal of the chief internal auditors as well as the for setting compensations for internal auditors, and, in ensuring the existence of direct channel of communication between audit committee and internal auditors. In contrast, the foreign banks operating in Malaysia perceived that the audit committee charter is only significantly relevant in ensuring the direct channel of communication between audit committee and internal auditors.

The legitimate power of audit committee appears to have the most profound effect on audit committee effectiveness. The written audit committee charter and the perceived authority of the audit committee had positive relationship on audit committee effectiveness. The perceived importance of legitimate power for audit committee and its consequential impact on internal auditors' objectivity in domestic banks could be attributed to the cultural variable that underlie Malaysia's institutional arrangement particularly the societal value of power distance where hierarchy and an unequal distribution of power in institutions and organizations are accepted. Hence, the domestic banks' board and audit committees need to focus more attention on the legitimate and perceived power of audit committees in order to enhance the professional objectivity of internal auditors.*

The study also revealed that there is a gap in perceptions between audit committee chairmen and chief internal auditors with regard to the ability of internal auditors in maintaining their objectivity when they are subject to pressures from the chief executive officer of their banks. This could indicate possible weakness in the control environment, as internal auditors were not able to perform their jobs in an independent manner.

The study also tested the relationship between executive management's support to internal audit department and internal auditors' objectivity. Although prior studies have not considered this variable, the chief internal auditors interviewed during the research process had indicated that the extent of executive management's support to internal audit has a bearing on the level internal auditors' objectivity and independence. This view was confirmed by this study. Therefore, through their actions and policies, the board and audit committee should communicate and demonstrate to the executive management that internal audit is one of the key departments in the bank.