CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

In this chapter, the internal auditors professional objectivity is discussed, focusing on the definition, importance, impairment, and enhancement. The effectiveness of audit committees is also discussed in detail (covering audit committee charter, size and composition, audit committees communication with the internal and external auditors, and their review of the financial statements). The last section in this chapter reviews the literature on the relationship between audit committees effectiveness and internal auditors professional objectivity.

2.2 PROFESIONAL OBJECTIVITY

2.2.1 Definition

Objectivity is a rare commodity and should not be compromised. It is a must in internal auditing (Vanasco, 1994a). The focus of professional standards and other literatures, however, has been on independence and in fact mainly on perceptions of independence. Literature review indicates that independence and objectivity are often treated synonymously and often with lack of clarity. Standards have invariably focused on independence and have paid scant attention if any to the concept of objectivity. Standards have also variably discusses 'independence in appearance', 'independence in fact', independence of mind' and 'mental attitude'. Little effort has been spent on defining these concepts and that of objectivity or on how they relate to an effective audit.

The term 'independence in fact' and independence of mind' really refer to objectivity, whilst the term 'independence in appearance' really means perceptions of auditor objectivity and do not in and of themselves guarantee objectivity. Therefore, a proactive approach to assuring effective audits should address the primary issue of objectivity rather than the secondary issue of independence in appearance'. An emphasis on perception will divert the attention from core issue. Objectivity is a core concept and one of the necessary conditions for an effective audit. Objectivity is a state of mind and freedom from bias, expressing or involving the use facts without distortions by personal feelings or prejudices (IIA, 2001a).

Objectivity requires the internal auditor to perform audits in such a manner they have an honest believe in their work and that no significant quality compromises are made (Vanasco, 1994a). In a survey conducted by the Malaysian Institute of Accountants (1991), it was discovered that half of the chief executives regarded internal auditing primarily as an integral part of or an independent check on the internal control mechanism.

BNM/GP10 guidelines defined objectivity is an independent mental attitude, which would enable the internal auditors to exercise judgment, express opinions and present recommendations with impartiality.

Meanwhile, independence is defined as the freedom from material conflict of interest that threaten objectivity. Objectivity is an intellectual quality and independence is a condition that facilitates a professional exercise of objectivity. Independence means the internal auditor should be objective and unbiased (Vanasco, 1996). Thus, to be objective the internal auditor must be independent. It can be seen that objectivity cannot be defined without mentioning independence. Neither can independence be defined without the word "objectivity". Therefore, these terminologies are two sides of the same coin. The professional internal auditor must have independence to fulfill a professional obligation, to render a free, unbiased, unrestricted opinion, and to report matters as they are rather than as some executives would like to see them (Sawyer, 1988, as cited by Vanasco 1996). Independence permits internal auditors to perform their work freely and objectively. Without independence, the desired results of internal auditing cannot be realized (Vanasco, 1996). Thus, Vanasco (1996) stated that the role of the internal auditor requires an unrestricted independence in order to perform a variety of duties for the organization they serve.

2.2.2 Importance of Professional Objectivity

Objectivity is essential since third parties and management rely on the work of the internal auditor. The Board of Directors of a firm for example, may rely on the effectiveness and adequacy of the internal controls of an organization, as evaluated by the internal auditor (Gul and Subramaniam, 1994). The external auditors do rely on the work of the internal auditors in many areas, some of which are: preparation of schedules; inventory observation; cash counts; branch audits; test of controls and substantive testing procedures; accounts receivable and payable; reviewing Electronic Data Processing (EDP), etc. Such reliance can reduce the audit fee and increase external audit coverage, but the external auditors require the internal auditors to be competent and objective (Ward and Robertson, 1980).

Internal auditors carry out their work throughout the year, and it will be more extensive and comprehensive than the work carried out by the external auditor. However, external auditors can rely on the work of the internal auditors only if they are objective and independent (Towers, 1998).

The IIA's Professional Practices Framework on `Standards for the Professional Practice of Internal Auditing (Standards)' stated that for any type of value adding and effective internal audit services, there must be two necessary and sufficient conditions that must be present and if both are present an effective audit is assured i.e. professionalism and objectivity (IIA, 2001a).

With regard to banking industry, the BNM/GP1 guidelines issued to BIs has underscored the importance of internal auditors independence when it required the BIs' board to establish an effective internal audit department, and to enhance the independence of the internal auditors in achieving their objectives, the board should ensure the internal auditors have full access to all records, placed under the direct authority of audit committee and their performance and remuneration is decided by the audit committee. Whilst, the BNM/GP10 stated that ``the independence and objectivity of the internal auditors are important prerequisites in the proper conduct of audits so as to render impartial and unbiased judgments. Internal auditors should not only be independent in fact but also be seen to be independent". The Basle Committee paper (BIS, 2001) calls for an independent internal audit function with professional competence in all banks. It further states that ``adequate internal controls within banking organizations must be supplemented by an effective internal audit function that independently evaluates the control systems within the organizations". The Principle 3 of the paper states that ``internal audit function assists senior management and the board of directors because his objectivity and independence will be greatly impaired (IIA, 2001b). Auditing the same area several times might result in personal relations with the auditor, which could impair his objectivity. It is a prudent policy to rotate auditors periodically from assignment to assignment (Vanasco, 1994a).

2.2.4 Enhancing Professional Objectivity

The status of the head of the internal audit department in the organization should be high, and he must also report to a higher level in order to enhance his objectivity (Vanasco, 1994b; Weizhong and Shourong, 1997; Scarbrough et al., 1998; and Vinten, 1999). The chief internal auditor should be elevated in the organization hierarchy to a level consistent with the Chief Finance Officer (Vanasco, 1994b). This will enable the internal auditor to fulfill his audit activities. The director of internal auditing department should be responsible to an individual in the organization with sufficient authority to promote his independence and to ensure: broad audit coverage; adequate consideration of audit reports; and appropriate action on audit recommendations (Braiotta, 1982, Vanasco, 1996). In the MIA's survey of 1991, chief executives saw the internal audit as a high profile function in terms of its position in the organization, and top level support accorded to it. According to the survey, about 64% of the internal auditors of the companies surveyed report to very high levels (that is from chief executives upwards).

In order to enhance the internal auditors' objectivity and independence, Weizhong and Shourong (1997) explained that the audit department should not be merged with another department. The IIA's professional standards (IIA, 2001b) states that the internal auditor should freely determine the scope and performance of his work as well as communicating the results of that work. This point was reiterated by Braiotta (1982) and Scarbrough et al. (1998). Objectivity also requires that internal auditors not subordinate their judgment in audit matters to that of others. These, however, cannot be fulfilled if the audit department is merged with another department (Vanasco, 1994a). In the MIA's survey (1991), when the internal auditors were asked whether any restriction was placed on their performance, some said yes, explaining that they were restricted in the area of payroll. This is a serious impairment of the internal auditors' objectivity and independence.

The internal auditors independence and objectivity, and therefore his effectiveness would be greatly enhanced where the internal auditor: have direct access to all departmental heads; have access to the chief executive and/or the management board; is independent of personnel directly responsible for the operations under review; is completely independent of all financial systems operating within the organization; have the right of reporting without editing under his name; have the right to report on any aspect of the financial work including that of the finance department; and is free from any conflict of interest and undue influence (Vinten, 1999).

The internal audit should be organized in a way that affords a higher organizational status as its role expands and more parties inside and outside the organization derive assurances from its work. To provide assurances to the governing bodies such as board or audit committees, the chief internal auditor should have direct and unrestricted access to that body. If the internal auditor does not have sufficient organizational status and autonomy, the ability to effectively manage conflict of interests and thus the objectivity of its works and reports is subject to question. Such risk may also be high if the chief executive officer has the power to hire and fire the chief internal auditor, or when the scope of audit activities or the unit's budget are determined by the top management without consultation with the governing bodies. In these situations, there is a risk that management may inappropriately affect the scope of the audit work or bias or suppress audit findings. When the risk that objectivity will not be achieved is significant, it would be inappropriate for parties other than management to derive assurance from the audit work (IIA, 2001a).

The report from Basle Committee on Banking Supervision (BIS, 2001) calls for an independent internal audit function. The Principle 5 from that report states that "the banks' internal audit departments must be independent from the every day internal control process. This means that the internal audit is given an appropriate standing within banks and carries out its work assignments objectively and with impartiality". The committee notes that "the principle of independence entails that internal audit departments operate under the direct control of the banks' chief executive officers, the board or the board audit committee depending on the governance process". In Malaysia, the BNM/GP1 guidelines issued by BNM in 1985 to banking institutions require that the internal audit departments to have direct access to the audit committee.

In reviewing and evaluating the organizational status of the internal auditors, the IIA (2001a) suggests that the governing bodies such as board or audit committees should consider at least the following factors which it believes would increase the chance that objectivity will be achieved, such as:

i). The **reporting level** of the chief internal auditor within the organization;

ii) The chief internal auditor's **unrestricted access** to the governing body;

iii) The governing board's involvement in drafting an **internal audit charter**;

iv) The role of governing board in influencing the **budget for and the scope** of internal audit activities;

v) The active **involvement, oversight, review and follow-up** by the governing board.

When the internal auditor has sufficient organizational status and autonomy, parties both within and outside the organization can have increased confidence in the internal audit function's ability to manage threats to objectivity with respect to the work it performs. Hence, the director or chief internal auditor is free from significant threats that might affect in turn any individual auditors' ability to make objective decisions regarding audit engagements and reports.

The Treadway commission emphasized the "tone at the top" in enhancing the objectivity and independence of the internal auditor. The right attitude of top management and the board of directors is considered vital to a good control environment, which can positively influence the scope of work, the reporting, and the independence and objectivity of the internal auditor (Kalbers, 1992).

Objectivity and independence is therefore an important principle for the internal auditor, and one way to enhance this is to set up audit committees responsible for overseeing the internal audit department as a whole (Vanasco, 1996, and Towers, 1998). The exposure draft on Guidelines on Internal Audit Function for Directors of Malaysian public listed companies (SCM, 2001) stated that "An Audit Committee serves to implement and support the oversight function of the Board in several ways' and one of it is "reinforces the objectivity of the internal audit department. If that department reports primarily to management and has no regular access to the Board or to a Board Committee, it may encounter resistance to recommendations that do not meet with the management's approval. Regular access to an Audit Committee helps address such resistance". To achieve the independence, the exposure draft suggested that the Head of Internal Audit report to the Audit Committee

BNM/GP1 stated that "to enhance the independence of the internal auditors, the board should ensure the internal auditors:-

a. have full access to all records;
b. are given appropriate standing in the organization's hierarchy i.e. internal auditors should be placed under the direct authority and supervision of audit committee; and
c. performance and remuneration package is evaluated and decided by the audit committee.

In summary, it has been recognized that internal auditors to be of value to an institution, they have to independent and objective in discharging their duties. Due to the importance of the element of objectivity, various regulatory and professional bodies have outlined the appropriate organizational structures and relationships between internal auditors, audit committees and executive management that are intended to enhance the objectivity of the internal auditors.

2.3 AUDIT COMMITTEES EFFECTIVENESS

2.3.1 Need For An Audit Committee

The audit committee is a committee of the board of directors, which assumes some of the boards' responsibilities (Menon and Williams, 1994).

Audit committees were first conceived of some fifty years ago, prompted partly by certain failures of major corporations, and disclosure of fraud and questionable payments which focused public attention on corporate accountability and the role of the accounting profession in the financial reporting process (Ernst and Young, 1992). Sawyer (1988), as cited by Vanasco (1994b), stated that audit committees can keep management staff on their toes. The prospects of an interface with the audit committee forces management to take action on problems that it might have let slide along. Audit committees, therefore, form an important part of the corporate governance process as well as ensuring the quality of financial reporting (Sori at al., 2001b and Scarbrough et al., 1998).

The role played by an audit committee has been defined differently by regulatory agencies and researchers, the main objective of having such a committee is increasing public confidence in the credibility of financial information published although the scope of audit committees' function is not conclusive (Hamid, Mohamed and Nassir, 1999). Public confidence is the cornerstone of a stable banking system. One of the ways to achieve this is for BIs to establish and ensure the effective functioning of an audit committee (BNM, 1985).

2.3.2 Definition of audit committee effectiveness

In defining audit committee effectiveness, Kalbers and Fogarty (1993) stated that "effectiveness is viewed as the competency with which the audit committee carries out its specific oversight responsibilities". They felt that the antecedent to effectiveness is power, which encompasses a broad perspective on both the capabilities and the resolve required to perform effectively. Others such as Reinstein (1980), Braiotta (1986) and Castellano et al. (1989) as cited by Kalbers and Fogarty (1993) had inferred effectiveness from work performed by audit committees. Collier (1993) suggested several factors that could effect the effectiveness of audit committees in carrying out their responsibilities, namely sound judgment, independence from management, full understanding of purposes and responsibilities of the audit committee, enthusiastic chairman, variety of backgrounds of the audit committee members and ability to devote the necessary time required to carry out the functions effectively. Other important criteria that contribute to the success of an audit committee are: availability of relevant information, provision of an agenda and related material in advance of meetings; ready access to the external auditor and internal auditor and prompt answering of queries; and the existence of written audit objectives and responsibilities.. According to Katz (1998) the characteristics of an effective, successful audit committee are "having a charter and clear sense of mission, a strong chair, open communication with internal auditor and a balance rapport with external auditors": However, research on the effectiveness of audit committees in carrying their responsibilities in Malaysia is still in its infancy stage (Hamid, Mohamed and Nassir, 1999).

Various regulatory authorities and bodies have made recommendations on the attributes needed to enhance audit committee effectiveness (McMullen and Raghunandan, 1996). The mere existence of audit committees with a list of duties does not guarantee that the audit committees will conscientiously and effectively carry out their responsibilities (Kalbers, 1992, Menon and Williams, 1994, and McMullen and Raghunandan, 1996). For instance, the Treadway Commission found that a significant proportion of companies cited in actions by the Securities and Exchange Commission had audit committees (McMullen and Raghunandan, 1996). Thus, the KLSE listing requirement (KLSE, 2001) and BNM/GP1 (BNM, 1985) have specified certain requirements for audit committees of all listed companies and banking institutions, respectively. BNM/GP1 has outlined the structure and duties of an audit committee in BIs that is expected to enable the audit committee to discharge its function effectively. The KLSE listing requirements (KLSE, 2001) too outlined the audit committees' composition, criteria for the audit committee chairman, need for written terms of reference, functions of audit committee, parties who can attend audit committee meetings. Besides the written terms of references or Audit Committee Charter, these regulatory requirements also specify the size and composition and functions of audit committees.

2.3.3 Variables affecting audit committee effectiveness

Generally, the four main variables that make the audit committees effective are as follows.

i) Audit committee charter;

ii) Size and composition;

iii) Direct communication; and

iv) Financial statement review.

2.3.3.1 Audit Committee Charter

The KLSE listing requirements specified that an audit committee must have a written terms of reference which deal with its authority and duties, while the draft statement on internal audit function issued by the task force set up by the Securities Commission (2001), went further to state that the charter should be approved by the board. Principle 19 in the Basle Committee paper (BIS, 2001) requires that "upon setting up an audit committee, the board of directors should draw up a written charter indicating the audit committee's composition, authority and duties as well as the way of reporting to the entire board of directors. This document should be approved by the board and reviewed and updated periodically".

Kalbers and Fogarty (1993) found that the legitimate power of audit committee has the most profound effect on audit committee effectiveness particularly the written audit committee charter and perceived authority of the audit committee had positive relationship on audit committee effectiveness. Components of organizations such as audit committees must possess power including the legitimate power to effectively discharge their duties. For audit committees to pursue their responsibilities objectively, the audit committee needs an unambiguous, practical and flexible terms of reference (charter), which should be deliberated upon and accepted by the board (Mohamad and Sori, 2001a). According to Vanasco (1994b), the Treadway Commission (1987) and the Blue Ribbon Committee (BRC) (NYSE, 1999), recommend that a written charter for the audit committee should be developed, and the full board should approve, review and revise it when necessary.

The first step in forming an audit committee, therefore, is to write an audit committee charter. In addition to specifying the committee's authority and responsibilities, the charter should also state the committee's purpose, composition, duties, and agenda in broad terms (Thorton, 1996). The charter helps the audit committee keep in mind the limits of its responsibility and avoid on taking matters, which ought to be left to management (Katz, 1998). A good charter is one that will impose on the audit committee a greater self-discipline (Mahoney, 1999).

2.3.3.2 Size and Composition

The KLSE listing requirements specify that audit committees should compose of not fewer than three members, majority of whom should be non-executive directors who are independent of the company. BNM/GP1 states that audit committee should consist of not less than three members, none of whom should be full-time executives of the banking institution. Whilst, the majority of the audit committee members should be independent non-executive directors, and the chairman should be an independent non-executive director (BNM, 1985). The KLSE listing requirements (KLSE, 2001) specifically stated that the chairman of the audit committee should be selected among the members and should be an independent director. A strong, skilled and independent chairperson is quite important for a properly functioning audit committee, because he sets the tone for the committee's activities (Katz, 1998). The BRC (NYSE, 1999), on the other hand prescribed for the New York Stock Exchange (NYSE) and the National Association of Security Dealers (NASD) companies, an audit committee composed solely of independent directors.

Good governance practices dictate that audit committees must be independent (Tsacoumis, 1999). The NYSE rules, characterize independent directors as those who are free from any "relationship that in the opinion of the board of directors, would interfere with the exercise of independent judgment" (Read and Raghunandan, 2001). This point was also emphasized by Sori et al.(2001d). According to a study by Sori et al. (2001b), the institutional investors perceived that majority of the audit committee members should be independent directors while 13% suggest that all should be independent directors. The argument to have independent members of the board as members of the audit committee is that outside directors can preserve a higher degree of independence from managements influence (Vanasco, 1996; Ernst and Young, 1992; and Sori et al., 2001c and 2001d). The above KLSE listing and BNM/GP1 requirements relating to the size and composition of audit committees, were also emphasized by the draft statement on internal audit function issued by the task force set up by the Securities Commission of Malaysia (SCM, 2001).

In preserving the independence of the audit committee, the KLSE listing requirements indicated that the members' term of office should be reviewed every three years. The members' term of office should be staggered expiration dates to ensure continuity. When members serve on the audit committee for too long, they loose their objectivity and independence as a result of familiarity and therefore become less effective (Vanasco, 1996). The BRC recommends that the members of an audit committee should be dedicated, interested, and willing to commit their time to the responsibilities of the audit committee (NYSE, 1999). This point was reinforced by Ernst and Young (1992), Cooper (1993), and Sori et al. (2001a).

The KLSE listing requirements also stated that audit committee members should be competent in the area of corporate accounting and financial control and reporting. Thus, it requires at least one member of the committee to be a qualified accountant, that is a member of the Malaysian Institute of Accountants (MIA). BNM/GP1 requires the BI's board of directors (including the audit committee members) to be technically competent persons of integrity with strong sense of professionalism, fostering and practicing the highest standards of banking and finance in the country (BNM, 1985). Meanwhile, the principle 19 of Basle committee paper (BIS, 2001) requires audit committee members to have background that is compatible with the committee's duties. And at least one member should have background in financial reporting, accounting or auditing. The BRC (NYSE, 1999) urges financial qualification as a requirement for all members of the audit committee, in order to effectively carry out their work.

Members skilled in functional areas such as accounting, finance, and corporate relation could be expected to contribute to the effectiveness of the audit committee through their expert power (Kalbers and Fogarty, 1993). Sori et al. (2001b) stated that all the investors included in their survey, agreed that all the audit committee members should be financial literate. Independent and qualified audit committees may be more willing and able to investigate accounting irregularities, exceptions and other relevant matters, and are likely to view internal auditing as a valuable resource in the financial reporting process (Read and Raghunandan, 2001). Conventional wisdom regards expertise of committee members as important to audit committee effectiveness (Robertson and Deakin 1977 as cited by Kalbers and Fogarty, 1993). Nevertheless, the expert power is only highly associated with financial reporting as the audit committee members often seek sources of expertise in management, auditors and other committee members (Kalbers and Fogarty, 1993).

2.3.3.3 Direct Communication

According to the KLSE listing requirements (KLSE, 2001), the audit committee should review with the external auditor, the audit plan, his/her evaluation of the system of internal controls, the audit report and the assistance given by the employees to the auditor. To be able to carry out the above functions effectively, the committee must exercise it's right of having a direct channel of communication with both auditors (internal and external). BNM/GP1 requires audit committees to review the scope and findings of the internal auditors, and that the reports of internal auditors and audit committee should not be subject to the clearance of chief executive or executive directors. It also emphasized that the external and internal auditors should have free access to the audit committee (BNM, 1985). The principle 19 from the report of the Basel Committee on Banking Supervision (BIS, 2001) suggests that the audit committee can be the body that encourages communication among the various elements of the governance system.

If the audit committee is to effectively accomplish its task of overseeing the financial reporting process, it should develop regular scheduled meetings and/or report with the outside auditors independent of management (NYSE, 1999). Only through regular, frank, open and confidential dialogue, will the audit committee be able to fully utilize the service of the external auditor (Katz, 1998, and NYSE, 1999). Through a close working relationship with the internal auditor, the audit committee can fulfill their role as a liaison between the independent auditor and management (Hamid, Mohamed and Nassir, 1999).

The audit committee should also review the adequacy of the scope, functions and resources of the internal auditor and ensure that he or she has the necessary authority to carry out his/her work. The review should be extended to the internal audit programs and processes as well as the results of these programs and processes, (investigations undertaken), as well as determining whether appropriate action had been taken on their recommendations (NYSE, 1999; Vanasco, 1994). This will be possible via a direct channel of communication between the internal auditor and the audit committee, which was mentioned as a key success factor for audit committee effectiveness. Direct communication can take the form of regular meetings independent of management, regular memos or reports circulated only to the audit committee (NYSE, 1999). Quality financial accounting and reporting only result from effective inter-relationship between an audit committee, the external auditor, management, and the internal auditor (NYSE , 1999; Read and Raghunandan, 2001).

2.3.3.4 Financial Statement Review

The KLSE listing requirement, specify that the audit committee should review quarterly results and year-end financial statements prior to the approval by the board of directors. It went on to state that such reviews should focus on: changes in or implementation of major accounting policy changes; significant and unusual events; compliance with accounting standards and other legal requirements; and any related party transactions and conflict of interest situation that raises questions on management integrity. BNM/GP1 also required the audit committee to review the financial condition of the BI, its internal controls, performance and findings of internal auditors, and to recommend appropriate remedial actions regularly, preferably at least once in three months. The overall objective of such review is to ensure the BI is financially sound and stable, which will entail public confidence in the banking system (BNM, 1985). The BRC (NYSE, 1999) also mentioned the same financial review functions for the audit committee. The committee should ensure that the financial statements comply with the necessary standards and requirements, that management adheres to a sound system of internal controls, and that the firms financial reporting process is not only in accordance with accounting and legal requirements, but also with good corporate governance (Scarbrough et al., 1998, and Hamid et al., 1999). The external auditor and strong internal auditors play key roles in demonstrating that the underlying information in the financial statement are properly and fully reported (Bows, 1987).

Through reviews, the audit committee can fulfill its objective of increasing public confidence in the credibility of published financial statements. Only by fulfilling its objectives the audit committee can be deemed to be effective (Hamid et al,.1999 and Sori et al, 2001c). By reviewing the financial statement, the audit committee will also fulfill its role of protecting shareholders interest (Verschoor and Liotta, 1990; McMullen and Raghunandan, 1996;, and Tsacoumis, 1999). Simnet et al. (1993), as cited by Sori et al. (2001c), found that audit committees do improve or maintain the quality of the financial reporting. Internal auditors view the audit committee as effective in their traditional role of reviewing the financial statements (Hamid et al., 1999). The BRC report (1999) stated that studies have found that independent directors are more likely to be able to evaluate objectively the propriety of management accounting, internal controls and reporting practices (Scarbrough et al. 1998; Raghunandan et al. 2001; and Read and Raghunandan, 2001).

Audit committee members need to have scheduled meetings to effectively carry out their function of financial statement review. The BRC`s sample audit committee charter require a meeting of four times per year or more as circumstances require (Read and Raghunandan, 2001). Effective audit committees meet three to four times a year (McMullen and Raghunandan, 1996). The number of meetings that the audit committee holds each year, and their duration are widely recognized as a measure of how effectively audit committees carry out their duties (Verschoor, 1992).

The KLSE listing requirements also specify that audit committees must prepare an annual report which must be clearly set out in the annual report of the listed company. It stated that such a report should include: the composition of the audit committee and the directorship of the members; the terms of reference of the audit committee; the number of audit committee meeting held during the year and their attendance; the activities of the audit committee for the financial year; and the existence of an internal audit function or activity. In their anecdotal comments, the chief internal auditors of three BIs I have interviewed felt strongly that such a report is likely to force the audit committee to carry out their duties more consciously before drawing out the audit committee report for the annual report.

There is no secret formula to what makes an effective audit committee(Katz, 1998). As in any human endevour, much depends on the intangibles, that is the personalities of the committee members, the institutions culture and traditions, the chemistry between the various participants of the audit process, and so on. However, paying an appropriate amount of attention to the key characteristics such as having a charter, strong and independent audit committee chairman, open communication with internal auditors and overseeing the work of internal and external auditors should help an audit committee fulfill its difficult but extremely important mission (Katz, 1998). If the audit committee maintains a close working relationship with both auditors (external and internal), all the three parties are likely to carry out their duties effectively (Vanasco, 1994b and 1996).

In summary, the need for an audit committee in public listed companies as well as banking institutions is a forgone conclusion. However, existence of an audit committee does not guarantee its effectiveness. The prior literatures suggest that for the audit committee to be effective there must an audit committee charter, the size and composition of an audit committee should be appropriate given the size and complexity of an organization, there should be a direct level of communication between audit committee and auditors, and finally, the audit committee must be actively involved in the review of financial statement including interim reports.

2.4 AUDIT COMMITTEES' RELATIONSHIP WITH INTERNAL AUDITORS

The IIA`s professional Standard suggest that the main purpose of audit committees is to promote the independence of external and internal auditors from management, and to assure that the directors exercise due care (Vanasco, 1994b). The difficulty of maintaining internal auditors' objectivity and independence, where an audit committee is lacking, is reinforced by Menon and Williams (1994) and Vinten and Lee (1993), as cited by Vinten (1999). In order to prevent management influence and create a truly independent relationship, the director of internal auditing should report solely to the audit committee (Vanasco, 1996). One of the benefits of audit committees, therefore, is to provide a framework within which internal auditors can maintain their objectivity and independence in the event of a conflict with management over audit reports (Gul and Subramaniam, 1994). This is essential because the nature of the internal audit work include the need to identify shortcoming in the firms' operational area, which frequently involve at least criticisms of the firms' senior management. Thus the internal auditor must have a high-level point of contact to whom he/she can report freely and candidly, and, this is provided by the audit committee. Where the internal auditor reports ultimately to the audit committee, the committee is in a position to monitor and increase the effectiveness of the internal audit (Cooper, 1993)

Audit committees must be supportive of the internal audit process if it is to function properly (Allison, 1994; Katz, 1998). Should the board unduly interfere or fail to support the internal audit function, there is a danger that internal auditors would loose the necessary objectivity and independence to perform their job (Vanasco, 1996). While the audit committee needs to shield the internal auditor from the potentials of hostile reactions to audit findings, the committee also has to ensure that the internal auditor is competent, fair, and reasonable in carrying out his/her duties (Katz, 1998).

For the committee to improve the objectivity and independence of the internal auditor, it should approve the internal audit charter (Verchoor and Liotta, 1990, Vanasco, 1994b and1996), be responsible for the hiring, firing and compensations of the internal auditor (Vanasco, 1996, and Weizhong and Shourong, 1997). The committee should also review the programs and work of the internal auditor (Vanasco, 1996) and have a direct channel of communication with them (Razaee and Lander, 1993).

2.4.1 Internal Audit Charter

An organization should ensure that the objectives of the internal audit are agreed at the highest level in the organization usually the main board or its audit committee, and are clearly understood by all levels of management. This understanding is achieved by having the internal audit charter or terms of reference (Vinten, 1999). The charter facilitates the accomplishment of the audit committee's objective of effectively serving the needs of the organization (Verschoor and Liotta, 1990).

The IIA standard states that the purpose, authority and responsibility of the internal audit activity, should be formally defined in a charter consistent with the standards, and approved by the board. The charter should be accepted by the audit committee (Verchoor and Liotta, 1990); Vanasco, 1996). The internal audit charter should be approved by audit committee in order to improve the relation between the two parties. Further, the audit committee should ensure that the charter provides the internal auditor with the level of independence necessary to discharge his duties effectively (Cooper, 1993; and Vinten, 1999).

The internal audit charter defines the boundaries of the internal audit function, establish the internal audit department within the organization, authorizes the internal auditor to have access to records, personnel, and property needed to conduct the audit, and prescribe the units relationship with other units within the organization and those outside the organization (Vanasco, 1994b). The IIA`s standards recommends that the audit committee should review and approve the internal audit charter, in ensuring that internal auditors carry out their responsibilities.

The Basle Committee (BIS, 2001) paper states that to achieve the independence the internal audit should be given an appropriate standing within an organization. This principle entails the internal audit department to report to the governing body and have the authority to communicate directly on their own initiative to the governing body (including audit committees) according to the rules defined by each bank in its audit charter. It required the audit charter (which establishes the objectives and scope of internal audit function, its position within the organization, its powers and responsibilities and the accountability of its head of the department) be finally confirmed by the audit committee. BNM/GP 10 required the internal audit charter to be approved by the audit committee and endorsed by the board so that the internal audit function may be discharged effectively. The internal audit charter serves to inform the CEO and all levels of management on the role, duties and responsibilities of internal auditors BNM, 1997).

2.4.2 Hiring and Firing of the Internal Auditor

On the subject of internal auditors independence and objectivity, since 1997 the BNM/GP10 guideline requires that the appointment, remuneration, performance appraisal, transfer and dismissal of the chief internal auditors should be decided by the BI's audit committee (BNM, 1997). BNM/GP1 reiterated this point by stating that in order to enhance the independence of the internal auditors, their performance and remuneration package should be evaluated and decided by the BI's audit committee (BNM, 1985). Vanasco (1996) and Scarbrough et al. (1998), stated that in a survey of chief internal auditors, it was shown that majority of internal auditors indicated that vesting the hiring-firing authority with the audit committee would enhance the internal auditors independence, improve oversight by the audit committee, and improve the ability of the internal auditor to get action on audit findings. The audit committee should review and approve the budget of the internal auditing staff in relation to the entity's auditing needs and potential auditing benefits. Where the audit committee is responsible for the internal audits budget, the authoritativeness and efficiency of the internal auditor will be ensured (Braiotta, 1982; Weizhong and Shourong, 1997; Read and Raghunandan, 2001).

In a survey by Kalbers (1992), both chief internal auditors and audit committee members indicated that most audit committees do not have much responsibility for setting the internal audit budget and the compensation of the chief internal auditor. When audit committees have less responsibility for these fiscal matters, internal auditors are likely to be less independent of management (Kalbers 1992). If the internal auditor is subject to incentives controlled by management, then it will put the auditor under pressure to make decisions that are not objective. The internal auditors would reserve their objectivity and independence when their incentives are determined by the audit committees (Gul and Subramaniam, 1994).

2.4.3 Direct Channel of Communication

Direct channel of communication between the director of internal auditing and the board/audit committee is critically important to the effectiveness of the internal auditing department (Verschoor and Liotta, 1990; Razaee and Lander, 1993; Allison, 1994; Vinten, 1999; Raghunandan et al., 2001). This could take the form of regular meetings independent of management, regular confidential memos and reports circulated only to the audit committee (NYSE, 1999; Tsacoumis, 1999). A direct channel of communication between the audit committee and the internal auditor, demonstrates to the organization the independent organizational status of internal auditing, and permits internal auditors to express impartial and unbiased judgments and recommendations (Verschoor and Liotta 1990; Razaee and Lander 1993). In an effective and well-functioning audit program, the firm's internal auditor reports his/her findings and recommendations to the audit committee (Vanasco, 1994b; Katz, 1998). This free and open communication is essential to the audit process, and can be promoted by the audit committee regularly giving assurance to the internal auditor that he/she has the committee's full confidence and support (Katz, 1998). The audit committees' support enhances the objectivity of the internal auditor and will enable him gain the co-operation of the auditees and perform their work free from interference (Vanasco, 1994a). Direct channel of communication enhances the probability that the internal auditors' recommendations will be implemented (Verschoor and Liotta, 1990).

The internal audit departments work schedule, plans, financial budget and significant interim changes should be communicated to senior management and the board in writing, for their review and approval (Verschoor and Liotta, 1990; IIA, 2001b). This will enable the board to determine whether the internal audit department's plan and objectives support those of the board. The chief audit executive should report periodically to senior management and the board on the purpose of the internal auditors activities, authority, responsibilities, and performance relative to it plan (IIA, 2001b). This point is also specified in the draft statement on internal audit function issued by the task force set up by the Securities Commission (SCM, 2001). Reporting should also include significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the board or senior management. The results of a survey conducted by Verschoor (1992), shows that more than 92% of the corporate directors of internal auditing provided their overall assessment as to the adequacy of internal auditing coverage and scope, annual internal auditing plan, and internal audits budget to the audit committee. A great deal of communication and coordination between the audit committee and the internal auditor is necessary, because the audit committee relies on the internal auditor for much of its information concerning corporate activities (Raghunandan et al. 2001). Thus direct communication is a major key in the relationship of the internal auditor and the audit committee.

In a survey by Peacock and Pilfrey (1991), internal auditors were asked to respond to a statement "I have access to the audit committee". Overall, 60% of the internal auditors agreed with this statement and 26% disagreed with it. However, according to a study by Kalbers (1992), chief internal auditors suggest in their anecdotal comments that they are indeed reluctant to report problems to audit committees, for fear of loosing their job. In such a situation, the internal auditors' objectivity and independence is impaired since they cannot freely report audit findings to the audit committees. One of the respondents did mention that with the help of his audit committee, he was able to implement some suggestions in the internal audit department, which would not have been possible with out the audit committee.

Direct communication works best when the chief internal auditor regularly attends and participates in those meetings of the board, which relates to its oversight responsibilities for auditing financial reporting, organizational governance, and control (Verschoor and Liotta 1990; Razaee and Lander 1993; Vanasco 1994b). In a survey by Olivario and Newmans (1993), about 85% of the internal auditors stated that they attended one or two meetings, while 4% reported that they had attended no meeting. The frequency of audit committee meetings with the internal audit executives, leads to internal auditor independence (Braiotta, 1992; Vanasco 1996; Scarbrough et al., 1998). Olivario and Newman (1993) indicated that more than half of the internal auditors surveyed indicated that meetings with audit committee were valuable in supporting their work and/or assuring independence of their work.

The director of internal auditing should meet privately with the board/audit committee (without members of management present) at least annually, a practice that would strengthen internal audit independence (Verschoor and Liotta, 1990; Verschoor, 1992; Vanasco, 1994b; Scarbrough et al. 1998). In a survey by Kalbers (1992), 31% of the chief internal auditors reported that they did not meet with the audit committee privately during the previous year. However, both the internal auditors and the audit committee members agreed that such meetings are typified by open and frank dialogue. This point was also reiterated by Read and Raghunandan (2001).

For the Malaysian banks, the BNM/GP1 required the banks' internal auditors to have free access to the audit committee (BNM, 1985). Upon the request of the auditors, the chairman of audit committee should convene a meeting to consider any matter that the auditors believe should be brought to the attention of the directors or shareholders. It further required the reports of internal auditors and audit committee should not be subject to the clearance of the chief executive officers or executive directors (BNM, 1985). Meanwhile, BNM/GP10 states that "the chief internal auditor (CIA) should be functionally responsible to audit committee. Regular communication with the audit committee helps to assure independence and provides the means for the CIA to keep the audit committee informed on audit matters". It further stressed that the role of the audit committee in the context of BNM/GP10 is basically to provide an avenue for the internal audit department to effectively voice their findings (BNM, 1997).

2.4.4 Reviewing Internal Audit Work and Program

The audit committees' mission is to ensure that the internal audit process is functioning properly (Tsacoumis, 1999). Thorton (1996) stated that audit committees have a responsibility to oversee the internal auditor; evaluate the internal auditors objective; review their work and performance; and ensure that their involvement in auditing the financial reporting process is appropriate and well coordinated with the work of the independent auditor. The audit committee should review the internal audit program and ensure that its scope is adequate, as well as the results of the internal audits as they relate to financial reporting and internal controls. Further, the audit committee should review significant and unexpected internal audit findings and managements response to them (Scarbrough et al., 1998; Read and Raghunandan, 2001). The audit committee should also assess any difficulties or audit scope restrictions that internal auditors had encountered during the audit (Read and Raghunandan 2001). These reviews enhance the professional objectivity and independence of the internal auditor, as well as the image of the audit staff in the organization (Braiotta, 1982).

The existence of audit committees improves the internal auditors' objectivity and independence (Gul and Subramaniam, 1994). Olivario and Newman (1993), Razaee and Lander (1993) and Cooper (1993), mentioned that the most important benefit to be gained from a close working relationship between the internal auditor and an effective audit committee is the independence of both the internal auditor and the audit committee, but their opinion is not based on any empirically based studies. This means that the mere existence of audit committees is not a sufficient condition for them to enhance the internal auditors objectivity. It is the effectiveness of such committee, which is a necessary condition for enhancing the objectivity and independence of the internal auditor. BNM/GP1 requires the audit committee to review the work of internal auditors and audit programmes (BNM, 1985). Such review is expected to improve the working relations between the two parties, and give the opportunity to internal auditors to discuss internal audit findings more openly with the audit committee. It also gives the opportunity to audit committee to determine conflict of interest situations being faced by the internal auditors. Principle 19 of Basle committee paper (BIS, 2001) also requires the audit committee to regularly discuss with the internal auditors on the functioning of the internal control system; the activities of internal audit department; risk areas of the BI's operations to be covered in the scope of audit; reliability and accuracy of financial information; any material accounting or auditing concerns highlighted by both internal and external auditors; and compliance with all rules and regulation.

To be effective, the audit committee's decisions should be logically influenced by the members' ability to obtain information and use it to achieve audit committee objectives i.e. information power (Kalbers and Fogarty, 1993). To obtain such information from the internal auditors the audit committees need to obtain, discuss and review the work of the internal auditors. Active interest of audit committee members in the audit function (diligence power) improves the audit committee effectiveness (Mautz and Newmann, 1970 as cited by Kalbers and Fogarty, 1993). In their anecdotal comments, the chief internal auditors of the three large local BIs confirmed that their independence and objectivity is most influenced by the active involvement of audit committee, particularly the chairman, in the work of the internal audit department. This improves their morale and gives them the courage to deal with conflict of interest situations. The active involvement of audit committee chairman also restraints the executive management from interfering in the work of internal audit department and take corrective actions promptly on audit findings.

2.5 CONCLUSION

Professional objectivity is important for internal auditors to effectively and efficiently serve their organizations and for all those who rely on their functions. Based on the literature reviews the effectiveness of audit committees is measured by how well they achieve their objectives. The four main characteristics that contribute to audit committee effectiveness are:- existence of audit committee charter; appropriate size and composition of audit committee; their direct communication with auditors particularly the internal auditors; and their involvement in the review of financial statements. The professional objectivity of the internal auditors is expected to be enhanced when an effective audit committee approves an internal audit charter; is responsible for the hiring, firing and compensation for internal auditors; have direct channel of communication with internal auditors; and review the work of internal auditors and their audit programmes.