CHAPTER 1: AN OVERVIEW

1.1 INTRODUCTION

In this chapter, the background for internal auditing is briefly discussed. It also gives a brief explanation of what is to be done in this study. The objective of the study, the problem statement and the justification are also discussed.

1.2 BACKGROUND

Internal auditing as "an independent objective, assurance and consulting activity designed to add value and improve an organizations operations (IIA, 2001). It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes" (IIA Code of ethics, 2001.). Internal auditors serve all members of management in fulfilling their responsibilities (Rezaee and Lander, 1993).

According to the IIA's standard (2001), the internal audit activity should contribute to an organisation's governance process by evaluating and improving the process through which: values and goals are established and communicated; the accomplishment of goals is monitored; accountability is ensured, and values are preserved. Thus according to Scarbrough et al., (1998), internal auditing can play an important role in preventing errors and fraud, and is a useful mechanism in the checks and balances of effective corporate governance.

Some benefits are accrued to the organisation as a result of having an internal audit department. According to Albrecht, Howe, Schueler and Stock (1988), having an internal audit as part of the internal control system of an organisation, has the following benefits: improving an organisation's governance process; safeguarding the assets of an organisation and improving it's internal controls; it leads to an efficient operation or productivity within an organization; it also leads to managementcomfort, because as an
arm of management, it informs them of the activities in the company; developing people because the internal audit activities covers the whole organisation, and is therefore considered a training ground for future managers; internal auditors assist in the development of systems and ensures that proper and effective controls are included; and finally, internal auditors consult with management on special or unusual problems. Thus all activities within an organization are potentially within the scope of the internal auditors' responsibilities (Horn, 1992).

From the above, it can be seen that the role and scope of the internal auditor within the organisation, has widened. As a result, the IIA's Code of Ethics, (2001) on objectivity, requires the internal auditor to exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Professional objectivity and independence is required to ensure managements integrity in its internal reporting, as well as increasing the reliability of the internal auditors report (IIA's Code of Ethics, 2001). Thus increased emphasis is placed on the professional objectivity and independence of the internal auditor. According to Vanasco (1996), one way to enhance the internal auditors professional objectivity and independence, is to have an audit committee to be responsible for overseeing the entire internal audit function.

This research is based on non-financial institutions, and focuses on empirically investigating the relationship between audit committees effectiveness and internal auditors' professional objectivity. It covers a literature review of professional objectivity and independence of internal auditors as well as audit committees and their relationship with internal auditors. The study is based on primary data, which is collected using a sample drawn from the registered Members of the Institute of Internal Auditors of Malaysia (MIIAM), as well as audit committee chairmen or representatives of the KLSE listed companies of non-financial institutions. Questionnaires were used to collect the data, which analysed using both descriptive analysis and hypothesis testing. Two sets of hypotheses (one on the audit committee effectiveness and the other on the relationship between effective audit
committees and internal auditors professional objectivity), are tested using paired sample t-test. The results of the hypothesis testing indicate whether or not effective audit committees actually enhance the internal auditors professional objectivity.

1.3 PROBLEM STATEMENT
The Kuala Lumpur Stock Exchange (KLSE) listing requirements, require all KLSE listed companies to have audit committees, whose responsibilities among other things will be to oversee the internal audit functions of the organisation. Since the activities of the internal auditor covers the entire organization (Horn, 1992), the IIA’s Standard (2001) states that internal audit activity should be independent and the internal auditors should be objective in performing their work. The IIA’s Standards also require internal auditors to communicate with audit committees and have regular meetings with them, that is, a close working relationship between the two. The question that needs to be answered is whether such a close working relationship between effective audit committees and internal auditors does enhance the internal auditors’ professional objectivity and independence?

1.4 OBJECTIVE
The objective of this study is to empirically investigate the relationship between audit committees effectiveness and internal auditors’ professional objectivity. The study attempts to determine whether or not audit committees effectiveness enhances the professional objectivity and independence of internal auditors.

1.5 JUSTIFICATION AND SIGNIFICANCE
A number of studies had been done overseas on the relationship between audit committee’s and internal auditors. These include among others (Gul and Subramaniam 1994, Kalbers 1192, Olivario and Newman 1993, Scarbrough,
Rama and Raghunandan 1998, McMullen and Raghunandan 1996, Raghunandan, Read and Rama 2001). Many studies had been done on various aspects of audit committees. Sori, Shamsher, Muhamad and Anuar, (1999, 2011a, 2001b, 2001c, 2001d, and 2001e) did several studies on audit committee in Malaysia. The Malaysian Institute of Accountants (MIA), also did a survey on “An overview of internal audit in Malaysia” (reports published in 1989 and 1991). Therefore no studies known to the author, was done on the relationship between audit committee’s effectiveness and the internal auditor’s professional objectivity, in Malaysia. Thus there is a gap, which this research is intended to fill.

The IIA’s Standard (2001), states that the internal audit process should contribute to the organisation’s governance process by evaluating and improving the process through which: values and goals are established and communicated; the accomplishment of goals is monitored; accountability is enhanced; and values are preserved. However, the results of these evaluations will not be reliable if the internal auditor is not objective. Therefore internal auditors’ objectivity and independence is crucial to promote corporate governance and corporate financial reporting procedures. The significance of this study is that it provides empirical information on the relationship between audit committees effectiveness and internal auditors professional objectivity, in Malaysia. Thus the findings are useful for policymakers, stakeholders and company management in formulating practical guidelines for improving corporate governance practices among Malaysian listed companies.

This research concentrates on KLSE listed companies that are non-financial institutions. These companies have been chosen because the KISE listing requirements made it mandatory for them to have audit committees. Financial institutions are excluded (insurance, banks, finance, etc), because they are monitored closely by Bank Negara Malaysia (BNM) and are likely to be substantially different from non-financial institutions, so that the sample is likely to be more homogeneous and effects of a tighter regulatory framework will be reduced.
1.6 CHAPTER LAYOUT
The study is organized into the following chapters:
Chapter one, looks at the definitions of internal auditing and the need to have an internal audit in an organization. The internal auditors objectivity and independence is briefly discussed as well as audit committees. This chapter also includes the objective of the study, the problem statement and the justification and significance of the study. Chapter two dwelled on the literature review. Here literature relating to the objectivity and independence of internal auditors, audit committees, and the relationship between audit committees and internal auditors professional objectivity, are reviewed Chapter three contain the methodology of the study. This chapter covers the theoretical framework, hypothesis development and the research method and design. Chapter four contains the statistical analysis. This includes tables that will be analysed as well as the statistical test of hypothesis. The final chapter (chapter five) is based on the conclusions drawn from the analysis of the data and suggestions for future research.

1.7 CONCLUSION
Internal auditors through their reports, provide information to both management and the board of directors. However, if the information that they provide is to have integrity, they must be free from management influence and give their honest judgment in their reports. One way to enhance the internal auditors objectivity, is to have audit committees that are responsible for the internal audit function.

This study provides empirical evidence as to whether effective audit committees enhance the internal auditors professional objectivity and independence, in Malaysia. The study contributes to the existing literature on internal auditors and audit committees in Malaysia. The next chapter reviews in detail, the literature on internal auditors professional objectivity, audit committee effectiveness, and the interface between the two, in order to show their link.