CHAPTER 2: 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
According to the IIA Research Foundation (2001), the term “independence in fact” and “independence in mind” really refers to objectivity and “independence in appearance” really means perception of auditor objectivity. The taskforce further stated that a proactive approach to assuring effective audit should address the issue of objectivity. Objectivity is a rare commodity and should not be compromised; it is a must in internal auditing (Vanaco, 1994a). Professional objectivity defined as “an independent mental attitude, which internal auditors should maintain in performing audits” (IIA’s Standard, 2001), that is a state of mind. The IIA Research Foundation (2001), objectivity is seen as “ freedom from bias, either expressing or involving the use of facts without distortions by personal feelings or prejudice. In an audit situation, objectivity simply means that results will be completely and honestly reported to the appropriate parties without the auditors judgment being skewed (IIA Research Foundation, 2001). Objectivity therefore, is one of the necessary conditions for effective audits. Objectivity requires the internal auditor to perform audits in such a manner that they have an honest believe in their work and that no significant quality compromises are made (Vanasco, 1994a). Without objectivity, the auditors’ services do not produce reliable and
trustworthy information for management, board of directors, audit committees, and ultimately capital providers (IIA Research Foundation, 2001).

Independence means the internal auditor should be objective and unbiased (Vanasco, 1996). The IIA Research Foundation (2001), defined independence as “freedom from material conflict of interest that threaten objectivity, that is a state where threats to objectivity are managed to the extend that the risk of ineffective internal audit services are acceptably controlled. 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 organisation they serve. Elliot’s committee as cited by the IIA Research Foundation (2001), stated that objectivity is an intellectual quality and that independence is a condition that facilitates a professional exercise of objectivity. The taskforce stated that independence then is simply a condition in which threats to objectivity are managed to an acceptable level.

2.2.1 Importance of Professional Objectivity

According to Gul and Subramaniam (1994), 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 organisation, as evaluated by the internal auditor. According to a survey by Ward and Robertson (1980), 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. Reliance on internal auditors work 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).

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

2.2.2 Impairment of Professional Objectivity
According to the IIA's Code of Ethics (2001), objectivity requires the internal auditors to make a balance assessment of all relevant circumstances and must not be influenced unduly by self-interest or by others in forming their judgments. The Code of Ethics (2001) also demands that the internal auditor should avoid any activity or relationship that conflicts with his organisations' interest or accept anything that will impair his professional judgment. Thus it obligates internal auditors to disclose all facts, which are likely to bias their reporting, if not disclosed.

The IIA's Standards (2001), mentioned that in order to enhance the auditors objectivity and independence, he cannot audit or assess operations for which he was previously responsible. For example if a staff of the accounts section is transferred to the audit department, that staff cannot turn around and audit the accounts section because his objectivity and independence will be greatly impaired.

Vanasco (1994a) stated that auditing the same area several times might result in personal relations with the auditor, which could impair his objectivity.
It is therefore a prudent policy to rotate auditors periodically from assignment to assignment.

2.2.3 Enhancing Professional Objectivity

According to Vanasco (1994b), Weizhong and Shourong (1997), Scarbrough et al. (1998) and Vinten (1999), the status of the head of the internal audit department in the organisation should be high, and he must also report to a higher level in order to enhance his objectivity. The chief internal auditor should be elevated in the organisation 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 organisation 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 1991 MIA survey, chief executives saw the internal audit as a high profile function in terms of its position in the organisation, 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 Standards 920010, states that the internal auditor should freely determine the scope and performance of his work as well as communicating the results of that work. Braiotta (1982) and Scarbrough et al. (1998) also reiterated this point. According to Vanasco (1994a), 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. In the 1991 MIA survey, 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.
According to Vinten (1999), the internal auditors independence and objectivity, and therefore his effectiveness would be greatly enhanced where the internal auditor: has direct access to all departmental heads; has 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 organisation; has the right of reporting without editing under his name; has 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. The Institute of Internal Auditors Malaysia’s (IIAM) Statement on Internal Control and the Securities Commission (2000) also provides that the internal audit function should be independent from the activities they audit.

According to Kalbers (1992), the Treadway Commission emphasized senior management’s support 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.

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).

2.3 AUDIT COMMITTEES EFFECTIVENESS

The audit committee is a committee of the board of directors, which assumes some of the board’s 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 could 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).

In most countries there is no legal requirements to have audit committees, Fisher (1994). Fisher (1994), also stated that in the USA (the New York Stock Exchange Listing Requirements, 1977) and Canada (legal requirements in 1971), it is compulsory for all listed companies to have audit committees. In the UK the Cadbury Committee recommended that companies should have audit committees, but did not make it compulsory. In Malaysia, the Kuala Lumpur Stock Exchange (KLSE) listing requirement (ss 15.10.1), made it compulsory for all KLSE listed companies to have audit committees, in August 1994.

However, the mere existence of audit committees with a list of duties does not guarantee that audit committees will conscientiously and effectively carry out their responsibilities (Kalbers, 1992, Menon and Williams, 1994, and McMullen and Raghunandan, 1996). Thus the KLSE listing requirement (ss. 15.10 to 15.16) has specified certain requirements for audit committees of all listed companies and the listed issuers must comply with these regulations. The KLSE listing requirements (ss. 15.12) indicated that the audit committees of all listed companies must have a written term of references (Audit Committee Charter). It also specifies the size and composition and functions of audit committees (ss. 15.10.1a to 1c). However, compliance with some of the requirements relating to the size and composition (ss. 15.10.1b to 1c) of audit committees had been deferred to June 2002. The practising internal auditors that I have contacted to obtain some preliminary information discussed informally regarding this issue, mentioned in their anecdotal comments that if audit committees comply with these listing requirements, there is a 60% chance that they will be effective.
2.3.1 Audit Committee Charter
The KLSE listing requirements (ss. 15.12), specified that an audit committee must have a written terms of reference which deal with its authority and duties, while the Securities Commission (2001), went further to state that the charter should be approved by the board. 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 (1999), recommends 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 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 (Thornton, 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).

2.3.2 Size and Composition
The KLSE listing requirements specify that audit committees should compose of not fewer than three members (ss. 15.10.1a), majority of whom should be non-executive directors who are independent of the company (15.10.1c). However, compliance with section 15.10.1c had been deferred until June, 2002. The BRC (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. According to a study by Abdullah (2001), about half of Malaysian companies appoint their chief executive officers to sit on their audit committee, and one third appoints the board chairman to sit on the same committee. This could
hinder the effectiveness of the audit committee (Abdullah, 2001). The KLSE listing requirements (ss. 15.10) 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).

Good governance practices dictates that audit committees must be independent (Tsacoumis, 1999). According to Read and Raghunandan (2001), the NYSE rules, characterise 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 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, Sori et al., 2001c and 2001d). The above KLSE listing requirements relating to the size and composition of audit committees was also emphasized by the Securities Commission (2001).

In preserving the independence of the audit committee, the KLSE listing requirements (ss. 15.21) indicated that the member's term of office should be reviewed every three years. The member's term of office should be staggered expiration dates to ensure continuity (Vanasco, 1996). Vanasco (1196), also pointed out that when members serve on the audit committee for too long, they lose their objectivity and independence as a result of familiarity and therefore become less effective. The Blue Ribbon Committee (BRC, 1999), further 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. This point was reinforced by Ernst and Young (1992), Cooper (1993), and Sori et al. (2001a).
The KLSE listing requirements 15.10.1c) also states 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). However, it must be noted that compliance with this section (15.10.1c) had been deferred to June, 2002. The BRC (1999) urges financial qualification as a requirement for all members of the audit committee, in order to effectively carry out their work. Sori et al. (2001b), stated that all the investors included in their survey, agreed that all the audit committee members should be financial literate. According to a study by Read and Raghunandan (2001), findings suggest that 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.

2.3.3 Direct Communication

According to the KLSE listing requirements (ss. 15.13.1a to 1d), 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 the internal and the external auditor (KLSE listing requirements ss. 15.13.1d). According to the BRC (1999), 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. The aim of such meetings is to assess the level of the firm's internal controls, and the quality and reliability of the financial statements, as well as help the audit committee gain an insight on the companies financial information. It is therefore 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 BRC, 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 et al. 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 (Vanasco, 1994b). The review should be extended to the internal audit programmes and processes as well as the results of these programmes and processes, (investigations undertaken), as well as determining whether appropriate action had been taken on their recommendations (BRC 1999, and Vanasco 1994b). 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 (Vanasco, 1994b). Direct communication as emphasized by the BRC (1999), can take the form of regular meetings independent of management, regular memos or reports circulated only to the audit committee. Quality financial accounting and reporting, results only from an effective interrelationship between an audit committee, the external auditor, management, and the internal auditor (BRC, 1999, and Read and Raghunandan, 2001).

2.3.4 Financial Statement Review

The KLSE listing requirements (ss. 15.13.1g) 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. The BRC (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 (Scarborough et al., 1998, and Hamid et al., 1999). According to Bows (1987), the external auditor and strong internal auditors play key roles in demonstrating that the underlying information in the financial statement is properly and fully reported.

Hamid et al. (1999) and Sori et al. (2001c) stated that through reviews, the audit committee could fulfill its objective of increasing public confidence in the credibility of published financial statements. 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. According to a study by Hamid et al. (1999), internal auditors view the audit committee as effective in their traditional role of reviewing the financial statements. 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 (Scarborough et al. 1998, Raghunandan et al. 2001 and Read and Raghunandan, 2001).

Audit committee members need to have scheduled meetings in order to effectively carry out their function of financial statement review. According to Read and Raghunandan (2001), the BRC’s sample audit committee charter require a meeting of four times per year or more as circumstances require. McMullen and Raghunandan (1996), mentioned that effective audit committees meet three to four times a year. 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 (ss. 15.16.1 to 3) also specify that audit committees must prepare an annual report which must include the committees composition, terms of reference, number of meetings held and members attendance of such meetings. The requirements further stated that
the report should also give a summary of the audit committee's activities in carrying out its functions and duties, as well as the existence of an internal audit function or activity and a summary of the activities of the function or activity (if there is no such function or activity, the committee must explain the mechanism that exist to enable them discharge their duties effectively). This report 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. Such a report is likely force the audit committee to carry out their duties before committing themselves in the committee's annual report.

According to Katz (1998), there is no secret formula to what makes an effective audit committee. As in any human endeavour, 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, if the audit committee maintain 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).

2.4 AUDIT COMMITTEES RELATIONSHIP WITH INTERNAL AUDITORS

According to Vanasco (1994b), the IIA's Standard (1987) 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. 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). According to Vanasco (1996) and the Securities Commission (2001), in order to prevent management influence and create a truly independent relationship,
the director of internal auditing should report solely to the audit committee. 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 shortcomings in the firm’s operational area, which frequently involve at least criticisms of the firm’s senior management. Thus the internal auditor must have a high-level point of contact to whom he/she can report freely and candidly, and the audit committee provides this. According to Cooper (1993), 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.

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 lose 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 and 1996), 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 programmes and work of the internal auditor (Vanasco, 1996) and have a direct channel of communication with them (Rezaee and Lander, 1993).

2.4.1 Internal Audit Charter

Vinten (1999), states that the 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. The internal audit charter or terms of reference achieve this (Vinten, 1999). The charter facilitates the accomplishment of the audit committee’s objective of effectively serving the needs of the organisation (Verschoor and Liotta, 1990).

The IIA Standard (2001), 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. However, Verchoor and Liotta (1990) and Vanasco (1996), stated that the charter should be approved by management and accepted by the audit committee. Cooper (1993) and Vinten (1999) stated that the audit committee should approve the internal audit charter and terms of references in order to improve the relation between the two parties. 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, Vinten, 1999). According to Vanasco (1996), an internal audit charter, which precludes interference or reprisal, is a guideline for the IIA’s Standards (2001) for enhancing the internal auditors objectivity and independence.

The internal audit charter defines the boundaries of the internal audit function, establish the internal audit department within the organisation, authorises 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 organisation and those outside the organisation (Vanasco, 1994b). The IIA’s Standards (2001) recommends that the audit committee should review and approve the internal audit charter, in ensuring that internal auditors carry out their responsibilities.

The Securities Commission (2001), specify that the internal audit charter should be approved by the board/ audit committee, and the approval should be disseminated to senior management. The draft statement (2001), for the mentioned that the head of the internal audit should periodically assess the adequacy of the purpose, authority, and responsibility of the internal audit as
defined in the internal audit charter, in enabling the internal audit activity to accomplish its objectives. The Securities Commission (2001), also indicated that the results of the assessment should be communicated to senior management and the audit committee.

2.4.2 Hiring and Firing of the Internal Auditor

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 (Braiotta, 1982, Weizhong and Shourong, 1997 and Read and Raghunandan, 2001). 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, and 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). The internal auditor is subject to incentives controlled by management, which puts the auditor under pressure to make decisions that are not objective. The internal auditor would preserve his objectivity and independence where incentives are determine by the audit committee, for the internal auditor (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, Rezaee and Lander, 1993, Allison, 1994, Vinten, 1999, and 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 (BRC 1999, and Tsacoumis 1999). A direct channel of communication between the audit committee and the internal auditor, demonstrates to the organisation the independent organisational status of internal auditing, and permits internal auditors to express impartial and unbiased judgments and recommendations (Verschoor and Liotta 1990, and Rezaee and Lander 1993). According to Vanasco (1994b) and Katz (1998), in an effective and well-functioning audit program, the firm’s internal auditor reports his/her findings and recommendations to the audit committee. He stated that 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 committee’s 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). According to Verschoor and Liotta (1990), direct channel of communication enhances the probability that the internal auditors’ recommendations will be implemented.

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’s Standard, 2001). This will enable the board to determine whether the internal audit department’s plan and objectives support those of the board. According to IIA’s standards (2001), 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’s plan. 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 (IIA’s Standard, 2001, and Securities Commission, 2001). 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 without 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, organisational governance, and control (Verschoor and Liotta 1990, Rezaee and Lander 1993, and Vanasco 1994b). In a survey by Olivario and Newmans (1993), about 85% of the internal auditors responding stated that they attended one or two meetings, while 4% reported that they had attended no meeting. Braiotta (1992), Vanasco (1996), and Scarbrough et al. (1998), stated that the frequency of audit committee meetings with the internal audit executives,
leads to internal auditor independence. Olivario and Newman (1993), indicated that more than half of the responding internal auditors in their survey indicated that meetings with audit committee were valuable in supporting their work and/or assuring independence of their work.

According to Verschoor and Liotta (1990), Verschoor (1992), Vanasco (1994b) and Scarbrough et al. (1998), 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. In a survey by Kalbers (1992), 31% of the chief internal auditors report 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, a point also mentioned by Read and Raghunandan (2001).

2.4.4 Reviewing Internal Audit Work and Program

The audit committee’s mission is to ensure that the internal audit process is functioning properly (Tsacoumis, 1999). Audit committees have a responsibility to oversee the internal auditors: in respect of evaluating the internal auditors objective; reviewing their work and performance; and ensuring that their involvement in auditing the financial reporting process is appropriate and well coordinated with the work of the independent auditor (Thornton, 1996). According to Scarbrough et al., (1998), and Read and Raghunandan (2001), the audit committee should review the internal audit programme 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. The audit committee should review significant and unexpected internal audit findings and management’s 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).
Gul and Subramaniam (1994) and the Securities Commission (2001), view that the existence of audit committees improves the internal auditors' objectivity and independence. Similarly, Olivario and Newman (1993, Rezaee and Lander (1993) and Cooper (1993), believe 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. 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 committees that is a necessary condition for enhancing the objectivity and independence of the internal auditor.

2.5 CONCLUSION

The above review has indicated that third parties rely on the internal auditor's report. As a result, those reports should have integrity and should be free from bias. Professional objectivity is quite important for internal auditors to effectively and efficiently serve their organizations. This would be enhanced where the audit committee oversees the internal audit function. However, the mere existence of audit committees, does not guarantee that they would enhance the internal auditor's professional objectivity and independence. For audit committees to efficiently oversee the internal audit function, and improve their professional objectivity and independence, they need to be effective.

The next chapter outlined the theoretical framework of the variables used in this study, as well as the development of the hypotheses that have been tested. The questionnaire design, the data collection method, and the statistical tests are also explained.