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AN EMPIRICAL STUDY OF THE ROLES OF AUDIT COMMITTEE IN PROMOTING GOOD CORPORATE GOVERNANCE

Idris Adamu Alhaji¹

Department of Technology Management and Business, University Tun Hussein Onn Malaysia 86400
Parit Raja, Batu Pahat, Johor, Malaysia, Hp: 0169294918
alhajiidris05@yahoo.com

Dr. Wan Fauziah bt Wan Yusoff²

fauziah@gmail.com

ABSTRACT

The global financial crisis and recent cases of corporate frauds have brought into sharp focus the consequence of the precarious role to be played by the audit committees in ensuring good corporate governance particularly due to defenselessness of the economy to any chaos in the financial system. This paper is inclined to explore the roles of audit committee in promoting good corporate governance an empirical study of literature review. Most of the organisation's failed due to lack of risk exposure relating to the organisation's governance in relation to; compliance with laws, regulations, & contracts operation and information system effective and efficiency of operation, reliability and integrity of financial and operation information and safeguarding the assets. The audit committee is established with the aim of enhancing confidence in the integrity of an organisation's processes and procedures relating to internal control and corporate reporting including financial reporting. Audit Committee provides an 'independent' guarantee to the board through its oversight and monitoring role. Among many responsibilities the boards entrust the Audit Committee with the transparency and accuracy of financial reporting and disclosures, effectiveness of external and internal audit functions, robustness of the systems of internal audit and internal controls, effectiveness of anti-fraud, ethics and compliance systems, review of the functioning of the whistleblower mechanism. Audit Committee also plays a significant role in the oversight of the company's risk management policies and programs. Audit Committee has thus become one of the main pillars of the corporate governance system in every organisation. The methodology used is based on the review of information collected from secondary sources i.e. published books, reports, research works, journals and newspapers. Some information is also collected through electronic sources, and the paper also intended to give some possible remedies in steering organisation's through today's complex business environment, expansion the field of vision, and clearly defining who's will be tracking the company's risk sensor, and taking a step forward to enhance its own financial performance.

Key words: Auditing, Audit committee and corporate governance.

¹ Post Graduate Student, Faculty of Technology Management and Business, Universiti Tun Hussein Onn Malaysia

² Senior Lecturer, Faculty of Technology Management and Business, Universiti Tun Hussein Onn Malaysia

Introduction

Following high-profile corporate governance failures there have been proposals and actions in a number of countries concerning the responsibilities and powers of audit committees (Audit Committees), their mandatory or voluntary status, membership and independence. This trend of development can be seen as part of a wider agenda regarding the potential “globalisation” of corporate governance. Following similar projects in areas of financial reporting, harmonization of governance structures internationally is an important area of current development. Indications of this are apparent from evidence of a momentous rise and harmonization in the use of Audit Committees internationally (Collier and Zaman, 2005) and from the European Commission’s 8th Directive requiring all public-interest entities in the European Union to have an Audit Committee (EC, 2006).

Nevertheless the fact that Audit Committees are now a common feature of corporate governance internationally, their effectiveness has been a subject of some concern to both researchers and regulators (Spira, 2002; Turley and Zaman, 2003, 2004). A typical example of this concern is the following reaction to the USA case of Enron, where the Audit Committee has been carped for failing to identify or prevent certain practices within the company:

One of the mysteries of Enron Corp.’s fall from grace is how an audit committee chock full of talent could have been blind to the company’s financial sleight of hand. The audit committee followed all the rules – but it let the shareholders down (Business Week, 2002, p. 28). Existing research has offered limited insight on the operational conditions surrounding Audit Committee activities within organizations. Focusing on the interaction of the Audit Committee with board members and individuals from financial reporting and internal audit functions as well the external auditors. In this context, and given the variety of governance traditions that exists internationally, research that assists understanding of the ways in which mechanisms such as Audit Committees operate within organizations is important.

First, while most existing research has examined the existence and characteristics of Audit Committees, this paper also explain and contribute from the various studies carry out by various scholars on how Audit Committee promote good governance such as internal control, financial reporting, external and internal audit. The focus of this paper is thus on the manner of Audit Committee activities and how this promote on governance outcomes.

Definition of Internal Auditing

Historically, internal auditing was perceived as being confined to merely ensuring that the accounting and underlying records of an organization’s transactions were properly maintained, that the assets management system was in place in order to safeguard the assets and also to see whether policies and procedures were in place and were duly complied with. With changing times, the concept of internal auditing has undergone significant changes with regard to its definition, scope of coverage and approach. In some organizations, the scope of modern internal auditing has been broadened from financial issues to include value for money, evaluation of risk, managerial effectiveness and governance processes.

In 1978, the Institute of Internal Auditors (IIA) defined internal auditing as: “An independent appraisal activity established within an organization as a service to the organization. It is a control, which functions by examining and evaluating the adequacy and effectiveness of other controls. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed” (Ali and others., 2007, pp 25-26).

The modern scope and focus of internal auditing are reflected in the current definition that was formally adopted by the IIA in 1999:

“An independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. 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”.

The notable difference between the definitions of 1978 and 1999 (as repeated in IIA 2008) is the prominence of objectivity in internal audit activities and also the emphasis on the evaluation and improvement of the effectiveness in risk management and governance processes. The current definition also contemplates two main internal audit services: assurance and consulting services.

Assurance services, according to IIA (2008, p.2):

Involve the internal auditor’s objective assessment of evidence to provide an independent opinion or conclusions regarding an entity, an operation, a function, a process, system, or other subject matter. The nature and scope of the assurance engagement are determined by the internal auditor.

There are generally three parties involved in assurance services:

1. The person or group directly involved with the entity, operation, function, process, system, or other subject matter - the process owner,
2. The person or group making the assessment - the internal auditor, and
3. The person or group using the assessment - the user.

Internal auditing is conducted by persons within or outside the organisation and in diverse legal and cultural environment; within organizations that vary in purpose, size complexity, and structure. Even though the above different may affect the practice of internal auditing in each environment, conformance with the IIA International Standards for the Professional Practice of Internal Auditing (Standards) is essential in meeting the responsibilities of internal auditors and the internal audit activity (IIA 2008, p.1.).

Role of Internal Auditing

Gramling et al. (2004) performed a literature review on the role of internal auditing in corporate governance. This review found that the role of an internal audit function in corporate governance has been analysed using the external auditors’ evaluation of its quality, determinants of its reliance decision, the extent and nature of its work relied on by the external auditor and other aspects of the external audit (Gramling et al. 2004).

Examination of this literature review shows that the majority of the research on internal audit has been related to the perceptions of the external auditor and whether the external auditor utilizes the internal auditor’s work. Another way of evaluating the work of internal auditors is to examine how well they detect errors within an organization and there has been limited research on this topic. One study on this topic found the number and

magnitude of errors requiring adjustment by the external auditor have been found to be substantially lower for entities that had an internal audit department compared to those that did not have an internal audit department (Wallace and Kreutzfeldt 1991).

Consequently, another role of internal auditing can be identified as involving three main components the evaluation and improvement of risk management, control and governance processes.

These elements are sometimes referred to as the “three pillars” of internal auditing (Figure 1 below). The three elements are reinforcements of the fundamentals of an internal audit function in the public sector. Risk management, control and governance encompass the policies and procedures established to ensure the achievement of objectives and include the appropriate assessment of risk, the reliability of internal and external reporting and accountability processes, compliance with applicable laws and regulations, and compliance with the behavioural and ethical standards set for public organizations and employees.

Figure 1- The Three Pillars of Internal Auditing



Source: Asare 2008, p.22

The Importance of Internal Audit.

The importance of internal auditing has also been underpinned by the decision of the New York Stock Exchange (NYSE) to amend its listing requirements to mandate that all listed companies in the United States (US) have an audit committee (NYSE 2003) to liaise between internal auditors, external auditors and management, ensuring the independence of the audit function. There is evidence in the US that the Securities and Exchange Commission (SEC) also attaches importance to internal auditing as there have been recent cases where enforcement actions by the SEC and subsequent settlements have required the registrant to engage internal auditors (Carcello et al. 2005). In Australia recent changes to the Corporations Act and the Australian Stock Exchange (ASX) Listing Rules have strongly emphasized the importance of good corporate governance. Given the perceived importance of internal audit as part of good corporate governance, these changes are likely to enhance the role and importance of internal audit in the Australian environment.

Despite the increasing focus on internal audit, there has been little research on the benefits and importance of this function. Studies have used an agency cost framework to illustrate the value relevance of the internal audit function (e.g., Carey et al. 2000; Carcello et al. 2005). While the variables of size, debt or agency are not associated with the presence of an internal audit function in Australian family owned companies, internal and external audit are used as monitoring substitutes by these companies (Carey et al. 2000). A more recent US study examined the size of internal audit budgets and found that they were positively related to company size; leverage; financial, service, or utility industries; inventory; operating flows; and audit committee review of the internal audit budget (Carcello et al. 2005). Results showed that internal audit budgets were negatively related to the percentage of internal auditing that was outsourced. The overall conclusion was that companies facing higher risk will increase their organizational monitoring through internal audit, providing evidence of the importance of the internal audit function.

Relationship between Internal And External Audit.

Professionally, internal auditors strive to create an effective function whose results can be relied upon by the external auditors as evidence of the overall strength of internal financial control. The detailed background knowledge which internal audit has of the organisation may be of particular value in allowing their external counterparts to understand the background and circumstances of the activity they are reviewing.

However, publicity about the role of external auditors in high profile private sector cases such as Enron has increased public and parliamentary expectations of external auditors, and has rightly or wrongly made public sector external auditors more cautious about the degree of reliance they place on internal audit (Glass 2005, p.8).

Establishing a professional working relationship between the internal auditor and the external auditor should deliver benefits to both parties. Such relationship allows potential overlaps and gaps in the overall audit activity to be identified and addressed, and assists in maximizing the extent to which external audit is able to rely on the work of internal audit in undertaking its work. Internal auditors also need to be aware of planned and actual external audit coverage in order to assist in identifying their information needs (ANAO, 2007, p.28).

An effective co-operation between internal and external audit helps both parties achieve their objectives and also helps them provide a better service to the bodies they work with and ultimately to Parliament and the public. However, such cooperation can only thrive in an environment where there is mutual confidence and the recognition that internal and external audits are both conducted within relevant professional standards and information exchanged is treated professionally and with integrity (NAO, 2000, p.11).

Audit Committee

Audit committees (“Audit Committee”) are recognized as the cornerstone of a successful and credible financial reporting system. To many, the Audit Committee is the epitome of corporate governance. The role of the Audit Committee is to lend creditability to the integrity of the internal control and financial reporting system, and to boost confidence in the company’s financial reporting. The essence to an Audit Committee’s function is its independence, given that it needs to be made up of entirely non-executive directors, majority of which are independent, which allows it to carry out its roles effectively. The Audit Committee has an oversight function over internal controls and risk management, and serves as a liaison between management and the external and

internal auditors, providing an authoritative avenue for resolution of divergence in views between the various parties.

The business landscape is fast evolving, and correspondingly, Audit Committees worldwide are being thrust into less-traditional roles and responsibilities like oversight of whistle-blowing arrangements, enterprise-risk management, fraud-risk analysis.

Purpose and Role of the Committee

The purpose of the Audit Committee (the “*Committee*”) is to provide assistance to the Board of Directors with respect to its oversight of:

1. The quality and integrity of the Corporation’s financial statements;
2. The Corporation’s compliance with legal and regulatory requirements;
3. The independent auditor’s qualifications and independence;
4. The Corporation’s Enterprise Risk Management (ERM) process;
5. The performance of the Corporation’s internal audit function and independent auditors; and
6. The risks associated with matters within the Committee’s responsibilities and duties.
- 7.

The Committee has sole authority from the Board of Directors for the appointment, compensation and oversight of the Corporation’s independent auditors, including the approval of any significant non-audit relationship. The Committee also shall prepare the report of the Committee that the rules of the Securities and Exchange Commission (the “*SEC*”) require be included in the Corporation’s annual proxy statement and shall perform such other duties as assigned to it from time to time by the Board of Directors. The Committee, however, is not responsible for certifying the Corporation’s financial statements or guaranteeing the auditor’s report. The fundamental responsibility for the Corporation’s financial statements and disclosures rests with management.

Authority

The audit committee has authority to conduct or authorize investigations into any matters within its scope of responsibility. It is empowered to:

- Appoint, compensate, and oversee the work of any registered public accounting firm employed by the organization.
- Resolve any disagreements between management and the auditor regarding financial reporting.
- Pre-approve all auditing and non-audit services.
- Retain independent counsel, accountants, or others to advise the committee or assist in the conduct of an investigation.
- Seek any information it requires from employees-all of whom are directed to cooperate with the committee's requests-or external parties.
- Meet with company officers, external auditors, or outside counsel, as necessary.

Composition

The audit committee will consist of at least three and no more than six members of the board of directors. The board or its nominating committee will appoint committee members and the committee chair. Each committee member will be both independent and financially literate. At least one member shall be designated as the "financial expert," as defined by applicable legislation and regulation.

Responsibilities

The committee will carry out the following responsibilities:

Financial Statements

- Review significant accounting and reporting issues, including complex or unusual transactions and highly judgmental areas, and recent professional and regulatory pronouncements, and understand their impact on the financial statements.
- Review with management and the external auditors the results of the audit, including any difficulties encountered.
- Review the annual financial statements, and consider whether they are complete, consistent with information known to committee members, and reflect appropriate accounting principles.
- Review other sections of the annual report and related regulatory filings before release and consider the accuracy and completeness of the information.
- Review with management and the external auditors all matters required to be communicated to the committee under generally accepted auditing *Standards*.
- Understand how management develops interim financial information, and the nature and extent of internal and external auditor involvement.
- Review interim financial reports with management and the external auditors before filing with regulators, and consider whether they are complete and consistent with the information known to committee members.

Internal Control

- Consider the effectiveness of the company's internal control system, including information technology security and control.
- Understand the scope of internal and external auditors' review of internal control over financial reporting, and obtain reports on significant findings and recommendations, together with management's responses.

Internal Audit

- Review with management and the chief audit executive the charter, activities, staffing, and organizational structure of the internal audit function.
- Have final authority to review and approve the annual audit plan and all major changes to the plan.
- Ensure there are no unjustified restrictions or limitations, and review and concur in the appointment, replacement, or dismissal of the chief audit executive.
- At least once per year, review the performance of the CAE and concur with the annual compensation and salary adjustment.

- Review the effectiveness of the internal audit function, including compliance with The Institute of Internal Auditors' *International Professional Practices Framework for Internal Auditing consisting of the Definition of Internal Auditing, Code of Ethics and the Standards*.
- On a regular basis, meet separately with the chief audit executive to discuss any matters that the committee or internal audit believes should be discussed privately.

External Audit

- Review the external auditors' proposed audit scope and approach, including coordination of audit effort with internal audit.
- Review the performance of the external auditors, and exercise final approval on the appointment or discharge of the auditors.
- Review and confirm the independence of the external auditors by obtaining statements from the auditors on relationships between the auditors and the company, including non-audit services, and discussing the relationships with the auditors.
- On a regular basis, meet separately with the external auditors to discuss any matters that the committee or auditors believe should be discussed privately.

Compliance

- Review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up (including disciplinary action) of any instances of noncompliance.
- Review the findings of any examinations by regulatory agencies, and any auditor observations.
- Review the process for communicating the code of conduct to company personnel, and for monitoring compliance therewith.
- Obtain regular updates from management and company legal counsel regarding compliance matters.

Reporting Responsibilities

- Regularly report to the board of directors about committee activities, issues, and related recommendations.
- Provide an open avenue of communication between internal audit, the external auditors, and the board of directors.
- Report annually to the shareholders, describing the committee's composition, responsibilities and how they were discharged, and any other information required by rule, including approval of non-audit services.
- Review any other reports the company issues that relate to committee responsibilities.

Other Responsibilities

- Perform other activities related to this charter as requested by the board of directors.
- Institute and oversee special investigations as needed.
- Review and assess the adequacy of the committee charter annually, requesting board approval for proposed changes, and ensure appropriate disclosure as may be required by law or regulation.
- Confirm annually that all responsibilities outlined in this charter have been carried out.
- Evaluate the committee's and individual members' performance on a regular basis.

Corporate Governance

Over the last two decades, corporate governance has attracted a great deal of public interest because of its apparent importance for the economic health of corporations and society in general. The headlines of the previous two years in particular portrayed a sad story of corporate ethics (or lack thereof): WorldCom, Anderson, Merrill Lynch, Enron, Martha Stewart, Global Crossing, Qwest Communications, Tyco International, Adelphia Communications, Computer Associates, Parmalat, Putnam, Boeing, Rite Aid, Xerox Falling stock markets, corporate failures, dubious accounting practices, abuses of corporate power, criminal investigations indicate that the entire economic system upon which investment returns have depended is showing signs of stress that have undermined investor's confidence. Some corporations have grown dramatically in a relatively short time through acquisitions funded by inflated share prices and promises of even brighter futures (many of these corporations have now failed). In others, it seems as if the checks and balances that should protect shareholder interests were pushed to one side, driven by a perception of the need to move fast in the pursuit of the bottom line. While some failures were the result of fraudulent accounting and other illegal practices, many of the same companies exhibited actual corporate governance risks such as conflicts of interest, inexperienced directors, overly lucrative compensation, or unequal share voting rights (Anderson and Orsagh, 2004). In the face of such scandals and malpractices, there has been a renewed emphasis on corporate governance.

Corporate governance covers a large number of distinct concepts and phenomenon as we can see from the definition adopted by Organization for Economic Cooperation and Development (OECD) – “Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions in corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance” From this definition we see that corporate governance includes the relationship of a company to its shareholders and to society; the promotion of fairness, transparency and accountability; reference to mechanisms that are used to “govern” managers and to ensure that the actions taken are consistent with the interests of key stakeholder groups. The key points of interest in corporate governance therefore include issues of transparency and accountability, the legal and regulatory environment, appropriate risk management measures, information flows and the responsibility of senior management and the board of directors. Many companies in the US have adopted legal compliance mechanisms which address ethics or conduct issues in formal documents (Weaver et al 1999), but much of this activity has been attributed to the 1991 U.S. Sentencing Commission's Guidelines for organizational defendants which prescribe more lenient sentences and fines to companies that have taken measures to prevent employee misconduct (Metzger et al, 1994 and Paine, 1994). From an ethical dimension, at a fundamental level, the key issues of corporate governance involve questions concerning relationships and building trust (both within and outside the organization).

Harshbarger and Holden (2004) point out that while many of the governance issues that organizations face are not new, the environment in which they confront them is more challenging than ever: State and Federal law enforcement have applied significantly increased resources and a more aggressive philosophy toward confrontation of governance lapses; the media spotlight has increased awareness among those constituents directly affected as well as the business community as a whole; shareholder proposals are taken more seriously; and the judiciary has demonstrated its willingness for a more stringent definition of good faith. As well, there are a number of factors that have brought ethical issues into sharper focus, including globalization, technology and rising competition. Van Beek and Solomon (2004) also note the ability to deliver a professional service will necessarily take place in an environment in which there is an increasing tendency towards individuality, while society as a whole becomes more global. The new realities of corporate governance show that no entity or agent is

immune from fraudulent practices² and have altered the way companies operate; they have re-defined the baseline for what is considered prudent conduct for businesses and executives (Dandino, 2004).

The Audit Committees' Role, Responsibilities and Key Relationships with Corporate Governance

Today, the audit committee is widely recognized as a senior board committee with "front line" governance responsibilities related not merely to financial reporting, but also to the oversight of continuous disclosure and corporate reporting.

It is important to consider the audit committee's role in the context of the governance process of the corporation as a whole. As a committee of the board, the audit committee must carry out its duties within the framework of the governance principles and practices established by the board of directors. Good governance promotes accountability of the key players, and ensures that management works in the best interests of the corporation and its shareholders to enhance shareholder value, while taking into account the legitimate interests of other stakeholders. The audit committee's role, and its commensurate accountability to the board, is directly related to how the board chooses to discharge its oversight function. The audit committee's effectiveness is directly linked to that of the board and, therefore, many of the issues that impact the audit committee's effectiveness are also likely to impact the effectiveness of the board.

Management's role and responsibility In corporate governance

Management's role is important. Management plays a key role in creating and maintaining the systems that encourage great governance. The corporate culture is an atmosphere set by the CEO, who stands responsible for balancing the competitive forces that buffet a company with the need to adhere to a strict code of conduct. This balance depends upon open communications, mechanisms for dealing with failure or weak financial results, and an incentive system that rewards good behavior. Management needs to work closely with the Council to design appropriate policies and procedures that support the corporate culture and encourage proper conduct.

Focus on accounting is paramount. Clearly defined, well-monitored internal and external audit functions are paramount to the success of corporate governance. Begin with the council's audit committee and its oversight of all audits. The committee should understand the areas of audit focus and be able to redirect that spotlight to any area of concern. Reevaluation of the process to draft corporate financial statements takes on renewed significance, given the new CEO certification requirements. Details such as determining asset valuations and assessing the initial estimates should undergo challenge and review. Internal audit functions need reexamination, as well as the quality of accounting principles and the extent of disclosure. Senior management should consider the quality and competence of the finance and accounting staff to make sure that they are equal to the complex work involved in quality financial reporting.

Conclusion

Failure in corporate governance is a real threat to the future of every corporation. With effective corporate governance based on core values of integrity and trust (reputational value) companies will have competitive advantage in attracting and retaining talent and generating positive reactions in the marketplace – if you have a reputation for ethical behavior in today's marketplace it engenders not only customer loyalty but employee loyalty. Effective corporate governance can be achieved by adopting a set of principles and best practices. A great deal depends upon fairness, honesty, integrity and the manner in which companies conduct their affairs. The

organisation should bear in mind the risk exposure relating to the organisation's governance in relation to; compliance with laws, regulations, & contracts operation and information system effective and efficiency of operation, reliability and integrity of financial and operation information and safeguarding the assets are the main focus of the organisation. Companies must make a profit in order to survive and grow; however, the pursuit of profits must stay within ethical bounds.

Companies should adopt policies that include environmental protection, whistle blowing, ethical training programs and so on. Such compliance mechanisms help develop and build corporate image and reputation, gain loyalty and trust from consumers and heighten commitment to employees. Compliance mechanisms contribute to stability and growth since it instills confidence; management, leadership, and administration are essentially ethical tasks. The focus of the virtues in governance is to establish a series of practical responses which depend on the consistent application of core values and principles as well as commitment to business practice. Virtues are powerful means to personal betterment and bring about social reform Because of its strong appeal to reason; it diffuses passion, prejudice, pride and self-interest and is a civilizing force in bringing about justice.

In the UK, a recent report by Sir Robert Smith on the Combined Code Guidance for Audit Committees (the *Smith Report*) states that "...management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control, and for providing assurance to the board that it has done so – except where the board is expressly responsible for reviewing the effectiveness of the internal control and risk management systems."

In Australia, the *ASX Principles of Good Corporate Governance* has a bet each way. It recommends that internal audit "...should report to management and should have all necessary access to management and the right to seek information and explanations." However, the ASX Principles then go on to suggest that "...companies should consider a second reporting line from the internal audit function to the board or relevant committee." Under the ASX Principles it is also recommended that the audit committee have access to internal audit without the presence of management, and that "the audit committee should recommend to the board the appointment and dismissal of a chief internal audit executive. I hope the above recommendation will contribute to the effectiveness and efficiency in the operation of organization and also hoped that this paper will also contribute to knowledge and practical, moreover, it will be a way forward for other researchers to bring more recommendation and remedies in the roles of audit committee in promoting good corporate governance.

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