

# Audit Committees Effectiveness and its Impact on the Objectivity of the Internal Auditors: Evidence from United Arab Emirates

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## Abstract

Internal auditors objectivity continue to be an important concept in the internal auditing profession, and audit committees can be viewed as a key safeguard mechanism for internal auditors in managing their professional objectivity. This study examines audit committee effectiveness and its impact on the objectivity of internal auditors in the bank sector in UAE. Data were obtained from all the banks listed in Abu Dhabi Securities Exchange using questionnaire technique. The research result reveals that there is significant positive effect of audit committee effectiveness on the objectivity of internal auditors; the results indicate that having an effective audit committee member will enhance the internal auditors objectivity. Also, the result shows significant positive effect on the objectivity of internal auditors related to having effective audit committee with authority over the CAE employment (appointment/dismissal). Also, the result indicates significant difference between the effectiveness of the audit committee members and the internal auditors objectivity related to qualifications, and no relationship between the effectiveness of the audit committee members and the internal auditors objectivity related to the experience. The research reveals that effective audit committees strengthen the position of the internal audit function by increasing the objectivity of internal auditors.

**Keywords:** Audit Committee Effectiveness, Listed Banks, United Arab Emirates, Objectivity, Internal Auditors.

## 1. Introduction

The boards of directors are increasingly recognizing the value of audit committees as instruments of control (Sawyer 2003). It is believed that while the existence of an audit committee is a pre-requisite for good corporate governance, effectiveness is the key. By keeping communication channels open, the audit committee chair can foster a healthy relationship with internal auditors.

The United Arab Emirates economy has an emerging tradition of active policy making, and the government is active in the key sectors such as banking. There were a number of significant new requirements for companies listed on Abu Dhabi Securities Exchange (ADX) when the UAE Securities and Commodities Authority (SCA) corporate governance guidelines became effective on April 30, 2010 including a requirement to establish permanent audit committee. "The code requires that the audit committee must comprise not less than three non-executive directors, the majority of which are independent directors (one of whom should head the committee), and one member at least must have financial expertise. The meetings of the audit committee should be held at least once every quarter, and they must submit written reports to the board of directors regarding their actions, findings, and recommendations" (UAE Corporate Governance Regime 2010).

The period following the 2008 crisis has seen an introduction of more codes and regulation pertaining to audit committees, specially the audit committee's responsibilities. The EU proposed regulations suggesting that expanded audit reporting to the audit committee, and stronger audit committee that will include at least one member with knowledge of audit and another with knowledge of accounting and /or auditing (Ernst & Young 2012) .

The Institute of Internal Auditors (IIA 2013a) explained the relationship among audit committee, the management and the internal auditing by saying that: because the audit committee is responsible to the board for oversight of management reporting on internal control, and the key role they play in assessing and reporting on risk management and internal control, these two share a healthy interdependence, and the critical connection between the audit committee effectiveness and internal auditing mandates that audit committee members maintain an in-depth understanding of internal audit best practice, and how their internal audit activity is functioning. Also the IIA (2013b) mentioned that "the audit committee responsibilities include ensuring the internal auditors access to the audit committee, encouraging communication beyond scheduled committee meetings, and reviewing internal audit plans, reports, and significant findings, and review with management and chief audit executive the charter, plans, activities, and staffing. The audit committee must review and concur in the appointment, replacement, or dismissal of the chief audit executive, and on regular basis, meet separately with the chief audit executive to discuss any matters that the committee or internal auditing believes should be discussed privately".

This paper contributes to the understanding of audit committees effectiveness and its impact on the objectivity of the internal auditors. It is useful to the banks management to focus more on internal auditors objectivity, reinforce it, and emphasize on the role of audit committees and their relationship with the chief audit executive.

The study seeks to answer the following questions:

1. Does an effective audit committee affect the internal auditors objectivity in the banks operating in the United Arab Emirates?
2. Does having an effective audit committee with authority over the chief audit executive employment (appointment/dismissal) affects the internal auditors objectivity in the banks operating in the United Arab Emirates?

## 2. Theoretical background

The study of (Wuexamines 2012) examines audit committee effectiveness from the perspective of audit committee members of listed companies in New Zealand. Data were obtained from 21 semi-structured, questionnaire based interviews with current audit committee members. The data were analyzed using a qualitative approach. The research results revealed that performing audit committee duties is an intended process, comprising at least two distinctive intentional orientations, in terms of which audit committee members tend to justify the effectiveness of their respective audit committees. Therefore, investigating audit committee members' intentional sense-making processes behind their audit committee activities can be argued to be of value in understanding the effectiveness of an audit committee. The research revealed that the audit committee acts as an instrument for the board of directors and the findings challenge several public expectations of audit committees, most noticeably the notion of 'independence'. The study illustrates the potential value for corporate governance stakeholders in considering the individuality of audit committee members, within the context of their specific organizations, in promoting corporate governance best practice.

The purpose of (Khamidullina 2012) study was to obtain a better understanding of the types of expertise required of audit committee members, and to see whether it was possible to identify the specific areas of expertise required of members of audit committee in monitoring the integrity of financial reporting, also it investigate the current level of UK audit committees members expertise, attempt to identify "knowledge gaps". A semi-structured interview was chosen as an appropriate method of gathering information; six representatives from six audit firms have been interviewed. The findings of this research showed the growing role of audit committee members in understanding and reviewing key accounting judgments contained in companies reporting, and the lack of UK audit committees expertise in IFRS, also this research found that the ability to ask the right questions scores highly in the hierarchy of audit committee skills, and the research found that audit committee involvement in the process of the annual report preparation (timing of the involvement) raised concern of auditors, and about the insufficient discussion during the meeting of audit committee with auditors of financial reporting issues emerging from audits.

A study of (Al-Sa'eed & Al-Mahamid 2011) aimed to understand the features of an effective audit committee and its role in strengthening financial reporting. A questionnaire based survey was circulated to public listed companies on the Amman Stock Exchange (Banking, insurance, and financial institutions). The study was aimed at internal audit managers and finance managers. A listing of Share -Traded Jordanian companies was available from the Amman Stock Exchange as of 30 September 2010. A total of 156 companies shares were traded on that day decided to distribute the questionnaire to all those companies, with confidence level of 95% and internal level of (10). The response rate of the questionnaire survey was (71%), where only (110) out of (156) questionnaires were returned.

The study results showed that the research respondents have a good level of education and experience. In addition, there was a relationship between having effective audit committee (internal controls, international standards on auditing, institute of internal audit; Jordan securities commission requirements, external audit, understanding of audit committee functions), and the financial reporting. Furthermore, the internal control, international standard on auditing and institute of internal audit, Jordan securities commission requirements, external audit, understanding of audit committee functions can explain a significant amount of the variability in financial reporting. Finally, the research results also showed that age and gender make a difference for our respondents when they evaluate financial reporting.

The study of (Soileau 2011) evaluated the potential influence that components of the corporate governance structure, the audit committee and IAF, have on enterprise risk management efforts within an organization. The study uses data obtained from a survey of internal audit function management of U.S. based publicly traded firms. Audit committee characteristics obtained manually from proxy statements filed with SEC, the survey asked respondents to indicate whether their organization had implemented ERM, as well as the maturity of implementation based on a six point scale for the period between 2006 and 2008.

Results of the study provide initial evidence that certain characteristics of audit committee (the number of audit committee meetings and percentage of audit committee members disclosed as financial experts) and internal audit functions (reporting independence and quality assurance review procedures) are associated with a firms likelihood of adopting and implementing ERM processes. These findings provide additional considerations as to

the value and importance of effective audit committees and internal audit functions to provide risk oversight and monitoring in organizations.

The study of (Hutchinson & Zain 2009 ) explored whether the relation between internal audit quality and firm performance is associated with firm characteristics of information asymmetry and growth opportunities and audit committee effectiveness. Data was collected through a mail questionnaire survey of public listed companies in Malaysia during 2003, by sending 504 questionnaires to the internal departments. The results showed that effective governance, in terms of internal audits and the audit committee is contingent on the risks associated with the firm's environment, and the results from this study demonstrate that an insider dominated audit committee may cause conflict for the internal auditor which in turn has an adverse effect on firm performance, and this suggests that the important thing is not the independence of the audit committee, but rather having the right mix of members with necessary skills to evaluate the risks faced by the firm, and the results showed that the association between internal audit quality and firm performance is stronger for firms with high growth opportunities, and that this positive association is weakened by increasing audit committee independence. These findings demonstrated the internal auditors conflicting roles and question the governance recommendations that require all members of the audit committee to be non-executive directors.

The primary objective of (Zain & Subramaniam 2007) study was to provide insights into internal auditors perceptions of their interactions with audit committee members in Malaysia. The study reflects the importance of the powerful position of audit committee in enhancing internal audit objectivity. Data obtained from 11 publicly listed companies through in-depth interviews of the head of the internal audit function. The findings of the study highlight the importance of the leadership role of audit committees in supporting the internal audit function, and the results indicated that infrequent informal communications and limited private meetings between the head of the internal audit function and audit committee, and a need for clear reporting lines. Further the findings indicated that audit committees are seen to be held in high esteem for their authority and are expected to take on greater leadership in the inquiry of management's decision making.

The purpose of (O'Leary & Stewart 2007) study was to explore the ethical decision making of internal auditors in Australia, and the impact of corporate governance mechanisms there on. It also aims to explore whether ethical decision making is influenced by years of experience in internal auditing. A sample of 66 internal auditors was taken with five ethical dilemmas. For each scenario, a key element of corporate governance was manipulated to assess its impact on ethical decision making. These were audit committee support; management integrity regarding accounting policies; management integrity regarding pressure on internal audit; external auditor characteristics; and organizational code of conduct. The study found that the existence of an effective audit committee had little impact on internal auditors perceptions of their willingness to act objectively; also they found that a higher quality external audit function was positively associated with internal auditors ethical decision making. However, the strength of other governance mechanisms did not appear to influence ethical decision making. Finally, the study found that more experienced internal auditors adopted a more ethical stance in some cases.

The study of (Abbott et al. 2003) examined the association between audit committee effectiveness, and internal audit outsourcing, and examined disclosed audit committee responsibilities to ascertain which committees had sole or joint authority over the employment of the chief audit auditor. Data obtained from a survey of 219 chief internal auditors and from relevant proxy statements filed in 2001, they received a total of 287 usable responses, of which 219 firms were not financial institutions. The results indicated that companies with effective audit committees are less likely to outsource internal auditing to the external auditor, and effective audit committees which also have authority over the chief internal auditors dismissals have been an incrementally negative relation with the extent of outsourcing, and where the audit committee is effective there is less outsourcing of activities which might impair the internal auditors objectivity and organizational status and/or impair the external auditors independence.

### 3. Hypotheses of the Study

The IIA (2013a) defined the objectivity of internal auditors in Standard 1100 – Independence and Objectivity as: “The internal audit activity must be independent, and internal auditors must be objective in performing their work”. They interpret objectivity as: Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others. Threats to objectivity must be managed at the individual auditor, engagement, functional, and organizational levels. Section 202 of Sarbanes Oxley (2002) defines Audit Committee as: A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.

According to Leech (2009), the internal auditors succeeded in assessing and reporting on Risk Management

(RM) during the recent period of global crisis, but unsuccessful in identifying and reporting the deficiencies that have been threatening the efficiency of (RM) within a reasonable time”. For this the IIA has changed the standards to enhance the role and contribution of internal auditors in monitoring, assessing, and reporting the effectiveness of conducting of RM process (IIA 2011).

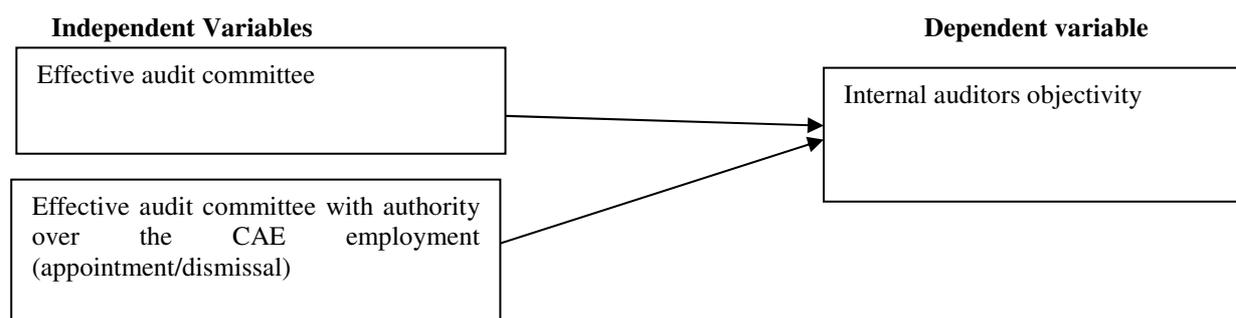
On the other hand, Bota (2009) argued that even if the internal auditor would be directed and conducted with highest efficiency and evaluation of RM, it would not be able to avoid the crisis without the support of the audit committee and management. In this situation the effective communication channels among management, audit committee, and internal auditors become more important and must be operated in as consistent manner that accurately contributes to prevent potential future financial crisis. Also, Sarens & De Beelde (2006) found that when internal audit operates primarily in a management support role, there is a lack of perceived objectivity, and the relationship with the audit committee is weak, while Goodwin (2003) found a relationship between dismissal of the CAE, and independence of audit committee.

Dezoort et al. (2002) developed a framework to classify the contribution factors of an effective audit committee, it consists of: audit committee composition, authority, resources, and diligence, while Singh (2011) stated that to establish with the audit committee, and compliance with IIA 's international standards for the comprehensive and balanced internal audit function, the CAE should consider communication skills and relationship professional practice of internal auditing. He added that the internal audit function should have a direct access to the audit committee and they are required to meet regularly and frequently to monitor and focus on strategic issues on time, also the audit committee.

### 3.1 The study has two hypotheses

H1: An objective internal auditor is negatively related to the degree of the effectiveness of the audit committee.

H2: The presence of an effective audit committee with authority over the chief audit executive CAE employment (appointment/dismissal) is negatively related to the degree of objectivity of the internal auditors.



**Figure 1. The relationship between the variables**

The elements of independent variables and dependent variables are in table (1).

**Table1. Elements of independent variables and dependent variables**

Effective audit committee	
1	The company has audit committee consist of nonexecutive members of the board of directors
2	There is specific strategy for internal auditing in the company
3	The audit committee adopts the internal audit department strategy and plans
4	The company has methods to assess risk
5	The Chief Audit Executive always attends the audit committee meetings
Effective audit committee with authority over the CAE employment	
1	The audit committee appointments and dismiss the Chief Audit Executive
2	There is organizational structure for the internal audit department.
3	The internal audit department has job description (duties, responsibilities and hierarchy).
4	The chief audit executive actively involved with the audit committee
Internal auditors objectivity	
1	The audit committee reviews the internal auditors reports.
2	The audit committee takes immediate action related to the internal auditors reports.
3	The hiring of internal auditors is done based on specific requirements regarding the audit profession
4	Using Outsourcing to evaluate the internal audit activity

#### 4. Population and Sample of the Study

Existing studies use various techniques to proxy audit committee effectiveness and its impact on internal auditors objectivity. A questionnaire has been developed to address the research questions. The questionnaire has been piloted with Chief audit executive, and the internal auditors in 14 banks listed in Abu-Dhabi security exchange. In order to answer the question regarding the relationship between audit committee and internal auditors, the chief audit executive, the audit committee members, and the internal auditors have been chosen as being most appropriate for obtaining this information. Likert five scales measure has been adopted to determine the degree of importance of each item of the questionnaire, where (5) points was given to the situation of "strongly agree" and (4) points for the case of "agree", and (3) points to the case of "neutral" and (2) points to the "disagree" and (1) point to "strongly disagree". The retrieved questionnaires were 35.

##### 4.1 Demographic of Study Sample

Table ( 2 ) gives a general overview of the sample surveyed in term of the demographic information.

**Table 2. Demographic information results**

		Frequency	Percent
Qualification	Bachelor	10	28.5
	Master Degree	19	54.2
	PHD	6	17.1
	Others	0	0
Professional certificate	Others mention	10	28.5
	CMA	3	8.6
	CPA	9	25.7
	C IA	13	37.1
Functional Level	Internal Auditor	14	40.0
	Internal Audit supervisor	7	20.0
	Chief Executive Auditor	14	40.0
Experience	1-5 Years	3	8.6
	6-10 Years	18	51.4
	More than 10 years	14	40.0
Audit committee meetings	times and more annually	35	100.0
Total		35	100.0

The respondents consists of 54% of master degree, and 17% of PhD , and 28.5% bachelor degree, which reflects the management trends in banks for having educated staff, with professional certificates as seen above 37.1% of the respondent holding CIA certificate, and 25.7% are holding CPA certificate.

##### 4.2 Internal Reliability

Coefficient of reliability (Cronbach's alpha) was used to measure the internal consistency of the paragraphs of the questionnaire for its ability to produce results compatible to the responses of respondents. Table (3) shows the results of reliability of the survey using the Cronbach's Alpha internal consistency. By reviewing the values of reliability coefficients of internal consistency; it shows that all the values are statistically acceptable and reflect consistency in a good degree which reflects the stability of the study.

**Table 3. Results of reliability analysis**

Scale	Cronbach's alpha
Objectivity of the internal auditors	.7215
Effective audit committee	.8296
Effective audit committee with authority over the CAE employment (appointment/dismissal)	.6894

##### 4.3 Data Analysis

To answer the first question of the study, "Does an effective audit committee affect the internal auditors objectivity in the banks operating in the United Arab Emirates?" Means and standard deviations are computed as presented in table 4.

**Table 4: Means and standard deviations for items related to question 1, ranked in a descending order**

Rank	N	Item	Mean	Std. Deviation
1	2	The audit committee reviews the internal auditors reports.	4.66	.591
2	12	The company has methods to assess risk.	4.49	.612
3	3	The audit committee takes immediate action related to the internal auditors reports.	4.46	.701
4	1	The company has audit committee consist of nonexecutive members of the board of directors.	4.34	.765
5	5	The audit committee adopts the internal audit department strategy and plans.	4.29	.667
6	6	The chief audit executive always attends the audit committee meetings.	4.29	.987
7	4	There is specific strategy for internal auditing in the company.	4.26	.886
8	8	Using Outsourcing to evaluate the internal audit activity.	4.17	1.098
		Total items	4.43	.474

Table 4 shows that Item 2 “The audit committee reviews the internal auditors reports” receives the highest mean (4.66) regarding the degree of agreement, followed by item 12 “The company has methods to assess risk” with mean (4.49), while item 3” The audit committee takes immediate action related to the internal auditors reports “ was ranked third with mean (4.46). This table also shows that item 8 “Using Outsourcing to evaluate the internal audit activity” occupies the last rank (mean = 4.17).

**Table 5. One-Sample Test (Test Value = 3)**

	N	Mean	Std. Deviation	t	df	Sig. (2-tailed)
H1	35	4.43	.474	17.910	34	.000

To answer the second question of the study, “Does having an effective audit committee with authority over the chief audit executive employment affects the internal auditors objectivity in the banks operating in the United Arab Emirates?” means and standard deviations were computed as presented in table5

**Table 6. Means and standard deviations for items related to question 2, ranked in a descending order**

Rank	N	Item	Mean	Std. Deviation
1	11	The internal audit department has job description (duties, responsibilities and hierarchy).	4.71	.458
2	13	The chief audit executive actively involved with the audit committee.	4.57	.608
3	7	The hiring of internal auditors is done based on specific requirements regarding the audit profession.	4.54	.701
4	10	There is organizational structure for the internal audit department.	4.54	.657
5	9	The audit committee appoints and dismisses the Chief Audit Executive.	4.34	.725
		All items	4.44	.543

Table 6 shows that item 11 “The internal audit department has job description (duties, responsibilities and hierarchy).” Receives the highest mean (4.71) regarding the degree of agreement, followed by item 13 " The chief audit executive actively involved with the audit committee." receives the highest mean (4.57) regarding the degree of agreement followed by items 7&10 " The hiring of internal auditors is done based on specific requirements regarding the audit profession “&“There is organizational structure for the internal audit department”, With mean (4.54), while item 9 “The audit committee appoints and dismisses the Chief Audit Executive." occupy the last rank (mean =4.34).

**Table 7. One-Sample Test (Test Value = 3)**

	N	Mean	Std. Deviation	T	df	Sig. (2-tailed)
H2	35	4.44	.543	15.628	34	.000

The study used (T) Test in table 8 to explain the relationship between the qualifications and the results of the study for the two questions. For the purpose of statistical analysis and to have reliable results, the PhD and the master degree were merged due to the small figure of the PhD.

**Table 8. T-test results**

	Qualification	N	Mean	Std. Deviation	t	df	Sig. (2-tailed)
H1	Master Degree	25	4.53	.385	2.116	33	.042
	Bachelor	10	4.16	.614			
H2	Master Degree	25	4.50	.436	1.197	33	.240
	Bachelor	10	4.25	.781			

Table 8 above shows there are statistically significant differences at ( $\alpha= 0.05$ ) due to qualification variable in favor of master degree for question 1, and no statistically significant differences at ( $\alpha= 0.05$ ) due to qualification variable for question 2.

The study used (T) Test in table 9 to explain the relationship between the experience and the results of the study for the two questions. For the purpose of statistical analysis, and to have reliable results we merged the experience (1-5) years with 10 years.

**Table 9. T-test results**

	Experience	N	Mean	Std. Deviation	t	df	Sig. (2-tailed)
H1	10 years or less	21	4.33	.455	-1.677	33	.103
	More than 10 years	14	4.60	.473			
H2	10 years or less	21	4.35	.589	-1.215	33	.233
	More than 10 years	14	4.57	.454			

Table 9 above shows there are no statistically significant differences at ( $\alpha= 0.05$ ) due to experience variable related to question 1 and 2, there is no relationship between the experience of (the CAE and internal auditors) and the objectivity of internal auditors.

The independent variables (effective audit committee, and effective audit committee with authority over the CAE employment (appointment/dismissal) explain 81.6% of the variance of the dependent variable (Internal auditors objectivity). Therefore these variables are the most effective ones on the objectivity of the internal auditors. See table 10.

**Table 10. R square results**

	R Square
Effective audit committee	
Effective audit committee with authority over the CAE employment (appointment/dismissal)	
Internal auditors objectivity	0.816

Regarding hypothesis 1 regression results in table 11 show that there is significant positive relationship between the effect of audit committee effectiveness and the objectivity of internal auditors at significant level  $p < 0.05$  and Beta is 0.608, and regarding hypothesis 2 regression results show that there is significant positive relationship between the effect of audit committee effectiveness with authority over the CAE employment (appointment/dismissal), and the objectivity of internal auditors at significant level  $p < 0.001$  and Beta is 0.394.

**Table 11. Regression results**

	Internal auditors objectivity (Beta)	Internal auditors objectivity (t value)
Effective audit committee	0.608*	6.375
Effective audit committee with authority over the CAE employment (appointment/dismissal)	0.394**	4.125

\*  $P < 0.05$

\*\*  $P < 0.001$

## 5. Conclusion

Considering the globalization and challenges in the United Arab Emirates economy, and because of the diverse nationalities in its culture, boards and audit committees in the bank sector are interested in having different professional qualifications in accounting and finance with diverse background.

The study indicates a significant positive relationship between audit committee effectiveness and the objectivity of the internal auditors. In contrast, however, O'Leary and Stewart (2007) in study of Australian internal auditors found that the existence of an effective audit committee had little impact on internal auditors perceptions of their willingness to act objectively. The difference in the findings can be related to the different nature of the country's economy, and having different study sample, in addition there was a huge change in the auditing profession after the financial crisis in 2008, with new rules and regulations regarding audit committees. Also the study finds that the more effective the audit committee, the more the internal auditors will act objectively. Goodwin and Yeo (2001) supports these findings through their research findings that an effective audit committee can strengthen the position of the internal auditor function by acting independent. Also the study finds significant positive effect of having effective audit committee with authority over the CAE employment (appointment/dismissal) on the objectivity of internal auditors, while Abbott et al. (2003) findings through their research results showed that an effective audit committees which also have authority over the chief internal auditors dismissals have been an incrementally negative relation with the extent of outsourcing, and where the audit committee is effective there is less outsourcing of activities which might impair the internal auditors objectivity, and Goodwin (2003) found a relationship between the dismissal of CAE and audit committee independence.

The research reveals that an effective audit committee strengthens the position of the internal audit function by increasing the internal auditors objectivity. Another interesting result of the study showed that there is statistically significant difference between the effectiveness of the audit committee members and the internal auditors objectivity related to qualifications of the internal auditors, and no relationship between the effectiveness of the audit committee members and the internal auditors objectivity related to the experience of the internal auditors. In contrast, however, O'Leary and Stewart (2007) found that more experienced internal auditors adopted a more ethical stance in some cases.

## 6. Recommendation and Limitation

Effectively functioning audit committees have proven to fulfill a vital role in strengthening the role of internal audit (Marx & Voogt 2010). The audit committee needs to educate itself more about how to enhance its effectiveness. Audit committees should spend more time with the CAE, and internal auditors, this will strengthen resistance to fraud, material weaknesses, and significant errors in financial reporting.

Audit committee members need appropriate orientation and ongoing training to fulfill their responsibilities to prompt their effectiveness, and their relationship with internal auditors, by keeping audit committee current on regulatory standards and developments.

Furthermore, this study only captured the banking sector in UAE viewpoints, for this future research need to be undertaken to cover all the sectors in the UAE, and make comparison between them, and various areas for future research needed including having traineeship programs for internal auditors regarding objectivity and how to maintain it, and investigating the relationship between top management and audit committee, and its effect on internal auditors objectivity.

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