

INTERDEPENDENCE BETWEEN AUDIT COMMITTEE AND INTERNAL AUDIT

Boris Tušek*, **Ivana Pokrovac****

Abstract

Internal audit is an indispensable resource and a source of information for the audit committee. Audit committees have to meet a number of obligations and responsibilities which is not possible without adequate communication with the internal audit. Internal audit is often seen as an "eyes and ears" of the audit committee. On the other hand, one of the key factors for the successful internal auditing functioning in an organization is a support that audit committee provides to the internal audit function. Previous studies stress out the importance of mutual interaction which is extremely important for reciprocal strengthening of each other's functions. The purpose of this paper is to investigate the relevant theoretical features of the connection between internal and Audit Committee.

Keywords: Internal Audit, Internal Audit Activity, Audit Committee

* *University of Zagreb, Faculty of Business and Economics, J.F. Kennedy 6, 10 000 Zagreb, Croatia*

** *University of Zagreb, Faculty of Business and Economics, J.F. Kennedy 6, 10 000 Zagreb, Croatia,*

Fax: 00385-1-233-5633

Tel.: 00385-1-2383-195

E-mail: ipokrovac@efzg.hr

1. Introduction

For the development of an internal audit in an organization it is extremely important that internal audit has the audit committee support. On the other hand, the realization of the role and responsibilities of the audit committee is not fully possible without relying on the internal audit results and findings. The internal audit is an indispensable resource and a source of information for the audit committee (Tušek and Žager, 2008. pp. 434-436). By that it is extremely important that audit committee can rely only on internal audit function which operates in accordance with the requirements placed on modern internal audit. Monitoring the effectiveness of internal control, internal audit and risk management system is among the most important tasks of the audit committee. It is therefore quite justified to investigate the mutual relationship between audit committees and internal audit functions.

The main focus of this paper is to determine significance of the connection between audit committee and internal audit function. The remainder of this paper will present the requirements of the International Standards for the Professional Practice of Internal Auditing regarding connection between internal audit and audit committee. Furthermore, it will present the implications of the impact of internal audit relations with Audit Committee on its activity primarily through a review of existing research.

2. Requirements of the International Standards for the Professional Practice of Internal Auditing regarding connection between internal audit and audit committee

Any area of professional activity, including internal audit, cannot exist without well-known principles and rules as the basis for the professional conduct of an activity. In this sense, the efforts have been invested in the designing and development of the overall framework of professional internal audit activity (IPPF - International Professional Practices Framework) published by the Institute of Internal Auditors (IIA - The Institute of Internal Auditors). This is a conceptual framework that identifies and summarizes guidelines (mandatory and strongly recommended) of internal audit professional activity.

In the context of the relationship between audit committees and internal audit there are several Standards and Practice Advisories that are directly or indirectly related to this issue. However, the primary is the Standard 1111- "Direct Interaction with the Board". According to the requirements of this Standard Chief Audit Executive "must communicate and interact directly with the Board." (IIA, 2011) According to Recommendation 1111-1 Board interaction, which further clarifies the previously mentioned requirement of the related Standard -1111, "direct communication occurs when the Chief Audit Executive (CAE) regularly attends and participates in Board meetings that relate to the Board's oversight responsibilities for auditing, financial reporting, organizational governance, and control. The CAE's attendance and participation at these meetings provide an opportunity to be apprised of strategic business and operational developments, and to raise high-level risk, systems, procedures, or control issues at an early stage. Meeting attendance also provides an opportunity to exchange information concerning the internal audit activity's plans and activities and to keep each other informed on any other matters of mutual interest. Such communication and interaction also occurs when the CAE meets privately with the Board, at least annually." (IIA,2011). It should be emphasized that this Standard and Practice Advisory are for the first time adopted in January 2009 and published as part of the overall International Professional Practices Framework. In this Standard and the Practice Advisory, and in all other Standards and Practice Advisories referred to below, under "Board" means the audit committee, if established and operated in company or Supervisory Board, if there is no audit committee.

In addition to mentioned Standard and Practice Advisory, requirements of other Standards and Practice advisories relating this matter are also important. According to the Standard 1110-*Organizational independence* - "the Chief Audit Executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The Chief Audit Executive must confirm to the Board, at least annually, the organizational independence of the internal audit activity. The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results (1110.A1)" (IIA, 2011). Practice Advisory 1110-1 states that "the Chief Audit Executive (CAE), reporting functionally to the Board and administratively to the organization's chief executive officer, facilitates organizational independence. At a minimum the CAE needs to report to an individual in the organization with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of engagement communications, and appropriate action on engagement

recommendations." (IIA, 2011) Chief Audit Executive (CAE - Chief Audit Executive) should directly report to the audit committee, thus ensuring independence in planning and execution of individual audit engagements. On the other hand, members of the audit committee must support the realization of internal auditing many roles and maintain its independence and encourage active co-operation between internal audit and management, through promoting internal audit as a function that can significantly add value to the organization. It is very important that members of the audit committee are persons with enough authority so that they can promote independence and reputation of the internal audit function within the organization (Bromilow and Berlin, 2005, pp.37.)

3. Roles and Responsibility of the Audit Committee

The Sarbanes-Oxley Act (2002) defines an 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"(Beasley et.al., 2009, p.67.). Audit committees have been long seen as a vital in enhancing the transparency and integrity of financial reporting. In the Anglo-American model of corporate governance, audit committee is a specialized sub-committee within the Board of Directors and is composed of independent members of the Board of Directors, while in the continental model of corporate governance with a two-tier governance structure, the Supervisory Board appoints the audit committee that performs certain monitoring tasks. An audit committee usually comprises between three and five members. Regardless of whether the Anglo-American or Continental model, the key requirement is that there should be appropriate involvement of independent, non-executive directors in monitoring the process of financial reporting, internal control and risk management. It does not relieve directors of any of their responsibilities but can assist them to fulfill those responsibilities and in order to do this, its role should be objective and independent (Deloitte, 2009). In principle, an audit committee is advisory in nature and not a prescriptive executive committee. The audit committee should not perform any management functions or assume any management responsibilities and should make recommendations exclusively to the board (Deloitte, 2009).

In the context of legal or regulatory requirements for the establishment of the audit committees' as opposed to a voluntary, it should be pointed out that the practice varies among countries. In certain countries the audit committees are mandatory for business entities the stocks of which are listed, while in other they are established as an economic necessity and a requirement for the delegation of supervisory functions.

Although the primary activity of the audit committee is to assist the Board in carrying out their responsibility regarding the overseeing the company's financial reporting requirements and interaction with internal and external audit, their responsibilities also extend to several areas that include (Mohiuddin and Karbhari, 2010, p.105.): internal control and risk management and monitoring of compliance with corporate legality and ethical Standards, including the maintenance of preventive fraud controls. According to Chambers (2005) the main activities of the audit committee include: advising Board on the reliability of financial information, advising Board in risk management and internal control, dealing with external auditors and overseeing the internal audit process.

The Institute of Internal Auditors (IIA) in the paper "The Audit Committee: Purpose – Process – Professionalism (2006) defines some detailed audit committee responsibilities which include:

- "Ensuring that financial statements are understandable, transparent and reliable.
- Ensuring the risk management process is comprehensive and ongoing, rather than partial and periodic.
- Helping achieve an organization wide commitment to strong and effective internal controls, emanating from the tone at the top.
- Reviewing corporate policies relating to compliance with laws and regulations, ethics, conflicts of interest, and the investigation of misconduct and fraud.
- Reviewing current and pending corporate-governance-related litigation or regulatory proceedings to which the organization is a party.
- Continually communicating with senior management regarding status, progress, and new developments, as well as problematic areas.
- Ensuring the internal auditors' access to the audit committee, encouraging communication beyond scheduled committee meetings.
- Reviewing internal audit plans, reports, and significant findings.
- Establishing a direct reporting relationship with the external auditors."

An effective audit committee will assist directors in discharging their duties relating to the mentioned areas and will also give rise to the following benefits (Deloitte, 2009):

- “It will assist in establishing and strengthening the independence and objectivity of the directors and the internal and external auditors.
- There will be improved communication and increased contact, understanding and confidence between directors, management and the internal and external auditors.
- There will be increased internal and external auditors’ accountability as their performance will be under greater scrutiny.
- It will help to create a climate of discipline and control which will reduce the opportunity for fraud.
- A more cost efficient and effective external audit will result. This will benefit both the company and the auditor.
- The objectivity and credibility of financial reporting will be strengthened and with appropriate communication, these benefits can be conveyed to stakeholders with the inclusion a statement from the audit committee in the annual report.”

Regarding the responsibilities of audit committees for internal audit process, Wolnizer (1995) noted that they are expected to (Mohiuddin and Karbhari, 2010, p.107.):

- “Evaluate the independence and competence of internal audit function;
- Discuss with the chief of internal auditors about internal audit reports, effectiveness of internal controls and problems in performing the internal audit;
- Review the scope of internal audits planned for the year;
- Review management's response to internal auditors' recommendations;
- Review and approve internal audit budget;
- Review the relationship between internal and external auditors and coordination of their work and
- Appoint and dismiss the head of internal audit.”

The committee should review the nature of the work performed by internal audit to ensure that it is achieving its objectives. Also, it is necessary to co-ordinate the activities of the external and internal auditors to avoid duplication of effort and to obtain maximum benefit from internal audit activities (Deloitte, 2009).

4. Some aspects of connection between Audit Committee and Internal Auditing

According to the IIA „the audit committee and the internal auditors are interdependent and should be mutually accessible, with the internal auditors providing objective opinions, information, support, and education to the audit committee; and the audit committee providing validation and oversight to the internal auditors. The critical connection between audit committee effectiveness and internal auditing mandates that committee members maintain an in-depth understanding of internal audit best practices and how their internal audit activity is functioning.“(IIA,2006). IIA proposes 20 questions that will serve as a tool to trigger awareness of the areas for which committee members might need more information in the process of understanding internal audit practices, and they include the following (IIA, 2006):

1. “Should we have an internal audit activity?
2. What should our internal audit activity do?
3. What should be the mandate of our internal audit activity?
4. What is the relationship between the internal auditors and the audit committee?
5. To whom should the internal auditors report administratively?
6. How is the internal audit activity staffed?
7. How do the internal auditors get and maintain the expertise they need to conduct their assignments?
8. Are the activities of our internal auditors appropriately coordinated with those of the external auditors?
9. How is the internal audit plan developed?
10. What does the internal audit plan not cover?
11. How are internal audit findings reported?
12. How are our corporate managers required to respond to internal audit findings and recommendations?
13. What services do our internal auditors provide regarding fraud?

14. How are we assured of internal audit effectiveness and quality?
15. Does our internal audit activity have sufficient resources?
16. Does our internal audit activity have appropriate support from the CEO and senior management team?
17. Are we satisfied that this organization has adequate internal controls over its major risks?
18. Are there any other matters that should be brought to our attention?
19. Are there other ways in which we and our internal auditors might support each other?
20. Are we satisfied with our internal audit activity?"

Looking at the internal organization of the internal audit department, at the highest hierarchical level in the organizational structure is a chief audit executive (CAE). He is responsible for the realization of the obligations and responsibilities of internal audit department and the person who represents the internal audit department. In this context, the relationship between audit committees and internal audit to a large extent depends on the relationship and communication between members of the audit committee and CAE. It is therefore logical that the audit committee has a direct interest to participate in the election and the appointment of CAE. Related to this, the audit committee should assess the skills and knowledge and all needed to meet the individual responsibilities of CAE.

The way the audit committee's participates in the appointment of the CAE may differ. Most commonly audit committee approves and confirms the choice of CAE appointed by management and rarely is directly and solely involved in this decision. According to some research (Bromilov and Berlin, 2005, p. 37.) 6% audit committees have the full responsibility for appointing CAEs, 41% audit committees have a shared responsibility with the management, while 53% (most of) audit committees approves or confirms the managements appointment of CAE. According to the aforementioned global internal audit profession study, published by The Institute of Internal Auditors Research Foundation (IIARF) Common Body of Knowledge (CBOK) which relate solely to the results from European countries, in 55% CAE is appointed by the Chief Executive Officer, in 44% of cases in the appointment of CAE is included Chairman of the Supervisory Board, while in 34% the audit committee. According to a survey (PWC and CIIA, 2009, p. 37.) of the internal audit practice in Croatia in 2009, in most cases (62%) CAE is appointed by the Management Board, while in banking sector in almost 50% cases the CAE is appointed by the Supervisory Board.

With the appointment of the CAE, audit committee should have an active role in evaluating and reviewing his results. The questions that audit committee may take into consideration when evaluating the main internal auditors is listed below (Bromilov and Berlin, 2005, p.39.):

- How does CAE respond to the activities of the audit committee?
- To what extent is the CAE acquainted with accounting policies and financial reporting of a company?
- To what extent do senior management and external auditor take into account the CAE?
- Does CAE give assurance regarding areas and engagements that are initiated by the Board itself?
- To what extent is CAE appreciated by the audit profession?

In the context of evaluation or assessment of CAE by the audit committee it is important and that the audit committee is aware and agrees with the compensation policy relating to the CAE. According to a study in which participated members of audit committees' majority (83%) of them assess CAE and generates inputs for their individual compensation. Assessments are carried out periodically, mainly through joint meetings of the audit committee and CAE.

Since the audit committee has appropriate authority regarding appointment of CAE, it is logical that it should participate in eventual dismissal decision. This is particularly important in order to eliminate the possibility of a unilateral dismissal of the CAE by management which may have some unacceptable motives such as the restriction of the internal audit department activity. According some research (Bromilov and Berlin, 2005, p. 39.) 73% of CAEs agrees with the statement that management can not dismiss the CAE without the approval of the audit committee.

Open communication between audit committees and internal audit is also one of the most important factors in their mutual relation. It should not be forgotten that communication is a two way process. This means that the efforts on the both sides are necessary. Internal audit, on the one hand must be prepared to communicate with the audit committee on a number of issues or specific requirements and audit committee on the other hand must be prepared to accept reasoned internal audit conclusions and findings

and must be determined to act accordingly. In other words, the audit committee must create positive climate and show cooperation in order to enable CAE to participate in any area that requires special attention of the audit committee.

As mentioned, key issues of the internal audit organizational role are related to its relationship with the Audit Committee. Previous research indicate the importance of functional reporting to the Board and administrative to the organization's Chief Executive Officer (Goodwin and Yeo, 2001; Sarens and De Beelde, 2005, 2006) According to research conducted by PricewaterhouseCoopers and the Croatian Institute of Internal Auditors in 2009 about internal audit practice and organization in Croatia, the most common reporting system in the current practice of internal auditing in Croatia is reporting to executive management (CEO, Executive Director, General Manager). On the question "to whom within your organization CAE or external service provider functionally reports" the majority (84%) of respondents answered "to General Director or CEO", 45% of them answered "to the Supervisory Board", and only 21% of respondents answered that they are functionally reporting to the Audit Committee. In comparison with the global PwC survey on internal audit, more than 90% of global respondents are functionally reporting to the Audit Committee." (PwC and CIIA, 2009, pp.25). According to the global research of internal audit profession in 2006, Common Body of Knowledge (CBOK) conducted by The Institute of Internal Auditors Research Foundation (IIARF), of total of 769 subjects (IIA) from 21 European countries, 36% of respondents believe that the internal audit function ensures independence by reporting directly to the Audit Committee while others report to target groups that fall within the scope of executive and senior management as well as in the previously mentioned study in Croatia (ECIIA, 2009, p.30.).

The growing role and importance of Audit Committees and internal audit in recent years, have influenced on greater study of their interaction (see for example Goodwin and Yeo, 2001; Goodwin, 2003; Gramling, Maletta, Schneider and Church, 2004; Raghunandan, Read and Rama 2001.) According to some research (Bromilow and Berlin, 2005, pp.35) more than 80% of the Audit Committee Chairman believes that the primary role of internal audit is related to assurance regarding functioning of the internal controls. Monitoring the effectiveness of internal control, internal audit and risk management system is among the most important tasks of the Audit Committee. It is therefore quite justified to investigate the mutual relationship between Audit Committees and internal audit functions. Gramling et.al. points out that quality connection between the internal audit function and Audit Committee provides a supportive environment to internal audit to carry out its activities related to risk assessment, control effectiveness and compliance (Gramling, 2004., p 198). Interaction is stressed out as very important both for internal audit and the Audit Committee (Bishop et.al., 2000; Goodwin, 2003).

Stewart and Subramaniam (2010) in their paper related to internal audit independence and objectivity synthesized existing body of knowledge relating inter alia the relationship between internal audit and the audit committee. According to their findings, most research related to organizational status of internal audit is focused on the relationship between internal audit and the audit committee. The following will illustrate some of them.

According to the IIA global survey research whose results are summarized in the CBOK study (Burnaby et. al., 2007) only 47% of CAE reported to the Audit Committee level were an Audit Committee was present (in 73% organizations), however, 91% respondents considered to have appropriate access to the Audit Committee, in those companies where it exists. Although the above studies analyzed the link between internal audit and the audit committee, little is known about the importance and impact of the qualification structure of the audit committee members on the position of the internal audit function. Raghunandan et. al. (2001) assessed the joint effect of the Audit Committee independence and expertise on its interaction with internal audit and concluded that the independent committees with at least one member with accounting/auditing expertise had longer meetings and direct communication with the CAE. Regular meetings between committee and internal audit provide Audit Committee better information on the relevant auditing and accounting issues and can be interpreted as Audit Committee's support to the internal audit function. In their study, Goodwin and Yeo (2001) examined the factors that may affect the independence and objectivity of internal audit, and one of which was the relationship with the Audit Committee. According to a survey results, among internal auditors in Singapore, there is a strong link between the internal audit function and Audit Committee, and the level of interaction is increased when the internal auditors communicate with the Audit Committee comprised solely of independent members. Goodwin (2003) considered that the maximum benefit from the interaction

between internal audit and the Audit Committee can be expected if members of the Audit Committee have technical expertise to understand the work of internal audit, together with the independence to enhance the status of internal audit (Sarens and De Beelde, 2006, pp.9.). The results of these studies suggest the following conclusion: effective audit committees, i.e. committees with independent and qualified/competent members positively affect the independence and objectivity of internal audit, and consequently on its effectiveness.

According to researches cited by Stewert and Subramaniam (2010), which are mainly based on interviews conducted among internal auditors and the members of the Audit Committees, internal audit relationship with the Audit Committee can strengthen the status of internal audit in favor of maintaining the independence and objectivity in their work (Mat Zain and Subramaniam, 2007; Turley and Zaman, 2007), and internal audit is considered a significant source of information that is of great help to the Audit Committee in fulfilling its responsibilities (Raghunandan et al., 2001, Goodwin and Yeo, 2001.), so it can be concluded that they have a very important relationship with a reciprocal strengthening of each other's function (Sarens and De Beelde, 2006., p. 7).

According to research conducted by Sarens and De Beelde (2006) in the case of Belgian companies, by analyzing the expectations and perceptions of internal auditors and the Audit Committee, both groups of respondents have high expectations in terms of their relationship. Members of the Audit Committee expect from internal audit strong information support (through reports), through which they will demonstrate and communicate their contribution to the monitoring and functioning of the organization and to play both an active and proactive role in risk management and activities, and proactive in managing risks. Internal auditors on the other hand complained about the limited interaction they have with Audit Committee and opportunities to participate in Audit Committee meetings and also with the follow up their findings and recommendations receive.

Spira (1999) points out that one of the advantages of Audit Committee establishment is strengthening the position of the internal audit function especially for support that Audit Committee provides to Internal Audit (Sarens and De Beelde, 2006, pp.8.). Bishop (2000) gave an overview of the supporting roles that internal audit can have in relation to the Audit Committee, which correspond with the responsibilities of the Audit Committee and include general assistance, financial reporting assistance, risk and control assistance with (Sarens and De Beelde, 2006, pp.9.). General assistance includes facilitating the information flow of to the Audit Committee or performing special projects or investigations, as requested by the Audit Committee. Financial reporting assistance relates to supporting the Audit Committee in its evaluation whether or not the company has satisfied its internal and external reporting objectives, supporting the committee in its assessment of the quality of financial reporting, providing information regarding the strength of controls through over the quarterly reports or assuring committee members that they are receiving reports with relevant and timely business performance measures. Risk and control assistance relate to supporting the Audit Committee in its evaluation of whether the company has satisfied its control objectives, providing information that will assist the Audit Committee monitor the company's control environment, and providing information that may be of assistance to the Audit Committee in monitoring key financial and business risks company is facing (Sarens and De Beelde, 2006, pp.8.).

The Institute of Internal Auditors (IIA) in 2010 released its most comprehensive study conducted on the practices of internal audit globally *Global Internal Audit Survey*. One of the research reports resulting from the study, *Imperatives for Change: The IIA's Global Internal Audit Survey in Action (Report V)*, provides imperatives for change in the future and recommendations for chief audit executives (CAEs) to prepare them to meet the changing needs of internal audit. One of the imperatives is an effective relationship with the audit committee which is fundamental to the success of internal audit.

Institute of Internal Auditors Research Foundation (IIARF) in 2010 published its most comprehensive research conducted on the practices of internal audit at the global level *Global Internal Audit Survey*. A comprehensive database included more than 13,500 responses from respondents in more than 107 countries. One of the research reports arising from the study *Imperatives for Change: The IIA's Global Internal Audit Survey in action (Report V)*, provides insight and recommendations to the Chief audit executives to prepare them to meet the changing needs of internal audit. One of the imperatives is an effective relationship with the audit committee which is fundamental to the success of internal audit. According to the report „gaining and maintaining audit committee support is essential to CAE success. On the one hand, the audit committee needs a clear, periodic, and concise update on the internal audit

activity, including both recommendations and challenges from the CAE. On the other hand, the audit committee is the CAE's best ally and must work through the audit committee chair to persuade management to provide internal auditing with the budget and resources the activity needs to achieve the internal audit plan."

5. Conclusion

Direct communication of the CAE with the Audit Committee, according to Standards, reinforces the organizational status of internal auditing, enables full support and unrestricted access to organizational resources and ensures that there is no impairment to independence. Previous studies have shown that the supervisory role of the Audit Committee contributes to the effectiveness of the internal audit function by providing a supportive environment and internal audit is seen as an important source of information that is helpful to the Audit Committee in fulfilling its supervisory activities. It is also noted that maximum benefit from the interaction between internal audit and the Audit Committee can be expected if members of the Audit Committee, together with the independence, have technical expertise in order understand the work of internal audit.

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