

# **The Influence of Internal Auditing on Effective Corporate Governance in the Banking Sector in Oman**

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Doi: 10.19044/esj.2018.v14n7p257 [URL:http://dx.doi.org/10.19044/esj.2018.v14n7p257](http://dx.doi.org/10.19044/esj.2018.v14n7p257)

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## **Abstract**

This research aims to examine the influence of internal audit on effective corporate governance in commercial banks listed on Muscat Securities Market (MSM) in Oman. A questionnaire was used to collect data and was distributed to the 100 top senior level officials and internal audit department of the commercial banks. The regression model that was used in this study was five dependent variables: internal audit independence; proficiency and due professional care; nature of work; quality assurance and improvement program; and managing the internal audit activity.

The finding of the research establishes a significant positive relationship between internal audit and effective corporate governance. Variables internal audit independence, proficiency and due professional care, and nature of work were significantly associated with corporate governance. For quality assurance and improvement program and managing the internal audit activity, their influence on corporate governance is not statistically significant.

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**Keywords:** Internal audit, Corporate governance, Commercial Banks, Oman

## **Introduction**

The financial problems experienced by many companies in the world in recent years have led to the need for a set of ethical and professional controls and principles to achieve confidence and credibility in the information contained in the financial statements. The function of the audit plays an important role in all institutions. It provides the senior management with the necessary information that helps in making decisions and also provides

information on the efficiency and effectiveness of the internal control system applied in these institutions.

It has been widely recognized that the role of the internal auditor has become increasingly more important in terms of creating good corporate governance structures (Allegrini et al., 2006; Carcello et al., 2005; Nagy & Cenker, 2002).

Corporate governance is the process by which organizations are managed and controlled (Gao et al., 2008). Larcker (2007) asserted that corporate governance mechanisms influence the decisions made by managers when there is separation of ownership and control. Thus, this is in a bid to enhance accountability and efficiency, and to ensure quality of the financial reporting process. Corporate governance is a key issue in the banking sector in general and aims at improving the performance in this important sector.

The concept of the relationship between internal control and corporate governance can be defined as the process and structure used to direct and manage the business affairs of the bank towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders' long-term value while taking into account the interest of other stakeholders (Capital Market Authority (CMA), 2015).

Consequently, a relationship between corporate governance and internal audit and to what extent this relationship contributes to business performance has been relatively under-researched. Theoretically, an organization with effective system of internal control is expected to achieve its objective efficiently and effectively, which is regarded as good corporate governance. On the other hand, an Organization with weak system of internal control will experience bad corporate governance. Also, the lack of internal controls and their deficient operation make companies vulnerable to a number of risks, such as improper recording of accounting transactions, making unauthorized transactions, fraud, all these having a significant impact on financial performance and competitiveness (Mihaela & Iulian, 2012).

Empirically, the researchers found a positive relationship between internal control and corporate governance. Pratolo (2007) found that effective internal control has positive relationship with good corporate governance at State Owned Enterprises in Indonesia (SOEs). Mensah (2003) found empirical evidence in Ghana that effective internal control improves good governance practices and decreases corruption. Based on the same view to these findings, Nila and Viviyanti (2008) also found that internal control has a positive relationship with good corporate governance at State owned enterprises in West Java Indonesia.

In Oman, in addition to old code (2002), a new Code of Corporate Governance was issued for Public Listed Companies in July 2015 by Capital Market Authority (CMA). The purpose of corporate governance is to set out

processes by which corporates are controlled and directed to create efficient enterprises which contributes to building a strong, transparent, and competitive national economy (CMA, 2015).

Despite the internal audit function has become an important mechanism for corporate governance, little research has been done on the effectiveness of internal audit and control and its relationship with corporate governance in Oman. Therefore, this study attempts to minimize the literature gap by examining the relationship between internal control and corporate governance in the context of Oman as a developing country.

The main objective of this research is to examine the relationship between the Internal Audit Function (IAF) and Corporate Governance (CG) in the banking sector in Oman. Furthermore, this research tries to answer the following questions:

What are the levels of implementation of Internal Audit in the banking sector in Oman?

What are the levels of implementation of corporate governance in the banking sector in Oman?

What is the impact of internal audit in strengthening corporate governance in the banking sector in Oman?

To achieve the above objectives, a questionnaire survey of commercial banks in Oman was carried out, enquiring corporate managers' views on corporate governance and the role of internal auditors.

## **Literature Review**

This literature presents the internal auditing concepts and functions, theoretical background of corporate governance, and the relationship between internal audit and corporate governance.

### **Internal Auditing Functions and Standards**

Historically, internal audit has been considered as a monitoring function. It is regarded as the “organizational policeman and watchdog” (Morgan, 1980). However, it is tolerated as a necessary component of organizational control but deemed subservient to the achievement of major corporate objectives.

According to the Institute of Internal Auditors (IIA), internal auditing has been defined as “an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations” (Nagy & Cenker, 2002). Also, Internal control is defined by Al- jabali et al. (2011) as: Independent activity objectively, confirmatory, and consultant determined to add value and improve the organization's operations, and in helping them achieve their objectives through a systematic and disciplined method to evaluate and improve the effectiveness of risk management and

control processes and governance. Currently, internal auditors can be portrayed as consultants and the internal audit function of companies which is used to achieve corporate objectives and add value. As noted by Sarens and De Beelde (2006), internal auditors are currently expected to make things happen rather than just waiting to respond to it.

It is argued that an effective internal audit function enables the board to perform its corporate governance duties. For example, Gramling et al. (2004) believed that the internal audit function is one of the four cornerstones of corporate governance, and that the internal auditing function of internal auditors has an important role to play in assisting the board to monitor the effectiveness of its governance.

In developed countries, the role of the internal auditor has recently been affected by the dramatic changes in regulations, mainly from corporate governance standards and the emphasis of strengthening the internal controls of organizations of these standards (Holm & Laursen, 2007).

Mihret and Yismaw (2012) stated that internal audit effectiveness can be guaranteed with the help of four interlinked components: internal audit quality, management support, organizational setting, and attributes of the auditees. They argued that the internal audit function needs to be able to produce quality audits. Vinten (1999) believes that internal audit effectiveness is achieved when there is independence, sufficient resources, and support from management.

International Standards for the Professional Practice of Internal Auditing (Standards) is essential in meeting the responsibilities of internal auditors and the internal audit activity.

The Institute of Internal Auditors (IIA) 1978 issued the Internal Audit Standards as follows: Independence and Objectivity, Proficiency and Due Professional Care, Quality Assurance and Improvement Program, Nature of Work, and Managing the Internal Audit Activity.

## **Corporate Governance**

Corporate governance has received increased attention and scrutiny over the last two decades. Corporate governance is defined as the total operations and controls of an organization (Fama & Jensen, 1983) or as an overall structured system of principles (Dey Committee, 1994). A comprehensive definition proposed by John and Senbet (1998) in their study stated that corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected. More recently, Roe (2004) defines corporate governance as the relationships that exist at the top of the firm: the board of directors, the senior managers, and the stockholders.

Corporate governance is based on a set of attributes, including ensuring accountability to shareholders or stakeholders (Keasey & Wright, 1997). It is considered to be the top extensively studied topics which serve as a tool for mitigating conflicts of interests between managers and investors. Corporate governance primarily aims to protect the capital owners from the opportunistic activities of management (Abdurrouf, 2011; Jensen & Meckling, 1976; Pandya, 2011). In addition, corporate governance offers the directors the right to create effective decisions in favor of the shareholders' interests in order to realize goals (Shleifer & Vishny, 1997). It is evident that firms with superior corporate governance enhanced their operating performance (Irina & Nadezhda, 2009).

Corporate governance represents “the system by which companies are directed and controlled” (Cadbury, 2000, 8). The control aspect of corporate governance includes the notions of compliance, accountability, and transparency (MacMillan et al., 2004).

### **The Relationship between Internal Auditing and Corporate Governance**

It has been widely recognized that the role of the internal auditor becomes increasingly more important in terms of creating good corporate governance structures (Allegrini et al., 2006; Carcello et al., 2005; Nagy & Cenker, 2002). In today's business environment, internal auditors are now providing management with a far broader range of information concerning the organization's financial, operational and compliance activities to improve effectiveness, efficiency, and the economy of management performance and activities (Rezaee, 1996). Corporate governance is expected to enhance the role of the internal auditor; and at the same time, the internal auditor also provides benefits to the external auditor (Holm & Laursen, 2007).

Mihaela and Iulian (2012) analyzed the effectiveness of internal control and the Impact of Corporate governance on companies listed on Bucharest Stock Exchange. An effective internal control leads to a fair presentation of the financial statements and thus increases stakeholders' confidence in the financial statements. In addition, Yassin et al. (2012) carried out a research that examines the relationship between internal audit and corporate governance in various commercial banks in Lebanon. The statistical analysis showed several significant tests supporting the hypothesis that the internal audit improves the quality of corporate governance.

Kibet (2008) in his study carried out a survey on the role of internal audit in promoting good corporate governance in State owned Enterprises (SOEs'). His survey, however, is aimed to explore the role and the use of internal audit function in promoting good corporate governance in public sector enterprises and also the challenges faced by the internal auditors in SOEs. The study concluded that internal audit function played a significant

role in corporate governance. Siddiqui and Podder (2002) examined the effectiveness of financial audit of banking companies operating within Bangladesh. For the purpose of this study, the audited financial statements of 14 sample banking companies have been analyzed. The study identifies seven (7) sample companies that have actually overstated their profits. Also, the research explores the level of independence, objectivity and competence of the auditors, assigned for auditing banking companies.

From the above discussion, it is clear that the internal auditing is probably one of the most dynamic and yet important subjects to come to our attention and become increasingly more important in terms of creating good corporate governance structures.

From the above, it is clear that the regulation of corporate governance is the government's attempt to ensure that the corporation pursues its defined purposes and protects the interests of its owners (Chang et al., 2006).

### **Hypothesis Development**

As we illustrated earlier, the main objective of this research is to investigate the impact of internal auditing on effective corporate governance. Internal auditing is an integral part of the corporate governance mosaic in both the public and the private sectors (Cohen *et al.*, 2002). In the previous literature, there are many research that analyzed the effectiveness of internal control and its Impact on corporate governance. Thus, the majority of the results present that the internal audit improves the quality of corporate governance. In Oman, the old code on corporate governance (the “Old Code”) was issued in 2002. Before the introduction of the new code in 2015, banks were the only entities that were forced to implement corporate governance. The role for a compliance governance in a bank is vital as its role is to investigate and manage the areas of banking regulations and laws, banking policies, and consumer protection. Also, little research of managers' perceptions on the impact of internal auditor on corporate governance in Oman has been conducted.

In order to study the impact of internal audit on effective corporate governance, the following dependent and independent variable were used:

#### **Dependent variable: Corporate governance.**

Independent variables: Five independent variables were chosen for the study. They are:

- 1-Internal audit independence
- 2-Proficiency and due professional Care
- 3- Nature of work
- 4-Quality assurance and improvement Program
- 5- Managing the internal audit Activity

Some of the above mentioned variables were used by the study of Vinten (1999), Yassin et al. (2012), and Kibet (2008).

On the basis of the relationship and variables discussed above, the following hypotheses were formulated and tested:

H1: Internal audit independence has a significant impact on corporate governance

H2: Proficiency and due professional Care has a significant impact on corporate governance

H3: Quality assurance and improvement Program has a significant impact on corporate governance

H4: Quality assurance and improvement Program has a significant impact on corporate governance

H5: Managing the internal audit activity has a significant impact on corporate governance

## Research Method

As the research in this area is very descriptive in nature, a survey questionnaire is considered to be the best approach to collect the data (Alleyne et al., 2006; Paper et al., 2003). The study population consists of internal auditors working in Omani commercial banks listed in Muscat Security Market. The research method of this study was a constructed questionnaire, which was sent to the 100 top senior level officials and the internal audit department of the commercial banks in Oman.

The questionnaire was designed to seek management perceptions on corporate governance and the role of internal audit. The questionnaire covers some important issues relating to the enhancement of the corporate governance system.

Subsequently, the regression model that was used in this study is;

$$CG = a + B_1X_1 + B_2X_2 + B_3X_3 + B_4X_4 + B_5X_5 + \epsilon$$

Where: CG = Effective corporate governance; a = constant term, X1 = internal audit independence; X2 proficiency and due professional care; X3 = nature of work; X4 = quality assurance and improvement program; X5 = managing the internal audit activity,  $\epsilon$  = Error Term.

## Results

**Table 1.** Means and standard deviations of Independence of internal auditors

Number	Description	mean	Std	Rank
1	The internal audit department has an organizational independence and ability to communicate with the board of directors and senior management.	4.28	.687	3
2	The internal auditor is independent to audit all activities.	4.23	.770	1

3	The internal auditor's performance is objectivity as neutral, unbiased and non-conflict of personal interests with all parties.	4.19	.736	5
4	The recommendations of the internal auditor shall be taken in all financial and administrative aspects.	4.17	.838	2
5	The internal auditor is independent since the executive departments are not interfering in the appointment, identification of fees, and remuneration of the auditor.	3.6	1.04	4
Average		4.1	0.578	

Table 1 shows that respondents confirmed on the third paragraph, with the most approval, have a mean 4.28 and Std .687. This paragraph shows that “the internal audit department has an organizational independence and the ability to communicate with the board of directors and senior management.” Also, it should be noted that the fourth paragraph represent the lowest acceptance of the respondents with mean 3.6 and Std 1.042. The paragraph shows “the independence of internal auditor since the executive departments are not interfering in the appointment, identification of fees, and remuneration of the auditor.” The total average of all factors is 4.1. Therefore, this indicates that the level independence of internal auditing was high in banking sectors in Oman.

**Table 2.** Means and standard deviations of Proficiency and Due Professional Care

Number	Description	Mean	Std	Rank
1	Internal auditor is continuously trained on professional standards.	4.32	.824	1
2	The internal auditor is skilled in the performance of work and scientific and practical qualifications.	4.22	.717	3
3	The Internal Auditor has communication skills, persuasion, teamwork, and dialogue skills.	4.19	.736	2
4	The internal auditor has the ability to handle the computer.	4.16	.74	5
5	The internal auditor is strengthened by their definition of IT and technology.	4.13	.636	4
6	The internal auditor has experience and knowledge of all laws and authorities.	4.10	.878	6
7	The internal auditor has accumulated experience in economics, taxation, finance, and law.	3.80	.705	7
Average		4.13		

From Table 2 above, the respondents confirmed on the first paragraph, with the most approval, shows a mean 4.32 and Std .824. This paragraph shows that “the Internal auditor is continuously trained on professional standards,” while the fourth paragraph represent the lowest acceptance of the respondents with mean 4.09 and Std.705. The paragraph shows that “the Internal Auditor has accumulated experience in economics, taxation, finance, and law.” The



total average of all paragraphs is 4.1. Therefore, this indicates that the level of proficiency and due professional care of internal auditing was high in banking sectors in Oman.

**Table 3.** Means and standard deviations of Nature of work

Number	Description	Mean	Std	Rank
1	The internal audit department contributes to the control and protection of the Bank's assets.	4.48	.591	1
2	The Internal Audit Department contributes to maintaining the integrity of financial and operational information within the Bank.	4.35	.688	3
3	The effectiveness of the role of internal audit in the follow-up and conduct of the bank's business properly.	4.32	.697	4
4	The internal audit department does a separate work from the Internal control department.	3.84	.925	2
	Average	4.16		

From Table 3 above, the respondents confirmed on the first paragraph, with the most approval, shows a mean 4.48 and Std .688. This paragraph shows that “the internal audit department contributes to the control and protection of the Bank's assets.” While the fourth paragraph represent the lowest acceptance of the respondents with mean 3.84 and Std .925, the paragraph shows that “the internal audit department does a separate work from the Internal Control department.” The total average of all paragraphs is 4.16. Therefore, this indicates that the level of nature of work for internal auditing was high in banking sectors in Oman.

**Table 4.** Means and standard deviations of Quality Assurance and Improvement Program

Number	Description	mean	Std	Rank
1	The auditor collects and examines all information to obtain results that support his review.	4.29	.576	2
2	The auditor will write the report and communicate the results of the audit work to the bank.	4.29	.708	3
3	The auditor plans and checks each review.	4.27	.628	1
4	The auditor follows up and ensures that the correct procedures are taken in the light of the audit results.	4.21	.678	4
	Average	4.27		

From Table 4 above, the respondents confirmed on the second paragraph, with the most approval, shows a mean 4.29 and Std 576. In this paragraph, “the auditor collects and examines all information to obtain results that support his review.” While the fourth paragraph represent the lowest acceptance of the respondents with mean 4.21 and Std .678, “the auditor follow up and ensure that the correct procedures are taken in the light of the audit results.” The total average of all paragraphs is 4.27. This indicates that the level of quality assurance and Improvement program for internal auditing was very high in banking sectors in Oman.

**Table 5.** Means and standard deviations of Managing the Internal Audit Activity

Number	Decryption	mean	Std	Rank
1	The internal audit Manager prepares risk plans to prioritize internal audit activity.	4.25	.726	1
2	The Internal Audit Manager shall develop a program to evaluate the work of the Internal Audit Section.	4.20	.740	5
3	The audit executive will communicate and follow up the internal audit activity plans.	4.15	.783	2
4	The Internal Audit Manager shall develop the policies and procedures necessary to guide the internal audit work.	4.13	.690	3
5	The internal audit manager coordinates with the internal and external parties that provide the services.	4.05	.855	4
	Average	4.16		

From Table 5 above, the respondents confirmed on the first paragraph, with the most approval, shows a mean 4.25 and Std.726. This paragraph was “The internal audit Manager prepares risk plans to prioritize internal audit activity.” While the fourth paragraph represent the lowest acceptance of the respondents with mean 4.05 and Std .855, “the internal audit manager coordinates with the internal and external parties that provide the services.” The total average of all paragraphs is 4.16. Therefore, this indicates that the level of quality assurance and Improvement program for internal auditing was high in banking sectors in Oman.

**Table 6.** Means and standard deviations of the level of Corporate Governance in Banking Sector in Oman

Number	Decryption	Mean	Std	Rank
1	Corporate governance encourages the Bank's growth, competitiveness.	4.29	.635	5
2	Corporate governance respects the rights of stakeholders as prescribed by law and ensure compensation in case of violation of their rights.	4.27	.826	1
3	Corporate governance leads to integrity, disclosure, transparency, responsibility, and equality.	4.20	.740	4
4	Governance achieves financial sustainability objectives, growth, and business development.	4.16	.741	6
5	Achieve equity among shareholders through controls based on law and order.	4.15	.719	7
6	Achieve sustainable growth and encourage profits.	4.15	.720	10
7	Ensuring the application of accounting standards to prevent corruption and mismanagement.	4.14	.880	11
8	Ensure a review of financial performance, reduce the cost of financing, and comply with provisions.	4.11	.647	2
9	Encourage institutions to make optimal use of their resources.	4.10	.711	3
10	Protecting shareholders and preventing conflict of objectives and conflict of authority.	4.08	.779	12
11	Addressing imbalances in financial structures.	3.96	.767	9

12	There is a separation between ownership, management, and control of work.	3.79	.913	8
Average		4.11		

From Table 6 above, the respondents confirmed on the fifth paragraph, with the most approval, shows a mean 4.29 and Std .635. This paragraph shows that “the corporate governance encourages the Bank's growth, competitiveness.” While the eighth paragraph represents the lowest acceptance of the respondents with mean 3.79 and Std .913, it however shows that “there was a separation between ownership, management, and control of work.” The total average of all paragraphs is 4.11. Therefore, this indicates that the level of corporate governance was high in the banking sectors in Oman.

### Testing the Hypotheses of the Study

The main hypothesis is that there is no statistically significant impact of the internal audit on corporate governance in the Omani banking sector.

To test this hypothesis, multiple regression and simultaneous input were used. All independent variables were introduced into the regression equation at once. The following tables illustrate this.

**Table 7.** The model of the impact of the internal audit in strengthening corporate governance in the Omani banking sector

Standard error for estimation	Modified coefficient	coefficient of determination	Coefficient of correlation
.37166	.460	.493	.702

Table 7 shows that the coefficient of correlation between the independent variables and the dependent variable (corporate governance) was 0.702, while the modified coefficient of the model is equal to 0.460. This indicates that independent variables collectively account for 46% of the variation in corporate governance, and the rest are due to other factors. This ratio is good and supports the results of the research.

**Table 8.** Analysis of the individual variance of internal audit role levels on governance

Source of Contrast	Total squares	Degrees of freedom	Average squares	F Value	Significant
Regression	10.456	5	2.091	15.140	.000
Errors	10.774	78	.138		
Total	21.230	83			

Table 8 above presents that the value of the regression model (F) was 15.140 and the statistical significance is 0.000. This means it is less than the statistical significance level (0.01). Therefore, the results confirm that there is a statistically significant effect of internal audit on corporate governance in the banking sector in Oman, and the level of statistical significance (0.01). This

result indicates that the model is significant and the internal audit is expected to affect corporate governance in the banking sector in Oman. As a result, the decision is to accept the hypothesis of the research (H0) that there is a significant impact of internal audit on the effective corporate governance in the banking sector in Oman. This result can be confirmed in Table 8, which shows the regression coefficients of the influence of internal audit on corporate governance.

Table 8. The regression coefficients of the influence of internal audit on corporate governance

Source of Variance	T value	B	Significant
Constant	.782	1.911	.06
Internal audit independence	.119	1.298	.004
Proficiency and due professional Care	.314	2.952	.004
Nature of work	.306	3.19	.003
Quality assurance and improvement Program	.095	.832	.408
Managing the internal audit Activity	.631	-.482	.042

Table 8 shows that the regression coefficients of the nature of work, Internal audit independence, proficiency and due professional care, and nature of work were statistically significant at 0.01. On the other hand, quality assurance and improvement program and managing the internal audit activity were not significant at the level of 0.01 and 0.05.

### Conclusion and Future Research

The primary objective of the research is to investigate the direct relationship between the internal audit and effective corporate governance in the banking sector in Oman. This section provides a discussion of the results concerning the impact of internal audit on corporate governance in the banking sector in Oman. The independent variables were Internal audit independence; proficiency and due professional care; Nature of work; quality assurance and improvement program and managing the internal Audit Activity. The sample consisted of 100 banks within the duration of three years (2014-2016). Multiple regression analysis was used to examine the relationship between the independent and dependent variables. Based on the results obtained, this study found a positive and significant association between internal audit and effective corporate governance. This result is consistent with previous studies that found significantly positive relationship between internal audit and corporate governance, such as the studies of Yassin et al. (2012), Kibet (2008), Allegrini et al. (2006), and Carcello et al. (2005).

This research expects to fill in the void in literature on the impact of internal audit on effective corporate governance in Oman in particular and Middle East in general.

In this research, all five dependent variables have been used to analyze the impact of internal audit on effective corporate governance in banking sector in Oman. Future researches expected to attempt to include other sectors of the economy such as industrial, petrol, mining, services etc.

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