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# A Study of Empirical Evidence of Effective Internal Audit (IA) in Corporate Governance (CG) in Pakistan

Ajab Khan Burki\*, Hanif Ullah Burki\*

\* *Bahria University, Islamabad, Pakistan*

## Abstract

The reason for writing this paper is to provide bits of knowledge regarding the effectiveness and validity of internal corporate governance practices in corporate governance measures of Pakistani banking sector. The present obligations and responsibilities of internal corporate audit and its implication on corporate governance characteristics are determined and estimated. To get the data for the same, survey was conducted through questionnaire related to the same domain of banking sector. The questionnaire's questions were based on three main entities: 1. the efficacy of internal corporate audit in relation to top management for corporate governance measures; 2. the audit department in terms of competencies and resources for effectively coping up with audit; and 3. the activities related to managing the risk in banking sector. The results of this study indicate very important and significant results regarding the implication of internal corporate audit in corporate and organizational governing measures. The outcomes cater significantly valuable parameters for all the stakeholders of the banking sector of Pakistan. Besides, this research provides valuable insight into the utility of internal corporate auditors and committees. The external auditors' roles can be easily redefined in terms of corporate governance due to the given study.

**Keywords:** Internal corporate Audit, Corporate/Organizational Governance, Agency Theory, Risk Management

## Introduction

The advancement of internal corporate governance amid last period was exceptionally progressive. Its expanded significance is a result of its raising thought in parts of corporate/organizational governance, essentially for its associations in managing the risk and inner control. The internal corporate auditors need to build their zone of working, with a specific end goal to show signs of improvement required in control, risk management and procedure of diminishing it. Due to immense need for enhancing the control, numerous new strategies get to be main focus due to the additional value of internal corporate audit in firms and in its governing aspects (Cohen et al. 2002).

As indicated by Sarbanes-Oxley act of 2002, corporate/organizational governance has gained a lot of impetus in worth and media fixation. Controls and codes defined and developed; projects of corporate/organizational governance, structure have been put into practice in a large portion of the organizations. Present conditions of issues are compelling internal corporate auditing team to reverberate their part, size and

commitment. It is guessed that the expanded significance of internal corporate audit is a result of the financial fiasco that occurred during 2007-0-9 and extended need of corporate/organizational governance.

Corporate/organizational governance principles and standards have been enhanced worldwide in the course of the most recent couple of years. Henceforth, it is critical for Pakistani banking industry to take after those improved principles and standards. For this reason, subsequent to 2002, Security Exchange Commission of Pakistan (SECP) is resolved to overhaul governance measures and codes so as to stay in a competitive position with global principles, standards and world monetary markets. The organizational codes have been overhauled in 2012 by (SECP, 2012.).

Internal corporate audit being a key part gives the money related position's free survey. Internal corporate auditors are the operators of the stockholders. This relationship is very helpful in terms of complying with better working aspects of the organization. This study concentrates at viability of internal corporate audit from three main perspectives; 1. the efficacy of internal corporate audit in relation to top management for corporate governance measures; 2. the audit department in terms of competencies and resources for effectively coping up with audit; and 3. the activities related to managing the risk in banking sector (Arena and Azzone, 2009).

There is very little consideration paid to look at this aspect in Pakistan. Pakistan's banking sector is the financial backbone in generating significant return for the economy as a whole. Therefore, to empirically investigate the implication of internal corporate audit on corporate/organizational governance is immensely important for having clear and thorough information.

## **Problem Statement**

Though the internal corporate audit in relation to corporate/organizational governance has considerably been researched throughout the world considering modern approaches after various notorious financial and accounting scandals, yet the effective research into the given area has not been adequately determined and estimated in the banking sector of Pakistan based on the main three aspects essential for determining the internal corporate audit efficacy on corporate or organizational governance that are 1. the efficacy of internal corporate audit in relation to top management for corporate/organizational governance measures; 2. the audit department in terms of competencies and resources for effectively coping up with audit; and 3. the activities related to managing the risk.

## **Research Objectives**

Because of tremendous significance of internal corporate audit capacity in corporate/organizational governance, this study goes for:

- 1.1 Discovering that which segments i.e. internal corporate audit activities; 2. Internal corporate audit competencies and resources; 3. Internal corporate auditors' liaison with the top management for audit working viably in Pakistan's banking sector and which segments require further development and improvement.
- 1.2 The effective internal corporate governance practices and its implication on

organizational/corporate governance for pragmatic understanding.

1.3 Testing and assessing the importance of each element of internal corporate audit on organizational/corporate governance of banking sector of Pakistan.

## **Literature. Review**

In recent years, the importance of corporate/organizational governance has increased imperative in groups of financial community and regulatory consideration. Basic piece of unit's corporate/organizational governance is identified with its capacity of internal corporate audit. Taking the historical perspective since 1930's great depression followed by the current financial recession of 2007-09, there has been exceedingly awful financial emergencies period by numerous market analysts. The collapse of various businesses, followed by declining purchasing power and larger hazards in financial and economic activities worldwide because of these financial turmoil has opened a new era for effective consideration for protecting the rights of shareholders (Ibrahim, 2011).

### *Internal Corporate Auditing*

Arena and azzona (2009) observed the mechanism of internal corporate audit to enhance the value of the firms due to effective control and better approaches of managing the incumbent risk. The main theme of this piece of paper highlights the importance of how value would be enhanced given proper and effective internal corporate audit with the given focus on key areas of controlling, governance and risk mitigation through proper management. In the past decades, the organizational/corporate governance has earned huge popularity due to huge regulatory and stakeholder attention especially after the world notorious financial and accounting scandals. The central role that drives effectively the corporate/organizational governance is through effective internal corporate audit. The importance of internal corporate audit has gained tremendous importance after the great depression of 1930's and the recent financial recession of 2007-09 which has shackled the interest of the shareholders and loosened the confidence and trust of the potential stakeholders on the functionalities of the financial market. Due to these debacles, various businesses across the globe have flopped, teaching towards unemployment that caters lowering the purchasing power of the masses which as a result has become a cause of hike in inflation. The effective internal corporate audit protects the community from such failure through sophisticated information system and modern approaches for effective smooth corporate governance mechanism in place (Ibrahim, 2011).

The internal corporate audit has been changed from traditional ones quiet significantly in many regards these days. According to Sawyer (2003), internal auditing is a scientific assessment done by the internal audit workers of various ranks and files for catering effective control over the overall functionalities of the firms; likewise: 1. All the requisite financial and operating information be specific, coherent, concise, precise and reliable; 2. Related risk be identified and hedging strategies be effectively in place; 3. Standards and internal policies be followed for greater control; 4. Reasonable criteria for operation be followed; 5. The requisite resources be used efficiently with due diligence; 6. The incumbent obligations related to organizational/corporate governance be complied up effectively by all employees to cater for the said objectives and goals of the organizations.

The role of internal corporate audit ensures managing the risk and controlling internally all the measures related to smooth running of corporate/organizational governance. In this regard, the audit team presents information with all requisite disclosures to audit committee for taking action if there is something wrong going on financially, the committees in return, are supervising and looking for discrepancies that may be violating the requisite standards or principles to make it sure for compliance.

The effective audit committee is always working independently for efficient utilization of resources provided if the environment is conducive and encouraging (Karagiorgos, Drogalas, Gotzamanis & Tampakoudis, 2010). The working aspect of audit is very broad these days. The role is not just refrained to accounting skills and management only rather, it has a broad-based spectrum of looking at various perspectives for effective corporate/organizational governance. In this regard, the competency of audit team should be at par for coping up effectively with requisite tasks (Karagiorgos, Giovanis & Drogalas, 2011).

### *Effectiveness of Internal Audit*

The effectiveness in any sphere of task is immensely important for coping up with the said objectives and goals of the corporation. In this connection, the internal corporate audit's performance is measured through various techniques by deploying metrics and other management related milestone for catering effectively the functionality of internal audit to be according to the laid down standards with optimal utilization of time and resources (IIA, 2008). There are few studies that determine the efficacy of internal audit while very limited studies are in literature regarding to pragmatically examining the effectiveness of internal corporate audit in corporations (Coram, Ferguson, & Moroney, 2008).

### *Organizational/Corporate Governance*

The corporate/organizational governance has gained tremendous impetus since last three decades because of various financial and accounting fiascos (Okpara, 2011). There are various techniques of organizational/corporate governance utilized in wide range across firms (Joseph and Pergola, 2011). One of the reasonable definitions given by Organization for Economic Co-operation and Development (O.E.C.D, 2004), it is the system where non profit firms are controlled and are providing guidance for getting optimal performance, catering for objectives related to managing the affairs of finance with due diligence of appropriate accountability and guidance. According to Roe (2004), organizational/corporate governance is originating from top i.e. board of directors, followed by senior management and overall all stakeholders of the firms. According to the given theme, the corporate governance is empowered with obligations for catering effective controlling through monitoring. These phenomena are contemplated against perks and privileges (Rupsys and Staciokas, 2005). It is evident that the main role of corporate/organizational governance is to ensure the smooth functionality of the firms with given standards to protect the rights of the stakeholders (Chang, Chou & Wang 2006).

The role of internal audit has been increased reasonably because of its importance in attracting foreign capitals for investment. The effectiveness of internal corporate audit is

providing the critical aspects of effectively governing the corporations for making them more resilient and reliable for the stakeholders (Mordelet, 2009). This acceptance and demand of governance has gained a lot of impetus due to economic activities increased for the past three decades.

The role of internal corporate audit for catering effective corporate/organizational governance is highly important for achieving the milestones of development and progress already envisaged. This would effectively undermine the riskiness in the investment or financial mobilization with developing the hedging techniques for managing them to create more value for the shareholders. The effective internal corporate audit ensures to take actions when the businesses are not effectively coping up with the due obligations according to the given standards and internal policies.

### *Corporate Governance and Internal Audit of Banking Sector*

The sound financial and banking system resides on the confidence and trust of the stakeholders. The recent financial crisis of 2007-09 has shackled the trust and confidence of the stakeholders on banking and generally on the financial system. Such crises erupted out of poor corporate/organizational governance policies. By having the effective policies of corporate/organizational governance, the imminent risk can be effectively hedged through proper risk management approaches and techniques. The investors are claiming that the major failure of the financial and banking sectors was predominantly due to lack of effective corporate/organizational governance measures (Palfi and Muresan, 2009).

The Basel Committee on banking Supervision (BCBS, 2006) dictates the relationships among stakeholders of the banking sector with proper guidelines to the board and management by complying up with setting their goals for their routine tasks and responsibilities for maximization of shareholders' value. In this regard, the trusts of the depositors are immensely critical by making them with confidence and trust of deploying and catering the corporate/organizational governance at par as per the defined banking rules and standards. This would cater for having a robust and effective audit team in place for control and monitoring which would regulate managing risk through deployment of compliance (Mihailescu, 2011).

### *Auditors Working as Agents*

The clash of interest dictates that the principal i.e. shareholders and the agent i.e. management are having their own self-interests to be preferred. This necessitates the urge for alignment for interests to cater the optimal value creation and minimize the opportunistic approaches and asymmetric information (Shapiro, 2005).

As it is evident that effective internal corporate audit has direct impact on corporate/organizational governance quality. Therefore, the role of internal corporate auditors is immensely critical for complying up with the rights of the shareholders. This necessitates the congenial working relation between the board of directors and the auditors for coping up effectively for the protection of the rights of the shareholders given the tougher implementation of standards and rules. But the important aspect in functioning independently is that the internal corporate auditors be free from any undue influence of the board of directors. Though the conducive relationship between the

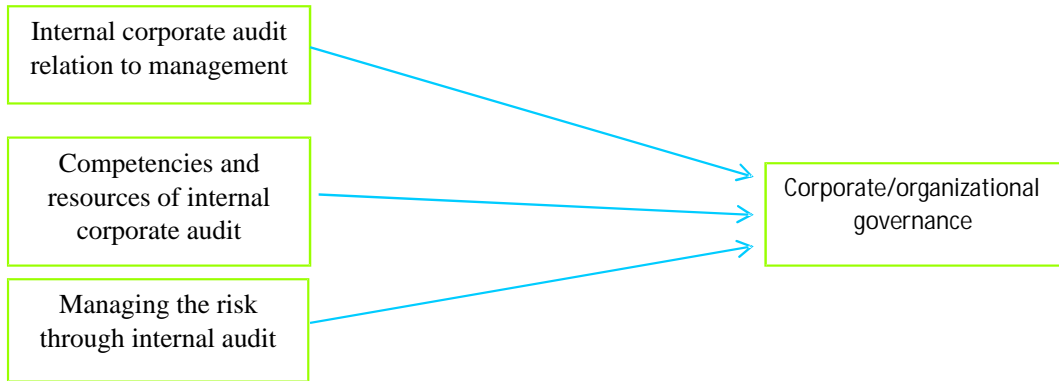
internal corporate auditors and the board is critical, yet the demarcation of duties, roles and responsibilities is defined as per the internal policies of the firms (Watts & Zimmerman, 1983). Similarly the ambiguities and confusion that may arise in the minds of the shareholders i.e. agents may be removed by the effective involvement of directors. This would be viable for the trust and confidence of the board of directors by the shareholders. In this regard, it would effectively cater the working of the auditors in a congenial manner (KFKB, 2013).

## **Theoretical Framework**

Previous researches linked to internal corporate audit and organizational/corporate governance has validated the relationship/interaction between the corporate/organizational governance and internal corporate audit ( Paape, Scheffe and Snoep, 2003). The relationship/association between audit committee and internal corporate audit has been explored by Goodwin (2009). According to Christopher, Sarens and Leung (2009) whom they assessed regarding the importance of internal corporate audit in organizational/corporate governance in Australian corporations. Similarly, Gramling, Maletta, Schneider, & Church (2004), have also examined and investigated the relationship between internal audit and corporate/organizational governance. In this regard, Christopher and Leung (2009), has examined the role of internal corporate audit for its independence and their liaison with audit committee and top management. Henceforth it was further determined by Sarens and Christopher (2010) about linking of internal robust control, management of risk, and organizational/corporate governance parameters and directions. Ibrahim (2011) has determined the internal corporate audit functionality in Egyptian corporations and its efficacy for assisting a better organizational/corporate governance mechanism. These studies reportedly examine the professional qualifications, experiences, risk management orientation of auditing, technological utilization of catering through efficient manner, the disclosure of reports, meetings' participation, various resources needed for effectively going along with sophisticated internal audit. All these studies were based on survey techniques for collection of data. Arena & Azzone (2009) research utilized the importance and effectiveness of internal corporate audit considering three key elements: 1. the efficacy of internal corporate audit in relation to top management for corporate governance measures; 2. the audit department in terms of competencies and resources for effectively coping up with audit; and 3. the activities related to managing the risk. This particular study would be utilized on the given three bases taking the perspective of Pakistani banking sector.

### *Model*

This study is based on the model given by Arena & Azzone (2009) with only one differentiation i.e. this study is focusing on relationship of internal corporate audit with the management instead of association and interaction of internal audit team with audit committee.



**Adopted from source:** Arena & Azzone, (2009.), “Identifying Organizational Drivers of internal audit Effectiveness”, International Journal of Auditing, Volume. 13, pp..43-60

### Hypotheses

**H-1:** Internal corporate audit relation to top management is positively related to corporate/organizational governance.

**H-2:** The competencies and resources of internal corporate audit are positively related to corporate/organizational governance.

**H-3:** internal corporate audit's activities in terms of effectively managing the risk are positively related to corporate/organizational governance.

### Methodology

This study incorporates three independent variables: 1. internal corporate audit relation to management; 2. competencies and resources of internal corporate audit and 3. Managing the risk through internal audit and the dependent variable is corporate/organizational governance. This theoretical framework is measured by utilizing instrument made by Cohen & Sayag (2010) by having some modifications.

For this study, self-disciplined questionnaires were distributed to the audit department of 22 major banks of Pakistan for having a thorough survey. Out of the total 250 distributed questionnaires, 147 were received- cumulative response was around 58%. The questionnaires comprise of three major portions for having various questions related to the given three independent variables and the dependent variables. The first part of the questionnaire comprises questions related to general characteristics of employee working in that department. The second part comprises 37 questions related to the three elements of the internal corporate audit. The said questionnaire is adopted from Cohen & Sayag (2010) by taking his prior consent and permission. He studied the effectiveness of internal audit in the corporations of Israel. Little changes have been done to effectively cater the objectives of this study with perspective to Pakistani banking sector. The third part comprising 13 questions related to the corporate/organizational governance which is a dependent variable. These questions cover all the aspects related to governing of the organizations. This study is based on 5 point Likert scale for effective survey. The

requisite responses are analyzed by using SPSS version 20 for outcomes. In this regard, to determine the impact of internal corporate audit on corporate/organizational governance, linear regression is used. The reliability test is conducted for the validity of data according to the given model.

The model for regression is given below as:

$$CG = \beta_1 + \beta_2 \cdot IAI + \beta_3 \cdot IAA + \beta_4 \cdot IAC + \epsilon$$

Where the  $\beta_1$  is constant,  $\beta_2$ ,  $\beta_3$  &  $\beta_4$  are coefficients of interaction/relationship of internal corporate audit with top management, internal corporate audit activities considering the risk management approach, and the internal audit team competencies and resources respectively. While CG represents the corporate/organizational governance used as dependent variable and  $\epsilon$  is for indicating the error term.

## Results And Analysis

### *Demographic Information*

The information collected out of the 147 respondents of the survey, the participants were: 50% Assistant Managers, 30% Tier-1 Managers, 20% Tier-2 Managers while 10% were Senior Managers. The mean of the respondents were: 20% as auditors with certifications, 65% with graduation degrees of MBA and M.Com and last 15% were though not professionally qualified and certified but were having other social sciences related degrees like MSc, MA etc.

### *Reliability of Data*

For checking the validity and reliability of the respondents' data, this research caters the Cronbach's Alpha value as 0.9 which shows significant consistency and reliability.

### *Descriptive Statistics*

The descriptive statistics in table-1 indicate the independent variables and dependent variables for their mean, standard deviation, variance, standard error of mean and skewness. The internal corporate audit activities for managing effectively the risk is the highest that show that the respondents were highly valued it. The mean of competencies and resources is high which indicates its effectiveness. Contrary to this, the interaction with management is not showing higher mean. The similar pattern is found in standard deviation and variance where it was highest in audit processes; in competencies and resources and interaction/relationship with management. The mean of standard error was low for all the variables. This indicates that the sample is well representing the whole population. The skewness value is showing positive tendency which indicates that the data is focused to the right-side of the mean. This result shows that the participants have opted for the effectiveness of the variables.

### *Regression Analysis*

According to the regression analysis, this study caters adjusted R square as 0.635. This value means that 63.5% of the variation in dependent variable (Corporate/organizational governance) has caused due to the given three explanatory variables (internal corporate

audit interaction with management, internal audit consideration/activities, and competencies and resources of internal audit). All these explanatory variables are having positive implication on corporate/organizational governance of banking sector of Pakistan.

The outcomes of regression model are as follow:

$$CG = 13.29 + 0.25 IAI + 0.58 IAA + 0.038 IAC +$$

The results indicate the following:

- For every unit enhances in I.A.A, the corporate/organizational governance measures would be increased by 25 units
- For every unit enhances in I.A.A, the corporate/organizational governance measures would be increased by 58 units
- For every unit enhances in I.A.C, the corporate/organizational governance measures would be increased by 3.8 units

## ANOVA

Table-3 presenting the Fischer value of 85, which shows that the research structure of this study is exceedingly significant. This means that the explanatory variables (I.A.A, I.A.C, I.A.C) critically define the changes in dependent variable (Corporate/organizational governance).

## T-Test

In our analysis of t-values, this study reject the H-2 (Hypothesis related to competencies and resources) where the t-value is less than 2 whereas, the rest two hypotheses (H-1 and H-3) are accepted as the t-values are higher than 2.

## Discussion

The outcomes of this piece of research show that internal corporate audit's efficacy has significantly strong relationship with organizational/corporate governance of banking sector of Pakistan. This study has been conducted thoroughly from the perspective of employees i.e. auditors working in the banking sector of Pakistan. The competencies and resources received very little focus and importance while the other two variables are given with significant importance. The self-administered questionnaires were distributed to the employees of banks working in Pakistan. The results could be expecting differently if the input would have been taken form the shareholders' perspective.

The brief analysis of the outcome achieved from the respondents against questionnaire, this study cater the following results: 81% of respondents urged that the audit department should meet the expectation/milestone defined by audit committee; 93% of respondents urged the importance of audit department to work as independently without any influence; 91% of respondents urged that the timeline of audit plan be ensured; 67% of respondents show satisfaction with the frequency of meeting with the management; 58% of respondents were satisfied for the huge amount of recommendations and implementation as envisaged; 63% of respondents determined that the department

provided advantages more than the cost; 86% of respondents were of the view that modern and sophisticated technology in the shape of software are used for catering significant high quality of work; 48% of respondents show satisfaction for the audit report quality; 39% of the respondents show satisfaction for staff adequacy; while 37% of respondents show satisfaction for budget sufficiency

Similarly the dependent variable (Corporate/organizational governance) shows the respondents in terms of the strong agreement for various questions are as follow: 65% of respondents relating it with incentives and bonuses for the employees; 79% of respondents linking it with employees' benefits; 58% of respondents associating it with option for share purchasing; 89% of respondents linked to targets with incentives and benefits. Contrary to these results, those who were strongly disagreeing: 53% of respondents have shown strong disagreement for the accessibility of ideas communicating from bottom to top effectively. However, in general, the internal audit department working in banking sector of Pakistan is very effective and it is safe to conclude that the audit team work in the best interest of the stockholder which eventually supports the congenial corporate/organizational governance.

In the given perspective of the outcome, it is safe to say that the ideas of the audit team/department must conveniently be recognized, listened and taken into higher consideration by the top management at priority for further enhancing and augmenting the spirit of corporate/organizational governance. Besides, it is noteworthy to address on strong footings those competencies and resources be optimally utilized. In our results it stood as beta coefficient of 3.8 that indicates that this shortcoming should be addressed with critical consideration by inculcating the employees through rigorous training and development. This would further enhance the knowledge of the incumbent employees for the betterment of their department, which will eventually be productive and further augment the corporate/organizational governance in the larger interest of the stakeholders. In terms of budget, the audit departments need to be considered for their concern. The employees must be compensated with adequate perks, privileges and handsome TA/DA for catering the motivation level to remain intact.

On the other hand, the staff inadequate ratio is also one of the main concerns for the audit department which could be a cause of negative implication.

In nutshell the audit departments of banking sector of Pakistan are playing vital role in corporate/organizational governance. Moreover, this could be further enhanced and revitalized by addressing the key shortcomings: low staff ratio; inadequate level of budget; and low focusing on human capacity development through training which become a source of hurdle for most effective auditing function internally.

Besides these, the top management must take into consideration all the requisite communication in a serious node for addressing and resolving the issues for coping up with the given internal policies to make the employees more satisfied and motivated.

## **Conclusion**

This research paper tries to provide the effectiveness of internal corporate audit's roles and functionalities and its implication on corporate/organizational governance in banking

sector of Pakistan. The findings of this research can be concluded that positive relationship of internal corporate audit activities for risk management and level of interaction with corporate/organizational governance of banking sector exist. The audit is free and independent of interferences which cater the objectivity in terms of purpose and accomplishment of milestones of audit and good organizational/corporate governance. Although the banking sector in Pakistan is confronted with many internal audit and corporate/organizational governance issues specifically in terms of internal corporate auditor which is currently more reliant on old traditional techniques of coping up with. The modern world requires and necessitates the urge for using the sophisticated technology for more accurate and in-time functionality with optimal time frame. Though in Pakistan, the audit department is not confined to the traditional reviews and evaluation function of controlling and effectively trading off various scenarios of the corporations, yet their involvement is very critical in terms of adding more value to the existing worth of the shareholders. The results of this study are very interesting for its significant implication to the functionality of the corporation. The audit is an important aspect for catering the effective corporate/organizational governance in banking sector of Pakistan with refocusing on some shortcomings i.e. inadequacy of competencies and resources. Pakistani banking sector is required to tackle all the shortcomings at priority basis for coping up with effective corporate/organizational governance. Furthermore, the results of this study are significantly useful for all stakeholders and specifically for the management of the corporation for taking corrective measures and for the regulators and standard setters for making more resilient rules and laws for more effective corporate/organizational governance in banking sector of Pakistan.

## **Contributions**

The given study contributes effectively in the incumbent literature of exploring the impact of internal corporate audit on corporate/organizational governance in the banking sector of Pakistan. The results of this study can be effectively used by the top management for taking corrective measures with a view for further enhancing the good governance; it can be used by the regulators for developing rules and laws to make corporate/organization governance more effective; it can be used by the stakeholders and standard setters for coping up with significant results in future.

Further this study provides a significant contribution by highlighting the shortcoming of competencies and resources for effectively catering the corporate/organizational governance in the banking sector of Pakistan which necessitate the need for human capital development of the audit employees through rigorous training and development for effective governance.

## **Limitations of the Study and Areas for Further Research**

There could be few limitations to the domain of this study, which are as follow:

- As the total number of respondents to the survey was 147, therefore, it can be safely assume to say that the results could have been more significant and reliable if the number of respondents was more.
- There are other avenues of determining good corporate/organizational

governance apart from internal audit which can also be considered for further study.

- The internal corporate audit in relation to effective corporate/organizational governance can also be studied from the shareholders' perspective for taking comparison with the existing study finding more debatable outcomes and thorough understanding of both perspectives in the banking sector of Pakistan.

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