AN EMPIRICAL INVESTIGATION OF THE RELATIONSHIP BETWEEN AUDIT COMMITTEE EFFECTIVENESS AND INTERNAL AUDITORS' PROFESSIONAL OBJECTIVITY: A FOCUS ON FINANCIAL INSTITUTIONS IN MALAYSIA

CHAPTER 1
AN OVERVIEW

1.1 INTRODUCTION

As both private and public entities around the world grow in size and influence, society is demanding greater accountability. This drive for accountability has led to an increased focus on audit activities as a major aspect of a viable governance system and in some parts of the world has even resulted in calls for mandating an internal audit function, including in Malaysia. The East Asian economic crisis in 1997/98 has generated substantial amount of analysis and debate largely focused on, among others, the need for a good corporate to re-establish investor confidence in the Malaysian capital market (Finance Committee, 1999). High profile corporate failures have forced governments, regulators and boards of directors of corporations to review and evaluate fundamental issues of corporate governance to protect the public and investors' interests as well as various stakeholders within the economy.

The recommendations in the Malaysian Code of Corporate Governance (Finance Committee, 1999) directed principally at the boards of listed companies, are aimed at increasing the efficiency and accountability of boards to ensure their decision-making processes are not only independent but are seen as independent. As part of its efforts to promote good corporate governance among corporations, the relevant regulatory authorities in Malaysia, namely Kuala Lumpur Stock Exchange (KLSE) and Bank Negara Malaysia (BNM) had made it compulsory for the boards to establish audit committees and spelt out the recommended size, composition, competencies, duties and responsibilities etc. (KLSE, 2001; BNM, 1985). One of the main principles of Malaysian Code of Corporate Governance (MCCG) is that the board should maintain a sound system of internal controls to safeguard shareholders' investment and the company assets and the board should be supplied in a timely fashion with information in a form and of a quality appropriate to enable it to discharge its duties (Finance Committee, 1999).

As part of best practices, the MCCG requires the board to identify principal risks and ensure the implementation of appropriate systems to manage these risks. A focused and detailed discussion of the company's processes for producing financial data, its internal controls, and independence of its external auditors might be too time-consuming for the full board. Also, the financial performance involves assessment of management. Hence, MCCG had recommended establishment of an independent audit committee that serves to implement and support the oversight of the board in several ways. It is envisaged that an independent audit committee would reinforce the objectivity of the internal auditing department (Finance Committee, 1999). The improved corporate governance and the development of audit function are driven by the greater demand for accountability (Porter, 1999). The effectiveness of the overall audit function also depends on the characteristics of each individual player, namely, internal auditors, external auditors and audit committee. According to Institute Of Internal Auditors(IIA) "A proactive, viable audit function requires the integration of services of all these three parties" (IIA, 2001a).

Of the important characteristics for a proactive and viable audit function, the one that has recently received the most attention are 'Independence and Objectivity' (IIA, 2001a). This is most evident in the external audit realm with the development of conceptual frameworks for independence in the European Union, the establishment of the Independence Standards Board (ISB) in the United States, and the recent release of the ISB's exposure draft on a conceptual framework for external audit independence in November 2000. In addition, the release of the Report and Recommendation of the Blue Ribbon Committee (New York Stock Exchange, 1999) in the USA substantiates the increasing emphasis on the importance of independent audit committee members. As internal audit activities grow from narrowly focused monitoring financial activities into broadly focused service activities and as these activities become a key component of corporate governance, independence for the internal auditor and the internal audit function likewise increases in importance.

Internal auditors objectivity and independence is crucial to promote corporate governance and corporate financial reporting procedures. Objectivity simply means that given an appropriate audit scope and professionalism, relevant and sufficient evidential matter will be effectively analyzed and results will be completely and honestly reported to the appropriate parties without auditors' judgment being skewed i.e. the auditors judgment will be free from bias (IIA, 2001a). The IIA Research Foundation believes that objectivity is one of the core requirements for an effective audit because without it, the auditors services do not produce reliable and trustworthy information for management, board of directors, audit committee, capital providers, and ultimately public at large.

The IIA Research Foundation (IIA, 2001a) recognises the importance of ensuring that internal audit activity remain a viable aspect of the corporate governance system by sustaining internal audit independence and objectivity in the face of the changing internal audit environment. However, there seem to be independence problems in internal auditing (IIA, 2001a). Management employs internal auditors, yet these same internal auditors are also often asked to review the performance of management and others (IIA, 2001a). In addition, management often relies on internal auditors for consulting services and incorporates audit recommendations into the re-engineering of business processes. The combination of the internal auditors' dependence on management, the increasing importance of internal audit activities, and the growth in the demand for consulting activities leads to escalating concern about internal auditors' independence (IIA, 2001a).

The Institute of Internal Auditors defined internal auditing as "an independent objective assurance and consulting activity designed to add value and improve an organizations operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes" (IIA, 2001c). The internal auditors serve all members of management in fulfilling their responsibilities (Razaee and Lander, 1993).

The internal audit activity should contribute to an organization's governance process by evaluating and improving the process through which: values and goals are established and communicated; the accomplishment of goals is monitored; accountability is ensured, and values are preserved (IIA, 2001b). Thus, internal auditing can play an important role in preventing errors and fraud, and is a useful mechanism in the checks and balances of effective corporate governance (Scarbrough, Rama and Raghunandan, 1998).

Some benefits accrue to an organization as a result of having an internal audit department. Having an internal audit as part of the internal control system of an organization has the following benefits (Albrecht, Howe, Schueler and Stocks, 1998):

- improves the organization's governance process;
- safeguards the assets of an organization and improving it's internal controls;
- leads to an efficient operation or productivity within an organization;
- leads to management comfort, because as an arm of management, it informs them of the activities in the company;
- develops people because the internal audit activities covers the whole organization, and is therefore considered a training ground for future managers;
- internal auditors assist in the development of systems and ensure that proper and effective controls are included; and
- internal auditors consult with management on special or unusual problems.

Thus all activities within an organization are potentially within the scope of the internal auditors' responsibilities (Horn, 1992). From the above, it can be seen that the role and scope of the internal auditor within the organization, has widened. As a result, the IIA requires the internal auditor to exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined (IIA, 2001c). Professional objectivity and independence is required to ensure management's integrity in its internal reporting as well as increasing the reliability of the internal auditors reports (IIA, 2001c). Thus increased emphasis is placed on the professional objectivity and independence of the internal auditor. According to Vanasco (1996), one way to enhance the internal auditors professional objectivity and independence, is to have an audit committee to be responsible for overseeing the entire internal audit function.

Meanwhile, for a strong and resilient banking system in our economy, the contribution of an effective internal control system that includes the internal audit function and audit committee is obviously significant. Given their knowledge and their ability to continuously monitor their respective banks, many parties rely on the so called objective assurance given by the internal audit department, It has been assumed that existence and `effective' audit committees would guarantee the professional objectivity and independence of internal auditors.

However, no studies known to the author, has been done, particularly in the Malaysian banking sector on the relationship between audit committees effectiveness and the internal auditors professional objectivity. Thus, there is a gap, which this research is intends to fill. The significance of this study is that it will provide empirical information on the relationship between audit committees effectiveness and internal auditors professional objectivity, in Malaysian banking sector.

1.2 PROBLEM STATEMENT

The Kuala Lumpur Stock Exchange (KLSE) listing requirements and Bank Negara Malaysia (BNM), the Central Bank of Malaysia' guidelines issued to BIs in Malaysia, BNM/ GP1[1], require all KLSE listed companies and BIs respectively, to have audit committees, whose responsibilities among other things will be to oversee the internal audit functions of the organization. Since activities of the internal auditor covers the entire organization (Horn, 1992), the IIA standard states that internal audit activity should be independent and the internal auditors should be objective in performing their

[1] BNM/GP1 refers to BNM guidelines on `Guidelines On Directorship In The Banking Institutions' issued in 1985 and subsequently revised in 1994.

work. The IIA standards also require internal auditors to communicate with audit committees and have regular meetings with them, that is, a close working relationship between the two. The Basel Committee (BIS, 2001)[2] paper on *'internal audit in banks and the supervisor's relationship with auditors'* felt that the creation of a permanent audit committee is "solution to meet the practical difficulties that may arise from the board of directors' task to ensure the existence and maintenance of an adequate system of controls". And such committees "reinforces the internal control system and the internal and external audit" (Principle 19, p15). The question that needs to be answered is whether such a close working relationship between effective audit committees and internal auditors does enhance the internal auditors' professional objectivity and independence?

1.3 OBJECTIVE OF THE STUDY

The objective of this study is to empirically investigate the relationship between audit committees effectiveness and internal auditors' professional objectivity in banking institutions(BIs) in Malaysia. The study investigates whether or not audit committees effectiveness enhances the professional objectivity and independence of internal auditors.

1.4 JUSTIFICATION AND SIGNIFICANCE OF THE STUDY

This study focuses on BIs due to the importance of banking system in an open economy like Malaysia. The development of a sound and strong financial system is a necessary pre-condition for steady and balanced economic and social development in Malaysia (BNM, 1999). Banking system is the largest component of the financial system accounting for about 70% of the total assets of the financial system (BNM, 1999). Financial stability is important given the critical functions served by the financial system in an economy. Weak or poorly managed financial institutions could lead to financial instability. Poor performance by the financial sector can be highly costly to society, in particular, if a banking system is prone to instability,

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[2] Issued by Basel Committee on Bank Supervision, Bank For International Settlement for the benefit of regulatory authorities of banks of member countries. It contains 20 principles that address a broad range of issues relating to the internal audit functions of banks, banking supervisors' relationship with auditors and the duties of audit committees.

depositors may avoid placing deposits in the banking system, thus, reducing the availability of funds to borrowers and the efficiency of intermediation process. Financial instability can hamper availability of credit and frustrate efforts to revive economy, besides having dire consequences to payments system and overall public confidence.

Recognizing the importance of banking system, BNM and Securities Commission (SC) of Malaysia have been taking various efforts to improve the level of corporate governance in Malaysia[3]. A fundamental strength of a BI lies in its governance structure. In the past, many bank failures have emerged due to weaknesses in the governance structure coupled with weak credit assessment. Among others, the competent and independent internal and external audit functions also play a crucial role in enforcing the practice of good corporate governance (BNM, 1999).

In this regard, BNM had issued in 1985 the BNM/GP1 guidelines, which was subsequently revised in 1994. Among others, it provided guidelines for the internal auditors of BIs to ensure that they perform their function in a more meaningful and independent manner. BIs were also required to establish and ensure the effective functioning of an Audit Committee, where at least two-third of the members were independent non-executive directors of the bank (BNM, 1985).

Further, in recognizing the role of internal auditors in banking institutions, which is also becoming increasingly challenging, in 1997 BNM issued a guideline called BNM/GP 10[4]. The rapid changes in the banking sector such as increased competition, introduction of new financial products and evolution in information technologies places greater emphasis on the role of internal auditors to ensure that sound operational and risk controls are in place. Internal auditors are also needed to assess the effectiveness of corporate governance, operational efficiency and productivity, asset quality and other inherent operating and financial risks. The internal audit function

[3] Few domestic banks are listed on KLSE, and therefore are subject to rules and regulations issued by SC and KLSE, such as KLSE Listing requirements.
[4] BNM/GP 10 refers to `Guidelines On Minimum Audit Standards For Internal Auditors Of Financial Institutions'.

and adequate systems and control procedures are key in the preparation of reliable financial statements by external auditors. In fact, the external auditors are beginning to rely largely on the preparation work done by internal auditors.

Nevertheless, the establishment of an Audit Committee, its powers as well as its position and relationship with internal auditors, have all along been regarded as sufficient steps to enhance the professional objectivity and independence of internal auditors by the regulatory authorities and the accounting profession. For instance, BNM/GP 10 stated that `regular communication with the audit committee helps to assure independence of the chief internal auditor', whilst, Principle 5 of Basel Committee report on internal audit in banks (BIS, 2001) states that ``the principle of independence entails that the internal audit department operates under the direct control of either the bank's chief executive officer or the board of directors or its audit committee depending on the corporate governance framework (p 4). Meanwhile, The Commercial Bank Examination Manual of USA (Federal Reserve, 2000)[5] states that ``frequently, the independence of internal auditing can be determined by its reporting level within the organization and by the person or level to whom these results are reported" (p 7).

A number of studies had been done overseas on the relationship between audit committees and internal auditors. Among others include Gul and Subramaniam (1994), Kalbers (1992), Olivario and Newman (1993), Scarbrough, Rama and Raghunandan (1998), McMullen and Raghunandan (1996), Raghunandan, Read and Rama (2001). Various aspects of audit committees had been studied. Sori, Shamsher, Muhamad and Anuar, did several studies on audit committees in Malaysia (1999, 2001a, 2001b, 2001c, 2001d, and 2001e). The Malaysian Institute of Accountants (MIA), also did a survey on "An overview of internal audit in Malaysia" (reports published in 1989 and 1991).

However, so far no study had been done on the relationship between the audit committee effectiveness and professional objectivity of internal auditors, particularly in the context of Malaysian banking system. Thus, the

[5] This manual is issued by the Federal Reserve Bank of United States for its bank examiners as a guide in performing their supervision function of commercial banks. Many countries use this manual as a source of reference.

findings will be useful for policymakers, stakeholders and BI's management in formulating practical guidelines for improving corporate governance practices among Malaysian banks.

1.5 RESEARCH METHODOLOGY AND DATA COLLECTION

Drawing on prior literatures the following nine sets of hypotheses were developed to accomplish the objectives mentioned in section 1.3 above:-

H_1: Internal auditors professional independence will be enhanced when Audit Committees approve the internal audit charter.

H_2: Internal auditors' professional objectivity will be enhanced when the audit committee is responsible for the chief internal auditor's hiring, firing and determining his incentives.

H_3: Internal auditors' professional objectivity will be enhanced if there is a direct channel of communication between them and the audit committee.

H_4: Internal auditors' professional objectivity will be enhanced when the audit committee reviews their work and audit programmes.

H_5: Audit committee will be effective when the board approves the audit committee's charter.

H_6: Audit committees will be effective when they comply with the size and composition requirements of the KLSE listing and BNM/GP1 requirements.

H_7: Audit committees will be effective when they have a direct channel of communication with the internal and the external auditor.

H_8: Audit committees are effective when they review the financial statements and the interim reports before the board approves them.

H_9: Effective audit committees enhance the internal auditor's professional objectivity.

A mail questionnaire was used to collect data. This research will concentrate on all the 26 banking institutions in Malaysia as end of March 2002. A survey instrument as shown in Appendix A was used to collect data.

Subjects were requested to make a subjective judgment on a seven-point scale. As the population size is relatively small all BIs were selected for this study. A total of 70 persons were chosen comprising audit committee chairman of all the 26 BIs, chief internal auditors of all the BIs and 18 deputy chief internal auditors of BIs who have attended the audit committee meetings i.e. excluding 8 foreign-owned banks which has a very small internal audit departments. The study intends to obtain feedback from 100% of the population identified. The respondents were chosen because of their active involvement in audit committee meetings and internal audit work as well as their close relationship with each other that is important to provide the necessary feedback to the research instrument and to the objectives of this study.

The data obtained from the study was analyzed by using the SPSS (version 9.0) statistical package. Besides performing descriptive analysis, reliability tests will be performed to measure the interrelationship between variables to determine to what extent the survey questions have measured what they are suppose to measure. Also, will perform multiple regressions analysis, General Linear Model Univariate analysis and ANOVA. The hypotheses test the effectiveness of audit committees and the effect of effective audit committees (independent variable) on the internal auditor's professional objectivity (dependent variable).

1.6 LIMITATIONS OF THE STUDY

The study only covers the banking institutions in Malaysia. Therefore, the implication of the study may only reflect the banking institutions in Malaysia under the supervision of the Bank Negara Malaysia, the Central Bank of Malaysia.

In spite of the assurance given on anonymity and that the survey feedback will be analyzed on an aggregate basis, the study could not elicit 100% response due to low response from audit committee chairmen and deputy chief internal auditors. It would not be easy to obtain 100% feedback from banking institutions in Malaysia in view of the sensitive nature of the banking industry, the stringent secrecy provision of the banking legislation, the seniority in rank of the respondents, their heavy responsibility and time constraints. Although the lower response from the deputy chief internal auditors is understandable as not all of them interact regularly with audit committee, hence not possible to provide feedback on audit committee effectiveness and its impact on the objectivity of internal auditors. The higher response rate from audit committee chairmen is desirable in future as this will provide greater insight on this study and eventually contribute to the enhancement of corporate governance in the banking system in Malaysia.

The adoption of anonymity precluded certain steps that might have been desirable including a second mailing to those respondents who did not respond to the first mail, possible telephone interviews with a sample of non-respondents to gauge the presence of response bias among those who did not respond, and any follow-up via mail and telephone to respondents to gather additional information. However, anonymity was deemed necessary to strengthen the reliability and validity of the results. The feedback cannot be traced back to individual respondents. For this study, the survey method of obtaining feedback was deemed most appropriate.

The main focus of this study is on the perception of the audit committee chairmen, chief internal auditors and deputy chief internal auditors on the criteria affecting the effectiveness of audit committees and its effect on the professional objectivity of the internal auditors. The variables of audit committee effectiveness and the factors affecting the objectivity of internal auditors may be measured using other approaches other than through survey methods. For instance, qualitative research methods incorporating case studies and interviews could provide a significant potential for researching the operations and effects of audit committees in the organizational and institutional context in which they operate (Turley and Zaman, 2001). However, in conducting qualitative research it has to be acknowledged that there are significant difficulties, for example, access to research sites, ensuring consistency and interpreting qualitative data (Turley and Zaman, 2001).

1.7 ORGANIZATION OF THE STUDY

The study will be organized into the following chapters:

Chapter one, defines internal auditing and the need to have an internal audit in an organization. The internal auditors' objectivity and independence are briefly discussed as well as audit committees. This chapter also includes the objective of the study, the problem statement and the justification and significance of the study. Chapter two dwells on the literature review. Here, literature relating to the objectivity and independence of internal auditors, audit committees, and the relationship between audit committees and internal auditors professional objectivity is reviewed. Chapter three discloses the methodology of the study. The chapter covers theoretical framework, hypothesis development and the research method and design. Chapter four contains the statistical analysis. This includes tables analyzed as well as the statistical test of hypotheses. The final chapter (chapter five) draws conclusions from the analysis of the data and provides suggestions for future research.

1.8 CONCLUSION

Many official organizations and bodies internationally as well as in Malaysia have proposed an important role for audit committees and internal audit in the improvement of financial reporting and control. Internal auditors play an important role in assisting the management, particularly the board and audit committee for an effective discharge of their fiduciary duties and in promoting good corporate governance in an organization. More so, in banking institutions in view of the significant role of banking system in an economy and the systemic impact of failures of an individual BI as well as due to the complexities and rapid developments in banking system that expose the BIs to substantial risks. The BIs' board, audit committee, their external auditors as well as regulatory bodies can only rely on the work of internal auditors if, and only if, they could provide objective and independent reports based on their auditing activities. This study provides empirical evidence on whether or not effective audit committees enhance the internal auditors professional objectivity and independence, in the banking industry in Malaysia. The study also contributes to the existing literature on internal auditors and audit committees in Malaysia.