

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 INTRODUCTION

Chapter Four reports the results of survey results and statistical tests performed. This chapter attempts to provide the summary and conclusion of this study as well as recommendations for future research.

5.2 SUMMARY AND CONCLUSIONS

This study has sought to investigate empirically the relationship between audit committee effectiveness and internal auditors' professional objectivity in banking institutions in Malaysia. First, the study examined the variables that affect the audit committee effectiveness and the professional objectivity of internal auditors. Then, it examined the effect of the variables affecting audit committee effectiveness on the variables that affect the objectivity of internal auditors. The answer that is being sought is whether the effective audit committee would actually enhance the professional objectivity of internal auditors of banks in Malaysia.

The results show that banks have generally complied with the directives of the Central Bank on formation, function and duties of audit committee. Consistent with prior studies, all the four variables, namely the existence of an audit committee charter, the appropriate size and composition of an audit committee, the direct channel of communication between audit committee and the auditors, and the audit committee review of financial statements including the interim reports contribute significantly to the effectiveness of an audit committee in the Malaysian banking system. Similarly, with regard to internal auditors' professional objectivity, the study confirms that all the four variables, namely, audit committee's approval of internal audit charter, the direct channel of communication between audit committee and internal auditors, vesting the responsibility with audit committee for hiring, firing and compensation of internal auditors and audit committee's review of internal audit work and programmes, would contribute significantly to the enhancement of the internal auditors' objectivity.

In terms of the impact of audit committee effectiveness on the objectivity of internal auditor, the study however revealed that the existence of

audit committee charter has the most significant impact in the enhancement of internal auditors objectivity, particularly in domestic banks. The domestic banks viewed that the existence of audit committee charter, that gives the power to the audit committee to discharge their duties, is important element :-

- for the approval of internal audit charter by audit committees;
- in giving them the power in appointing or removing the chief internal auditors as well as the compensations for internal auditors; and
- in ensuring the existence of direct channel of communication between audit committee and internal auditors.

In contrast, the foreign banks operating in Malaysia perceived that the audit committee charter contributes significantly in ensuring the direct channel of communication between audit committee and internal auditors. These results were supported by Kalbers and Fogarty (1993). They have stated that the legitimate power of audit committee has the most profound effect on audit committee effectiveness, particularly the written audit committee charter and perceived authority of the audit committee had positive relationship on audit committee effectiveness. They argued that components of organizations such as audit committees must possess power including the legitimate power to effectively discharge their duties. The perceived importance of legitimate power for audit committee and its consequential impact on internal auditors' objectivity in domestic banks is not surprising as this phenomena could be attributed to the cultural variable that underlie Malaysia's institutional arrangement particularly the societal value of *power distance*. *Power distance* is the extent to which hierarchy and an unequal distribution of power in institutions and organizations are accepted (G. Hofstede, 1980 as cited by Choi, Frost and Meek, 1999).

The study also revealed that there is a gap in perceptions between audit committee chairmen and chief internal auditors of Malaysian banks with regard to the ability of internal auditors in maintaining their objectivity when they are subject to pressures from the chief executive officer of their banks. When the internal auditors are under pressure or face certain restrictions from the chief executive officers, the audit committee chairmen claimed that the

likelihood of the internal auditors continuing to perform their audit activities as planned or report such restrictions to the audit committee is very high. To the same situations, the chief internal auditors were slightly skeptical in their perception. This could indicate possible weakness in the control environment as internal auditors were not able to perform their jobs independently (Kalbers, 1992). In fact, the study revealed that some chief internal auditors and/or their deputies (26% of respondents) claimed that their audit committee is not responsible for their appointment, remuneration and compensations. In addition, 16% of the respondents claimed that their audit committee chairmen are not independent directors. Under such circumstances, the internal auditors will likely compromise on their objectivity when under pressure from the chief executive officers who is perceived to be more powerful than the audit committee chairmen.

The study also tested to ascertain the effect of executive management's support to internal audit department on their objectivity. Although prior studies have not considered this variable, the chief internal auditors interviewed during the research process had indicated that the extent of executive management's support to internal audit has a bearing on the level internal auditors objectivity and independence. This view was confirmed by this study as the respondents had given a mean score of 6.4 in the Likert scale indicating that the objectivity of internal auditors will be highly affected if executive management does not give equal support to internal audit department like other business functions in the banks.

5.3 IMPLICATIONS

This is a pioneer study that provides empirical evidence on the extent of the impact of effective audit committees in enhancing the professional objectivity and independence of internal auditors of banks in Malaysia. The study also contributes to the existing literature on internal auditors and audit committees in Malaysia. Perhaps a follow-up study in a year time would provide further insights on this topic of research.

This study has reaffirmed the importance of BNM guidelines, namely BNM/GP1 and BNM/GP10 in ensuring effective audit committees in the country's banking system. Nevertheless, this study also shows that while

accepting the universal best practices for the effective functioning of an audit committee, due regard must be given to the cultural context in which the institutions operate as well as the specific objectives of the audit committees. The domestic banks' boards and audit committees need to focus more attention on the legitimate and perceived power of audit committees in order to enhance the professional objectivity of internal auditors. This is crucial as internal auditors of banking system play a crucial role in the maintenance of safe and sound banking system.

The gaps in perception between the audit committee chairmen and chief internal auditors probably indicate to the banks' boards and the supervisory authorities the following possible reasons:

- Audit committee members are sometimes less active than necessary, believing controls are strong when they are not; or
- Internal auditors are not effective in communicating information and problems to the audit committee; or
- Chief internal auditors may not have been given adequate opportunity to report to the audit committee; or
- Chief internal auditors are apprehensive about reporting negative findings (Kalbers, 1992).

Regular meetings between audit committee chairmen and chief internal auditor may reduce such gaps. The study revealed that there is lack of private meetings between these two parties. This suggests that the audit committee chairmen of the banks may have to interact more frequently with the chief internal auditors to enable the internal auditors to be more objective in performing their functions. Some chief internal auditors could be subjected to the pressure from their chief executive officers, as in their perception the audit committee is not effective. This is possible as some audit committee chairmen are not deemed as independent and that audit committee is not responsible for the appointment, dismissal and compensation of chief internal auditors. Hence, audit committees' full compliance with BNM/GP1 and BNM/GP10 guidelines would reduce such gaps in perception.

Another implication that arises from this study is that the board and audit committee must continuously ensure that internal audit department is

not treated as a second-tier department in the bank. They should communicate and demonstrate to the executive management through their actions and policies that internal audit is one of the key departments in the bank.

5.4 RECOMMENDATIONS FOR FUTURE RESEARCH

Although the present study provides useful information on how to improve audit committee effectiveness in order to enhance the professional objectivity of internal auditors of banking industry in Malaysia, several aspects merit further action.

In view of the reluctance on the part of audit committee chairmen to participate in the survey method, future researches on 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. However, in conducting qualitative research it has to be acknowledged that there are significant difficulties, for example, access to research sites, and, ensuring consistency and interpreting qualitative data. Also, in view of their busy schedules the audit committee chairmen should be given ample time to plan and participate in the research process.

There is no secret formula to what makes an effective audit committee. As in any human endeavour, much depends on the intangibles, that is the personalities of the committee members, the institutions' culture and traditions, the chemistry between the various participants of the audit process, and so on. Although appropriate amount of attention was given to the key characteristics such as having a charter, strong and independent audit committee chairman, open communication with internal auditors and overseeing the work of internal and external auditors, future research could review the consequences of organizational culture and the perceived dominance of the chief executive officer over the chairmen of board and audit committee on the objectivity of internal auditors. Such research would provide

further contributions in improving the corporate governance of Malaysian banks.

5.5 CONCLUSION

Many official organizations and bodies internationally as well as in Malaysia have proposed an important role for audit committees and internal audits 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 bank failures.

The BIs' board, audit committee, their external auditors as well as regulatory bodies can only rely on the work of internal auditors only if they could provide objective and independent reports based on their audit activities. The independence and objectivity of the internal auditors are important prerequisites in the proper conduct of audits so as to render impartial and unbiased judgments.

This is a pioneer study, which had investigated empirically the extent of the impact of audit committee effectiveness in enhancing the professional objectivity of internal auditors in the Malaysian banking system. The study provides several insights that are valuable for supervisory authorities and the bank's management that are crucial to enhance the level of corporate governance particularly in domestic banking institutions. The results of this study could contribute towards the Central Bank's continuous effort to improve the corporate governance in Malaysian banks. Particularly, in its earnest plans to enhance the resilience of domestic banks to meet future challenges.

Finally, the study has also outlined the implication and provides useful recommendation for future research.