Chapter 1

Introduction

This chapter provides an introduction to the overall thesis. It will discuss the background of research, the problem statement, the research questions, the justifications of research and the research objectives as well as providing the orientation of this thesis.

1.0 Background of Research

The development of the conceptualization of risk has been widely discussed and the current emphasis on the notion of risk centrals around the social contest over the control of the economy and society. It has been suggested that the contest to control the economic and social resources will continue to evolve and the current corporate governance development is but its latest manifestation (Spira and Page, 2002). Over the past decades, the control over resources i.e. the ownership of means of production, has gradually moved into the hands of private corporations with successive privatisations. One direction which this contest would expected to develop in is the area of regulation (Hopwood et. al., 1990, pp78). However, the impetus for regulation would only be invoked frequently as a result of some public scandals which produce public discontentment and concern that lead to demand for regulatory mechanisme by the public (Watts and Zimmerman, 1986, p. 227). The corporate governance and accounting scandals in UK and US in the past decades (Matyjewicz and D'Arcangelo, 2004) including the downfall of worldwide corporate giants such as Enron, Xerox, Worldcom and Parmalat, have adversely impacted the corporate world (Che Haat, Rahman and Mahenthiran, 2008). Due to the general reluctance for affected industry group to subject to state regulation, a self-regulation solution would be more acceptable arrangement for both parties i.e. the agents of state avoiding responsibility whilst institutional representatives gain control, power, resources and prestige. It is suggested that the interest groups may seek power in the organisations by asserting their own perception of risk and how it should be managed (Spira and Page, 2002).

As a consequence of privatisation, the role of control has formally been passed over to professional managers ie. the agent, hence the ownership and control of resources become separated. This, in itself presents to the owners, with the doubts if these professional managers who have self seeking motives, could serve the owner's interest well (Adams, 1994). For this reason, monitoring services eg. internal and external auditing are necessary to ensure that the interest of the principal be preserved. On the same token, it is also in the agents's interest to demand monitoring services eg. internal auditing to help them to secure their position as well as to reduce the risk of principals making adverse adjustments on the executive compensation (McNamee, McNamee, 1995). The financial scandals in the 90s highlighted the apparent failures of accountability and invariably, audit and internal control mechanisme which are designed to promote accountability, have provoked debates for reform (Spira and Page, 2002).

On a separate but related note, the internal auditing approach has undergone several profound transformation stages in the past decades (McNamee, McNamee,1995). The earliest and most traditional approach to internal auditing was totally compliance based (substantive) and focused almost exclusively on financial activities, involving a large volume of transactions. This was followed with a system based approach where the internal auditor's main focus was on processes and the systems within and across the organisation. The system based approach relies on examining the adequacy of controls as opposed to reviewing a large number of transactions. The focus on internal auditing then shifted to a risk based approach. The risk based approach focuses on the activities that are critical to the organisation, concentrating on achievements of objectives rather than controls. Its emphasis is on the overall business framework rather than individual systems (Gower, 2005). The concept of risk in auditing is not a new phenomenon in the auditing profession (Alderman & Tabor, 1989). In fact, risk has been a key concept in internal auditing (Walz, 1991). Selim and McNamee (1999 pp 159) define risk as "a concept used to express uncertainty about events and/or their outcomes that could have a material effect on the goals and objectives of the organization".

The concept of risk was first recognized by the American Institute of CPAs auditing standard board in auditing standards back in 1963 in the A.U section 150.05 of AICPA Professional Standards which states

> *"The degree of risk involved also has an important bearing on the nature of the examination..... The effect of internal control on the scope of an examination is an outstanding example of the influence on auditing procedures of a greater or lesser degree of risk of error; ie., the stronger the internal control, the less the degree of risk" (Alderman and Tabor, 1989 pp 56 - 57).*

As the concept of risk evolves, more auditing standards were established to provide guidance for audtiors specifically on the consideration of risks and to promote a risk driven approach rather than a procedural based audit approach It has been suggested that if auditors were to use the procedures driven approach, the important decisions concerning the nature, extent and timing of audit procedures may be compromised and controlled by inappropriate, though important factors and this could lead in ineffective and inefficient audit outcomes (Alderman & Tabor, 1989).

The concept of risk which provides a framework for better control of audit effectiveness and efficiency, has received increasing support in the accounting literature on risk in the 80s (Alderman and Tabor, 1989). The concept was given due recognitions in the auditing profession and this was notable as it was incorporated in numerous auditing standards set. Risk assessment auditing standards seek to improve the quality and effectiveness of audits by substantially changing audit practice. Statements on Auditing Standards nos. 104-111 provide increased rigour to the audit process in a number of key areas and linking risk assessment to further audit procedures (Ramos, 2009). The emphasis of the auditing standards on risk has a signification impact on the profession and the way internal auditors carry out their auditing work. In June 1999, the Institute of Internal Auditors (IIA) officially adopted a new definition of internal auditing function. The new definition was developed by Guidance Task Force (GTF) and it defines internal auditing function as:

> *'An independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes' (IIA, 1999).*

The new definition presented a significant opportunity for internal auditing to emerge and demonstrate its potential to add value, to break away from its historical characterization as the "organizational policeman and watchdog" (Morgan, 1979). The new definition shifts the focus of internal audit function from one of assurance to that of value adding as well as attempts to guide the profession toward a standard driven approach with heightened identity (Bou-Raad, 2000; Krogstad et al., 1999; Nagy & Cenker, 2002). It focuses on a consultative approach within which the organisation operates and concentrates on effeciency and effectiveness instead of accurancy of recording which has been the profession's focus (Bou-Raad, 2000).

Hence, with the change of emphasis of the internal auditing function, the focus of internal audit work has shifted over the last decades from systems-based auditing to process-based auditing to risk-based auditing (IIA – UK and Ireland, 2003). The work of internal auditors has shifted from being control-driven to being business risk-driven and risk-based internal auditing contributes to effective risk management (McNamee and Selim, 1998). In fact, Internal auditing could add value to the organisations by helping them to achieve economy, efficiency and effectiveness (Al-Twaijry et al., 2003) through providing consulting services to management and employees and by assisting them in the management of risk (Spira and Page, 2003). Thus, risk-based internal auditing has emerged as an important contributor to effective risk management (Allot, 1996).

The role of internal auditors are seen to be moving away from the traditional roles of 'bean counters' and 'number crunchers' to roles that have seen them becoming involved in almost every facet of an organisation's operations (Bou-Raad, 2000). With internal auditing function being redefined, intenal control system is found to be increasingly associated with risk management. Both Turnbull Report (1999) and its predecessor, Hampel (1998), emerged against a backdrop of growing demand for corporate reporting on the effectiveness of internal control and risk management as a consequence of some well publicised financial scandals. The Turnbull Report (1999) was premised on the adoption by corporate boards of risk-based approaches to internal control and on the subsequent monitoring of their effectiveness (Fraser and Henry, 2007). Internal control system facilitates the effective and efficient operation of companies by enabling them to respond appropriately to significant business, operational, financial, compliance and other risks (Sarens and Beelde, 2006). In short, the system of internal control of an organization would support the achievement of the organization's objectives.

However, there is considerable debate as to the role of the internal audit function in risk management (Beasley, Clune and Hermanson, 2004). Even with the increasing association of internal control systems with risk management, the relationship between risk management and internal control has not been clearly articulated. Lindow and Race (2002) argued that internal auditors should play a key role in monitoring a company's risk profile. To ensure consistency of approach across a wide range of business units, internal monitoring bodies such as internal audit functions and audit committees are becoming increasingly involved in risk management, but it is unclear whether these particular bodies are the optimal means of dealing with risk management issues (Fraser and Henry, 2007). Internal Audit departments are called upon to play a variety of roles in their organization's enterprise risk management (ERM) activities especially since The Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its Enterprise Risk Management-Integrated Framework in September 2004, which provides a model for ERM process and defines ERM as:

"A process, effected by a entity's board of directors, management and other personnel, applied in strategy setting and across the entreprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives"(COSO, 2004, pp 4).

The developement of a common terminology and an accepted framework for ERM provides some clarity to ERM activities but the nature of the ERM roles some of which are non auditing could compromise internal auditors role in the organisation (Gramling and Myers, 2006) as it would affect their independence and objectivity in discharging their auditing functions. Most of the literature on risk based auditing and risk management has focused on developed countries with very little attention given to this subject in developing countries, including Malaysia (Yazid, 2009). The empirical research towards ERM is found to be lacking in Malaysia (Yazid, 2006). Weak corporate governance (Mitton, 2002) and poor risk management (Jin, 2001) were found to be the main factors attributable to the company failures during the East Asian financial crisis in 1997. The Malaysian corporate landscape was then blemished by a couple of cases of bad corporate governance such as Tenaga National Berhad, Renong, Perwaja Steel and Malaysia Airlines System (MAS). This has resulted in calls for better corporate governance, risk management and transparency among Malaysian companies (Yazid, 2006, Che Haat, Rahman and Mahenthiran, 2008). As a consequence of the financial crisis in the 90s, risk management initiative was integrated as an important part of corporate governance code in many countries. In 2000, Malaysia had introduced the Malaysian Code on Corporate Governance which was initially voluntary but subsequently, the revamp of the Listing Requirements of Bursa Malaysia in 2001 has made it mandatory for all listed companies to provide a mandatory statement of compliance with the Code.

1.1 Problem Statement for Research

The current emphasis on the notion of risk is central to a social contest over the control of economic and society. (Spira and Page, 2002). The separation of ownership and management functions and the existence of information asymmetry has introduced the possibility of conflicts between the principals and their agents (Haniffa and Hudaib, 2006). This conflict which reflects in corporate governance development, represents the power relations and political settlements amongst stakeholders namely the shareholders, creditors, management and employees (Jackson, 2000). Ongoing pressure from stakeholders to mitigate risk in order to protect their interest seems likely to be influential in the development of internal auditing in the future (McNamee and Selim, 1998). In fact, thefocus on risk management has become central to this competition since it defines the management's accountability (Spira and Page, 2003). These developments have brought forth a notable shift in the focus and approach to internal auditing to risk based and by virtue of the shift, demands are placed upon internal auditors by management in discharging their regulatory and business responsibilities. The new definition of internal audit elicits issues in internal auditing worthy of examination.

Firstly, the effectiveness of the risk based auditing approach in contributing to the achievement of the organisational objectives is a crucial consideration to promote good corporate governance. Internal auditors in adopting the risk based approach would best deploy the limited resources at their disposal to the areas identified as vital to the achievement of the goals and objectives of the organisation. Balancing the complexity and competing demands of stakeholder needs with limited internal auditing function resources also requires effective audit management and planning by the chief audit executive (CAE) (PwC, 2006). It has been known that effective managing or controlling of the risk drivers can result in market leadership, increasing a company's growth and investor confidence (Meier, 2000). By the same token, factors that promote the adoption of risk based approach which primarily focuses on prioritisation of deployment of limited resources on mitigating the significant organisational risks, through identification of the risk factors and managing of those risks would assist organisations to achieve their objectives and goals. Hence, a study that seeks to establishing the factors that promote the adoption of the risk based approach to internal auditing and how the extent of the adoption of this best practice approach would add value in promoting the achievements of organisational goals.

Another issue begs explanation, does the change in orientation of internal auditing changes the internal auditors' activities? (Nagy & Cenker, 2002). As the use of a risk-based approach easily lend itself to an interest in the risk management process (Beasley, Clune and Hermanson, 2004), internal auditors by virtue of the nature of their work and knowledge, are the ideal candidates to understand, identify, assess, report and perhaps, assist the organisation in managing risks. It would be possible that their adoption of risk based auditing approach would make them more responsive and receptive to involvement in ERM intitiatives as they would be accustomed to the concept. If indeed, the application of risk based auditing goes beyond the realm of the core internal auditing work or practice, does the degree of application of risk based approach to their work have any impact on their responsiveness in risk management activities or could it be just a pure coincidence.

Most prior literature on aspects of internal auditing have focused on empirical evidence from the Anglo-American world (Castanheira, Rodrigues and Craig, 2009). In Malaysia, the recent related empirical studies central around the internal auditor's role in ERM and corporate governance practice in public listed and government linked companies. The new definition of internal auditing function which places greater emphasis on risk based audit has presented some interesting issues for deliberation and examination. Irregardless what might be the reasons for the increased in adoption of risk based auditing approach by the internal auditors, the paper seeks to explore the possible explanations for the issues highlighted above.

1.2 Research Questions

The issues and concerns highlighted above stem from the shift in focus of internal auditing function to risk based and how the adoption of this risk based auditing approach influences the perception of their role in risk management. Hence, it begs the following questions for further investigation,

1. What are the company specific factors which determine the adoption of risk based auditing approach by the internal auditors and to what extent?
2. Does the adopting of risk-based auditing approach made Internal Auditors more receptive or responsive to participation in ERM activities?
3. To what extent does the adoption of risk –based auditing approach influence Internal Auditor's responsiveness to risk management activities?

4. What are the company specific factors that influence the responsiveness of Internal Auditors to risk management activities?

1.3 Justification of the Study

There was a growing prominence of risk based approach and its adoption by internal auditors in performing internal auditing workbut researches with the similar research orientation as proposed in this study found to be lacking in the Malaysia.

This study is initiated after a careful analysis of the problem statement. It attempts to address the issue whether the adoption of risk based approach to auditing would make internal auditors more responsive to participate in risk management activities since it easily lends itself to an interest in the ERM process as mentioned by Beasley, Clune and Hermanson (2004). Also, the factors that drive the adoption of risk based auditing amongst the practitioners within the internal auditing profession may be well publised in the literature but are these factors equally ‘commanding’ in influencing the responsiveness of the practioners in their involvement in risk management activities. All these issues shall be investigated in this research paper in the context of the internal auditing practice in Malaysia.

1.4 Objectives of Research

The main purposes of this research are basically to determine the factors that influence the adoption of risk based auditing approach by the internal auditors and how this approach influence directly or indirectly the internal auditor’s responsiveness to ERM activities of the organisations in Malaysia. The relationship between the extent of adoption of the risk based auditing approach and their responsiveness to risk management activities will also be explored in detail. The impact on the responsiveness of internal auditors to risk management activities will be further examined in respect of the company specific factors identified.

The understanding of how company-specific factors influence the adoption of risk-based auditing approach both at the annual audit planning and individual audit execution stages allows stakeholders to assess the organisation's effectiveness in protecting their interests. It will also explain why such drivers of risk based auditing influence internal auditor's choice of auditing approach. With the shift of focus in the auditing profession toward risk based approach, the adoption of risk based approach by internal auditors would naturally present an opportunity for them to play an active role in risk management activities. The knowledge of how the risk based approach influences the type of ERM assignments that internal auditors would take up, may help the profession to understand the reasons for the adoption of such ERM roles by internal auditors. This could provide a basis for the likes of IIA to further improve on the guide or standard issued in this respect if deemed necessary.

1.5 Orientation of Research

This study consists of five chapters. The remaining chapters include:

Chapter 2**, Literature Review -** contains discussion and evaluation of journals, articles and research studies in relation to the main subjects of this study.

Chapter 3, **Research Method -** describes how the research was conducted in terms of a research setting, sample used, data collection, measurement scales and analysis methods.

Chapter 4, **Research Results -** reports on the research results, analysis and findings.

Chapter 5, **Discussion and Conclusion** - presents the summary of research results, discuss on the research findings and implications, limitations to the research, conclude and provide recommendation for future research.

Bibliographies and appendices are included at the end of Chapter 5