CHAPTER 1: INTRODUCTION

1.0. OVERVIEW

Corporate governance has become the corporate buzzword since the last two decades (Chapra and Ahmed, 2002). Not until the recent corporate scandals involving gigantic corporations such as Enron, WorldCom, Global Crossing and so forth, the response of corporate entities as well as amongst the public themselves toward the significance of corporate governance are very disappointing. Nevertheless, increasing number of collapses have made public especially investors more aware of the importance to demand high level of corporate governance practices from business entities which they have entrusted their money in them.

The bankruptcy of Enron has evolved into a scandal of enormous proportions involving allegations of fraud, corruption and unethical practices such as financial manipulation and questionable accounting practices on the part of Enron's corporate executives, members of its board of directors, external auditors and high government officials in the USA (Baker, 2002 and Chatzkel, 2003). The weaknesses in Generally Accepted Accounting Principles (GAAP) of the US, and Financial Accounting Standard Board (FASB) gave enough room to the Enron's management to get an advantage from it by inflating income.

Meanwhile, Malaysia also has its very own classical examples. The Malaysian Airlines System (MAS) and Renong Bhd were the clear victims in this case. For the case of MAS, the national carriage company was under the mountain of debts especially after 1997, due to its high operation costs and related transaction with the company that owned by the directors at that time. As a consequence, MAS' share prices had dropped significantly. As for Renong Bhd, which was once the country's most powerful conglomerate with interests spanning from infrastructure, banking, oil and gas to property, the Asian financial crisis exposed its highly indebted situation. There are many more conglomerates like Renong, who live on soft loans from government-supported banks whose non-performing loans ballooned several folds when the financial crisis struck.

All the above are examples of the failure in corporate governance. Such failures might result from the failure in the current codes on the corporate governance. Good corporate governance requires more than an active board, the right committees and meeting the legal requirements. It is also about creating wealth for all shareholders while taking into consideration the interests of other stakeholders. In fact, good corporate governance requires establishing internal audit function, creating a culture of ethics, having governance framework, ensuring management has a comprehensive understanding of how to manage risks and the right monitoring processes.

1.1. CORPORATE GOVERNANCE AND INTERNAL AUDIT

Subsequent to all the disastrous events, the press, the U.S. Security and Exchange Commission (SEC) and the members of Congress had all declared that the existing process of establishing auditing standards and monitoring public accountants was a failure. This results in the Sarbanes-Oxley Act (SOA) passed in 2002. The SOA is seen as causing radical changes and strong new rules for public accounting, corporate governance and others including internal audit, since 1930's (Moeller, 2004). The internal auditing profession in the US has indeed been experiencing a major reformation.

As the concept of internal auditing adopted in Malaysia originates from the US, the Institute of Internal Auditors (IIA) Malaysia is using the Professional Practices Framework issued by the IIA US as their reference. New standards for professional practice of internal auditors (2002) have emphasized the role of internal auditing as a "value added" service rather than just performing the routine compliance and operational audit. Since 2002, all companies listed on the Bursa Malaysia are required to have an internal audit function. In addition to that, companies are required to include an internal control statement together with the annual reports (Listing Requirement 2002).

The role of Internal Audit function in ensuring good corporate governance and development in Malaysia are vital in order to provide continuation of a sound business framework for respectful companies. Corporate governance in a general term is about creating wealth for shareholders while taking into consideration the interests of other stakeholders. In other words, a company with good corporate governance is likely to balance the objectives of maximising profit and corporate responsibilities.

1.2. PRIOR STUDY

In the US and UK, many studies have been conducted on the importance of internal audit in corporate governance. There also exists an extensive practitioner literature on specific internal auditing topics, such as risk management, risk-based auditing, audit planning, etc. The academic literature on internal auditing practices is, on the contrary, rather limited and often very time specific. Furthermore, the Asian literature on this topic is scarce, because most empirical research work focuses on the US context.

Of late, a few studies on internal audit have been conducted in the context of Malaysia. Study by Haron et al (2003) revealed the importance of competence and work performed by internal auditors. The study suggested that the external auditors would be able to rely on the internal auditors and in turn the audit will be more cost effective to the companies.

Ahmad et al (2003) focused the discussion on the current development of the internal auditor's role in the detection and prevention of fraud. For the

Malaysia scenario, the Professional Practices Framework, the guidelines on Internal Audit Function and the New Handbook on Corporate Governance were used as a basis of discussion. It was recommended that pro-active action be taken in disallowing outsourcing of internal audit function, on the grounds that an external auditor might not be able to carry out the exact day-to-day job of an internal auditor. Another recommendation of the study Ahmad et al (2003) was that, as a result of a shift in the internal audit focus towards value added and consultancy services, the coordination between the internal audit function and the external auditors is therefore necessary to ensure proper coverage and to minimise duplication of work especially on the reviewing of the internal control.

IIA Malaysia, as part of its objective to enhance the position of the internal auditor in corporate governance, conducted a Survey on Internal "Audit Functions of Public Listed Companies in September 2002. Respondents had rated risk management corporate governance and business analysis as the top three skill sets and knowledge for internal auditors. Such ratings reflect the endorsement of the position of internal auditors in governance practices as a result of the recent accounting scandals in overseas.

All the above quoted studies accentuate that internal auditors will continue to play an important role in discharging an entity's board governance. With time this profession can become a key function to boost stakeholders and investors confidence in the capital market.

1.3. PURPOSE OF THIS PAPER

As the corporate governance framework for Malaysia continues to undergo constant review and development, to ensure it remains effective and updated, it is high time that Malaysian companies take full advantage of the opportunity in ensuring effective corporate governance.

It is proposed that, in the context of corporate governance, the importance of the internal audit to organisations cannot be underestimated. Maintenance and enhancement of skills and knowledge of the business are critical if internal auditors are to continue to be a key part of the corporate governance arrangements in the future.

This study attempts to contribute to the literature by studying the importance of internal auditing in corporate governance. The paper will focus on the importance of internal audit in the development of corporate governance. As the internal control system is one of the important elements for good corporate governance, the level of internal control among some major Malaysian companies will be examined via questionnaire. Then the descriptive statistical evidence of internal control will be presented for discussion.

1.4. SIGNIFICANCE OF INTERNAL AUDIT

Since the internal auditors' role is to assist that controls of the company is in place. At a minimum, the company is to disclose that there is an ongoing process for identifying, evaluating and managing significant risks faced by the company. As summarised in 1.4.1 to 1.4.5 below, the IIA highlighted five areas of concern by which internal auditing can help the board operate most effectively.

1.4.1. Strategy and Planning

Strategy is critical to an organisation's long-term success. The internal audit department can be a key player in collecting the information and making sure that it is accurate and complete. As the new strategy is developed, internal auditing can provide great value in identifying gaps as well as areas where additional attention is needed to ensure a high likelihood of success.

1.4.2. Risk Management

With the possible exception of strategy, the topic most discussed at the board level is risk. Management might not have a process in place that elevates serious risk considerations to the board level in a timely manner, and a board would not like to be kept in the dark about impending trouble. Because managing risk is a core competency for most internal audit departments, they can provide great value helping the board identify significant risks.

1.4.3. Tone at The Top

To develop the desired value-based culture, the mind-set and actions of the CEO and the senior management team should convey the organisation's values, mission, and direction for the future. Internal auditors have long considered integrity and ethical values when assessing their company's control environment.

1.4.4. Measuring and Monitoring Performance

Industries, markets, and competitors have become too complicated and dynamic for only financial reports, which are largely after-the-fact yardsticks. Monitoring company performance must be done right and continuously. But to do so properly, the board needs to move well beyond reviewing traditional financial reports, and it is in this area that internal auditing can add substantial value.

1.4.5. Transformational Transactions

Recent studies confirm that the vast majority of acquisitions fail to meet the acquirer's objectives, with many never recovering the purchase price, let alone the cost of capital. Consider the expertise internal auditors bring to the due diligence process, ensuring relevant issues and concerns are brought to management and the board.

Finally, internal auditing can lend its proven expertise to analysis of capital expenditures relative to strategy, plans, and budgets. In addition to its importance in corporate governance, internal auditing can also be of value both in evaluating the success or failure of past deals and in assessing the post-deal integration plan and progress toward its execution.

1.5. MEETING THE CHALLENGE

If the Asian financial crisis and recent corporate scandals across the globe have done any good, it is to emphasize the importance of corporate governance. A few years ago, it was fashionable to mention the term 'corporate governance', but today, there is an urgent need to put it into practice to prevent abuse. For controlling shareholders' interest, a good corporate governance framework is absolutely necessary.

Today's boards clearly need to examine their responsibilities carefully and determine how they will go about the task of meeting their obligation to shareholders. The process works best when internal auditors do the same, stepping up to the governance plate with leading-edge information and guidance, thoughtful and accurate analysis, and insightful consultation and recommendations.

A significant element of a robust corporate governance framework is a sound control environment. That environment encapsulates the management of risks confronting an organisation both as an opportunity and as something to be minimised or eliminated. While risk should be managed corporately at all levels of the organisation, internal audit can assist both by providing advice from its own experience and knowledge as well as providing assurance about the approaches being taken, their application and effectiveness.

An internal audit function could be viewed as a "first line defence" against inadequate corporate governance and financial reporting. With appropriate support from the Board of Directors and Audit Committee, internal auditors are in the best position to gather intelligence on inappropriate accounting practices, inadequate internal controls, and ineffective corporate governance.

By having a real and visible presence in the organisation, internal audit is also well placed to promote the principles of good corporate governance and act as a deterrent to the adoption of poor practices. To be able to fulfil this role and meet the challenges ahead it will be fundamentally important to establish a close working relationship with key internal stakeholders.

In summary, internal auditing is integral to good corporate governance, and it has been proven that good corporate governance helps business sustainability. Internal auditors through their reports, provide information to both management and the board of directors. Properly conceived and implemented, the internal auditing function can play a critical role in promoting and supporting effective organisational governance (Ramamoorti, 2003).

The subsequent sections of this paper are arranged as follows. Chapter 2 will deal with the literature review on the corporate governance and internal auditing, covering the definition and their importance. Chapter 3 focuses on methodology and how the research study is conducted. Chapter 4 will be the analysis of research result, summary of respondents and interpretation of major findings. The last chapter will be the conclusion, as well as highlights on limitations, implications and recommendations of the study.