CHAPTER 2: LITERATURE REVIEW

2.0. INTRODUCTION

In this chapter, the importance of corporate governance is discussed, focusing on the definition of corporate governance, the role of board of directors, the need for and the issues on corporate governance.

The role of internal audit for corporate governance in Malaysia is also discussed in detail covering listing requirements of Bursa Malaysia, ownership structure of public companies in Malaysia, collaboration of internal auditor with external auditor and the increasing demands for internal audit

2.1. CORPORATE GOVERNANCE

2.1.1. Definition of Corporate governance

Corporate Governance is about managing the potential conflict between outside investors of a firm i.e. creditors and shareholders, and corporate insiders i.e. controlling shareholders and managers (Prowse, 2003; Lemmon & Lins, 2003). It is a set of mechanisms to ensure that outside investors get a fair return on their investment (Denis & McConnell, 2003; Dedman, 2003). Good corporate governances exist when the insiders and the outsiders communicate honestly and openly (Grant, 2000).

There are numerous definitions of corporate governance, but in essence it is about creating wealth for all shareholders or beneficiaries, while taking into consideration the interests of other stakeholders.

2.1.2. The Role of Board of Directors

A corporation must have a Board of Directors (the Board). The Board, categorised in the earlier paragraph as part of corporate insiders, is charged with the overall responsibilities for the corporation. It represents a group of people who gather together to collectively add value to the firm they lead (Ingley & Van de Walt, 2003).

Board members are required to act in a prudent manner on behalf of the corporation's best interests. In January 2001, the Malaysian Code on Corporate Governance (MCCG) introduced the Code of Best Practices which prescribes a board structure that favours the separate chairman / chief executive officer roles, and the appointment of independent non-executive directors to the Board.

The Board does not manage the firm, but the management does. The Board hires, fires, monitors and compensates management (Denis, 2003; Denis & McConnell, 2003). Interaction among Board members is important. A Board should not be a passive instrument that holds allegiance to the managers, and depend on managers for information (Coles, McWilliams & Sen, 2001).

The Board must act cautiously in managing the affairs of the corporation, and no Board member should put his or her personal interests ahead of those of the corporation. All Board actions should be documented to show that corporate business was conducted responsibly.

2.1.3. Need for Corporate Governance

Berle and Means (1932) observed that a consequence of the separation of ownership and management was ownership dispersion and that such dispersion made subsequent monitoring and discipline of management difficult.

Corporate governance issues arise wherever contracts are incomplete and agency problems exist. The heritage of modern governance can be attributed to this observation. That is, corporate governance developed as a way of ensuring that investors receive a return on their investment by protecting against management expropriation or use of the investment capital to finance poor projects. This fact is clearly evident from the empirical investigation of corporate failures during the 1980s, with corporate governance proposed as a general prescription (Tricker, 1984)

Shleifer and Vishy (1997: 769) suggest that both the legal protection of investors and some form of concentrated ownership are essential elements of a good corporate governance system.

2.1.4. Issues on Corporate Governance

The bankruptcy of Enron Corporation has evolved into a scandal of enormous proportions involving allegations of fraud, corruption and unethical practices. Enron had "legally" hide substantial amount of its cost and liabilities into its "special purpose entity (SPE)". The company that uses this practice explicitly has an intention to confuse the public and investors. The Enron's corporate crime was done with the help of its close "business partner", Arthur Andersen that collapsed together with it.

The conflicts between Enron and its auditors are too obvious because the ties between these two gigantic companies went even deeper when Arthur Andersen was not just appointed as an external auditor but also as an internal auditor in the mid-1990s. The auditors had been in conflict to act independently and at this situation auditors have always been in the uncomfortable position of having to judge the financial integrity of the companies that pay them. Arthur Andersen had begun to be a business partner of Enron instead of the auditor that governed by professional ethic.

A more recent case involves Parmalat, an Italian dairy-products group. Parmalat used its subsidiaries to hide the declining in its finance. It has been said that Parmalat simply created "artificial" assets to offset as much as USD16.2 billion in liabilities and falsified account over a 15-year period, using complex financial transaction to shore up its balance sheet, and forcing it into bankruptcy on December 2003 (Edmondson, 2004). Such case was really giving some blows to the international accounting industry.

2.1.5. Cases in Asia

Not long after the East Asian financial crisis, a study was commissioned by the Asian Development Bank (ADB) to investigate the corporate governance structures of the Asian crisis economies. In the comprehensive analysis, drawn from five individual case studies of Indonesia, Korea, Malaysia, Thailand and the Philippines, the ADB provided a comparison of governance structures, focusing on ownership, finance and control. They found, on the whole, that the governance structures of the crisis economies closely resembled each other. Generally, the elements were high ownership concentration (allowing insiders to dominate control), bank-centric financial systems, ineffective shareholders' rights and low transparency. Malaysia was not spared from the contagious effect that followed the 1997 financial crisis in boosting investor confidence, as financial analysts in the world over viewed Malaysia in the same basket with that of its regional neighbours.

2.1.6. Cases in Malaysia

Malaysia, being a developing country in the area of South-East Asia also has its very own classical examples. The 1997 crisis had seen Malaysia going through a series of corporate failures involving the country's gigantic conglomerates such as the Malaysian Airlines System (MAS) and Renong Bhd.

For the case of MAS, the independence of its auditors was really questionable. The auditors, Arthur Andersen, had failed to issue qualified report for the financial accounts ended 2000 and 2001 although there were indications that the company was having problem with the going concern issue. MAS 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. Nevertheless, the government of Malaysia had become the saviour of the century by buying back the stake from Naluri Sdn Bhd at RM8 per share, which was double of market price. In this case, not only MAS has the problem with its corporate governance, but also the government of Malaysia.

As for Renong Bhd, which was once the country's most powerful corporation with interests spanning from infrastructure, oil and gas, and banking to property, but the Asian financial crisis changed all that. There are many more conglomerates just like Renong, the 1997 financial crisis exposed the woes of these highly indebted conglomerates since many of them live on soft loans from government-supported banks whose non-performing loans ballooned several folds when the financial crisis struck.

This hard lesson taught Malaysia corporations that corporate governance, or rather the lack of it, can have a profound impact on the market.

2.2. CORPORATE GOVERNANCE DEVELOPMENT IN MALAYSIA

Corporate Governance in Malaysia is relatively new. After the Asian crisis in 1997, Malaysia saw the need to improve corporate governance in firms to regain investors' confidence. Foreign direct investments in Malaysia had dropped from USD5.1 billion in 1997 to USD3.7 billion in 1998 (Haley, 2000b, p.19). Weak corporate governance has often been cited as one of the causes of the said crisis (Suto, 2003; Mitton, 2002). Michael Backman was quoted by Haley (2000a, p.24) as alleging that Asia suffered from the disease of insufficient transparency. Western model of corporate governance is perceived as the ideal model that Asian countries aspire (Kang, 2003). As a move to investors' confidence, Bursa Malaysia introduced the Listing Requirements on in 2001, which includes a Code of Best Practices to regulate the practice of corporate governance by public listed companies (PLCs) in Malaysia (Kang, 2001).

2.2.1. Listing Requirements of Bursa Malaysia

After the 1997 Asian crisis, Bursa Malaysia eventually introduced the Listing Requirements (LR) on 22 January 2001. The LR includes a Code of Best

Practices to regulate the practice of corporate governance by public listed companies (PLCs) in Malaysia (Kang, 2001).

The LR was modelled after the UK Codes comprising of the Cadbury, Greenbury and Hampel Reports (Kang, 2001; Ow-Yong & Cheah, 2000). The Code of Best Practices therein prescribes a board structure that favours the separate CEO/chairman roles, and the appointment of independent non-executive directors to the Board. The Code is prescriptive in nature and compliance with the Code is voluntary.

Compliance with the Code is voluntary, but is sprinkled with a mandatory disclosure of the extent of compliance with the Code. Thus, firms will be singled out for non-compliance, and hopefully, the stigma attached will induce or motivate compliance.

2.2.2. Ownership Structure of PLCs in Malaysia

Malaysia PLCs are typically characterised with high levels of ownership concentration, and significant participation of owners in management (Khatri, Leruth & Piesse, 2003; Claessens & Fan, 2002). Hence, the agency problem in Malaysia may not be between shareholders and managers, but between minority shareholders, and the majority shareholders who often have virtual control over the managers (Morck & Yeung, 2003; Hanazaki & Liu, 2003; Claessens & Fan, 2002).

On a study of family firms in Taiwan, Yeh, Lee and Woidtke (2001) discover that a family typically needs only 15% equity on a listed firm to control the firm effectively. The critical level of control in Malaysia is perhaps different. In line with the National Economic Policy, the Bumiputra (indigenous Malays) usually holds 30% equity in a PLC (Haniffa & Cooke 2002; Yeung 1999). The family firm will therefore need to hold more than 30% equity to reach the critical level of control, and strengthen its position by appointing their own 'independent directors' on the Board. To pre-empt any hostile takeover, the family firm will need to ensure that the remaining shares floating in the open market are well dispersed.

Family firms in Malaysia tend to control PLCs through a confused array of pyramid structure and cross-holdings (Morck & Yeung, 2003; Morck, 2003; Solomon et al., 2003). The complex set of interrelationships among the variables that influence performance suggests that there is no single set of governance mechanisms that is optimal for all firms (Prowse, 2003; ed. Denis, 2001).

2.2.3. Can Listing Requirements Improve Corporate Governance?

Can the present Listing Requirements (LR) of Malaysia mitigate the conflicts in PLCs to improve corporate performance? With the initiative to look into corporate governance, the Bursa Malaysia together with PricewaterhouseCoopers (PWC) commissioned a joint survey (KLSE-PWC, 2002), to establish the extent of corporate governance practices among pubic listed companies in Malaysia. The preliminary findings were adopted in the proposed MCCG in February 1999, which came into effect in March 2000. The MCCG has put risk management, controls and internal audit functions on centre stage.

In a recent survey conducted by Bursa Malaysia-PWC (2002), the findings are that local and foreign fund managers are willing to pay at least 10% premiums on Malaysia public listed firms that have excellent corporate governance practices. Watts (2003) from UK concurs with the findings. Perhaps there is light at the end of the tunnel after all.

2.3. THE ROLE OF INTERNAL AUDIT

2.3.1. Overview

In view of the increase of accounting frauds, the revised definition of internal auditing indicates that the profession's scope now includes evaluating and improving the effectiveness of a company's governance process. In an article (Internal Auditor, August 2000), IIA Chairman Jacqueline Wagner predicts that audit committees and boards will look increasingly to internal auditors to be their eyes and ears across the organisation.

The importance of internal auditing has been widely recognised during the past two decades. In June 1999, the Institute of Internal Auditors (IIA) promulgated a new definition of internal auditing which focuses on independence and objectivity, identifying an assurance and consulting role for internal audit and emphasizing adding value and improving effectiveness of risk management, control and governance processes. Krogstad et al. (1999, p. 33) outlined the development of this new definition and noted that "internal auditing's interface with governance raises the stakes for the profession".

The revised definition of internal auditing indicates that the profession's scope now includes evaluating and improving the effectiveness of a company's governance process. Although this new interest in the potential of internal audit to contribute positively to corporate objectives, it offers an opportunity for a stronger claim to professional status, difficulties remain. Pentland (2000), seeking to establish the boundaries of audit, observed that auditors are experts in process rather than content:

> ...in areas such as environmental audit, specialists from other disciplines offer strong competition to the expert status of the traditional internal auditor.

Similar challenges are encountered in the area of risk management and may be rebutted by the assertion that internal audit has the advantage of independence (ICAEW 2000, p.9) but the tension remains between the consultancy role of internal audit and claims of independent status.

2.3.2. Collaboration with External Auditor

Recent events in the corporate sector have increased the prominence of internal auditing. The bankruptcies, financial reporting irregularities, and fraudulent activities that took place in Enron, WorldCom and other firms have greatly increased scrutiny on corporate monitoring. Especially in light of the external audit failures associated with these events, internal audit's role in corporate monitoring is sure to be expanded.

While external auditors are concerned primarily with financial reporting, internal auditors typically do not spend most of their time dealing with financial reporting. A survey by Barrett et al. (1990) found that, on average, internal auditors spend 32 percent of their time on financial audits. Interestingly, though, a survey by KPMG Peat Marwick (1999) found that internal auditors were more likely to discover fraud than external auditors.

Fogarty and Kalbers (2000, p.134) explored a range of dimensions of professionalisation in internal audit, identifying independence, autonomy and self-regulation as key attributes, but cautioning that:

> ... organisations should also be aware that internal auditing inherently involves role conflict. Efforts to eliminate role conflict may deny internal auditors the very essence of their roles in the organisations.

2.3.3. Audit and Internal Control

Claims for professional status both support and are supported by the identification of areas in which professional expertise may be demonstrated. The financial scandals, which provoked worldwide concern with corporate governance in the 1990s, highlighted apparent failures of accountability. Inevitably audit and internal control, mechanisms designed to secure accountability, became a focus for the debate about reform. Internal auditors, traditionally specialists in internal control but not highly regarded within organisations, have attracted the attention of boards grappling with external demands for assurance about corporate governance practice.

Thus Turnbull's Report (1999) on broader approach to internal control has offered internal audit the opportunity to claim expertise in the crucial area of risk management. The Report located internal control clearly within the framework of risk management. It also recognised that profits are, in part, the reward for successful risk-taking in business, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it.

The power base of internal audit is firmly established: it is a key component of good corporate governance practice. But to what extent has the opportunity identified for extending this advantage been exploited by internal auditors?

There is a consensus that important changes are occurring in the nature of internal auditing. McNamee and McNamee (1995) characterised the history of internal auditing since the Second World War as one of a transformation from validation of transactions to one of systems auditing. They also detected a change in which internal auditors became "a primary agent for transformational change" in helping users of systems to "design test and monitor their own controls" (McNamee and McNamee, 1995, p. 35).

2.3.4. Increasing Demands for Internal Audit

The scope of internal auditing now embraces wider concepts of corporate governance, risk and control, recognising that control exists within an organisation basically to manage risk and promote effective governance (IIA, 2003). These fundamental shifts in the nature of internal auditing mirror, to a large degree, developments within the profession over the past decade. For example, the growing uses of control self-assessment techniques as an adjunct to, and replacement for, traditional internal audit activities. Consequently, the new definition is, in large measure, a reflection of current reality in many internal auditing 'practices' rather than an anticipation of future developments.

The role of the internal auditor is increasing. An expanded concept of intangible assets, the speed of electronic commerce and the acceptance of global competition are driving companies to redefine the way they conduct business. Recognising their objective, analytic abilities, as well as their broad organisation wide perspective, management is calling upon internal auditors to assist in addressing these changes (McCall, 2002). In this advisory capacity, internal auditors are redefining themselves as proactive management consultants who advise on mitigating the risks inherent in implementing new business strategies.

2.3.5. Importance of Internal Audit in Corporate Governance

Power (1999a, b) suggested that there has been a fundamental change in the nature of corporate governance from "regulation from above" to "regulation from the inside" and that the key to what he calls this "proactive compliance based style of regulation" is a "risk based future orientation". Risk management is integral to "the new self-governance of the organisation". Despite Power's worldview of an "audit society", it is likely that there is growing divergence of compliance cultures. In many risk-oriented approaches compliance is downplayed. As previously noted, different risks are subject to widely different regimes and a compliance culture is only one kind of regime.

The growth of concern for corporate governance has been of great benefit to the standing of internal auditors and has boosted their claims to professional status by emphasizing the benefits of independence of judgement and objectivity in their reports. Following the notion that Western model of corporate governance is the ideal model for Asian countries (Kang, 2003), Bursa Malaysia has mandated all PLC to establish internal audit functions as a move to improve investors' confidence.

With an established internal audit function, companies are able to have good corporate governance through a sound corporate support for the business. This is achievable when the internal audit function in a company is given the authority and independent roles of providing assurance, consulting, process improvement and risk management in the areas of corporate responsibilities. Hence, internal auditors in this context would have the ability to be accepted as providing value at the highest levels of their companies by enhancing corporate governance through the above-mentioned independent roles.

2.4. CONCLUSION

As a summary, the overall review of this chapter indicates that it has been increasingly recognised in both the private and public sectors that appropriate corporate governance arrangements are a key element in corporate success. They form the basis of a robust, credible and responsive framework necessary to deliver the required accountability and 'bottom line' performance consistent with the organisation's objectives, even when the bottom line is difficult to measure.

The relationship of good corporate governance and internal auditing is clearly identifiable because internal audit function, on its own, is part of a mechanism to ensuring good corporate governance. In short, there are many ways of ensuring good corporate governance and internal auditing has definitely been recognised as one of them.

The next chapter outlined the theoretical framework of the variables used in this study. The questionnaire design, the data collection method, and the statistical tests are also explained.