

## **CHAPTER 3: RESEARCH METHODOLOGY**

### **3.0. INTRODUCTION**

This section of the report contains a write up on the research methodology, which comprises the survey sample, model adopted, survey questionnaire, assessment of questionnaire and method of analyses.

### **3.1. SURVEY SAMPLE**

In Malaysia, internal audit function is mandatory for public companies whose shares are listed on the Bursa Malaysia. However, some unlisted companies, especially those with foreign ownership, do opt for voluntarily compliance.

This study adopts the approach that major companies in Malaysia are more likely to have an internal audit function, the population represents both public and private companies who maintain their own internal audit department. As this research topic is mainly focusing on internal audit's role, respondents must be currently working as internal auditors, and the company they are working for must maintain its own internal audit division. Companies who outsourced their internal audit function are excluded from the sampling.

From the database provided by the IIA Malaysia, 50 companies of various

industries were selected based on their nature of business. The eight main categories of business industries were identified as: 1) banking and finance, 2) telecommunications, 3) education, 4) manufacturing, 5) construction, 6) information technology, 7) commercial and 8) other services. All the 50 companies have in-house internal audit division.

### **3.2. MODEL ADOPTED**

This study aims to examine the role of internal audit toward corporate governance development in Malaysia, with particular focus on the role of internal control. Reference is made to prior research in the development of corporate governance policy in the UK and US.

Corporate governance concerns in the UK have centred on financial aspects, seeking improved financial controls and financial reporting quality to strengthen the accountability of boards to shareholders. The provisions of the Cadbury Code, published in 1992, were explicitly designed to improve internal control mechanisms, based on the assumption of relationship between internal control, financial reporting quality and corporate governance. As Maijoor (2000) has observed, this assumption has yet to be tested.

In the US, the Treadway report (Treadway, 1987) focused on the prevention range of corporate governance issues. The Committee of Sponsoring Organisation (COSO) produced a further report in 1992 specifically addressing the role of internal controls in securing improved corporate governance (COSO, 1992).

COSO's model developed by the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors, and the Institute of Management Accountants has been adopted as the generally accepted framework for internal control by entities representing all sectors of business and government and is widely recognised as the definitive standard against which organisations measure the effectiveness of their systems of internal control.

### **3.3. SURVEY QUESTIONNAIRE**

#### **3.3.1. Overview**

The survey questions are adopted from IIA Research Foundation's El Paso Internal Control Assessment Survey. El Paso Corporation developed this self-assessment tool to support the internal control and financial statement assertions required by the Sarbanes-Oxley Act. It is however based on COSO's Internal Control, covering both Integrated Framework and all of internal control.

The questions are adopted because of its in-depth study in the field of internal audit. El Paso's Chief Audit Executive (CAE), Basil Woller, bases his overall opinions on several "data points":

- The work of a Financial Reporting and Compliance group within internal audit. This group performs a risk/control analysis and full audit of the financial reporting process in each of El Paso's five business segments every year.
- Financial statement certifications that are required from managers throughout the organisation and the work managers do in support of these certifications.
- The CAE is an executive member of the disclosure committee. He observes the process and discussion, plays "devil's advocate," and gains comfort from the depth and seriousness of the questions raised.
- The CAE is present when the CFO and CEO do their final review. He observes the quality and depth of their review firsthand.

Taken together, these steps give El Paso robust and well-documented support for the required assertions. The survey adds value by going beyond what is required to address all aspects of internal control. The various risks facing a company are identified and assessed routinely at all levels and within all functions in the organisation. Control activities and other mechanisms are

proactively designed to address and mitigate the significant risks. Information critical to identifying risks and meeting business objectives is communicated through established channels up, down, and across the company. The entire system of internal control is monitored continuously and problems are addressed timely.

This survey questionnaire comprises of 5 parts (as elaborated in sections 3.3.2 to 3.3.6 below), in accordance with the COSO model's definition of internal control. The five components of an effective internal control system (namely Control Environment, Risk Assessment, Control Activities, Information and Communication, as well as Monitoring) work to support the achievement of an entity's mission, strategies and related business objectives. A copy of questionnaire is enclosed in APPENDIX A.

### **3.3.2. Control Environment**

Part 1 of the questionnaire examine the Control Environment, which is influenced by company's history and culture and sets the tone of the organisation, influencing the control consciousness of its personnel. It is the foundation for all other components of internal control, providing discipline and structure. The control environment has a pervasive influence on the way business activities are structured, objectives established, and risks assessed. It also influences control activities, information and communication systems, and monitoring activities. Effectively controlled companies strive to have

competent people, instil a company-wide attitude of integrity and control consciousness, and set a positive “tone at the top”. They establish policies and procedures, including a written code of conduct, which fosters shared values and teamwork in pursuit of the company’s objectives.

### **3.3.3. Risk Assessment**

Part 2 of the questionnaire perform Risk Assessment. All companies regardless of size, structure, nature, or industry, encounter risks at all levels within their organisation. Risks affect each company’s ability to survive, successfully compete within its industry, maintain financial strength and positive public image, and maintain the overall quality of its products, services, and people. There is no practical way to reduce risk to zero. Indeed, the decision to be in business creates risk. Management must determine how much risk is to be prudently accepted, and strive to maintain risk within these levels. Objective setting is a precondition to risk assessment.

There must first be objectives before management can identify risks to their achievement and take necessary actions to manage the risks. Objective setting, then, is a key part of the management process. While not an internal control component, it is a prerequisite to and an enabler of internal control.

### **3.3.4. Control Activities**

Part 3 measures Control Activities, that are policies and procedures used to ensure management directives are met. Control activities vary depending upon the nature of the risk mitigated and are carried out to ensure that the risks are minimised to an acceptable level. Control activities can be divided into three categories, based on the nature of the company's objectives to which they relate, i.e., operations, financial reporting, or compliance. Depending on circumstances, controls could help to satisfy company objectives in one or more of the three categories.

### **3.3.5. Information and Communication**

Part 4 assesses Information and Communication. Pertinent information must be identified, captured, and communicated in a form and time frame that enables people to carry out their responsibilities. Information gathering mechanisms produce reports containing operational, financial reporting, and compliance related information that makes it possible to run and control the business. They deal not only with internally generated data, but also with information about external events, activities, and conditions necessary for informed business decision-making and external reporting.

Effective communication also must occur in a broader sense, flowing down, across, and up the organisation. All personnel must receive a clear message

from top management and control responsibilities must be taken seriously. They must understand their own role in the internal control system, how individual activities relate to the work of others, and they must have a means of communicating significant information upstream. There also needs to be effective communication with external parties such as customers, suppliers, regulators, and shareholders.

### **3.3.6. Monitoring**

Part 5 questionnaire deals with Monitoring. Internal control systems need to be monitored as a process that assesses the quality of the system's performance over time. This is accomplished through on-going monitoring activities, separate evaluations of a combination of the two. On-going monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations (audits) will depend primarily on assessment of risks and the effectiveness of on-going monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to senior management and the Board.



### **3.4. ASSESSMENT OF QUESTIONNAIRE**

In Part 1 of the questionnaire, the evaluation of Control Environment is based on the factors, i.e., (i) Board and Audit Committee, (ii) Management Philosophy and Operating Style, (iii) Organisational Structure, and (iv) Assignment of Authority and Responsibility.

#### **i. Board and Audit Committee**

The control environment and “tone at the top” are influenced significantly by the entity’s board of directors and audit committee. Factors include the board or audit committee’s independence from management, experience and stature of its members, extent of its involvement and scrutiny of activities, and the appropriateness of its actions. Another factor is the degree to which difficult questions are raised and pursued with management regarding plans or performance. Interaction of the board or audit committee with internal and external auditors is another factor affecting the control environment.

#### **ii. Management Philosophy and Operating Style**

Management’s philosophy and operating style affect the way the company is managed, including the kinds of business risk accepted. A company that has been successful taking significant risks may have a different outlook on internal control than one that has faced harsh economic or

regulatory consequences as a result of venturing into dangerous territory. An informally managed company may control operations largely by face-to-face contact with key managers. A more formally managed one may rely more on written policies, performance indicators, and exception reports.

### **iii. Organisational Structure**

A company's organisational structure provides the framework within which *its activities for achieving company-wide objectives are planned, executed, controlled, and monitored.* Significant aspects of establishing a relevant organisational structure include defining key areas of authority and responsibility and establishing appropriate lines of reporting.

### **iv. Assignment of Authority and Responsibility**

This component includes the assignment of authority and responsibility for operating activities as well as establishing reporting relationships and authorisation protocols. It involves the degree to which individuals and teams are encouraged to use initiative in addressing issues and resolving *problems as well as limits of their authority.* It also deals with the policies describing appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties.

Part 2 is about risk assessment component of control, the evaluation of which is based on the following:

### **i. Company-Wide Objectives**

Objective setting can be a highly structured or an informal process. Objectives may be explicitly stated, or be implicit, such as to continue a past level of performance. At the company level, objectives are often represented by the company's mission and value statements. Assessments of the company's strengths and weaknesses, and opportunities and threats, will lead to an overall strategy.

Company-wide objectives are linked and integrated with more specific objectives established for various activities. By setting objectives at both the company and activity level, a company can identify critical success factors.

These are the key things that must go right if goals are to be attained. Objective setting enables management to identify measurement criteria for performance, with focus on critical success factors.

### **ii. Risk Identification**

The process of identifying and analysing risk is an on-going process and is a critical component of an effective internal control system. Management must focus carefully on risks at all levels of the company and take

necessary actions to manage them. A company's performance can be at risk due to internal or external factors. These factors, in turn, can affect either stated or implied objectives. Risk increases as objectives increasingly differ from past performance.

### **iii. Managing Change**

As economic, industry, and regulatory environments change, a company's activities should evolve to address those changes. As a company's activities evolve, the internal control system requires change because an effective system under one set of conditions will not necessarily be effective under another. Mechanisms to manage change should be forward-looking, so a company can anticipate and plan for significant changes. Fundamental to risk assessment is a process to identify changed conditions and take actions as necessary. Early warning systems should be in place to identify conditions signalling new risks.

In Part 3 of the questionnaire, control activities component of control is evaluated according to the following factors:

**i. Policies and Procedures**

Control activities usually involve two elements: a policy establishing what should be done and procedures to affect the policy. Many times, policies are communicated orally. Unwritten policies can be effective where the policy is a long-standing and well-understood practice, and where communication channels involve only limited management layers and close interaction and supervision of personnel. Regardless of whether a policy is written, it must be implemented conscientiously and consistently. A procedure will not be useful if performed mechanically without a continuing focus on conditions to which the policy is directed.

**ii. Control Activities in Place**

Control activities are a significant part of the process by which a company strives to achieve its business objectives. Control activities serve as mechanisms for managing and mitigating risk, thereby enabling the achievement of objectives. Control is built directly into processes and always relates back to the risk it was designed to mitigate. Control activities, which are added on in reaction to insignificant or non-existent risks, can result in burdensome layers of redundant controls, which can increase cost and impede efficiency.

Part 4 of the questionnaire focuses on information and communication component of control. Information is needed at all levels of the organisation to run the business, and move towards achievement of the company's objectives in all categories - operations, financial reporting, and compliance. The assessment of the questionnaire is based on (i) Quality of Information, and (ii) Effectiveness of Communication.

#### **i. Quality of Information**

Information is identified, captured, processed, and reported by information systems. The Information gathering mechanisms may be computerised, manual or a combination. They may be formal or informal. Keeping information consistent with needs becomes particularly important when a company operates in the face of fundamental industry changes, highly innovative and quick-moving competitors, or significant customer demand shifts.

#### **ii. Effectiveness of Communication**

Communication is inherent in information gathering mechanisms. Information must be provided to appropriate personnel so that they can carry out their operating, financial reporting, and compliance responsibilities. Communications also must take place in a broader sense, dealing with expectations, responsibilities of individuals and groups, and other important matters.

Lastly, in Part 5 of the questionnaire, monitoring component of control is evaluated based upon the factors covering (i) On-Going Monitoring, (ii) Separate Evaluations, and (iii) Reporting Control and Process Deficiencies.

**i. On-Going Monitoring**

On-going monitoring procedures are built into the company's normal recurring operating activities. They are performed on a real-time basis reacting dynamically to changing conditions. Since separate evaluations (audits) take place after the fact, problems will often be identified more quickly by the on-going monitoring routines.

**ii. Separate Evaluations**

The frequency of separate evaluations necessary for management to have reasonable assurance about the effectiveness of the internal control system is a matter of management's judgment. In making that determination, consideration should be given to the following: the nature and degree of changes occurring and their associated risk; the competence and experience of the people implementing the controls; and the results of on-going monitoring.

**iii. Reporting Control and Process Deficiencies**

Deficiencies in a company's internal control system surface from many sources, including the company's on-going monitoring procedures, separate evaluations of the internal control system, and external parties.

A “deficiency” may represent a perceived, potential, or real shortcoming, or an opportunity to strengthen the control system to provide a greater likelihood that the company’s objective will be achieved.

### **3.5. DATA COLLECTION PROCEDURE**

Survey questionnaires were sent to the companies with audit department. Each company was encouraged to provide 3 respondents of different job levels e.g. Audit Senior, Audit Manager and Head of Department. This criterion is applied to determine if internal auditors of different job level have different view and opinion toward the same internal control system in a company. For instance, an internal control policy that ‘agreed’ by an audit junior as sufficient, might be rated as ‘disagree’ by his / her audit manager.

The survey results were collected via email reply or via fax. However, no responses were received via mail. Respondents were given two to three weeks to reply and after the deadline, a reminder with survey questionnaire attached was emailed again for those who did not respond to enable them to participate in the survey. All queries and clarifications regarding the survey questionnaire were immediately attended to, using email and telephone. Further information was obtained from respondents’ company websites.

To ensure confidentiality, no names of respondents were required and



assurance were given in the cover letter that the information collected would be analysed on aggregate basis and would only be used for the purpose of this research.

### **3.6. METHOD OF ANALYSIS**

Data collected through questionnaire were then tabulated for summarising its frequencies of occurrence. The SPSS software was used to carry out all the necessary statistical tests. Descriptive analysis – mean, was used to analyse the opinions given by the respondents.

The subsequent chapter elaborates and analyses the overall results obtained through the survey questionnaires. A summary of respondents is provided, along with an analysis of research results, interpretation and conclusion of major findings.