

THE ROLE OF INTERNAL AUDITORS IN INSTITUTIONS OF HIGHER EDUCATION: AN EMPIRICAL INVESTIGATION

CHAPTER ONE AN OVERVIEW OF THE RESEARCH PROJECT

1.1 INTRODUCTION

The definition of corporate governance as set out in the Finance Committee's Report on Corporate Governance in Malaysia is, **"the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholder value, whilst taking into account the interests of other stakeholders"**(High Level Finance Committee Report On Corporate Governance, Feb 1999).

In Malaysia, the issue of corporate governance has become an important topic of discussion particularly following the 1997 Asian Financial Crisis. However, initiatives to address and strengthen corporate governance had been well under way prior to 1997. One of the steps taken by the government to improve the corporate governance in the private sectors was to require the company listed on KLSE to form an audit committee in year 1994. Subsequently, in the year 1998 a high level "Finance Committee on Corporate Governance", which comprised of both government agencies and industries was appointed by Ministry of Finance to identify the weaknesses exposed by the crisis and recommending appropriate changes to the governance systems in the corporate environment. Among the first fruits of the work of Finance Committee was the release of the Malaysian Code of Corporate Governance in March 2000.

While no direct correlation between corporate governance and shareholder value has been proven conclusively, a number of important studies have demonstrated that many shareholders, particularly institutional shareholders, place a premium

on good corporate governance (Ali Abdul Kadir, 2001). As quoted by Ali Abdul Kadir, (2001), McKinsey Survey of June 2000, revealed that in the Asian region institutional investors both local and foreign are willing to pay a premium of between 20%-30% for the shares of companies that demonstrate good corporate governance.

The demand for corporate governance can no longer be burdened solely to the corporations. Institutions of Higher education should embrace the concept of corporate governance. Similar to their counterparts in industry, colleges and universities are facing increase demand for accountability (Chamberlain, Gordon, and Plunkett, 1993). Students for example demand a strong institutional commitment to quality teaching; politicians and oversight agencies want assurances that educational institutions are contributing to some definition of public goods (e.g. economic development) as well as complying with laws and procedural regulations; donors and grant makers ask for proof that their contributions and investments have been well spent in terms of their own agendas and priorities; and alumni want assurance that the reputation of their alma mater is being advanced so that the value of their degree continues to grow (Kearns, 1998).

Therefore, management of university must give equal attention to the processes and governance mechanisms of their institutions (Balderston, 1974). Internal auditing was identified as one of the various key participants to promote good governance in corporate sectors (Ali Abdul Kadir, 2000); hence, the management of institutions of higher education should realize the importance of internal audit function in their institutions.

Studies such as "University Audit Department In United States" (Gordon and Fischer, 1999), "The Role of Internal Auditors In Colleges And Universities" (Zabihollah Rezaee, Robert C. Elmore, Joseph Z. Szendi, 1999) and "Factors Associated With Effective Operational Auditing At Colleges" (Ali N. Azad, 1992)

was carried out in United States in relation to the internal audit function in educational environment.

In Malaysia, however, there is no prior study on internal auditing focused on this area. Prior study in Malaysia such as "The Effectiveness of The Internal Auditor In Malaysian Listed Firms" (Annuar, Mohamad Ali, Shamsheer, Zulkarnain, 2001), "The Profile of Internal Auditing In Malaysia" (Malaysian Institute of Accountant, 1988 & 1989), "The Profile of Internal Auditing in Malaysian Public Listed Companies " (Institute of Internal Auditors Malaysia (IIAM), Malaysian Institute of Corporate Governance (MICG) and Ernst & Young, 1999) revealed the importance of internal auditing as one element of sound control environment in corporate sectors.

Given the importance of internal auditing in corporate environment, this study focuses on the role of internal auditors in institutions of higher education so as to benefit the institutions and its stakeholders in their efforts towards establishing and maintaining good governance in institutions of higher education.

1.2 RELATED LITERATURE

Various studies have been carried out in overseas to examine the role of internal auditors in colleges and universities. Some of commonly items examined in their studies are listed in the Table 1.1.

Table 1.1 Lists of Prior Studies On Internal Auditing In Institutions of Higher Education In Overseas

Study	Item Examine	Hypotheses
<p><u>Drucker Meyer, 1975</u> The Importance of Internal auditing for Higher Education Administration</p>	<ol style="list-style-type: none"> 1. Type of External Audit 2. Type of Internal Audit 3. Reporting responsibility of Internal Audit Function 4. Internal Audit Procedures 5. Size of Internal Audit Staff 	None
<p><u>Ali N. Azad and Ted D. Skekel, 1990</u> Personal Attributes And Effective Operational Auditing</p>	<ol style="list-style-type: none"> 1. Objectivity 2. Technical Competence 3. Experience 4. Professional certification 5. Human relations 	None
<p><u>Ali N. Azad, 1992</u> Factors Associated With Effective Operational Auditing At College</p>	<ol style="list-style-type: none"> 1. Independence 2. Audit Plan 3. Audit Program 4. Audit Supervision 5. Continuing Education 6. Training 7. Audit report 8. Audit Follow-up 	None
<p><u>Don Chamberlain, Gus Gordon and Linda Plunkett, 1993</u> Improving Accountability In Colleges And Universities</p>	<ol style="list-style-type: none"> 1. Program Audit 	None
<p><u>Azad, Ali N, 1994</u> Operational Auditing In US Colleges And Universities</p>	<ol style="list-style-type: none"> 1. Scope of operational auditing 2. Perceived importance of audit areas 	<p>1. <i>Relationship between Type of Institution (Public Vs Private) with the internal audit scope</i></p> <p>2. <i>Relationship between Type of institution with Perceived Important audit areas</i></p>
<p><u>Zabihollah Rezaee, Robert C. Elmore, Joseph Z. Szendi, 1999</u> The Role of Internal Auditors In Colleges And Universities</p>	<ol style="list-style-type: none"> 1. Internal Audit Function In Universities 3. Authority Over the Internal Audit function 4. Importance of Audit Areas of university Activities 5. Importance of The Role. University Internal Auditors 	<p><i>Relationship between Type of Institution (Public Vs Private) with internal auditors roles and important audit areas</i></p>
<p><u>Montondon and Fischer, 1999</u> University Audit Department In The United States</p>	<ol style="list-style-type: none"> 1. Independence and Credibility 2. Access to Decision Makers and reports Relied Upon 	<p><i>Relationship between Type of Institution (Public vs. Private) and accountability</i></p>

Drucker.M (1975) revealed that to improve the management of institutions of higher learning, internal auditing should be conducted. Azad (1994) in his study on "Operational Auditing In US Colleges And Universities" concluded that there was no significant difference existed between the scope of operational auditing in public and private colleges and universities and between the perception of the public and private institution internal auditors on the important audit areas. However, his study only concentrated on the areas of operational auditing.

Rezaee et. al. (1999) found that 68% of colleges and universities in United States have internal audit function. They concluded that there were no significant differences in the role of internal auditors between the public and private universities.

Montondon and Fischer (1999) found that only 12.2% internal auditors in public and 10.9% of internal auditors in private institution reported that their findings impact budget decision. They hypothesized that public universities demonstrate greater accountability and independence than private universities. Their hypothesis was based on the argument that public institutions of higher education serve greater diversity of stakeholders than private institutions of higher education. Their study showed that United States public universities have structured internal audit department that conformed more closely to the professional guideline than private universities. Even though with an internal audit department configured along professional guidelines, they concluded that administrators were not optimally utilising their internal auditors.

In Malaysia, being a statutory body a public institution of higher education is governed by Government Act and Regulation. With respects to the role of internal auditor, Treasury Circular No 2/1979 (Implementation of Internal Audit in Government Agency of Federal Territory) states the objective, function and scope of internal audit department. It also explains the concept of financial audit, management audit and audit programme. However, the private institutions of

higher education are not bound to follow this circular. Currently, there is no guideline issued by the regulators to require them to establish internal audit department except for the public institutions of higher education. In the case of the private institutions of higher education only members of Institute of Internal Auditors (IIA) who serve as internal auditors in such institutions will comply with guidelines by IIA. The question is how many such members serve in private institutions of higher education?

Here the question of compliance to create the governance system will come into picture. In the case of public institutions, the instruction to create internal audit department is mandatory and there is no reason for them not to comply with it. However, for private institutions of higher education, the compliance to the professional guideline is only voluntary on their part and the compliance is only expected from the members of professional body (in this case IIA). Hence, if the private institution does not have internal audit department, it does not commit any offence under the IIA guideline. However, if their internal auditors who are member of the IIA breach any part of IIA by Laws, then the IIA can enforce sanction on them.

Table 1.2 and Table 1.3 summarise the Treasury Circular and IIA Guideline on the role of internal auditors.

Table 1.2 Treasury Circular Guideline On The Role Of Internal Auditors

1. To check the soundness, adequacy and reliability of accounting information and internal control.
2. To ascertain whether financial transaction being managed properly in accordance with the accounting standard
3. To evaluate the operation of the agency in terms of efficiency, effectiveness and economic benefit of it.
4. Suggest to the management steps needed to improve the operation of the agency and any corrective action needed.
5. Provide the Head of the agency and independent report on a timely manner, therefore he can make economic decision and proper usage of public fund
6. When necessary, provide information to the Central Authority to assist them in evaluating and improve their general policy and scope of internal audit.

Source: Treasury Circular 2/79 (Implementation of Internal Audit in Government Agency of Federal Territory)

Table 1.3 IIA Guideline On The Role of Internal Auditors

- **Risk Management**

- The internal audit activity should monitor and evaluate the effectiveness of the organization risk management system
- Should evaluate risk exposure relating to the organization governance, operations, and information systems regarding;
 - a. Reliability and integrity of financial and operational information
 - b. Effectiveness and efficiency of operations
 - c. Safeguarding of assets
 - d. Compliance with laws, regulations and contracts.

- **Control**

The internal audit should assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement. This should include;

- a. Reliability and integrity of financial and operational information
- b. Effectiveness and efficiency of operations
- c. Safeguarding of assets
- d. Compliance with laws, regulations and contracts.

- The internal auditor should ascertain the extent to which operating and program goals and objectives have been established and conform to those of the organization.
- Review operations and program to ascertain the extent to which results are consistent with established goal and objectives.
- Ascertain the extent to which management has established adequate criteria to determine whether objectives and goals have been accomplished.
- During consulting engagements, internal auditors should address controls consistent with the engagements objectives and should be alert to the existence of any significant control weaknesses.
- Should incorporate knowledge of controls gained from consulting engagements into the process of identifying and evaluating significant risk exposures of the organization.

- **Governance**

The internal audit should contribute to the organization's governance process by evaluating and improving the process through

- Values and goals are established and communicated
- The accomplishment of goals is monitored
- Accountability is ensured
- Values are preserved

Source: IIA Guideline, 2001

1.3 PROBLEM STATEMENT

Good internal control system is a prerequisite for effective corporate governance and management. The recent waves of massive corporate restructuring and business failures reflect lack of this, resulting in an awareness of greater need for proper stewardship of enterprise and effective control governance.

Internal auditing function is part of corporate governance structure where it plays an increasingly important role in monitoring internal control system of the company and its financial reporting systems (Megat Najmuddin, 1999).

Dr. Mahathir Mohamad (2002) in his capacity as Finance Minister has instructed Statutory Bodies in Malaysia to review, improve and increase enforcement on their internal control system. Being a Statutory Body, a public university is bound to report to the Ministry of Finance within three months from the date of the instruction letter on the action taken to improve the internal control and governance system in its organization. Thus, public institutions of higher education should regard this instruction as a challenge to strengthen their internal control and governance systems.

Treasury Circular 2/79 states that one of the functions of the internal audit is to check the soundness and adequacy of internal control system in organization. Therefore this study provides the state of affairs currently with regards to the their role in evaluating and suggesting improvement to the universities internal control system.

Internal auditing has been recognized as an important function in corporate sectors. Hence, this study investigates the existence and the role of the internal auditors in another sector in Malaysia i.e. institutions of higher education. Such investigation is considered essential in order to provide useful feedback to the management of institutions of higher education in Malaysia, its regulators and to facilitate the development of future policies and acts to strengthen its administration especially in light of substantial number of private institutions of

higher education. Table 1.4 presents the statistic of private Institutions of higher education in Malaysia.

Table 1.4

Statistic of Private Institutions of Higher Education As At 31 May 2001

Institutions	Number of Institutions	No Of Student	No Of Lecturers
College	652	209,589	8445
Universities	10	20839	855
Branch of Foreign University	4	1641	95
Total	666	232068	9395

Source: Ministry of Education Website [Http:\\ www2.moe.gov.my/jps](http://www2.moe.gov.my/jps)

This study seeks to answer the following questions:

1. Whether the internal audit function exists in institutions of higher education and to what extent it supports good governance of the institutions?
2. What is the perception of the management of institutions of higher education? with respect to the internal auditor role in these institutions?
3. What does management perceive as important audit areas in institutions of higher education?
4. Whether there are differences in the scope of internal audit, perception of the management on the role of internal audit, important audit areas in institutions of higher education and the perception of the internal auditors on internal auditing in public and private institutions of higher education?

1.4 OBJECTIVES OF THE STUDY

The objective of this study is to examine one element of the governance structure i.e. internal auditing in the institution of higher education in Malaysia. This study answers the question on the existence of internal audit functions, perception on the role of internal auditors and the important areas of internal audit in the institutions of higher education. This study addresses questions to head of internal audit department to investigate the scope of internal auditing in their institutions. The purpose of the investigation on the scope of internal auditing is to answer the first research questions i.e. whether the role of internal auditors in the institutions of higher education supports its governance.

To answer the second and third research questions, this study explores the perception of the Board of Directors, Vice-Chancellor, Financial Controller and Registrar on their perceived important role of the internal auditors and perceived important audit areas in institution of higher education.

This study also investigates the perceptions of the internal auditors on their role in institutions of higher education. The responses are used to answer part of the fourth research question.

This study investigates whether there is a difference in scope of internal auditing, management perceived important audit areas, management perceived internal auditor roles and internal auditors perception on their roles between both types of institutions of higher education (public vs. private)

1.5 RESEARCH METHODOLOGY & DATA COLLECTION

Public and private institutions of higher education differ in terms of funding sources and are regulated by different acts.¹ Being a statutory body, a public institution of higher education is hypothesized to demonstrate better governance

¹ Public Institutions of Higher Education are regulated under Colleges and Universities Act 1971 and Private Institutions of Higher Education are regulated under Private Education Act 1996

system than private institution because it is bound to comply with various acts that applicable to other Statutory Bodies. However, a private institution does not have many regulations, which demand exact compliance.

This study concentrates on one element of the governance system in institutions of higher education i.e. internal auditing. The following hypotheses are tested in the institutions of higher education in Malaysia.

The first hypothesis is as follows:

H1: There is significant difference between the scopes of internal auditing in public and private institutions of higher education

Second Hypothesis is as follows:

H2: The perceived importance of audit areas is different between the management of public and private institutions of higher education

The third hypothesis is as follows:

H3: The perceived importance internal auditor roles is different between the management of public and private institutions of higher education

The Fourth hypothesis is as follows:

H4: There is significant difference between the perceptions of internal auditors in public and private institutions of higher education

Sample consists of public and private institutions of higher education in Malaysia, which offer degree programme and 3+0 Degree Programme approved by LAN². The information is extracted from the Ministry of Education website. Questionnaires are mailed to the Financial Controller, Vice Chancellor or Head of the institution, Chief Internal Auditors, Internal Auditors, Board of Directors and Registrar of the institutions of higher education.

The sample is partitioned by type of institutions of higher education (public or private). A majority of survey questions requested simple 'yes' or 'no' response as to the role of the internal auditor. A Chi-Square Test is used to establish relationship between the types of the institutions and the scope of internal auditing.

Several questions require the respondents to rank the priority of the internal audit work. Respondents are required to indicate in Likert scale their complete agreement with the statement (score = 5) or complete disagreement (score = 1). Frequencies are calculated for each variable of interest. Mann-Whitney Rank Sum test, a nonparametric test analogous to the parametric two-sample t-test is used to analyse the frequencies.

1.6 LIMITATIONS AND CONTRIBUTION OF THE STUDY

The samples for the private institutions of higher education are limited to the institutions that hold universities status, branch of foreign universities and private institutions of higher education that approved by LAN² to conduct 3+0 degree program.

Currently there are 10 private universities and 35 colleges approved by LAN and 4 branches campus of foreign universities.

² LAN is National Accreditation Board, established to ensure the quality of courses offered by private institutions of higher education

This study creates awareness and stress the importance of internal audit functions in institutions of higher education as well as serves to provide valuable inputs to regulators in implementing new polices to strengthen the governance system of institutions of higher education in light of the vast number of institutions of higher education, currently 18 public and 666 of private institutions of higher education.³

1.7 ORGANISATION OF THE STUDY

The project is presented in five chapters as follows:

- Chapter One: An Overview of the Research Project
- Chapter Two: Literature Review
- Chapter Three: Research Methodology and Methods
- Chapter Four: Research Findings
- Chapter Five: Conclusion. Provides recommendations for future research.

1.8 CONCLUSION

This chapter provides an overview of the study. It explains the significance and the purpose of this study. The next chapter reviews both overseas and local literature pertaining to internal auditing in institutions of higher education.

³ Ministry of education statistical data as at May 2001, <http://www.moe.gov.my>