

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 INTRODUCTION**

Chapter One specify the objective and significant of this study. This chapter presents the background of the study.

#### **2.2 LITERATURE REVIEW**

There are many factors that contribute to the competitiveness of a firm; a market or an economy, such as superior resources and better technology, good governance or management is a precondition to competitiveness that underlies all these other factors (Ali Abdul Kadir, 2002).

The issue of enhancing standards of governance has occupied much of our thoughts nowadays; particularly this issue has become hot topic after the recent economic turmoil.

The release of Malaysian Code on Corporate Governance<sup>3</sup> in the year 2000 aims to set out principles and best practices towards achieving the optimal governance framework in corporate environment. The Malaysian code of Corporate Governance emphasise on the responsibility of the Board of Directors as one element of governance mechanism.

One of the items stated in Part 1 of the Malaysian Code on Corporate Governance is the Board of Director should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets. The explanatory notes to the code further explains that this not only covers financial controls but operational and compliance controls, and risk management, since

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<sup>3</sup> The Code sets out four forms of recommendations. Part 1 sets out broad principles of good corporate governance in Malaysia. Part 2 sets out best practices for companies, intended to assist the companies designing their approach to corporate governance. Part 3 is exhortations to other participants and part 4 is explanatory notes and "mere best practices".

there are potential threats to shareholders' investment in each of these areas. The code also required the board of directors to establish an internal audit function. Where internal audit function does not exist, the board should assess whether there are other means of obtaining sufficient assurance of regular review and/or appraisal of the effectiveness of the system of internal controls within the company. The internal audit function is integral part of an effective system of corporate governance (Malaysian Code of Corporate Governance, 2000).

In July 2002, IIA Malaysia in collaboration with SEC and KLSE successfully launched a set of guideline to assist boards of directors of public listed companies in relation to establishment of internal audit function. The Guidelines on Internal Audit Function states that the role of internal auditor is to assist the board of directors, audit committee and management in the effective discharge of their responsibilities in establishing cost-effective controls, assessing risks, recommending measures to mitigate those risks and ensuring proper governance process.

This guideline also mentions the key internal audit activities that add value to an organizations, which includes reviewing objective and operational activity, evaluating risk, analysis of operation, providing assurance on compliance with law and regulations, reviewing internal control, safeguarding of assets, consulting and facilitating the management.

The Malaysian Code on Corporate Governance is principally an initiative of the private sector as indicated by the membership of the Working Group on Best Practices in Corporate Governance. Similarly, the IIA Guideline also meant to be used by the management of public listed companies. Therefore it is more relevant to the governance of public listed companies. However, these principles also can be applied to the public sectors and other Statutory Bodies. In the context of public sectors, the code need to be adapted to reflect the key characteristics of public sectors entities, which distinguish them from the private

sectors. In fact, public sector entities have to satisfy diverse stakeholders than private sectors.

In public sector, Dr. Mahathir Mohamad (2002) in his capacity as Finance Minister required Statutory Bodies in Malaysia to review, improve and increase enforcement on their internal control system. The management of Statutory Bodies have to report to the Ministry of Finance the action taken to improve the internal control and governance system in their organization.

The Auditor General in his circular no 1/2000 regarding the audit follow-up action mentioned that Ministries, State Government, Statutory Bodies are continuously repeating the same mistake on the non-compliance with the laws, government procedures, rules and circulars, improper maintenance of accounts and finance record and inefficient expenses maintenance which cause wastage to the government resources (<http://www.audit.gov.my>).

Thus, the instruction from the Finance Minister and comments from the Auditor General implies that internal control and governance system in Statutory Bodies in Malaysia need to be improved.

Much thought and study has been done in relation to the internal auditing in private sectors 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 (MIA), 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) . However there is no prior study known to the author on the role of internal auditors in institutions of higher education.

In Malaysia, institutions of higher education can be divided into two broad categories i.e. government funded institutions and private funded institutions. The government-funded institutions of higher education consist of Universities, Government Sponsored College, Polytechnics and Teacher Training Colleges.

Whereas, there are four types of private institutions of higher education, which are Private Colleges, Private Universities and Universities Colleges, Branch Campus of Foreign Universities and Distance Learning Centres. Public institutions of higher education are governed by Colleges and Universities Act 1971 while private institutions of higher education are governed by Private Higher Education Institutions Act 1996.

Higher education institutions, like other business entities also should maintain good governance system. The education institutions are one of the businesses, which show very rapid development. As at May 2001, the numbers of private institutions of higher education in Malaysia are 666, there are 17 Public Universities, and 1 government sponsored college as at June 2002. Among the private institutions of higher education, some are incorporated as public listed companies and subsidiaries of public listed companies, foreign university branch and others are incorporated under Companies Act as private companies.

With respect to internal audit function, Treasury Circular No 2/1979 (Implementation of Internal Audit in Government Agency of Federal Territory) requires the Statutory Bodies to establish internal audit department. As part of the Statutory Bodies, Public Institutions of Higher Learning are bound to comply with this circular. Meanwhile, in the private sectors, KLSE Revamp Listing Requirement requires public listed companies to establish internal audit department. However, the listing requirement only applies to private institutions of higher education, which are incorporated as public listed companies. Currently, there is no guideline issued by the government to require the private institutions of higher education to establish internal audit department. The next section of this chapter discusses on the overseas literature relating to the internal auditing in the institutions of higher education and related local literature on internal auditing.

### **2.3 INTERNAL AUDITING IN COLLEGES AND UNIVERSITIES**

Stewardship of private enterprises has been long recognized as an important concept by investors and standard setters (Chamberlain et. al 1993).

However, in recent years, accountability and assessment of nonprofits entities have emerged as major areas of consideration for both the Financial Accounting Standard Board (FASB) and the Governmental Accounting Standard Board (GASB) in United States. Colleges and universities, like other not-for-profit entities, are facing increased demands to become more accountable to their constituencies by achieving more efficient and effective utilization of existing resources and improving their quality. Internal auditors are the best position to assist administration at all levels of a university to accomplish the stewardship function objectively (Chamberlain et. al 1993).

Drucker (1975) mentioned that to ensure that institutions derive the most from internal auditing, the following would appear to be essential:

1. The governing body should formally establish an internal auditing department
2. An audit committee of the governing body should oversee the coordination of internal and external audit operations.
3. The internal auditing department should report to an official who will ensure the deficiencies are promptly considered and corrective actions taken.

The professional internal auditor must have independence to fulfil a professional obligation, to render a free, unbiased, unrestricted opinion, and to report matters as they are rather than as some executives would like to see them (Sawyer, 1988, as cited by Vanasco, 1996). Independence permits internal auditors to perform their work freely and objectively. Without independence, the desired results of internal auditing cannot be realised (Vanasco, 1996). Thus Vanasco, (1996), stated that the role of the internal auditor required an unrestricted independence in order to perform a variety of duties for the organization they serve. For internal auditors, practical independence needs to be constituted

through the organizational and reporting status of the internal audit department (Azad, 1992).

Attribute 1100 of IIA guideline states that the internal audit activity should be independent, and internal auditor should be objective in performing their work. Further attribute 1110 explains that the chief audit executive should report to a level within the organization that allows the internal audit activity to fulfil its responsibilities. Then attribute 1110.A1 explains that internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.

Gordon and Fischer, (1996) provides mix results concerning the degree of independence experienced by internal auditors for colleges and universities. The most affirmative evidence of independence was reflected by those auditors who are hired by the president and/or board of directors, have written authority for unrestricted access to records and regularly meet with the board. These are all formal indicators of evidence; informal indicator may be more important. One informal way that the internal auditor's work can be influenced is through the board and administration's perceptions of the quality of internal auditors work. Further a survey by Azad (1992) concluded that reporting to the audit committee was the most important factor for improving the independence.

One way to improve efficiency and effectiveness of operation is through the implementation of operational auditing (Drucker 1975) and (Henke, E.O, 1972). (Azad, 1994) found out that institutions of higher education that participated in his survey utilized operational auditing to some degree but the utilization was rather limited in scope. His study also concluded that no significant differences existed between the scope of operational auditing between private and public colleges and universities. From this result it may be argued that the type of institutions, whether public or private does not favour the utilization of operational auditing. Both institutions might use the operational auditing to certain extent, as a matter of economic necessity only. For example, the academic departments are given

priority by the internal auditors in their audit in view of the importance of this function in the institutions of higher education.

Rezaee et. al. (1999) revealed that respondents perceived the traditional roles of compliance audits, financial fraud audits and financial reporting audit as being the most important compared to the more proactive role of internal auditors in participating with administrators in college and university decision making.

Both studies by Azad (1994) and Rezaee et. al. (1999) showed that institutions of higher education viewed the traditional roles of compliance auditing and financial reporting audit more superior than operational auditing. The emerging organizational governance and accountability issues all over the world should shift the focus of the internal auditors to more involve in evaluating the risk exposure, control and governance of the organization. Management, who are in the position to understand the need of the business and the accountability that should be presented, have to properly identify the area that should be given priority in audit.

Nevertheless, the study by Rezaee et. al, (1999) only considered the perception of the vice-president of finance, this might affect the result which more bias to the traditional role of internal auditing since the respondents were very much familiar with this area. If more than one category of respondent were selected such as the registrars or the board of directors, their perception might be different.

## **2.4 INTERNAL AUDITING IN PUBLIC AND PRIVATE SECTORS IN MALAYSIA**

In Malaysia, the mandate for The Auditor General to perform management audit in Public sector is derived from Section 6 of the Audit Act 1957 which states that the Auditor General shall in his audit make such examinations as he may deem necessary to ascertain whether in his opinion moneys have been applied to the

purpose for which they were appropriated or authorized and the activities related to such purposes were carried out or managed in an efficient manner with due regard for economy and avoidance of waste or extravagance and whether the provision of laws relating to the matters subject to his audit have been complied with in all respect.

The intention of management audit in public sector is to create awareness to the regulators and the public at large of the success, or otherwise of the government in obtaining value for money in public expenditure, collection of revenue and the utilization of public resources (Datuk Hj. Mohd Khalil, 1999).

Public sector or in the context of this study, public institutions of higher education should make full use of management auditing to monitor its efficiency and effectiveness. Regulators also can use the result of management audit to assist them in resource allocation and to review their policies and regulations in the public institutions of higher education.

In private sector, preliminary survey done by Malaysian Institute of Accountant in June 1988 on the overview of internal audit in Malaysia revealed that 94% of the respondent stated that their internal audit department covered operations/ management/ efficiency audit. This result appears to indicate a high awareness of the need for operations auditing (Akauntan Nasional, 1989). The second survey was carried out by Malaysian Institute of Accountant in the year 1989 to get more details overview of internal audit in Malaysia. The questionnaires were sent to the chief executive and the internal audit manager. The focused upon the survey was to get understanding on the trends in the role and scope of internal audit, professionalism in internal audit, the career aspirations of internal auditors, the education and training requirements of internal auditors, management's attitude to internal audit, management's perception of the skills, training and career requirements of internal auditors and support mechanism for the internal audit function.



The results of the surveys showed that, Chief Executive generally saw internal audit as a high profile function in terms of its position within the organization and top-level support afforded to it. CEO also viewed the internal audit was participative rather than authoritative. Half of the CEO regarded internal audit primarily as an integral part of an independent check on the internal control mechanism, whilst very few saw the internal auditor as a consultant to the management. Only 20% of internal audit managers believed that auditees saw internal audit as something other than a policing function and half of them saw the internal auditor as an intermediary between line and top management. The study carried out by MIA was divided into three sub issues which are area covered by internal audit, question of EDP audit and audit of management effectiveness.

An interesting fact is that 68% of the chief executive being surveyed believed that the audit of operations was a major area covered by internal audit while the result of the survey on the internal audit manager shows that only 35% of internal auditors were spending more than 50% of their time in this area.

The audit of EDP systems was seen by 54% of CEO as major area being covered but results showed that 71% of the internal audit manager being surveyed spent 10% or less of their time on EDP audit. Result of the survey also indicated 73% of the internal audit manager were spending 10% or less of their time on audit of management effectiveness. However interestingly, 94% of internal audit managers felt that they should comment on management effectiveness (Akauntan Nasional, 1991). The results of the MIA surveys showed substantial gap between the expectation of the management and the real scope of the audit being carried out in those institutions surveyed. Both parties i.e. the management of the institutions and head of internal audit department should discuss the reason of this gap. This may be due to the less involvement of the management in the audit planning or the audit department did not have enough

resources and skills to cover areas, which are beyond the traditional auditing such as audit on EDP system.

Another survey was carried out by the Malaysian Institute of Corporate Governance, IIA Malaysia and Ernst & Young to evaluate the current state of internal audit and risk management function in companies throughout Malaysia. The survey showed that the general perception of internal audit function is skewed towards providing independent appraisals, safeguarding assets, preventing errors and fraud, and conducting independent reviews on operations. The results showed that 13% of the companies surveyed do not have any internal audit function, 15% of the respondents indicated that their internal audit function is outsourced while 72% possess their own internal audit function. On risk management issues, 96% of respondents regarded risk management as an important issue within their companies.

The surveys carried out by MIA in year 1988 and 1989 include listed and unlisted companies, Statutory Authorities and Government Departments while the survey done by Malaysian Institute of Corporate Governance, IIA Malaysia and Ernst & Young covered only public listed companies. There is no prior survey that focuses on the internal auditing in institutions of higher education. Thus, it is the time now to see the contribution of internal auditing in institutions of higher education. Instruction by Finance Minister to Statutory Bodies in Malaysia to strengthen their governance process should be considered as challenge to the internal audit department in public institutions of higher education. Even though the specific role of internal audit activities varies from organization to organization based on factors such as size, type of operations, capital structure, legal and regulatory environment (IIA, 2001), internal auditor should realize the demand for it in institutions of higher education is also crucial for the development of Malaysia as a centre of academic excellent.

It is very important to understand the functions of internal auditor before the evaluation on it can be done. According to the IIA guideline, the nature of the

work of Internal Audit are divided into three broad components which are, risk assessment, control and governance. Even though Treasury Circular does not elaborate in details the function of internal audit department and the role of internal auditor as in the IIA guideline but the role expected from the internal auditors in public institutions of higher education cover the same areas as the IIA guideline, except that Treasury Circular does not mention about risk assessment. In this study, the internal auditors are asked whether they perform these functions in their institutions. The following paragraphs discuss the role of internal auditors mentions in IIA guideline and Treasury Circular.

## **2.5 THE ROLE OF INTERNAL AUDITORS**

### **2.5.1 RISK ASSESSMENT**

Risk is defined as the probability that an event or action such as exposure to financial loss, non-ethical conduct, loss of reputation and non-compliance with legal requirements and business guidelines may adversely affect the organization. Focusing on risk management helps ensure that the audit function is operating effectively, (Allott, 1996).

Attribute 2110 of the Internal Audit Guideline states that the internal audit activity should assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems. Further, it explains that the internal audit activity should monitor and evaluate the effectiveness of organization's risk management system, evaluate risk exposures relating to organization's governance, operations and information systems.

### **2.5.2 CONTROL**

Drucker (1975) in his conclusion remarks stated that to improve management of institutions of higher education, an internal review process should be established. This activity will ensure a timely feedback of information on which to evaluate whether the institution's established goals are being accomplished. A properly

functioning internal auditing department will help pinpoint areas for potential revenue improvement and cost reduction.

Attribute 2120.A1 mentions that the internal audit activity should evaluate the adequacy and effectiveness of controls encompassing the organization's governance, operations, and information systems. Further, Attribute 2120.A3 states that internal auditors should review operations and programs to ascertain the extent to which results are consistent with established goals and objectives to determine whether operations and programs are being implemented or performed as intended.

On the same issue, Treasury Circular 2/79 states that the functions of internal audit department are to check the soundness, adequacy and reliability of accounting information, internal control and evaluating the efficiency and effectiveness of the operations of the organization.

### **2.5.3 GOVERNANCE**

Drucker. M (1975) stated that in order to utilize resources effectively, the purpose of the institution must be clearly established. A definite strategy needs to be devised to arrive at those goals. In any organization, including educational institutions, each organizational unit and member should know what is expected. This expectation, to carry any real meaning, must be communicated in writing. There is no basis to review if the instructions are given orally.

Attribute 2130 of IIA guideline states that the internal audit activity should contribute to the organization's governance process by evaluating and improving the process through which (1) values and goals are established and communicated, (2) the accomplishment of goals is monitored, (3) accountability is ensured, and (4) values are preserved. Treasury Circular, on the other hand, mentions that internal audit department should suggest to the management steps needed to improve the operation of the agency and any corrective action needed.

The above three areas of internal audit work i.e. risk assessment; control and governance are key areas that covers so many aspect of business environment. Internal auditors should include all those areas in their audit plan in order to provide better assessment to the healthiness of the organization they serve.

Given the recent focus on improving control structures, strengthening organizational governance process, and reporting on internal control effectiveness in other business establishments, equal attention should be given to the institutions of higher education. Internal auditing has been identified as one of the element of good governance systems and there is no reason why academic institutions should ignore this element to enhance their efficiency and effectiveness.

## **2.6 CONCLUSION**

The above literature reviewed has shown the importance of internal auditing as one of the governance mechanism in institutions of higher education outside Malaysia, while in Malaysia there is no prior study done in this area. The local study on internal auditing such as "The Effectiveness of The Internal Auditor In Malaysian Listed Firms" (Annuar, Mohamad Ali, Shamsheer, Zulkarnain, 2001) and "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) focused on the private sectors; hence, this study examines the role of internal auditor in another important sector i.e. institutions of higher education in Malaysia.

This chapter describes the difference between public and private institutions of higher education in Malaysia with respect to the requirement to establish internal audit function. This study empirically investigates whether mandatory guideline from the government affect the existence of internal audit department. Additionally, this study investigates whether there is significant difference in the scope and perception about internal audit between public and private institutions

of higher education. The next chapter outlines the hypotheses development and justifies the methodological framework use to test the hypotheses.